New York State Bar Association
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January 31, 2005

The Honorable Mark W. Everson
Commissioner
Internal Revenue Service
Room 3000 IR
1111 Constitution Avenue, N.W.
Washington, D.C. 20224

Dear Commissioner Everson:

I am pleased to submit the New York State Bar Association Tax Section's Report No. 1078. The Report responds to Announcement 2004-75, which requests comments on the proper timing and character of income, gain, loss, and deduction for holders and issuers of "interest only" interests subject to prepayment risk (so-called "IOs") that are issued by a "real estate mortgage investment conduit (a "REMIC") or other entity. We offer several recommendations.

First, we recommend that the IRS issue regulations that permit holders of REMIC regular interests to deduct negative amounts under the "prepayment assumption catchup" ("PAC") method and require holders of REMIC residual interests to include equal amounts of taxable income. We recommend that the deductions by the holder be treated as amortized bond premium and the inclusions by the residual holders be treated as amortized bond issuance premium, and we would permit taxpayers to claim worthless debt deductions under section 166 only for losses that are attributable to defaults (and we would not permit section 166 losses in respect of faster-than-expected prepayments).

Second, we recommend that regulations provide that a secondary market holder of a REMIC regular interest whose issue price is more than 125% of its principal amount apply the PAC method with an adjustment that reflects the holder's purchase price, or alternatively, accrue market discount based on the fraction described in section 1276(b), except that the fraction would reflect the

PAC method based upon a new prepayment assumption that produces a yield equal to the original holder's yield.

Third, we recommend that regulations be issued that provide that, if a regular interest would produce a yield under the PAC method that is less than the AFR, the REMIC should adjust the prepayment assumption or assumed interest rate with respect to that regular interest to produce a yield that is equal to the AFR. (The adjustment would apply only to that regular interest and would not affect the prepayment assumption or yield of the other regular interests.)

Fourth, we repeat the recommendation we made in 1996 that regulations be issued that would permit taxpayers to integrate their section 1272(a)(6) securities with hedges of those securities under regulations sections 1.1221-2, 1.446-4, and/or 1.1275-6. We also recommend that regulations permit taxpayers to treat their section 1272(a)(6) securities as hedges of other ordinary property or liabilities under regulations sections 1.1221-2, 1.446-4, and/or 1.1275-6.

Finally, we repeat our 1996 recommendation that bonds or coupons stripped from a portfolio of loans be subject to an "aggregation rule" and be treated as if they were a single debt instrument subject to the PAC method.

If you have any comments regarding this report, please do not hesitate to contact us.

Respectfully submitted,

David P. Hariton

David P. Hariton
Chair

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