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Tax Aspects of REMIC Residual Interests

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I. INTRODUCTION

With the creation in 1986 of the “real estate mortgage investment conduit” (REMIC),¹ there came into existence a new type of financial instrument, the REMIC residual interest, the economics and tax treatment of which are quite unlike those of any other financial instrument. The REMIC residual interest is a unique creature of the tax laws and exists only because the tax laws say it must, and not because there is a particular demand for such instruments in the marketplace. Moreover, residual interests are intensely regulated by arcane and complicated tax rules that are designed principally to maximize a holder’s tax liability. Yet, REMIC residual interests are a staple of the mortgage-backed securities marketplace today—a marketplace that has become gargantuan in recent years.² The raw number of residual interests and their prevalence in the portfolios of sophisticated investors and securities dealers can only increase steadily as more and more mortgages are pooled into REMICs. Accordingly, it is appropriate to examine the complex tax rules associated with residual interests, particularly since these rules are relevant not only to the holder of a residual interest, but also to the REMIC itself, and therefore indirectly to the holders of regular interests in the REMIC.

1. REMICs are governed principally by the tax rules in §§ 860A through 860G and the regulations thereunder (collectively, the “REMIC rules”). The REMIC code provisions were enacted by the Tax Reform Act of 1986, Pub. L. No. 99-514, § 671, 100 Stat. 2085, 2309-18, and later amended by the Technical Corrections and Miscellaneous Revenue Act of 1988, Pub. L. No. 100-647, § 1006(t), 102 Stat. 3342, 3419-27 [hereinafter TAMRA]. Regulations were adopted in 1992. T.D. 8458, 1993-1 C.B. 147.

In general, a REMIC is a self-liquidating entity that holds a pool of mortgage loans and issues interests in those mortgages to investors. More technically, a REMIC is defined as an arrangement of which substantially all the assets are qualified mortgages and permitted investments, and all of the interests are either regular interests or part of a single class of residual interests. IRC § 860D(a). In addition, to qualify as a REMIC, the arrangement must make a timely election and have reasonable arrangements in place with respect to the ownership of residual interests in the REMIC by disqualified organizations. *Id.* With the exception of the rules relating to disqualified organizations, which are discussed further in Part III.C., *infra*, this Article does not elaborate on the requirements for qualifying as a REMIC.

2. As of the end of the first quarter of 1994, the total principal amount of mortgage-backed securities outstanding had reached \$1.6 trillion, up from \$917 billion at the end of 1989. 80 Fed. Res. Bull. A38 (No. 9, Sept. 1994). Some \$710 billion of outstanding mortgage backed securities consist of Freddie Mac and Fannie Mae REMIC securities. Tom Albertson, *A Tale of Two REMIC Markets, Secondary Mortgage Markets: Mortgage Market Review 1994*, at 26 (a publication of Freddie Mac). It has been estimated that historically about 24.75% of mortgage originations will end up in REMICs. Joseph Hu & Chip Stern, *Observations: Prospects of Derivative Mortgage Securities, Mortgage Backed Securities Letter*, Sept. 5, 1994, at 6.

This Article provides a comprehensive analysis of the tax issues associated with creating, issuing, holding and trading REMIC residual interests. This far ranging inquiry is necessary because REMIC residual interests are a novelty and do not fit within, nor are they readily analogized to, normal tax concepts and rules that apply to other financial instruments. For example, the tax laws have spent many decades working out the appropriate treatment of debt and equity, and how to distinguish between the two. And in recent years the tax laws have become increasingly adept at untangling the tax treatment of various derivative financial instruments, such as notional principal contracts. Yet, the REMIC residual interest is neither debt, equity, option nor notional principal contract—although it has points of similarity to each of these—and consequently it has the fortune or misfortune of entering the marketplace with no applicable tax common law to help establish the appropriate tax treatment. As a result, although a handful of specific provisions in the REMIC rules resolve a great many issues, the tax treatment of residual interests is unsettled in a number of important respects.

This Article seeks to catalogue the tax aspects of residual interests and, in doing so, to identify the open issues, address the relevant tax policy considerations, and suggest possible solutions.

II. WHAT IS A REMIC RESIDUAL INTEREST?

In an asset securitization, relatively illiquid receivables are pooled and interests in the cash flows thereon are sold to investors. Although the concept is simple enough, the legal forms of securitization transactions can differ significantly.³ One of the simplest and earliest forms of securitization is the venerable mortgage pass-through trust, in which mortgage loans are pooled in a trust and investors purchase trust certificates representing undivided ownership interests in the pool.⁴ Taxation of the holders of a pass-through arrangement is relatively straightforward: the holders of trust certificates are the owners of trust assets and they are taxed on their pro rata shares of the

3. For a general overview of securitization, see Thomas R. Boemio & Gerald A. Edwards, Jr., *Asset Securitization: A Supervisory Perspective*, 75 Fed. Res. Bull. 659 (No. 10, Oct. 1989); 1 Tamar Frankel, *Securitization: Structured Financing, Financial Asset Pools, and Asset-Backed Securities* (1991).

4. Rev. Rul. 70-545, 1970-2 C.B. 7, modified by Rev. Rul. 74-169, 1974-1 C.B. 147; Rev. Rul. 70-544, 1970-2 C.B. 6, modified by Rev. Rul. 74-169, 1974-1 C.B. 147. For a brief review of the evolution of the tax treatment of mortgage pass-through arrangements, see Subcommittee on Asset Securitization, A.B.A. Sec. Tax'n, *Legislative Proposal to Expand the REMIC Provisions of the Code to Include Nonmortgage Assets*, 46 Tax L. Rev. 299, 302-04 (1991) [hereinafter *American Bar Association Legislative Proposal*]. Pass-through trust arrangements are commonly used today to securitize nonmortgage assets, such as credit card or automobile receivables, for which no REMIC-like vehicle is available.

net income on the assets. Since the certificateholders are the equity holders, there is no residual interest in this type of securitization;⁵ all cash flows simply pass through to the equity holders.⁶ The trust entity itself is structured as an "investment trust"⁷ and as such is not subject to entity level taxation.

A different form of securitization is the so-called "pay-through" arrangement,⁸ in which investors acquire separate debt obligations of an issuer that are funded by the underlying assets being securitized. Payments on the issuer's obligations are structured to match, in large part, the payments received on the assets, but investors do not actually own the assets; they are only secured creditors. Beneficial ownership of the assets rests with a separate class of equity holders. An "owner trust"⁹ is an example of a pay-through arrangement, as is the REMIC.¹⁰ Pay-through arrangements are similar to pass-through arrangements in that the economic substance of both types of securitizations is the sale of cash flows from assets to investors. However, since a pay-through arrangement involves separate debt obligations of an issuer, the cash flows from assets can be carved up in much more sophisticat-

5. This statement is true as a legal matter, although as an economic matter some certificate holders may bear all or a disproportionate share of the losses and, in this respect, resemble residual interest holders.

6. Equity characterization, however, is not absolute. For certain purposes in applying the so-called portfolio interest rules in §§ 871(h) and 881(c), a pass-through certificate is treated as a separate debt instrument issued by the trust. Temp. Regs. § 35a.9999-5(e). Moreover, it is possible that the Service will impose similar treatment in other areas, such as the market discount rules in §§ 1276-78. See David C. Garlock, *Federal Income Taxation of Debt Instruments* 346-47 (Supp. 1993).

7. Regs. § 301.7701-4(c). This regulation does not define an investment trust per se, but states that in order for an investment trust to qualify as a trust for tax purposes, (1) there must be no "power under the trust agreement to vary the investment of certificate holders," and (2) subject to certain exceptions, the trust generally must not possess multiple classes of ownership interests. *Id.*

8. The term pay-through arrangement is borrowed from James M. Peaslee & David Z. Nirenberg, *Federal Income Taxation of Mortgage-Backed Securities* 13 (rev. ed. 1994); see also I Frankel, *supra* note 3, at § 2.5.4.3.

9. The term owner trust is used to refer to a grantor trust entity that is the issuer of debt obligations. It is used to distinguish the grantor trust issuer from the trust created under the bond indenture in connection with the debt issuance. The debt obligations of an owner trust are typically referred to in the mortgage-backed security industry as collateralized mortgage obligations (CMOs).

10. The issuer in a pay-through securitization may also be a corporation, in which case pass-through treatment is accomplished by virtue of the interest deduction that is available to the corporation to offset income on its assets. On other legal structures for securitizing assets, see generally Kenneth G. Lore, *Mortgage-Backed Securities: Developments and Trends in the Secondary Mortgage Market* § 6.01 (1990-91 ed.).

ed and creative ways. In a pass-through trust arrangement, investors must generally share the cash flows pro rata.¹¹

A pay-through arrangement thus involves structuring a series of debt obligations to match the aggregate cash flows on the assets being securitized. The match, however, generally will not be perfect and some of the cash flow on assets will not be paid out to the debt holders. This mismatch means that residual amounts of cash flow will be left over and these scraps are taxable to the equity holder, who thus holds what is referred to as a residual interest in the securitized assets. Since it is generally more efficient to channel as much of the cash flow as possible to the debt holders, there is pressure in structuring a securitization to make the remainders available for the equity holder as small as possible.¹² Outside the REMIC context, tax concerns arise about the substantiality of the residual interest in the assets of a debt issuer, since the characterization of the investors' interests as debt is potentially jeopardized if the value of the residual interest becomes too insubstantial or ephemeral.¹³ Thus, the "residual interest" in a non-REMIC pay-through arrangement generally will possess a real entitlement to a portion of the cash from the assets. However, in the case of a REMIC, as discussed below, traditional debt-equity analysis is not applicable and the amount of residual equity can be effectively eliminated, if desired.

In addition to being taxable on the remainders, the equity holder in a pay-through arrangement also bears the tax burden of timing mismatches. As the owner of the assets the equity holder is taxable on the income on the assets, but is entitled to an offsetting deduction for income paid to the debt holders. Because of timing differences, the income items in some periods may exceed the deduction items and the equity holder may have taxable income, although the timing mismatch generally will reverse in later periods and generate offsetting losses to the equity holder. Timing differences can arise for a number of reasons, but the principal cause, discussed in greater detail

11. With only limited exceptions, an entity will not qualify as a trust if it possesses more than one class of ownership interests, defined as different rights or priorities with respect to trust income. Rather, such an entity will constitute a partnership or a corporation. This greatly limits flexibility in dividing up cash flows. See generally Reid A. Mandel, *Investment Yields: Tax Consequences of Bifurcations, Layering, Tiering And Differentiation: A Study in Income and Principal Gene-Splicing*, 65 *Taxes* 965 (1987) (discussing the major alternatives to REMICs for those interested in division of income streams among investors with differing goals).

12. See *infra* note 30 (discussing the analogy to limited partnerships).

13. In addition, the lack of residual equity creates a concern that the issuer has, in reality, sold the securitized assets to the debt holders and that such assets are being held in trust for the holders, which trust itself would risk corporate characterization if there were multiple classes of debt holders. See John P. Simon, *Selected Federal Income Tax Aspects of Securitizing Debt Obligations*, 66 *Taxes* 897, 903 (1988).

below, is the so-called “tranching” of the debt obligations and the term structure of interest rates.¹⁴ Income and deductions created by timing differences will ultimately offset each other and net to zero. However, timing is everything and the pain of a substantial tax liability on phantom income in one year is only partially eased by the prospect of offsetting phantom losses in a later year.

REMIC residual interests are a special type of residual equity interest in a pay-through arrangement. Like the equity holder in a non-REMIC pay-through arrangement, the REMIC residual interest holder is taxable on the remainders and bears burden of timing differences. Frequently the residual interest is viewed as a cost or inefficiency in a REMIC securitization; the sponsor of the REMIC generally could realize a better return from the securitization if no residual interest were created. As a result, there is pressure to minimize the amount of cash to which a residual interest is entitled, so that today many residual interests are entitled to minimal or even zero cash flow from the REMIC. For example, assume a REMIC is formed by contributing to it mortgages with an aggregate principal amount of \$100, each of which pays interest at a fixed rate of 7%. The REMIC in turn issues two regular interests, class A and class B, which are entitled, respectively, to principal of \$75 and interest at the rate of 7% and principal of \$25 and interest at the rate of 7%. Clearly, there are no remainders for the residual interest; all of the cash flow from the mortgages has been dedicated to the class A and class B regular interests. As a result, the residual interest will be issued with a zero cash flow entitlement.¹⁵ In this case, as we will see later, the residual interest is effectively reduced to no more than an agreement by the holder to assume the REMIC’s tax liability in exchange for an up-front payment.

On occasion, however, structuring considerations will necessitate that a residual interest possess material economic terms. For example, in one type of REMIC that has recently begun to appear, an “interest only” or IO instrument and a “principal only” or PO instrument are contributed to a REMIC.¹⁶ Assume that the IO pays interest at the rate of 8% on a reference

14. See *infra* Part V.A.

15. Although a residual interest is issued with zero cash flow entitlement, the holder is nevertheless the equity stakeholder in the REMIC and is entitled to any cash that is not needed to pay the class A and class B regular interests. Possibly, stray cash amounts will appear from time to time, which the residual interest will get. For example, if a REMIC sells a mortgage at a premium (probably an unlikely occurrence), the premium typically would go to the residual holder. Generally, disclosure in the offering documents for such residual interests will state that it is not expected that there will be material amounts of such stray cash.

16. The IO is an instrument that represents the right to receive some or all of the interest payments on a mortgage security (e.g., an agency pass-through certificate). The rights to the principal of the mortgage security (and any other remaining interest amounts) are then transferred separately to other holders. The PO, conversely, represents the right to receive only

principal balance of \$100 and the PO pays principal of \$100. The REMIC issues a single regular interest, class A, with a principal balance of \$100 that pays interest equal to LIBOR, with interest on the IO in excess of LIBOR used to pay down the class A principal balance. Based on a broad band of prepayment assumptions and historical data regarding LIBOR, it can be expected that sufficient funds will always exist ultimately to pay the class A its principal and interest entitlement. Any cash not needed to retire the class A then goes to the residual interest. Depending on how closely the LIBOR and prepayment assumptions are borne out, the residual interest may receive very little cash or the holder may literally strike it rich.¹⁷

Although residual interests are a permanent fixture of today's mortgage-backed securities market, the actual market for residual interests is small, consisting of only relatively few sophisticated investors and securities dealers. Yet, it is an active market in that hundreds of REMICs are formed each year, each necessarily involving the creation and typically the sale of a residual interest. In order to appreciate fully the market for residual interests it is important to realize that although a residual interest may be structured to provide the holder with an insignificant cash flow, this does not mean that the acquisition of a residual interest is a "noneconomic" event. On contrary, it is as economic an event as the acquisition of any other derivative financial instrument. Even if a residual interest provides the holder with no cash flow entitlements from the REMIC, the holder will be paid an up-front amount, by the transferor of the residual interest (the REMIC sponsor), to accept the tax burdens and benefits that result from ownership. The holder is thus making a sophisticated financial bet, the same bet, if not quite on the same scale, as the holder of the residual interest in the IO/PO REMIC described above. If events turn out in its favor (e.g., the mortgages enjoy favorable prepayment experience), the residual interest holder may realize a significant yield, whereas if events are less favorable, the holder may lose money. The term "noneconomic" residual interest is commonly used, and the term has a technical meaning as discussed below, yet it is something of a misnomer to the extent that it connotes that a holder cannot recognize any profit from ownership of a residual interest.

principal payments on a mortgage security.

17. For example, in the most extreme (and unrealistic) case, if the PO prepays tomorrow and the IO never experiences any prepayment (the underlying mortgage security from which it derives is never prepaid), then the class A will be retired when the PO pays off, and the entire interest stream from the IO will go the residual interest for the life of the IO—a total return likely to be many hundreds of times greater than the price paid for the residual interest.

III. THE CREATION AND ISSUANCE OF RESIDUAL INTERESTS

One condition to qualification as a REMIC is that there be a single class of residual interests in the REMIC.¹⁸ An improperly created residual interest, or the absence of a “single class” of residual interests, will jeopardize REMIC status.¹⁹ Although the consequences of creating a “bad” residual interest are thus ominous, the REMIC rules relating to the creation and issuance of residual interests were not intended to lay down treacherous and deceptive rules to trip up unwary taxpayers; the rules are neither complex nor subject to significant uncertainties in meaning. Rather, the rules are largely procedural and impose only minimal restrictions on the substantive economic characteristics of residual interests. The emphasis is primarily on designating an appropriate person to take responsibility for the REMIC’s taxable income. Nevertheless, since the consequences of an improper residual interest include the failure to qualify as a REMIC, it is important to review the modest rules that do exist.

A. *Definition of a REMIC Residual Interest*

The Code defines a REMIC residual interest in laconic fashion as a “an interest in a REMIC which is issued on the startup day, which is not a regular interest, and which is designated as a residual interest.”²⁰ The statutory definition thus consists of three elements: An interest (i) other than a regular interest, (ii) issued on the startup day, and (iii) designated as a residual interest. Since a regular interest is defined, in part, as any interest in a REMIC that is designated as such,²¹ the act of not designating a residual interest as a regular interest is sufficient in and of itself to meet the “not a regular interest” requirement. Prior to TAMRA, however, there was no designation requirement for regular interests and thus an issue existed whether a residual interest must actually differ economically from regular interests in order to meet the “not a regular interest” requirement.²² Since 1988, however, it is clear that the “not a regular interest” requirement is not intended to restrict the economic characteristics of a residual interest.

Concerning the “issued on the startup day” requirement, the term “startup day” is defined as the day when residual and regular interests are

18. IRC § 860D(a)(3).

19. IRC § 860D(b)(2).

20. IRC § 860G(a)(2).

21. IRC § 860G(a)(1).

22. James M. Peaslee & David Z. Nirenberg, *Federal Income Taxation of Mortgage-Backed Securities* 73-74 n.39 (1989).

issued by the REMIC,²³ which creates a certain circularity. Meeting this requirement generally raises few issues, however, although in theory a concern could arise if the terms of a residual interest were modified after the startup day, which could be construed as the issuance of a new residual interest after the startup day in exchange for an old one. An additional concern that could arise, again in theory, relates to a pre-existing entity for which a REMIC election is sought. For example, assume a corporation is formed, stock is issued and six months later the corporation issues mortgage-backed securities and seeks to make a REMIC election. Possibly it could be argued that the residual interest (the stock) was issued *before* the startup day.²⁴ As a practical matter, the issue never seems to arise, since it is easily bypassed by simply designating the relevant assets of the entity (rather than the entity itself) as a REMIC.

Turning finally to the designation requirement, the regulations provide that a residual interest is designated as such by attaching to the REMIC's first tax return information concerning the terms and conditions of the residual interest (or by attaching a copy of the offering circular or prospectus containing such information).²⁵ The requirement is thus largely a procedural one and is easily satisfied. The organizational documents of a REMIC generally will carefully designate the residual interest and amply describe its terms. Conceivably a problem could arise if a REMIC chose to effect a designation by merely attaching a public offering document to its return, which the regulations permit. This approach, however, places an additional premium on ensuring that the disclosure is correct, since a misstatement of the residual interest terms in an offering document not only can give securities law concerns, but could also affect the status of the residual interest (and hence the REMIC). But apart from the risk of erroneous disclosure, the residual interest is frequently not included in the securities being publicly offered under a prospectus and its terms may not be adequately described therein. Attaching such an offering document to the tax return can thus give rise to questions about whether a proper designation has been timely made.²⁶

23. IRC § 860G(a)(9). The regulations provide that a REMIC sponsor "may contribute property to a REMIC in exchange for regular and residual interests over any period of 10 consecutive days and the REMIC may designate any one of those 10 days as its startup day." Regs. § 1.860G-2(k). The day so designated is treated as the day the regular and residual interest were issued. *Id.*

24. Peaslee & Nirenberg, *supra* note 8, at 107-08. Since a residual interest is a creature of the REMIC election, it is strange to speak of one existing before an election is made.

25. Regs. §§ 1.860D-1(d)(2)(ii), 1.860G-1(c).

26. These concerns apply equally to regular interests, which, as noted above, are also subject to a designation requirement. IRC § 860G(a)(1); Regs. § 1.860G-1(a)(1). Often classes of regular interests are not publicly offered (they are privately placed or retained by

Although the likelihood of such a mistake may seem remote, it must be borne in mind that the person actually charged with making the REMIC election and filing tax returns may possess little sophistication and knowledge of the requirements.²⁷ Presumably the Internal Revenue Service (the "Service") would be lenient in granting relief in such situations.²⁸

In addition to elaborating on the designation requirement, the regulations also confirm what is implicit in the statutory scheme: a residual interest need not entitle a holder to any distributions from the REMIC.²⁹ Prior to the issuance of the regulations, some questioned whether a residual interest could be issued that entitled the holder to nothing and, out of caution, typically tax counsel required that a residual interest have some minimum principal amount (\$10,000 was a common figure). This concern was based in part on the fact that it seemed counterintuitive to speak of a residual interest, with no entitlement to any cash flow, as being an "interest" in the REMIC,³⁰ and in part on the question of how one effects a "transfer" of

the REMIC sponsor) and are described, if at all, only in an extremely cursory fashion in the public offering document covering the other classes.

27. This is evident from the number of requests for relief under Regs. § 301.9100-1(a) by REMICs whose tax return preparers forgot to file tax returns for the REMIC and make a timely REMIC election (or in one case failed to have the return signed by the right person). See Priv. Let. Rul. 9411022 (Dec. 16, 1993); Priv. Let. Rul. 9309043 (Dec. 9, 1992); Priv. Let. Rul. 9239010 (June 24, 1992); Priv. Let. Rul. 9239007 (June 24, 1992); Priv. Let. Rul. 9144014 (July 30, 1991); Priv. Let. Rul. 9144013 (July 30, 1991); Priv. Let. Rul. 9144012 (July 30, 1991); Priv. Let. Rul. 9139007 (June 26, 1991); Priv. Let. Rul. 9111057 (Dec. 19, 1990); Priv. Let. Rul. 9108008 (Nov. 19, 1990); Priv. Let. Rul. 9006009 (Nov. 2, 1989). Often these failures apparently are due to misunderstandings about who is responsible to do what, which underlines the need for tax counsel to be very specific in the REMIC's organizational documents about who is to file tax returns.

28. The Service may, upon a showing of good cause, grant a reasonable extension of time for making an election. Regs. § 301.9100-1(a); Rev. Proc. 92-85, 1992-2 C.B. 490, modified by Rev. Proc. 93-28, 1993-2 C.B. 334.

29. Regs. § 1.860G-1(c); Staff of the Joint Comm. on Tax'n, 99th Cong., 2d Sess., General Explanation of the Tax Reform Act of 1986, 416 (Comm. Print 1987) [hereinafter 1986 Act Bluebook].

30. A distant analogy to the concerns over zero entitlement residual interests arises with respect to certain limited partnerships (particularly those used as a securitization vehicle), where there is often pressure in structuring them to make the general partner's partnership interest as small as possible. If the general partner's interest in partnership capital or profits is too small or trivial, a concern exists that the general partner is not a partner at all (i.e., it has no real interest in the venture). See William B. Brannan, *Lingering Partnership Classification Issues (Just When You Thought it Was Safe To Go Back Into the Water)*, 1 Fla. Tax Rev. 197, 214-16 (1993). In this regard, the Service requires for ruling purposes that the general partner maintain a minimum 1% interest in the partnership, although this phases down to as little as .2% for partnerships with capital contributions of \$250 million or more. See Rev. Proc. 92-88, 1992-2 C.B. 496, § 4.01(1). Significantly, the Service chose not to impose any such economic standards on residual interests.

something that has no positive cash flow entitlements and that may in fact represent a net liability to the holder. As noted above, it is relatively common now for a residual interest to be issued with zero distribution rights.

So much for the statutory definition of a residual interest. As the foregoing shows, the formal requirements are few and relatively minor. As described in the following subsections, however, a number of collateral requirements exist that a REMIC must meet in issuing a REMIC residual interest.

B. A Single Class of Residual Interests

Section 860D(a)(3) provides that a REMIC must have one, and only one, class of residual interests and all distributions to such interests, if any, must be pro rata.³¹ This prohibition is straightforward and generally presents few structuring issues.³² One issue that occasionally arises is whether some person holds a "disguised" equity interest in the REMIC. The REMIC regulations resolve this in many common situations by providing that a number of common rights vis-a-vis the REMIC are not considered "interests" therein (and thus do not give rise to an impermissible second class of residual interests).³³ In addition, prior to the REMIC regulations, concerns occasionally were expressed about this requirement in the case of two-tier or double REMIC structures. If the separate existence of the REMICs were ignored and the two collapsed and treated as a single REMIC, one might be troubled by the existence of two different classes of residual interests. However, the threat of two-tier REMIC structures being collapsed is now a remote one, if indeed it was not always so. The REMIC regulations allow for tiered REMIC

31. Although the statutory scheme is clear that a REMIC must issue a residual interest, the REMIC need not issue any regular interests. This was not entirely certain before the REMIC regulations were issued. Peaslee & Nirenberg, *supra* note 8, at 99 & n.9; see also H.R. Conf. Rep. No. 841, 99th Cong., 2d Sess. II-228 (1986), reprinted in 1986 U.S.C.C.A.N. 4075, 4313 (suggesting that a REMIC must issue both regular and residual interests). The preamble to the final REMIC regulations, however, plainly states that a REMIC need not issue regular interests. 57 Fed. Reg. 61,295 (1992) ("The REMIC *must* issue one, and only one, class of residual interests. A REMIC *may* issue one or more classes of regular interests.") (emphasis added).

32. The fact that one residual interest holder may be singled out to be the tax matters person should not affect the single class requirement. Such a designation is specifically recognized and permitted in the regulations. Regs. § 1.860F-4(d).

33. Regs. § 1.860D-1(b)(2). Under this regulation an interest in a REMIC does not include rights to receive payment for services, stripped bonds or coupons not held by a REMIC (such as excess servicing compensation), rights to reimbursements under credit enhancement contracts, and certain rights to acquire REMIC assets (e.g., pursuant to a clean-up call). See generally Peaslee & Nirenberg, *supra* note 8, at 100-05 (discussing what is an interest in a REMIC).

arrangements to be created in a single document, even if for state law purposes only a single entity is created.³⁴

C. *The Existence of "Reasonable Arrangements"*

As discussed in detail below in Part VII, the REMIC rules are seemingly tireless in their quest to police who holds a REMIC residual interest. One cornerstone in this war on inappropriate holders is the requirement that a REMIC must possess "reasonable arrangements" that are designed to ensure that (i) residual interests in the REMIC are not held by "disqualified organizations" and (ii) information necessary for the application of the penalty tax in section 860E(e)³⁵ will be made available by the entity. These requirements are intended, in essence, to "deputize" the REMIC and force it to take steps to restrict who comes into possession of its residual interests.

As originally enacted, REMIC provisions did not restrict ownership of residual interests by disqualified organizations, and thus did not contain any "reasonable arrangements" requirement. In 1988, TAMRA added these elements, effective generally for any REMIC with a startup day after March 31, 1988,³⁶ when it became apparent that taxation on REMIC income could be easily avoided by transferring the residual interests to entities that are not subject to U.S. taxation. There are, however, a multitude of older REMICs that do not have, and need not have, any "reasonable arrangements."³⁷

1. *Transfer Prohibitions.*—The first prong of the reasonable arrangements requirement is that arrangements exist to ensure that residual interests are not held by disqualified organizations. A disqualified organization is defined in section 860E(e)(5) as:

34. Regs. § 1.860F-2(a)(2)(i).

35. The § 860E(e) penalty tax is described in greater detail below in Part VII.E.

36. The TAMRA amendments do not apply to a REMIC with a startup day after March 31, 1988, if it was formed pursuant to a binding written contract in effect on that date. TAMRA, *supra* note 1, § 1006(t)(16)(D)(i), 102 Stat. at 3425. The startup day for purposes of the effective date of the TAMRA amendments is the startup day as that term was defined prior to the enactment of TAMRA (which changed the definition of startup day). Under the pre-TAMRA definition, the startup day was any day chosen by the REMIC that was on or before the day its regular and residual interests were issued.

37. Although an older REMIC need not have reasonable arrangements in place, any transfer of a residual interest in such a REMIC after March 31, 1988 to a disqualified organization is nevertheless subject to the § 860E(e) penalty tax enacted by TAMRA for such transfers (as described more fully below in Part VII.E.). TAMRA, *supra* note 1, § 1006(t)(16)(D)(ii), 102 Stat. at 3342; Regs. § 1.860A-1(b)(3). On the development of the TAMRA legislation relating to disqualified organizations and reasonable arrangements, see generally Thomas A. Humphreys & Robert M. Kreitman, *Mortgage-Backed Securities: Including REMICs and Other Investment Vehicles* ¶ 308 (1994).

(A) The United States, any State or political subdivision thereof, any foreign government, any international organization, or any agency or instrumentality of any of the foregoing,

(B) any organization (other than a cooperative described in section 521) which is exempt from tax imposed by this chapter unless such organization is subject to the tax imposed by section 511, and

(C) any organization described in section 1381(a)(2)(C).

This list is an exclusive one and is intended to encompass those entities that by law are exempt from U.S. taxation. Other tax-exempt entities, such as section 501(c) organizations, are not included in the list, since they are taxable on unrelated business taxable income. A special provision provides that so-called "excess inclusion" income on a residual interest will be treated as unrelated business taxable income.³⁸

As for what measures constitute reasonable arrangements, the legislative history states that they include "restrictions in the governing instruments of the entity prohibiting disqualified organizations from owning a residual interest in the REMIC and notice to residual interest holders of the existence of such restrictions."³⁹ The legislative history further provides that the reasonable arrangements requirement will not be met if it is contemplated when the REMIC is formed (apparently by the REMIC sponsor) that disqualified organizations will own residual interests in it.⁴⁰ The legislative history thus seems to envision a system such as the so-called TEFRA D rules that apply to bearer debt instruments.⁴¹ However, the TEFRA D rules provide a reasonably clear safe harbor for taxpayers to achieve certainty, whereas prior to the regulations described below, REMICs were left to the whims and vagaries of "reasonableness," which often prompted tax counsel to impose some fairly stringent safeguards against transfers of residual interests to disqualified organizations.

38. IRC § 860E(b).

39. S. Rep. No. 445, 100th Cong., 2d Sess. 86 (1988), reprinted in 1988 U.S.C.C.A.N. 4515, 4604-05.

40. *Id.* at 4605.

41. See Regs. § 1.163-5(c)(1) (requiring that reasonable arrangements exist to prevent a bearer debt instrument from being sold to a U.S. person and that notice to this effect be provided to holders by way of a legend). See generally Peter J. Connors & Peter F. Hiltz, Final Regs. Ease Rules for Portfolio Bearer Debt Offerings, 73 J. Tax'n 166 (1990).

Fortunately, the regulations now provide a bright-line definition of reasonable arrangements, stating that a REMIC will be considered to have adopted such arrangements if:

- (A) The residual interest is in registered form (as defined in [Treas. Regs.] § 5f.103-1(c)); and
- (B) The qualified entity's organizational documents clearly and expressly prohibit a disqualified organization from acquiring beneficial ownership of a residual interest, and notice of the prohibition is provided through a legend on the document that evidences ownership of the residual interest or through a conspicuous statement in a prospectus or private offering document used to offer the residual interest for sale.⁴²

The registration requirement is the same as the one that applies generally to registration-required debt instruments under section 163(f). In general, a residual interest is in registered form if it is registered as to both principal and interest (if any) with the REMIC, and the residual interest can be transferred only through a book entry system or by surrendering the residual interest instrument to the REMIC and having a new instrument issued in the name of the new holder (or through both methods).⁴³

With respect to the second part of the definition, the organizational documents (generally the pooling and servicing agreement, trust indenture or similar document) must prohibit transfers of residual interests to disqualified organizations. It should be noted that the prohibition refers to *beneficial* ownership and drafters of the REMIC documents must be careful to couch the transfer prohibition language in such terms. One common provision that many REMIC documents contain is a statement that any transfer in violation of the prohibition shall be null and void and the transfer shall be disregarded. Prior to the regulations, such a provision was a reasonable response to the uncertainty about what constituted reasonable arrangements. Now, it is clear that this type of statement is not necessary under the regulations and can impose needless administrative burdens on the REMIC.⁴⁴ All that is required

42. Regs. § 1.860D-1(b)(5).

43. Temp. Regs. § 5f.103-1(c).

44. Revesting ownership of the residual interest with the transferor may amount to punishing the transferor for the transferee's sins (e.g., the transferor may have paid the transferee to accept ownership of the residual and may now be saddled with a substantial REMIC tax liability). This makes no sense, and the likely effect will be merely to provoke lawsuits where the transferor is the innocent victim of the transferee's misrepresentations. See *infra* note 463.

is a clear prohibition; the REMIC need not impose sanctions for violations. In fact, as discussed immediately below, the REMIC statute provides rules for those occasions when, despite reasonable arrangements, a residual interest falls into the hands of a disqualified organization, further indicating that the REMIC need only prohibit, not punish, violative transfers.

In addition to prohibitions in the organizational documents, a prohibition must be placed in a legend on the document evidencing ownership of the residual interest or in the public or private offering document. Generally, a REMIC will meet both of these standards, setting forth a legend and inserting notice of the prohibition in the offering documents.

Two final notes on the reasonable arrangements requirement are in order. First, curiously the regulations do not implement the point in the legislative history that the reasonable arrangements requirement will not be met if it is contemplated (probably by the sponsor) at the time the REMIC is formed that a disqualified organization will acquire a residual interest (other than for a transitory period). Nevertheless, this actual knowledge restriction still exists as the expressed intent of Congress and it is not vitiated by the Service's decision not to address the issue in the regulations. Second, related to the foregoing, REMIC documents often prohibit transfers of residual interests to a person that holds the interest as a so-called "book-entry" nominee. By having such a restriction, obviously a REMIC reduces materially the chances that beneficial ownership of a residual interest could fall into the hands of a disqualified organization, which is generally a desirable goal even if REMIC qualification is not at issue. However, strictly speaking, such a restriction on book entry nominees, while desirable, is not required under the definition of "reasonable arrangements."

2. *Information Requirements.*—The second prong of the reasonable arrangements requirement is that there be arrangements to ensure that the REMIC makes available the necessary information for the application of the section 860E(e) penalty tax. Section 860E(e) is discussed below in Part VII.E, but, in brief, it imposes a penalty tax, generally on the transferor, for transfers of residual interests to disqualified organization. The penalty tax is equal to the product of the highest tax rate specified in section 11(b)(1) (currently 35%) and the present value of total anticipated excess inclusions for future periods after the transfer. The regulations provide that a REMIC must provide to the Service and to the person liable for the penalty tax a computation showing the present value of anticipated excess inclusions for future periods.⁴⁵

45. Regs. § 1.860D-1(b)(5)(ii).

The regulations provide that a REMIC meets this information requirement if its organizational documents require it to provide the foregoing information to the IRS and to persons liable for the tax. However, a REMIC's obligation to provide this information is triggered only by a request for it. A REMIC is under no obligation to determine if its residual interests have been transferred to a disqualified organization.⁴⁶ If a request is made, the REMIC must provide the information within 60 days and may charge a reasonable fee without the income constituting income derived from a prohibited transaction.⁴⁷

IV. TAXING THE HOLDER OF A RESIDUAL INTEREST

A REMIC must compute its separate taxable income and in this respect the REMIC is recognized as an entity for tax purposes. However, the holder of the residual interest, and not the REMIC, is taxable on REMIC taxable income and in this respect the REMIC is a pass-through entity akin to a partnership.⁴⁸ The partnership analogy, however, is a rough one at best. For example, unlike a partnership, the income and deduction items of the REMIC generally do not pass through and retain their character in the hands of the residual interest holder.⁴⁹ Instead, taxable income is computed at the REMIC level and only the resulting, bottom-line taxable income or net loss is passed through and taken into account by the holder as an ordinary income or loss amount.⁵⁰

The discussion below begins with how a REMIC computes its taxable income. The next section addresses how this income is taken into account by a holder, starting first with a discussion of how a holder computes its basis in a residual interest. A topic touched on only briefly in this section is the treatment of excess inclusion income, which is addressed more thoroughly in Part V. Finally, the discussion considers certain special topics, such as the

46. Regs. § 1.860E-2(a)(5).

47. *Id.*

48. In fact, for procedural purposes under the Code, a REMIC is treated as a partnership. IRC § 860F(e); Regs. § 1.860F-4(a).

49. One exception to this is that the investment expenses of a REMIC for the calendar quarter pass through and retain their character as such in the hands of pass-through interest holders. Temp. Regs. § 1.67-3(a)(1). For a further discussion of the character of REMIC income and losses, see *infra* Part IV.B.2.

50. IRC § 860C(e)(1). Perhaps the closest analogy to the way residual holders are taxed on REMIC income is anti-deferral rules that require U.S. shareholders to take into account currently a deemed dividend amount based on a foreign corporation's earnings and profits. IRC § 551(a), (b) (pertaining to foreign personal holding companies); IRC § 951(a) (pertaining to controlled foreign corporations).

treatment of so-called "up-front" payments to residual interest holders and the treatment of transfers of residual interests.

A. *Computing the Taxable Income of the REMIC*

1. *Gross Income of the REMIC.*—Since a REMIC is limited in the kind of assets it may hold and in the kind of activities it may undertake, the gross income items of a REMIC typically will consist of only a limited array of different types of income. The first and most obvious type of income item will be coupon interest on the REMIC's qualified mortgages. If the qualified mortgages are actual mortgage loans or mortgage-backed pass-through certificates, the REMIC may also be required to accrue market discount to the extent that it purchased such assets at a price below their adjusted issue price.⁵¹ On the other hand, if the REMIC holds other REMIC regular interests, then it is quite possible that the REMIC will have original issue discount accruals (and possibly market discount accruals as well).

Because the amount of market discount or original issue discount, if any, will depend in the first instance on the REMIC's basis in the qualified mortgages, it is necessary consider briefly the applicable basis rules. In general, a REMIC receives a basis in the assets, including qualified mortgages that are contributed to it on the startup day, equal to the aggregate issue prices of the REMIC's residual and regular interests.⁵² This rule is a sensible one, but curious results arise when the residual interest is issued with negative fair market value (i.e., when the sponsor makes an up-front payment to a holder to accept ownership). As described below, the Service requires the residual interest to be taken into account as if its fair market value were zero, the result of which is manifestly to overallocate basis to the REMIC's qualified mortgages.⁵³ This has the collateral effect of reducing REMIC accruals of discount, but it also then reduces the REMIC's accrual of interest expense too. In short, a certain symmetry should result.

Apart from interest and discount income on qualified mortgages, a REMIC will also realize investment income on the reinvestment of proceeds

51. In unusual circumstances a REMIC may be required to accrue original issue discount on such mortgages, but typically whole mortgage loans will not be issued with original issue discount.

52. Regs. § 1.860F-2(c). "Issue price" is defined by reference to the definition in the original issue discount regulations. IRC § 860G(a)(10); Regs. §§ 1.860G-1(d)(1), 1.1273-2.

53. For example, if a REMIC issues class A and class B regular interests, each with an issue price of \$50 and issues a residual interest, class R, for which the sponsor pays the holder \$2 to accept ownership, it is clear that the sponsor's net proceeds from this transaction are \$98 (\$50 + \$50 - \$2). Yet, by ignoring the negative issue price of the residual interest, the basis rules will require the REMIC to take a basis in its assets equal to \$100.

from its assets pending distribution.⁵⁴ Similarly, a REMIC may realize income on qualified reserve fund assets.⁵⁵ Reserve fund assets may take any form (stock, bonds, deposits, et al.), so long as they are held for investment (i.e., not as part of an active business, such as securities trading) and are in a reasonably required amount.⁵⁶ Thus, a REMIC may derive a variety of possible types of income from its qualified reserve fund, but as a practical matter such income is likely to comprise only a minimal part of a REMIC's total gross income.

In addition to the foregoing, a REMIC is subject to the same rules as other taxpayers. In particular, a REMIC can realize cancellation of indebtedness income to the extent that it is relieved of liability under its indebtedness (i.e., the regular interests). This can arise when regular interests are written down due to credit losses on qualified mortgages. Frequently, however, the REMIC will have a corresponding write-off with respect to its qualified mortgages, which will thus offset the COD income, but this may not always be the case.

2. *Calculating REMIC Net Income or Loss*

Once the gross income of the REMIC has been identified, the rules for computing REMIC taxable income or net loss are simply stated: a REMIC's taxable income must be determined under an accrual method of accounting and, with certain enumerated modifications, in the same manner as for an individual.⁵⁷ The first such modification is that regular interests in the REMIC shall be treated as indebtedness of the REMIC.⁵⁸ This is one of the important advances made by the REMIC legislation—to remove the vexing debt vs. equity issue. In this context, the principal effect of this statutory pronouncement is to ensure that relevant payments to regular interest holders constitute interest and thus are deductible in computing REMIC taxable income or net loss.

Today, however, having identified an expense item as interest is only half the job; one must then run the gauntlet of restrictions that can apply to the deductibility of interest. In this respect, the regulations set out two

54. A REMIC is permitted to hold cash flow investments, which are defined in general terms as investments of payments related to qualified mortgages, for a temporary period pending distribution to REMIC interest holders. Regs. § 1.860G-2(g)(1)(i). The return on such investments must be in the nature of interest. *Id.*

55. See Regs. § 1.860G-2(g)(2) (defining "qualified reserve fund").

56. Regs. § 1.860G-2(g)(3).

57. IRC § 860C(b)(1).

58. IRC § 860C(b)(1)(A). An identical rule in § 860B(a) provides that in computing the taxable income of a holder, a REMIC regular interest is treated as debt.

additional modifications that are relevant. First, they sensibly provide that, contrary to the normal rule applicable to individuals, a REMIC is allowed an interest expense deduction without regard to the investment interest limitations under section 163(d).⁵⁹ Second, they provide that in applying section 265 (denying a deduction for amounts related to tax-exempt income), a REMIC is treated as a financial institution.⁶⁰ As a result, if the REMIC holds assets that produce tax exempt interest, an amount of the REMIC's interest expense deduction is disallowed based on a ratio of the REMIC's tax exempt obligations to its total assets.⁶¹

A second modification provided by the statute relates to market discount on a mortgage or other debt obligation held by the REMIC. Generally, a holder of a debt obligation acquired with more than a de minimis amount of market discount must accrue market discount on either a ratable or a constant yield basis, and recognize the accrued market discount as the debt instrument is repaid, or upon its disposition to the extent of any gain.⁶² Alternatively, a holder can elect to recognize market discount currently.⁶³ In case of a REMIC, however, the choice is fixed: market discount must be accrued on a constant yield basis and recognized as it accrues.⁶⁴

A third statutory modification is that a REMIC is not allowed any of the deductions listed in section 703(a)(2).⁶⁵ Section 703(a)(2) sets out certain deductions that are not allowed in the case of partnerships: personal exemptions, foreign or possessions taxes, charitable contributions, net operating loss carryovers or carrybacks, and depletion. None of these prohibited deductions is particularly surprising. Denial of a net operating loss carryover or carryback deduction is common to all pass-through entities, since the entity's losses pass through to the investors and are carried over or back by the investors according to their own particular facts. Some have questioned the wisdom of disallowing a REMIC any kind of deduction for foreign or possessions taxes, since those taxes do not otherwise pass through as a credit or deduction for the residual interest holders, and thus are, in effect, lost.⁶⁶ Likely the drafters got carried away in following the partnership rules and simply overlooked this glitch.

59. Regs. § 1.860C-2(b)(2).

60. See Regs. § 1.860C-2(b)(5).

61. IRC § 265(b)(2). For this purpose, however, the special exception in § 265(b)(3), relating to qualified tax-exempt obligations, does not apply. Regs. § 1.860C-2(b)(5). Thus, such obligations are included in the numerator of the ratio described in the text.

62. IRC §§ 1276-78.

63. IRC § 1278(b).

64. IRC § 860C(b)(1)(B).

65. IRC § 860C(b)(1)(D).

66. Peaslee & Nirenberg, *supra* note 8, at 280 n.26.

The last two statutory modifications pertain to transactions that give rise to penalty taxes on the REMIC. First, in the case of a “prohibited transaction,” the REMIC does not take into account any item of income, gain, loss or deduction in computing its taxable income or net loss.⁶⁷ Instead, a prohibited transaction is, in effect, segregated from other REMIC activities and placed in a separate basket; all income and deduction items related to the transaction are netted and the resulting net gain, if any, is subject to a 100% tax (any net loss disappears and is not otherwise taken into account).⁶⁸ Second, the amount of any net income from foreclosure property is reduced by the amount of tax imposed by section 860G(c).⁶⁹ Intended to deter a REMIC from entering into a business activity via a foreclosure, a single level of tax (currently at 35%) is imposed on the net income from foreclosure property. A full, second level of tax at the residual holder level was not considered appropriate and to prevent this result the residual holder, in effect, gets a deduction (but not a credit) for the taxes paid by the REMIC. However, if there is a loss from foreclosure property (e.g., the property is sold at a loss), the REMIC would take that loss into account in computing its taxable income or net loss.⁷⁰

The regulations add two other modifications. First, they provide that in computing REMIC taxable income or net loss, any gain or loss from the sale of any asset of the REMIC is treated as deriving from the sale or exchange of property that is not a capital asset.⁷¹ This implements the instructions in the legislative history of TAMRA that the IRS issue regulations allowing REMICs to deduct capital losses without limitation.⁷² Second, the regulations provide that any debt owed the REMIC is not treated as a “non-business debt” under section 166 and thus the REMIC is allowed an ordinary deduction when the debt becomes wholly or partially worthless.⁷³ This too implements instructions in TAMRA legislative history to this effect.⁷⁴

It is interesting to note that the regulations do not implement other instructions in the TAMRA legislative history. In particular, the legislative

67. IRC § 860C(b)(1)(C).

68. IRC § 860F(a). This is unlike the treatment of prohibited transactions under the REIT rules, which permit net losses from such transactions to be deducted in computing real estate investment trust taxable income. See IRC § 857(b)(2)(F); 1986 Act Bluebook, *supra* note 29, at 397 n.36, 398-99. It is not clear why the REMIC prohibited transaction rules, which are otherwise closely modeled on the REIT prohibited transaction rules, differ in this respect.

69. IRC § 860C(b)(1)(E).

70. This is consistent with the treatment of net losses on foreclosure property in the REIT context. Regs. § 1.857-3(c).

71. Regs. § 1.860C-2(a).

72. S. Rep. No. 445, *supra* note 39, at 88, reprinted in 1988 U.S.C.C.A.N. at 4607.

73. Regs. § 1.860C-2(b)(3).

74. S. Rep. No. 445, *supra* note 39, at 88, reprinted in 1988 U.S.C.C.A.N. at 4607.

history specified that in connection with allowing a REMIC to treat its bad debts as other than "nonbusiness debt" and to deduct capital losses without limitation, regulations should prevent individuals from using the REMIC election to circumvent the limitations that would otherwise apply to them with respect to these items.⁷⁵ Perhaps the IRS decided it had enough general tax avoidance weapons in its arsenal to attack the truly abusive cases that it declined the offer to issue specific regulations. Individual taxpayers, however, can take some comfort that the IRS is not likely to challenge a transaction that has as a collateral effect the avoidance of the foregoing limitations, assuming the transaction otherwise has independent economic significance.⁷⁶

B. Taking Into Account REMIC Taxable Income or Net Loss

1. *In General.*—Once REMIC taxable income or net loss for a taxable year has been determined, it is taken into account by a REMIC residual interest holder based on the number of days in the REMIC taxable year that it held the residual interest.⁷⁷ The REMIC is required to allocate its taxable income or net loss after each calendar quarter and to provide notice to each residual interest holder of such holder's share of that income or loss.⁷⁸ Mechanically, the total income or loss for the calendar quarter is allocated ratably to each day of the quarter and the amount allocated to each day is then allocated proportionately among the residual holders.⁷⁹

As in the case of a partnership, the residual interest holder takes into account its share of REMIC income or loss in computing its tax liability, regardless of whether any actual distributions are received. The amount taken

75. *Id.*

76. The legislative history also specified that a REMIC should not be allowed a dividends received deduction, but this is not reflected in the regulations. S. Rep. No. 445, *supra* note 39, at 88, reprinted in 1988 U.S.C.C.A.N. at 4607. The Service, however, may have realized that the legislative history's concern is misplaced. A REMIC is required to compute its income as if it were an individual and a dividends received deduction is only available for corporate shareholders. See IRC § 860A(a) (stating that a REMIC is not treated as a corporation for federal income tax purposes).

77. IRC § 860C(a)(1).

78. Regs. § 1.860F-4(e)(1)(i). Notice is provided on Schedule Q of Form 1066, which must be delivered to each residual interest holder no later than the last day of the month following the close of the calendar quarter. *Id.* The REMIC is permitted to use any reasonable counting convention in allocating income or loss, such as 30 days per month, or 90 days per quarter, or 360 days per year. Regs. § 1.860C-1(c).

79. IRC § 860C(a)(2). The statute thus expressly prohibits any special allocation of income or losses among residual holders, although, even absent this language, a special allocation would likely give rise to an impermissible second class of residual interests.

into account is treated as ordinary income (or loss).⁸⁰ When actual distributions are received, they generally are not included in taxable income, but rather reduce the holder's basis in the residual interest.⁸¹ However, as in the case of a partnership, if distributions do exceed basis, the excess is treated as gain from the sale or exchange of the residual interest and such gain generally would be capital gain.⁸²

Special rules apply to net losses allocated to a residual interest holder. Similar to a partnership, a holder may not take into account its share of net losses for the quarter to the extent that the losses exceed the holder's adjusted basis in its residual interest as of the close of that quarter.⁸³ Any loss disallowed because of insufficient basis may be carried forward indefinitely by the holder to succeeding quarters.⁸⁴ As noted above, losses cannot be carried over by the REMIC and used to offset its income in future periods. Any disallowed losses that remain at the time a residual interest is disposed of or retired disappear unused.

One problem with the foregoing scheme is the uncertain relationship of distributions on a residual interest to a holder's basis in a residual interest. In particular, distributions can occur at any time during a taxable year, but basis adjustments (based as they are on net income or loss) can be triggered no earlier than the end of calendar quarters. Logically, the determination of whether a distribution triggers gain recognition should be suspended pending the end of the calendar during which the distribution, but the answer is not entirely clear. This point is addressed in detail in Part IV.B.3, which discusses the holder's basis in a residual interest.

2. *Character of REMIC Income and Losses.*—As noted above, the statute provides that a residual interest holder's share of REMIC taxable income or net loss shall be treated as an item of ordinary income or loss. Although that designation is helpful in distinguishing such items from capital gains or losses, for many purposes under the Code one must further determine whether an item of ordinary income or loss is of a specific type or not.

80. IRC § 860C(e)(1). The loss is taken into account as an ordinary deduction. Foreign taxpayers that are not taxable on net income would therefore receive no benefit from this deduction. See Regs. §§ 1.871-7(a)(3), 1.881-2(a)(3).

81. IRC § 860C(c), (d)(2); Regs. § 1.860C-1(b)(2)(i).

82. IRC § 860C(c)(2). For a discussion on the status of a residual interest as property, see *infra* Part IV.E.1. Gain or loss would not be capital if the residual interest was held by a taxpayer in its capacity as a dealer. For a discussion of special considerations regarding dealers in residual interests, see *infra* Part VI.B.2.

83. See IRC § 860C(e)(2)(A). Cf. IRC § 704(d) (providing that a partner's share of partnership losses are allowed only to the extent of the partner's adjusted basis in the partnership interest).

84. IRC § 860C(e)(2)(B).

For example, a panoply of tax rules may apply based on whether an item of ordinary income is passive investment income such as interest, dividends, etc. In some cases, the Code and regulations specifically state how REMIC residual income should be treated, but in many other instances there is no clear answer.

a. *REMIC Losses*

In general.—A REMIC will incur a number of deductible expenses, principally for interest, and if such deductions exceed gross income the REMIC will experience a net loss. Except in the case of certain “pass-through interest holders,” REMIC deductions do not pass through to the residual interest holders. Rather, they are deductible by the REMIC in computing its taxable income. In this manner, the residual interest holder can, in effect, receive the benefit of a deduction for items that it might not itself be able to deduct, such as capital losses or, in the case of noncorporate holders, partial write-offs of bad debts.⁸⁵ However, except in the abusive case where the residual interest holder is using the REMIC intentionally to avoid these limits, Congress apparently did not intend to prevent this result.⁸⁶

If a REMIC's deductions exceed its gross income and a net loss thereby arises, this loss generally passes through to residual interest holders as a simple ordinary loss. However, it may be necessary in some instances to obtain greater precision about the nature of the ordinary loss. For example, for purposes of section 469, a residual interest holder's share of a REMIC's ordinary loss should be treated as an expense clearly and directly allocable to portfolio income producing property.⁸⁷ Similarly, the loss should also be taken into account as an item of “investment expense” in determining net investment income for purposes of section 163(d).⁸⁸

Pass-through interest holders.—Notwithstanding the general rule that REMIC deductions do not pass through, in the case of a so-called “pass-through interest holder” (“PTIH”),⁸⁹ such holder's share of the amount of

85. See *supra* text accompanying notes 71-76.

86. *Id.* Cf. Temp. Regs. § 1.67-3(a)(2)(ii)(B)(2)(ii) (concerning a REMIC that is substantially similar to an investment trust and that is structured for the principal purpose of avoiding the investment expense limits).

87. See Temp. Regs. § 1.469-2(d)(4). As described below, a holder's share of REMIC income is treated in the regulations as portfolio income for purposes of the passive loss rules. See *infra* text accompanying note 103.

88. By referencing the portfolio interest rules, § 163(d)(5)(A)(i) causes a REMIC residual interest to be treated as property held for investment.

89. A PTIH is defined in general as a residual interest holder (or in the case of a single tier REMIC, a residual or regular interest holder) that is:

REMIC deductions attributable to investment expenses⁹⁰ is broken out and separately reported to him. The PTIH then accounts for such investment expenses according to its own facts (i.e., subject to the 2% floor under section 67). In this manner, individuals are prevented from avoiding the 2% floor on miscellaneous itemized deductions through investing in pass-through entities and only reporting their share of the entity's income net of such expenses.

Mechanically, the PTIH is treated as having received income in the amount of his allocable share of investment expenses and as having directly paid such expenses.⁹¹ This can have the obvious effect of increasing a holder's share of REMIC income or reducing its share of the REMIC's net loss, based on whether the holder is able to deduct such expenses in full. Yet, such expenses do not increase or decrease the holder's basis in the residual interest.⁹²

One situation in which the reporting of investment expenses to PTIHs is complicated is the so-called double REMIC structure, in which all of the regular interests of a lower-tier REMIC are held by an upper-tier REMIC that issues its regular interests to investors.⁹³ In such arrangements, there will be

(1) An individual (other than a nonresident alien whose income with respect to this or her interest in the REMIC is not effectively connected with the conduct of a trade or business within the United States),

(2) A person, including a trust or estate, that computes its taxable income in the same manner as in the case of an individual, or

(3) A pass-through entity . . . if one or more of its partners, shareholders, beneficiaries, participants, or other interest holders is (i) a pass-through entity or (ii) a person described in paragraph . . . (1) or (2) [above].

Temp. Regs. §§ 1.67-3(a)(2)(i)(A), (ii)(A). A pass-through entity, in turn, is defined as including, in principal part, a trust, partnership, S corporation, common trust fund described in § 584, a nonpublicly offered regulated investment company, and a REMIC. Temp. Regs. § 1.67-3(a)(3)(i).

90. Investment expenses are defined as expenses paid or accrued by the REMIC for which a deduction is allowable under § 212 in determining the taxable income of the REMIC. Temp. Regs. § 1.67-3(a)(4). Typical investment expenses of a REMIC would include servicing fees, trustee fees, and other administration fees, but they would not include interest expense. Of course, it may not always be obvious whether an item of income paid to a servicer is in fact fee income or, alternatively, a retained ownership interest in the REMIC mortgages (e.g., a stripped coupon). See, e.g., Rev. Rul. 91-46, 1991-2 C.B. 358 (characterizing excess servicing fees as a stripped coupon).

91. Temp. Regs. § 1.67-3(b)(1).

92. Temp. Regs. § 1.67-3(b)(5). On the rules applicable to PTIHs, see generally Ann M. Hannaford & James C. Engel, Final REMIC Regulations on Allocation of Investment Expense: Round One, 6 J. Bank Tax'n 20 (1993).

93. The double REMIC is frequently used to enable the creation of types of regular interests that could not be created directly in a single REMIC. See generally Peaslee & Nirenberg, *supra* note 8, at 217-20 (providing copious examples of the technique). Both REMICs are typically created in a single document and the two REMICs are separate purely

two residual interests (a lower-tier and an upper-tier residual interest) and the question arises as to how to allocate investment expenses between the two residual interests. This is an issue because, except for tax purposes, there is in substance only a single economic entity and a single set of expense items and no easy basis may exist for dividing up such expense items between the upper and lower tier REMICs.⁹⁴ The issue is more acute if the upper- and lower-tier residuals are held by separate PTIHs. Absent further guidance, the two REMICs should be free to divide up the expenses between themselves in any reasonable way.

b. *REMIC Taxable Income.*—REMIC residual holders take into account their shares of REMIC taxable income as items of ordinary income. Although special rules apply to that portion of REMIC taxable income that constitutes an excess inclusion (generally limiting the extent to which such excess inclusion income may be offset by deductions), the character of REMIC taxable income is not otherwise specified by the REMIC provisions.⁹⁵

The first question that arises in considering the character of REMIC taxable income is whether such income should be viewed, in whole or in part, as interest income. Clearly a residual interest is not a debt instrument, but one could plausibly argue that since the items of gross income of a REMIC predominantly, although not necessarily exclusively, consist of interest income, one should “look through” in some sense and treat at least a portion of the taxable income of the REMIC passed through to the residual interest holders as having the character of interest. Yet, there is no authority that supports that characterization, other than in the case of actual REMIC distributions to foreign holders.⁹⁶ In fact, the Code and regulations seemingly are careful to avoid this characterization.⁹⁷ One limited exception to this

as a formal matter. The regulations expressly sanction such double REMIC structures. See *supra* text accompanying note 34. The prevalence of double REMIC structures and the fact that they serve little purpose other than to accomplish indirectly what cannot be accomplished directly under the REMIC rules suggests that the definition of a regular interest in the REMIC Regulations probably should be broadened or revamped to reflect the reality of the marketplace.

94. Regs. § 1.860F-2(a)(2)(i) sanctions the creation of tiered REMICs in a single document and requires that the organizational documents clearly and expressly identify the assets of, and interests in, each REMIC. It does not require clear identification of each REMIC's expenses.

95. For a detailed discussion of excess inclusions, see *infra* Part V.

96. See H.R. Conf. Rep. No. 841, *supra* note 31, at II-238, reprinted in 1986 U.S.C.A.N. at 4326. For a further discussion, see Part VI.A.1.

97. See, e.g., Temp. Regs. § 1.67-3(b)(4) (providing that investment expenses allocated to a regular, but not residual, interest holder constitute additional interest income);

relates to REITs holding residual interests, for which income on a residual interest is treated as interest on a “qualifying real property loan” to the extent that the income of the REMIC would qualify as such.⁹⁸

Absent interest characterization, no other pigeonhole seems even remotely viable, yet that answer complicates the application of certain other provisions of the Code, such as the domestic personal holding company (“PHCI”) and foreign personal holding company (“FPHCI”) rules. In applying those rules, PHCI and FPHCI income includes dividends, interest, royalties, rents, and other specified types of passive income.⁹⁹ A residual interest holder’s share of REMIC taxable income (whether or not such amounts represent excess inclusions) does not fit into any one of the listed items in section 543 or section 553, although it is indeed a strange result that such income is not includible.¹⁰⁰

A more practical issue arises with respect to tax exempt organizations that hold residual interests. Although excess inclusions are expressly treated as unrelated business taxable income (“UBTI”), it is not immediately obvious why nonexcess inclusion amounts are not also treated as UBTI.¹⁰¹ The structure of the UBTI rules is to include all gross income from any unrelated trade or business regularly carried on by an institution, exclusive of certain passive types of income, such as interest, dividends, royalties, etc. Given the large investment activities of many tax exempt organizations, it is generally important to ensure that income falls within one of the excluded categories of passive income. In this regard, residual interest income is not interest or dividends nor seemingly any other type of income listed in section 513(b).¹⁰² Yet, the fact that the statute expressly provides that excess inclusions are UBTI must mean that they otherwise would not be, although it

Temp. Regs. § 1.469-2(c)(3)(i)(A) (providing that portfolio income includes interest, dividends, and income from a REMIC).

98. For a detailed discussion of this rule, see *infra* Part VI.C.

99. IRC §§ 543(a), 553(a).

100. The answer is less clear with respect to the definition of FPHI in § 954(c). A comparison of § 954(c)(1)(B)(i) and (ii) may suggest that a REMIC residual interest does not give rise to interest, which, as noted, is consistent with the treatment elsewhere in the Code.

101. One issue that has been raised is whether such amounts could be treated as debt financed income in light of the fact that the REMIC is leveraged by virtue of the regular interests. Debt financed income treatment is unlikely, and certainly unjustified, for the reasons stated in Peaslee & Nirenberg, *supra* note 8, at 284-85 n.47.

102. Regs. § 1.512(b)-1(a)(1) provides that, in addition to excluding dividends and interest, UBTI does not include “other substantially similar income from ordinary and routine investments to the extent determined by the Commissioner.” Regs. § 1.512(b)-1(a)(1). To date, no such determination has been made with respect to nonexcess inclusion income under a residual interest.

would not be the first time the Code made redundant and nonsensical statements.

In another context, the regulations expressly provide that income from REMICs (apparently including income under both regular and residual interests) will be treated as portfolio income (although not as interest) for purposes of the passive loss rules.¹⁰³ Further, since a residual interest is treated as property held for investment by virtue of the fact that it produces portfolio income,¹⁰⁴ gross income from the residual interest is treated as investment income for purposes of section 163(d). Thus, income under a residual interest increases the individual taxpayer's allowable interest expense deduction. In something of a perverse twist, the mandate that excess inclusions cannot be offset by other deductions¹⁰⁵ can be neutralized through the investment interest expense rules.

EXAMPLE: Investor X at the end of 1994, has net investment income of \$400 from certain securities and investment interest expense of \$500. Investor X also holds a REMIC residual interest under which X has income for 1994 of \$100, all of which is an excess inclusion. Investor X has net investment income for 1994 of \$500 (\$400 + \$100) and therefore is allowed to deduct the full \$500 of investment interest expense. Thus, even though Investor has the misfortune of incurring \$100 of excess inclusion, which cannot be offset by deductions, this adversity is neutralized by the additional investment interest deduction that Investor X enjoys.

In light of the recent amendments to section 163(d) to eliminate long term capital gains from investment income,¹⁰⁶ one may question the tax policy basis for including income on REMIC residual interests in investment income for purposes of section 163(d).

3. Determining a Residual Interest Holder's Basis.—As the foregoing indicates, an important element in determining the tax treatment of the residual interest holder is its basis in the residual interest. In general, basis calculations are similar to those that apply in determining a partner's basis in

103. Temp. Regs. § 1.469-2(c)(3)(i)(A). In TAMRA, Congress stated its intent that portfolio income treatment would apply. S. Rep. No. 445, supra note 39, at 88 n.46, reprinted in 1988 U.S.C.C.A.N. at 4607.

104. IRC § 163(d)(5)(A)(i).

105. See infra Part V.B.2.

106. See Omnibus Budget Reconciliation Act of 1993, Pub. L. No. 103-66, § 13206(a), 107 Stat. 463, 463 [hereinafter OBRA 1993].

its partnership interest. However, the basis rules are not necessarily intuitive and can produce curious results. The starting point in understanding the basis rules is to recognize the distinction between the basis of a residual interest issued to a REMIC sponsor upon formation of the REMIC and the basis of a residual interest acquired from the sponsor or from a secondary transferee. This distinction is analogous to the distinction between section 722 and section 743 in the partnership context.

The regulations ordain that all formations of REMICs, however effected, will be treated for tax purposes as a contribution of assets to a REMIC by a "sponsor"¹⁰⁷ in exchange for the regular and residual interests in the REMIC.¹⁰⁸ The statute characterizes this contribution transaction as one in which the sponsor does not recognize gain or loss.¹⁰⁹ Any gain or loss is recognized when the sponsor sells regular or residual interests, or, in the case of retained interests, such gain or loss is accrued over the weighted average life of the REMIC.¹¹⁰ The REMIC, however, takes a basis in the contributed assets equal to fair market value.¹¹¹ The formation, thus, is somewhat analogous to a deferred inter-company transaction within a consolidated group (the transferee takes a fair market value basis; gain/loss recognition is deferred). In the contribution transaction, the sponsor will have an aggregate basis in the regular and residual interests that it is considered to receive equal to aggregate of the adjusted bases of the property it transfers to the REMIC, increased by the amount of "organizational expenses" incurred.¹¹² This aggregate basis is allocated among regular and residual interests

107. A sponsor is defined as "a person who directly or indirectly exchanges qualified mortgages and related assets for regular and residual interests in a REMIC." Regs. § 1.860F-2(b)(1).

108. Regs. § 1.860F-2(a)(1). Thus, if the form of the transaction is that the sponsor forms the REMIC, the REMIC sells regular/residual interests to investors and forwards the proceeds to the sponsor, the transaction is treated as if the sponsor received back the interests and sold them directly to the investors.

109. IRC § 860F(b)(1)(A).

110. See IRC § 860F(b)(1)(C) & (D). For a further discussion of accrual of gain or loss on retained residual interests, see *infra* Part IV.D.

111. IRC § 860F(b)(2). Fair market value for this purpose equals the aggregate of the issue prices of the regular and residual interests. Regs. § 1.860F-2(c). The definition of "issue price" is discussed *infra* note 211.

112. Regs. § 1.860F-2(b)(3)(i). This follows the rule for partnerships. See, e.g., Rev. Rul. 87-111, 1987-2 C.B. 160. Organizational expenses are defined in Regs. § 1.860F-2(b)(3)(ii)(A) as expenses "directly related to the creation of the REMIC" and include, for example, legal fees related to creation of the REMIC, accounting fees, and other administrative costs. Cf. Regs. § 1.709-2(a)(1) (defining organizational expenses for partnership purposes as expenses "incident to the creation of the partnership"). Organizational expenses do not include syndication expenses under either definition.

in proportion to their fair market values on the pricing date (or, if none, the startup day).¹¹³

In the case of a secondary transferee of a residual interest, basis is determined under normal concepts and generally should equal cost.¹¹⁴ Although "cost" is typically not a difficult concept to apply in most asset acquisitions, the concept is a hard one in the case of a transfer of property that has negative value, such as a residual interest that requires the seller to make an up-front payment to the buyer. How basis should be calculated in such cases is discussed in greater detail below in Part IV.C.2. Outside of transfers of residual interests involving up-front payments, determining a holder's cost basis in a residual interest should present few unique issues.

One interesting wrinkle regarding a secondary transferee is the fact that the transferee's basis in the acquired residual interest does not give rise to any adjustment in the REMIC's basis in its assets. Unlike a partnership, there is nothing analogous to a section 754 election and section 743(b) basis adjustment. The result is that the secondary residual holder is over- or under-taxed to the extent REMIC assets have increased or decreased in value. In theory, one would think the residual holder should either amortize the "acquisition" premium or accrue "acquisition" discount, but such is not the case under the current scheme. The legislative history recognized the problem:

The Congress understood that the taxable income allocated to holders of residual interests in a REMIC who purchased such interests from a prior holder after a significant change in value of the interest, could be substantially accelerated or deferred on account of any premium or discount in the price paid by such purchaser.¹¹⁵

Yet, having recognized the issue, Congress opted for the Service to craft an appropriate solution in regulations. The regulations contain no special rule and apparently none is contemplated.¹¹⁶ Thus, until and unless a special rule is issued, secondary transferees are stuck with the burden or benefit of this lack of an adjustment to a REMIC's asset bases.

113. The allocation is made by multiplying the aggregate bases of REMIC property by a fraction, the numerator of which is the fair market value of an interest and the denominator of which is the aggregate fair market values of all the REMIC regular and residual interests.

114. See IRC § 1012.

115. 1986 Act Bluebook, *supra* note 29, at 421 n.81. See also H.R. Conf. Rep. No. 841, *supra* note 31, at II-233 n.15, reprinted in 1986 U.S.C.C.A.N. at 4321 n.15.

116. This issue was not listed in the preamble to the final REMIC regulations as an issue that is under consideration by the Service. See 57 Fed. Reg. 61,297-98 (1992).

Once a residual interest holder's basis is established, periodic adjustments are made as in the case of a partnership. First, basis is increased by the daily portions of REMIC taxable income taken into account by the holder and by the amount of any contribution to the REMIC described in section 860G(d)(2).¹¹⁷ Contributions other than those described in section 860G(d)(2) are subject to a 100% penalty tax (i.e., the contribution is paid over to the fisc);¹¹⁸ thus, no basis adjustment is appropriate. Basis is decreased, in turn, by the amount of cash or the fair market value of property distributed to the holder by the REMIC with respect to the residual interest, and by the daily portions of REMIC net losses taken into account by the holder.¹¹⁹

Unlike a partnership, however, the REMIC rules do not provide for a basis adjustment for the receipt of tax-exempt income by a REMIC, although the possibility of a REMIC receiving such income is acknowledged in the regulations, which provide a special rule for the application of section 265.¹²⁰ This appears to be a conceptual flaw in the basis adjustment scheme.¹²¹ Similarly, unlike a partnership, the residual holder's basis is not decreased by the amount of nondeductible expenditures, such as interest incurred to purchase or carry tax exempt obligations. Once again, this appears flawed.¹²² The proper approach should be to provide both a positive basis adjustment for tax-exempt income and a negative basis adjustment for nondeductible expenditures. However, since it is unlikely that a REMIC would derive substantial tax exempt income, these flaws may be largely academic.

117. IRC § 860C(d)(1); Regs. § 1.860C-1(b)(1). A contribution described in § 860G(d)(2) is one made after the REMIC startup day that is either (i) to facilitate a clean-up call or qualified liquidation, (ii) a payment in the nature of guarantee, (iii) a contribution made within three months of the startup date, (iv) any contribution to a qualified reserve fund, or (v) any other contribution permitted in the REMIC regulations.

118. IRC § 860G(d)(1).

119. IRC § 860C(d)(2); Regs. § 1.860C-1(b)(2).

120. See Regs. § 1.860C-2(b)(5).

121. For example, if a REMIC held a single asset which generated \$1,000 of tax-exempt income (for simplicity, assume the REMIC has a basis of \$0 in the asset prior to receipt of the income) and incurred \$500 of interest expense with respect to its regular interest holders, the REMIC would not be entitled to a deduction for the \$500 interest expense under section 265 and the residual holders would not receive a basis adjustment for such income. Thus, a subsequent sale of the residual interest for \$500 would trigger gain and effectively result in taxation of \$500 of tax-exempt income. See also *infra* note 122.

122. For example, if a REMIC held a single asset which generated \$500 of tax-exempt income (once again, with a basis of \$0) and incurred \$1,000 of interest expense with respect to its regular interest holders, the REMIC would not be entitled to a deduction for the \$1,000 interest expense and the residual holder would not experience a negative basis adjustment for such expenditure. Thus, a subsequent sale of the residual interest at a loss of \$500 would trigger a loss and effectively result in a \$500 deduction of disallowed interest expense.

A far more practical problem exists with respect to the relationship between the basis adjustment system and distributions on residual interests. As noted above, a distribution on a residual interest in excess of a holder's adjusted basis therein is treated as gain from the sale or exchange of such interest. However, while distributions may occur at any time, with one exception, basis adjustments occur no more frequently than the end of calendar quarters.¹²³ The one exception to this, which seemingly proves the rule, is that if a holder disposes of a residual interest, appropriate basis adjustments are deemed to occur immediately before the disposition.¹²⁴ Conversely, absent a disposition, basis adjustments prior to the end of a quarter are apparently not authorized.

This situation gives rise to some uncertainty about the correct relationship between basis adjustments and distributions, as the following example illustrates.

A REMIC has net income or loss for the calendar quarters of a taxable year of -\$1,000, \$1,500, \$500, -\$1,000, respectively.¹²⁵ Its net taxable income for the year thus is \$0. At the beginning of the taxable year, the sole residual interest holder has an adjusted basis in such interest of \$1,000. On May 15 (the middle of the second calendar quarter), the REMIC makes a distribution (the first distribution of the taxable year) to the residual interest holder of \$1,000. Several possible ways to account for the distribution exist:

1. *Taxable Year Look-Back.* The distribution could be considered to result in gain at the time of the distribution to the extent it exceeds a holder's adjusted basis as of the beginning of the taxable year. Under this approach, the holder realizes no gain on the distribution since it exactly equals his adjusted basis of \$1,000 at the beginning of the taxable year.

123. Section 860C(d) merely provides that basis is increased or decreased by the amount of income or loss taken into account under § 860C(a). The amount of income or loss taken into account under § 860C(a) in turn equals the sum of a holder's daily portions for the taxable year, determined by allocating quarterly income or loss among the days of each quarter. It is not entirely clear when such income or loss is considered to be taken into account for purposes of basis adjustments. Arguably, these items could be considered taken into account only at the end of a taxable year when a holder's total share of REMIC net income or loss under § 860C(a) can be determined. Alternatively, and more likely, they could be considered taken into account at the end of each calendar quarter, the smallest accounting unit of the REMIC.

124. Regs. § 1.860C-1(b)(3).

125. For purposes of this simple example, no excess inclusion amounts are assumed.

2. *Calendar Quarter Look-Back.* The distribution could be considered to result in gain at the time of distribution to the extent it exceeds the holder's adjusted basis as of the beginning of the last calendar quarter. Under this approach, the holder's basis of \$1,000 is reduced to \$0 at the end of the first calendar quarter by the REMIC's \$1,000 loss for that quarter. Thus, the holder would recognize gain of \$1,000 upon receipt of the distribution on May 15.
3. *Pro Rata.* The distribution could be considered to result in gain at the time of distribution to the extent it exceeds the holder's adjusted basis as of May 15. Under this approach, the holder's basis of \$1,000 is reduced to \$0 at the end of the first calendar quarter by the REMIC's \$1,000, but it is then increased by \$750, the pro rata share of the second quarter net income of \$1,500 (45 days/90 days x \$1,500). Thus, the holder would recognize gain of \$250 upon receipt of the distribution on May 15.
4. *Calendar Quarter Delay.* Determination of the tax treatment of the distribution could be deferred until the end of the calendar quarter in which it occurs and then tested by reference to the holder's adjusted basis at such quarter end. Under this approach, the holder's adjusted basis of \$1,000 at the beginning of the year is decreased to \$0 by the first quarter loss and then increased to \$1,500 by the second quarter net income. The distribution of \$1,000 is then measured against this \$1,500 adjusted basis and thus would be nontaxable to the holder.
5. *Taxable Year Delay.* Determination of the tax treatment of the distribution could be deferred until the end of the taxable year in which it occurs and then tested by reference to the holder's adjusted basis at such year end. Under this approach, the holder's adjusted basis of \$1,000 at the beginning of the year remains unchanged since the REMIC's net income for the taxable year is \$0. The distribution of \$1,000 is then measured against this \$1,000 adjusted basis and thus would be nontaxable to the holder.

Although perhaps a hyper-technical reading of the statute and regulations could support alternative 1 or 2, those approaches are hard to defend since they can yield patently arbitrary and potentially ridiculous results. The

prospectivity approach of alternatives 4 and 5 is reasonable, both from the standpoint of equity and administrability, but precedent in other areas of the Code suggests that a clear statutory or regulatory mandate may be necessary to achieve this result.¹²⁶ Having had to resolve this Solomonic puzzle in actual practice, the author chose to follow alternative 3. The reasoning was that this reading was not necessarily inconsistent with the statutory language and was a fair attempt to bridge the gaps in the statutory scheme.¹²⁷

The foregoing basis calculus should raise few eyebrows; those versed in partnership taxation are well accustomed to this type of articulation. One interesting footnote to the discussion concerns the basis of residual interests that have a negative fair market value—i.e., the sponsor has to make a payment to someone to induce them to accept ownership of it. The issue of negative basis is related to the treatment generally of up-front or inducement payments and is addressed in that context in the next section.

126. For example, a similar issue arises with respect to distributions from partnerships. See IRC § 731(a)(1). However, by regulation the Service has effectively provided that the determination of whether a distribution exceeds basis is to be made at year-end. Regs. §§ 1.705-1(a)(1), 1.731-1(a)(1)(ii). This year-end rule was created to avoid the administrative burdens of computing basis at the time of every distribution. See G.C.M. 36919 (Nov. 12, 1976). This concern arose from the language of the § 731(a)(1) which, unlike § 860C(c)(2), states that gain is triggered to the extent that a distribution of cash exceeds adjusted basis "immediately before the distribution." IRC § 731(a)(1). An express regulatory scheme similar to that in subchapter K applies in the case of distributions from a subchapter S corporation. See Regs. §§ 1.1367-1(d), 1.1368-1(e)(1), -3 ex. 1. An additional analogy can be found regarding the determination of whether distributions from a subchapter C corporation are considered a dividend of earnings and profits or a return of capital. However, in this context, the statute expressly provides a timing rule. IRC § 316(a)(2) (providing that earnings and profits are to be computed as of the end of the taxable year).

In sum, it is interesting to note that when Congress and the Service have recognized the problem, a calendar year delay approach is adopted to resolve it. Such a rule would seem appropriate under § 860C(c)(2) as well, but in the absence of an explicit rule, it would take a bold leap of faith to follow that approach.

127. It is true that the regulations state that the pro rata method must be used in the event of a disposition of a residual interest, suggesting perhaps that it is not otherwise authorized. However, in determining whether a distribution produces gain, one is in effect measuring whether there has been a disposition of the residual interest and, if so, what the amount of gain realized is. Thus, one might argue that it is perfectly consistent to use the pro rata method in determining the treatment of distributions. Also, it is not clear that the legislative history and the regulations meant that the pro rata approach should apply only in the case of actual dispositions; they do not necessarily preclude its use where reasonable in other contexts.

C. Treatment of Up-Front Payments

As previously described, a residual interest may entitle the holder to minimal or zero cash distributions from the REMIC—i.e., all of the REMIC's cash flow is dedicated to the regular interests. Yet, the residual interest holder still will be taxable on "phantom" income of the REMIC. Although phantom income should ultimately be offset by phantom losses, which may provide tax benefits for the holder, a net liability arises from the timing difference; phantom income today, but no offsetting deduction for phantom losses until tomorrow.¹²⁸ As a result, by its terms the residual interest may not have any net economic value and in fact may represent a net liability for the holder. No one would willingly acquire a security that amounts to no more than a net liability. Thus, the sponsor must make a payment to a holder in connection with the transfer in order to make the transaction profitable for the holder.

The calculation of the amount of the up-front payment can be a complex affair, although the basic pricing elements can be described in general terms.¹²⁹ The foundation for pricing a noneconomic residual interest is a model or projection, based on an assumption about prepayment rates (among other variables), of the REMIC's taxable income and net losses, given the issue prices of the regular interests. Based on that model, it is possible to project the associated tax liabilities and tax losses in holding the residual interest. In theory, the excess of the present value of future tax liabilities over the present value of expected tax benefits¹³⁰ should represent the amount of an up-front payment that purchaser could accept. The discount rate used in computing the present values would reflect a risk premium to cover uncertainties.

The following example illustrates the pricing calculation using simplified numbers. The table assumes a residual interest that entitles the holder to zero cash distributions, produces phantom income (excess inclusions) and losses as set out below and has anticipated life of nine years.

128. In general terms, phantom income or loss means income or losses that a taxpayer must recognize for tax purpose without any associated cash receipt or outlay. A number of causes can give rise to phantom income or loss, but the principle one at issue in the case of REMIC residual interest arises as a result of so-called "tranching." For a discussion of phantom income, see *infra* Part V.A.

129. In reality, the market for noneconomic residual interests is not an entirely perfect one. In the case of publicly underwritten REMICs, the underwriter-sponsor may put a noneconomic residual up for bid and place it with the lowest bidder. Sophisticated purchasers will do their own modelling and formulate their own bid. Other purchasers may rely on the sponsor's modelling and make a bid based on that.

130. The calculus would also factor in an assumption regarding the tax liability of the purchaser on the up-front payment.

Up-Front Payment Calculation

| Year | Residual Interest Income/(loss) | Tax (liability) /benefit |
|--------------------------------------|------------------------------------|-----------------------------|
| 1 | \$100.00 | \$(35.00) |
| 2 | 75.00 | (26.25) |
| 3 | 50.00 | (17.50) |
| 4 | 25.00 | (8.75) |
| 5 | 0 | 0 |
| 6 | (25.00) | 8.75 |
| 7 | (50.00) | 17.50 |
| 8 | (75.00) | 26.25 |
| 9 | (100.00) | 35.00 |
| Total | 0 | 0 |
| 1. Present value* of tax liabilities | | \$78.01 |
| 2. Present value* of tax benefits | | 54.99 |
| 3. Difference in present values | | 23.01 |

*/ Assuming a discount rate of 6%.

Based on the assumed discount rates, the prospective purchaser of the residual interest in this example requires an up-front payment of at least \$23.01.¹³¹ Since neither projected tax liabilities nor the value of the tax losses is certain (e.g., the losses may not be fully usable at the time they arise), the purchaser would also require some premium to cover these risks. For example, the purchaser might choose to discount future tax benefits by a higher figure (e.g., 10%) than is used to discount future tax liabilities.

Although the purpose and pricing of an up-front payment is readily grasped, the appropriate tax treatment of an up-front payment remains elusive. The IRS has indicated that it is studying this issue and may issue regulations in the future.¹³² In general, only three broad options are available: immediate recognition of the full payment, delayed recognition (amortization), or some form of adjustment to the basis of the residual interest. In weighing these alternatives, refinement of what constitutes an "up-front payment" is also necessary. These points are addressed below.

131. This assumes that the purchaser would be able to shelter the \$23.01 with losses. If the payment would instead attract tax liability, to that extent the purchaser would seek a gross-up. For example, assuming the payment were taxable in full in year 1 at a marginal rate of 35%, the purchaser would seek to have the payment grossed up to \$35.40.

132. 57 Fed. Reg. 61,298 (1992).

1. *Existence, Timing and Manner of Income Recognition.*¹³³—

When a sponsor makes an up-front payment to a holder to accept ownership of a REMIC residual interest, the sponsor is in essence making the holder whole for its agreement to assume the tax liabilities associated with ownership of the residual interest. From the holder's perspective, the up-front payment is simply part of its overall return on the residual interest. In determining the tax treatment of up-front payments, the threshold issue is whether such payments are income at all. If they are, the follow-up question is when should the transferee recognize such income—in full at the time of receipt or spread over some period of time?

a. *Receipt of Income?*—It may seem curious to even raise an issue whether an up-front payment constitutes income; the bald receipt of cash would seem to be the epitome of income, absent an offsetting liability to repay the cash (such as in a loan transaction).¹³⁴ Yet, it is not entirely clear that an up-front payment should be considered income. The transfer of a residual interest accompanied by an up-front payment could be viewed as simply the purchase of property by the transferee and any cash it receives would be merely an adjustment to the purchase price, which should be reflected solely in the basis of the acquired property.¹³⁵ In short, the transferee is acquiring property in exchange for consideration and such a purchase transaction should not be the occasion for income recognition to the buyer.¹³⁶

133. For a discussion of character issues relating to up-front payments, see *infra* Part IV.E.2.a.

134. See *infra* note 143.

135. In essence, the transferee has bought property subject to a liability. Just as a buyer increases basis in purchased assets by the amount it pays to satisfy liabilities it assumes in the purchase transaction (see, e.g., *David R. Webb Co., Inc. v. Commissioner*, 77 T.C. 1134, 1137 (1981), *aff'd*, 708 F.2d 1254 (7th Cir. 1983)), so too the buyer should decrease its basis in purchased assets by the net amount it receives in such a transaction as consideration for assuming such liabilities. As one commentator has noted, "it is counter-intuitive to suggest that the buyer has income in a purchase transaction." Kevin M. Keyes, *The Treatment of Liabilities in Taxable Asset Acquisitions*, 50 *Inst. on Fed. Tax'n* §§ 21.02, 21.04[2][iii] (1992). The problems with viewing the acquisition of a residual interest as an acquisition of property subject to a liability are discussed below in Part IV.C.2.a.

136. An up-front payment made to the transferee of a residual interest has some similarities to the assumption by a buyer of assets of contingent liabilities of the seller. In any such asset sale, one can bifurcate the transaction and view some portion of the property transferred to the buyer as an up-front payment for the buyer's agreement to assume the liabilities. Cf. Michael L. Schler, *Sales of Assets After Tax Reform: Section 1060, Section 338(h)(10), and More*, 43 *Tax L. Rev.* 605, 672-73 (1988) (making a similar point). However, the state of the law on the assumption of contingent liabilities is itself confused and chaotic, and provides no firm star to steer by. See generally Alfred D. Youngwood, *The Tax Treatment of Contingent Liabilities in Taxable Asset Acquisitions*, 44 *Tax Law.* 765 (1991) (describing

An instructive example of this analysis is the case of *Commissioner v. Oxford Paper Co.*,¹³⁷ in which a lessee in ailing financial condition assigned its lease to the taxpayer. The taxpayer assumed the lessee's rent obligations under the lease. As consideration for this assumption, the lessee paid the taxpayer \$100,000 in cash, some stock, and a plant worth \$350,000. The court held that the transaction was in reality a purchase of property by the taxpayer (the plant and the stock) in exchange for the taxpayer's agreement to assume the lessee's liabilities. Neither the cash nor any of the property received was includible in the taxpayer's income, but rather the court held that the taxpayer should take a cost basis in the property received equal to the value of liabilities assumed less the cash received.¹³⁸ This approach was also taken in Revenue Ruling 55-675,¹³⁹ in which the Service clarified that cost should not include assumed liabilities that are so contingent and indefinite in nature that they are not susceptible to present valuation.

The analogy to *Oxford Paper* and Revenue Ruling 55-675, however, is not a perfect one. In those cases, the taxpayer acquired items of property in addition to receiving a payment of cash, and separate from such items were certain liabilities of the seller that the buyer agreed to assume. The case is different with respect to residual interests. While it probably requires no great leap of faith to conclude that the residual interest is property,¹⁴⁰ there are no direct liabilities of the transferor that the transferee is assuming as the cost of the residual interest. Rather, the liabilities at issue are tax liabilities of the transferee that arise after the sale as a result of phantom income that is generated by the residual interest after the sale. In short, it is as if the transaction in *Oxford Paper* consisted simply of the lessee giving the plant plus the cash to the taxpayer, and by virtue of being the owner of the plant, the taxpayer thereby became subject to future tax assessments that exceed the value of the plant. One can still argue that such a transaction is an asset acquisition and the up-front payment is not income to the purchaser, but admittedly that is a different transaction than that at issue in *Oxford Paper*

the relevant authorities and addressing the tax issues involved); New York State Bar Ass'n, Comm. on Alternative Minimum Tax, Report on the Federal Income Tax Treatment of Contingent Liabilities in Taxable Asset Acquisition Transactions, 49 Tax Notes 883 (Nov. 19, 1990) (same).

137. 194 F.2d 190 (2d Cir. 1952).

138. A fuller discussion of *Oxford Paper* and related authorities can be found in William B. Landis, Liabilities And Purchase Price, 27 Tax Law. 67, 72-74 (1973).

139. 1955-2 C.B. 567.

140. For a discussion of the status of residual interest as property, see *infra* Part IV.E.1.

and Revenue Ruling 55-675.¹⁴¹ How a basis adjustment approach like that in *Oxford Paper* could apply is considered further in Part IV.C.2.c., below.

In sum, an up-front payment could be viewed as an adjustment to basis rather than as income. Although such an approach would be consistent with the economic reality of transactions involving such residual interests and would produce reasonable tax results, as discussed below in Part IV.C.1.c. such an approach could give rise to manipulation and allow taxpayers some measure of electivity regarding the tax treatment of up-front payments. However, before considering these points further, the alternative treatment of an up-front payment as an item of income must be considered.

b. *Treatment of Up-Front Payments as Income.*—Under normal realization principles, the receipt of a lump sum of cash in a closed transaction, over which the recipient has full dominion and control, would be income to the recipient.¹⁴² If that view is accepted, then the issue of timing arises—should the up-front payment be recognized in full in the year received or should recognition occur periodically over some longer period?

Under normal realization principles, one would expect the receipt of a lump sum of cash to be subject to immediate inclusion in gross income. Immediate recognition is also supported by the prepaid income for services cases, which require that the taxpayer include such amounts in income unless they are clearly related to services that are required to be provided in the future according to a fixed schedule.¹⁴³ Although the noneconomic residual

141. Support for an adjustment to basis approach, however, may also be found in authorities involving short sales, which may present a closer analogy. In I.T. 3721, 1945 C.B. 164, supplemented by I.T. 3858, 1947-2 C.B. 71, modified by Rev. Rul. 57-29, 1957-1 C.B. 519, an example is provided in which a taxpayer assigns an out-of-the money, when issued, sell contract to a third party and makes a payment to the third party as consideration for the latter's assumption of the liabilities thereunder. The Service held that the third party did not recognize income on the receipt of the assignment payment; rather this amount was to be taken into account in determining the gain or loss by the third party on closing out the contract. I.T. 3721, 1945 C.B. 164, 172.

142. *Commissioner v. Glenshaw Glass Co.*, 348 U.S. 426, 431 (1955); *North American Oil Consolidated v. Burnet*, 286 U.S. 417, 424 (1932). But query whether the transferee really has enjoyed an accession to wealth. Even if the transferee has not, strictly speaking, acquired property subject to liabilities, still it can be questioned whether the transferee has truly experienced a net accretion to net worth equal to the full amount of the up-front payment. See New York State Bar Ass'n, Comm. on Alternative Minimum Tax, supra note 136, at 897-98.

143. In three famous cases, the Supreme Court addressed whether prepayments for services were immediately includible in income by accrual method taxpayers. *Schlude v. Commissioner*, 372 U.S. 128 (1963) (involving prepaid dance lessons); *American Auto. Ass'n v. United States*, 367 U.S. 687 (1961) (involving advance payments of annual dues); *Automobile Club of Mich. v. Commissioner*, 353 U.S. 180 (1957) (same); see generally Laurie

holder is certain that it will have to perform the service of paying the REMIC's tax liability each year, the precise services and the time for providing them (i.e., the amount of the REMIC's tax liability and the years in which such a liability will exist) are uncertain and contingent. Thus, seemingly the *Schlude* line of cases also calls for immediate inclusion.

On the other hand, in contrast with normal realization principles, is the rule applicable to notional principal contracts. Notional principal contracts provide a close analogy to residual interests in certain respects.¹⁴⁴ In particular, an up-front payment on a REMIC residual interest, from the recipient's perspective, is not unlike an assignment of an "out-of-the-money" swap position, in connection with which the assigning swap party makes an up-front payment to the assignee. In the case of a swap, the recently promulgated regulations require the assignee-third party to amortize into income the "up-front" payment it receives over the remaining term of the swap.¹⁴⁵ Although this swap rule presents a potentially helpful analogy, unfortunately the rule is *sui generis*; the principles of the swap regulations are bereft of supporting rationale and seemingly sprang, figuratively speaking, from Zeus' head in full armor. It is difficult therefore to extend them to other similar situations.¹⁴⁶

Some authority independent of the notional principal regulations may also suggest that amortization is appropriate. For example, in a 1988 Private Letter Ruling,¹⁴⁷ the Service considered the case of a taxpayer (the lessee) that sold certain facilities to an unrelated corporation (the lessor) and then leased them back in the form of an arrangement that qualified as a safe harbor lease. Under the arrangement, the lessor gave installment notes to the lessee for the purchase of the facilities, the lessee held a purchase option at

L. Malman, Treatment of Prepaid Income—Clear Reflection of Income or Muddied Waters, 37 Tax L. Rev. 103 (1981) (reviewing the case law). In those cases, the Court held that prepaid income could not be deferred, reasoning in part that it was not certain that the services for which the payments were made would ever be performed or, if they were performed, whether they would be performed in the period to which income would be deferred. Subsequent to *Schlude*, cases have allowed deferral where there is relative certainty as to performance and the timing of the services. See *Artnell Co. v. Commissioner*, 400 F.2d 981 (7th Cir. 1968); see also *Boise Cascade Corp. v. United States*, 530 F.2d 1367 (Ct. Cl.), cert. denied, 429 U.S. 867 (1976); *Collegiate Cap & Gown v. Commissioner*, 37 T.C. Memo (CCH) 960, T.C. Memo (P-H) ¶ 78,226 (1978).

144. The New York Bar Association recommends that up-front payments be amortized based on the analogy to notional principal contracts. New York State Bar Ass'n Tax Section, Comm. on Pass-Through Entities, Report on the Proposed Real Estate Mortgage Investment Conduit Regulations, 92 TNT 100-58 (Mar. 19, 1992) (LEXIS, FEDTAX library, TNT file) [hereinafter Report on Proposed REMIC Regulations].

145. Regs. § 1.446-3(h)(3), (5) ex. 2(c).

146. See also Bruce Kayle, The Taxpayer's Intentional Attempt to Accelerate Taxable Income, 46 Tax Law. 89, 109 (1992) (making this point).

147. Priv. Let. Rul. 8807065 (Nov. 24, 1987).

lease end for a nominal sum, and the lessee was obligated to pay the lessor rent amounts. Subsequently, the lessee sold all of its interest in the facilities and the lessor's installment notes to a third party (the assignee). The assignee paid the lessee a sum of money for the items it received, but the sum was less than the remaining balance of the installment notes. The Service ruled that the difference between the balance of the installment notes and the payment from the assignee was in reality a payment to the assignee from the lessor in consideration for assuming the lessee's lease obligations (principally, the payment of rent). The Service held that the payment to the assignee for the assumption of the lessee's obligations should be includible in the assignee's income ratably over the remaining term of the lease—"in effect, as an offset to [the assignee's] future rental deductions," according to the Service. Like the notional principal regulations, Private Letter Ruling 8807065 contains no supporting rationale nor does it cite any authority for its conclusion.

Beyond the foregoing situations, little other direct authority exists on the treatment of receipt of up-front payments. Falling back on more distant analogies, one line of authorities that may superficially seem relevant relates to payments to purchasers of newspapers or magazines in consideration of their assumption of the business' prepaid subscription liabilities. In this situation, the Service has required the purchaser to include the payment in income,¹⁴⁸ but has not expressly addressed the timing of the inclusion in income. Rather, the IRS has indicated simply that it is subject to the taxpayer's normal accounting method and the requirement that it clearly reflect income under section 446. Thus, these authorities do little to advance the analysis.

A second analogy concerns so-called "structured settlements" and other settlement funds—arrangements under which a person makes lump sum payment to an assignee in consideration of the latter assuming the former's liabilities with respect to a plaintiff (e.g., tort damages). If an assignment of the liability qualifies under section 130, the assignee need not include the payment in gross income,¹⁴⁹ whereas, according to the legislative history, if the assignment does not so qualify then the full payment would be included

148. Rev. Rul. 71-450, 1971-2 C.B. 78; Priv. Let. Rul. 8749076 (Sept. 11, 1987); Priv. Let. Rul. 8612050 (Dec. 23, 1985); cf. *James M. Pierce Corp. v. Commissioner*, 326 F.2d 67 (8th Cir. 1964) (dealing with tax treatment of assignor/seller). See generally Alan S. Lederman, *Special Tax Benefits of Magazine Publishing Enhance Its Usefulness as a Tax Shelter*, 55 J. Tax'n 26, 28-29 (1981) (discussing the treatment of the assignee/buyer on receipt of payment to assume subscription liabilities).

149. IRC § 130(a).

in gross income.¹⁵⁰ The legislative history stops short of specifically addressing the timing of the inclusion, although it appears to have envisioned that the payment would be includible in full in the year the assignment is made.

In sum, the law authorizing or requiring amortization, such as it is, is murky. Amortization authorities, such as Private Letter Ruling 8807065 and the notional principal contract regulations, at best represent what the law could be (and perhaps should be), and indicate that the Service can, when it wants to, authorize amortization under its general authority to require that an accounting method clearly reflect income. However, amortization of up-front payments for REMIC residual interests cannot be said to be required under current law. If one concludes that an up-front payment is income, then until and unless the Service issues further guidance normal realization principles should be determinative, and under such principles the up-front payment should be included in gross income in full in the taxable year it is received or accrued under the taxpayer's accounting method.

c. *Tax Policy Issues.*—Since, however, the Service is currently considering addressing the tax treatment of up-front payments, it is appropriate to step back and ask what should the law be? What position should the Service take on this point? In general, it must be acknowledged that the issue is not an easy one, but several tax policy issues, of varying significance, can be identified.

Marketplace Distortion.—One policy consideration that might be advanced in favor of either not treating an up-front payment as income or requiring amortization is that such treatment is necessary in order to prevent market distortions. If up-front payments are taxable in full immediately, normal economic forces will push noneconomic residual interests into the hands of those who would pay the least: holders with net operating losses. Taxable holders would have to factor in associated federal income taxes in negotiating the up-front fee, whereas “tax-exempt” holders (those with NOLs) would not. Thus, a tax driven distortion in the marketplace would be created. However, this distortion, if one chooses to label it as such, has nothing peculiar to do with residual interests, but relates to allowance of a deduction for losses. Loss taxpayers will always place a higher, after tax value on current income than nonloss taxpayers; this loss “distortion” already pervades the marketplace generally and there is no reason to single out REMIC residual interests as the beachhead for battling this perceived problem.¹⁵¹

150. H.R. Rep. No. 426, 99th Cong., 1st Sess. 659 (1985) (“[T]he full amount of the consideration received is included in gross income.”).

151. Moreover, it is unclear whether amortization solves the perceived distortion in any event. Even under an amortization regime, loss taxpayers presumably would still value a

Perhaps a more fundamental objection to the validity of this policy is one's uneasiness with the notion of the Service through regulations attempting to redress perceived market distortions. The regulatory process is a blunt instrument indeed, and the Service is neither well qualified to nor efficient in using the tax system to fine-tune market forces. Instead, the Service should identify and implement other, more appropriate tax policy goals at issue and let the chips fall where they may in the marketplace.

Conflict with Loss Limitation Policies.—One tax policy issue that requires careful consideration is whether immediate recognition of an up-front payment is appropriate where noneconomic residual interests are acquired by taxpayers with expiring losses, including losses that are about “expire” as a result of a pending section 382 ownership change. These taxpayers could acquire residual interests and use the up-front payment to soak up losses that might not otherwise be usable.¹⁵² It would seem that this policy issue ultimately turns on the resolution of the fundamental question of whether the up-front payment is properly viewed as income attributable to the current period or income that relates to future periods. If it is concluded that the income is properly attributable to future periods, then indeed it would transgress the policy of section 382 and section 172 to permit the taxpayer to accelerate that income into the current taxable year.¹⁵³ If, however, the

residual interest differently than nonloss taxpayers—i.e., the premium placed on such an investment by loss taxpayers would be reduced, but not necessarily eliminated. Only by treating the up-front payment as a nonincome item would the perceived distortion be neutralized.

152. An analogous issue concerns the status under § 382 of a loss recognized by a transferor as a result of making an up-front payment incident to the transfer of a residual interest. If the residual interest was held by the transferor prior to a § 382 ownership change and later sold within five years after the ownership change, is the loss a built-in loss? Similarly, if the transferor retains the residual interest, are future REMIC losses realized within the five year period built-in losses? The former probably should be. The answer is less clear in the latter case. Cf. Lewis R. Steinberg, *Selected Issues in the Taxation of Swaps, Structured Finance and Other Financial Products*, 1 Fla. Tax Rev. 263, 293-96 (1993) (addressing similar § 382 questions with respect to out-of-the-money swaps).

153. An alternative analysis of an up-front payment would be to view it as a loan to the buyer of the residual interest coupled with an agreement of the buyer to repay the loan by paying the tax liability associated with the residual interest. Cf. Regs. § 1.446-3(g)(4), (6) ex. 3 (recasting a swap with significant nonperiodic payments as a swap plus a loan); *Mapco, Inc. v. United States*, 556 F.2d 1107 (Ct.Cl. 1977) (recasting purported sale of future pipeline revenue in exchange for \$4 million as a nonrecourse loan); *Hydrometals, Inc. v. Commissioner*, 31 T.C. Memo (CCH) 1260, T.C. Memo (P-H) ¶ 72,254 (1972) (recasting purported sale of future manufacturing income for \$2.3 million as a loan), *aff'd*, 485 F.2d 1236 (5th Cir. 1973), *cert. denied*, 416 U.S. 938 (1974). But cf. *Estate of Stranahan v. Commissioner*, 472 F.2d 867 (6th Cir. 1973) (upholding sale treatment of future dividend payment virtually certain to be made). See generally Kayle, *supra* note 146, at 105-08; Jeffrey P. Cantrell, et al, *Notice 89-21 Crashes the Interest Rate Swap Party*, 45 Tax Notes 337, 338-40 (Oct. 16, 1989). However, the authorities adopting the loan analysis all involve a relatively fixed stream of

up-front payment is not viewed as necessarily relating to future periods, then neither section 382 nor section 172 would independently dictate amortization. Taxpayers are largely free to acquire current income when and as they please without violating any policy of section 172 or section 382.

Does the up-front payment relate to future periods? Indeed it does. The up-front payment is meant to compensate the holder, on a present value basis, for the fact that future burdens associated with ownership will exceed future benefits. In this respect, the up-front payment certainly does represent an acceleration of income. The concern this raises can be more clearly seen if the acquiror of a target corporation with NOLs that will be subject to section 382 after the acquisition transfers residual interests it owns to the target in contemplation of the acquisition and makes up-front payments to the target. Effectively, the acquiror can sop up target NOLs. Accordingly, one must be troubled by the existence of loss limitations and the ability of taxpayers to manipulate or avoid those limitations by entering into income acceleration transactions—such as, arguably, the acquisition of an up-front payment residual interest. However, as described below, requiring amortization of the up-front payment or adopting an adjustment to basis approach raises other, potentially equally troubling tax policy issues.

Administrability and Taxpayer Electivity.—One problem with requiring amortization of up-front payments or with adopting an adjustment to basis approach, which in the end may doom such approaches, is simply the difficulty of defining what is an “up-front payment” for purposes of such a rule. In structuring a REMIC residual interest, the sponsor may have significant flexibility as to whether an up-front payment is used. For example, instead of a sponsor making an up-front payment to a holder to accept ownership, it can simply assign a principal balance to the residual interest. The holder would then pay little or nothing for the residual interest and look to the economics of the residual interest by its terms to furnish the compensation. In the most extreme case, the sponsor could simply divert the up-front payment that it would have made to the holder to the REMIC and have the REMIC pay the funds out within the first three months.¹⁵⁴ In less extreme

future income that is reduced to its present value by, in effect, borrowing against it. No such fixed stream of future income exists with respect to the buyer of the residual interest. (Moreover, the stream of future liabilities associated with a residual interest is contingent, not fixed.) It would therefore seem to be something of a stretch to apply the disguised loan cases to the transfer of a residual interest.

154. In general, a REMIC is allowed to hold assets other than qualified mortgages and permitted assets for an initial period ending at the close of the third month beginning after the startup day. IRC § 860D(a)(4). Thus, so long as the cash representing the up-front payment is distributed by the REMIC during this period, REMIC qualification is unaffected, although the REMIC would be subject to prohibited transaction taxes on any earnings on the payment prior to distribution. IRC § 860F(a)(2)(B).

cases, the sponsor could structure the REMIC so that the residual interest principal was paid down from cash flow on the mortgages over a longer period of time, such as six months or a year.

Returning to the example above, the sponsor could make an up front payment of \$23.01 to the holder, or choose among any number of alternatives that are identical in present value terms. For example, instead of issuing the residual interest with zero principal and interest entitlement, the sponsor could issue the residual interest with a principal balance of \$23.01 and an interest rate of 6% (the discount rate assumed in the above example). The REMIC would be structured to pay down the principal balance within some brief period of time—for example, six months. The sponsor would not make an up-front payment to the holder and the holder would pay \$0 for the residual interest, thus taking a basis of \$0 in the residual interest. The net result is that when distributions of \$23.01 (with interest) are made, they will be fully includible in income unless, of course, the payment is characterized as an upfront payment and a special amortization or basis adjustment rule is appropriate.¹⁵⁵

A special rule that requires amortization or basis adjustments will thus create competing regimes for taxing residual interests based on the formal distinction between how compensating payments to the holder are made. Such a rule would effectively grant taxpayers the option to select the most appropriate tax regime and structure the residual interest accordingly. That situation obviously would be unacceptable to the Service and suggests that perhaps the best course of action may be simply to retain the default rule of having up-front payments taxable immediately in full.

Of course, an alternative possibility is to attempt to craft a substantive definition of an up-front payment that is not bound purely by the form and thus easily manipulable. Yet, it is not clear what the substance of an up-front payment is and how it could be defined with precision. Distinguishing between “distributions” and “up-front payments” would involve a subtle and complex line drawing exercise, one that would surely produce arbitrary results. However, to pursue the analysis further, perhaps one could craft a set of rules similar to the disguised sale rules for partnerships¹⁵⁶ and provide that if, under a given prepayment assumption, a residual interest holder will receive substantially all (defined perhaps as a specified percentage) of the cash it is entitled to receive within some initial period after the issue date

155. Distributions in excess of basis (here, \$0) are includible in income as gain from the sale of the residual interest. However, depending on when the distributions are made, basis likely will be above \$0 on account of REMIC taxable income that will have accrued. Also, the interrelationship of basis adjustments and distributions would affect the answer. See discussion *supra* Part IV.B.3.

156. IRC § 707(a)(2)(B).

(e.g., by the end of the taxable year), then the anticipated distributions will be treated not as distributions, but as up-front payments.¹⁵⁷

2. *Up-Front Payments and Basis.*—Resolving the proper treatment of an up-front payment will also affect the calculation of a holder's basis in a residual interest. As noted above, under general tax principles the basis of a holder (other than the REMIC sponsor) in a residual interest should equal "cost," although applying that concept to negative value property, such as an up-front payment residual interest, can be confusing.

a. *What is Cost?*—At first blush, one may conclude that the transferee of a residual interest accompanied by an up-front payment has no positive cost investment in the asset; rather, the transferee has a negative investment equal to the up-front payment it receives. Yet, the reason the property has negative value must be on account of a liability or other encumbrance on the property that the transferee assumes. Indeed, at previous points in the discussion it has been suggested that the acquisition of a residual interest can be analogized to the acquisition of property subject to a liability.¹⁵⁸ Under traditional tax principles, subject to a number of special rules and exceptions, a transferee's basis in property should reflect assumed liabilities.¹⁵⁹ Accordingly, viewed in the abstract, one might take the position that the transferee of a residual interest should compute its basis by adding in the liabilities it has assumed and then reducing that figure by the amount of the up-front payment à la *Oxford Paper* and Rev. Rul. 55-675.¹⁶⁰

The latter approach may have some appeal at a theoretical level, but it has a conceptual drawback. From a tax perspective, the holder has not truly purchased property subject to a liability; the holder has purchased property that is expected to generate income. It is true that the income may be largely, if not entirely, phantom income and the residual interest will therefore represent a net liability on account of taxes. Yet, that should be irrelevant from the perspective of the tax laws—income is income. In other words, the

157. In order to prevent easy avoidance of such a rule, anticipated credit losses would have to be taken into account—a point that is discussed in greater detail below in connection with significant value residuals issued to thrift institutions. See *infra* Part V.B.3. Taking credit losses into account not only would compound the complexity of the rule, but also would compound the arbitrariness of the results.

158. See *supra* note 135.

159. See, e.g., *U.S. v. Hendler*, 303 U.S. 564 (1938); *Crane v. Commissioner*, 331 U.S. 1 (1947); *Consolidated Coke Co. v. Commissioner*, 70 F.2d 446 (3d Cir. 1934).

160. The effect would be to produce a basis of zero in the hands of the transferee, since the up-front payment would probably be taken as the best evidence of the value of the net liability assumed by the transferee. Application of a basis adjustment approach is discussed further *infra* Part IV.C.2.c.

residual interest is not directly saddled with any liabilities per se; liability for taxes on future income generated by property is in reality a personal liability of the transferee, not a liability burdening the property.¹⁶¹ Accordingly, cost should not include such future tax burdens.¹⁶²

Therefore, although the net economic effect of acquiring a residual interest may be that of assuming a liability, it is questionable whether existing tax authorities could accommodate treating such liability as a part of cost, especially since the liability does not directly burden the property per se. Accordingly, it would seem that under normal tax principles, the basis of a transferee in a residual interest accompanied by an up-front payment should not reflect the economic liability being assumed. But how then should the transferee's basis be computed?

b. *A Negative Basis Approach.*—If an up-front payment received by the transferee is not includible in full in the gross income of the transferee upon receipt, clearly the transferee has made a negative investment in the property and correspondingly should take a negative basis. It would be a strange result indeed to give a holder a basis of zero in a residual interest, but defer recognition of the up-front payment. That amounts to giving the holder a free step-up in basis without the associated gain recognition. Ultimately, of course, the gain will be recognized, but prematurely granting

161. The issue of liability for future taxes as a cost includible in basis was considered in *Joell Co. v. Commissioner*, 41 B.T.A. 825, 827 (1940), acq. 1942-1 C.B. 1. In *Joell*, the court held that the amount of such liability, although expressly assumed by the purchaser of a building, was not a "cost" includible in the purchaser's basis. Rather, only the amount of taxes that had accrued prior to the purchase could be capitalized in basis. The court, however, reasoned in part that the seller could not have reasonably factored such taxes into the sales price—a rationale which would not apply in the case of a seller of a residual interest.

162. Even if one were to adopt a view that the purchase of a residual interest accompanied by an up-front payment should be treated for tax purposes as, in some sense, the acquisition of property burdened by a liability, it is unclear whether under the existing authorities the liability at issue could be taken into account for basis purposes. It can be argued that the liability at issue is a contingent one, and that the buyer should capitalize such a liability only as and when it becomes fixed. See, e.g., Temp. Regs. § 1.338(b)-3(c)(1); *David R. Webb Co. v. Commissioner*, 77 T.C. 1134, 1137 (1981); Rev. Rul. 55-675, 1955-2 C.B. 567; *Keyes*, supra note 135, at § 21.04[2][b][i]. This latter point, however, is not entirely persuasive, since the existence of the up-front payment in some sense demonstrates that the amount of the net liability being assumed is capable of present valuation and therefore should not be viewed as an excluded contingent liability. This is further bolstered by the existence of the excise tax imposed on a transferor for a transfer of a residual interest to a disqualified organization. That tax is imposed on future excess inclusion amounts and thus evidences a conclusion that such liabilities can be presently valued for tax purposes. IRC § 860E(e)(2); Regs. § 1.860E-2(b)(3), (4); see also the discussion infra Part VII.E.2. Recent caselaw has also evidenced a broadened view of when contingent liabilities may be includible in basis. See *Transamerica Corp. v. U.S.*, 999 F.2d 1362 (9th cir. 1993).

basis affects the economics of the residual interest, since this "extra" basis will affect the amount of REMIC losses that the holder may take into account (as well as the amount of gain, if any, the holder would recognize upon distributions from the REMIC), not to mention the gain or loss the holder would recognize if it sells the residual interest.¹⁶³

Implementing a negative basis approach, however, is complicated by the fact that the Code and the Service have an aversion to the notion of negative basis. Section 860C(d)(2) provides that a holder's basis in a residual interest may not be decreased below zero, suggesting that a holder cannot take a cost basis in a residual interest that is less than zero. And this is in fact the view of the Service, as expressed in the preamble to the 1991 proposed REMIC regulations, in which the Service states that existing tax rules do not accommodate residual interests with a negative basis and a negative issue price.¹⁶⁴ Yet, while it is true that the Code does prohibit negative basis in many contexts,¹⁶⁵ negative basis exists in other contexts, such as in the case of stock of consolidated group members (i.e., excess loss accounts).¹⁶⁶ Thus, the question is really *which* "existing tax concepts" are most appropriate in the REMIC context.

The need to confront the negative basis issue is avoided, of course, if an up-front payment is treated as includible in gross in full upon receipt. In this case, the basis of the residual interest should appropriately equal zero. For example, if X acquires a noneconomic residual interest and receives an up-front payment of \$1,000, which it recognized immediately, basic tax concepts would hold that X computes its basis as the amount paid (-\$1,000)

163. This point is recognized by the New York Bar Association Tax Section, *supra* note 136, at 12-14. The Bar suggests that in the name of rough justice perhaps the Service may want to ignore the issue. But why not just get the answer right. It is not that difficult an issue and the necessary rules for implementing a negative basis system would not have to be that complex.

164. See 56 Fed. Reg. 49,531 (Sept. 30, 1991). This statement is lacking in the preamble to the final regulations, but so are many other items. Thus, it should not be taken to mean that the Service necessarily has abandoned its position.

165. The paradigm example of the prohibition on negative basis is section 357(c), which denies a transferor a negative basis in stock received in exchange for property transferred to a controlled corporation if liabilities are assumed in excess of the transferor's adjusted basis in the property. Instead, the transferor recognizes gain to the extent of the excess liabilities and takes a basis of zero in the stock received. This result has been questioned. See George Cooper, *Negative Basis*, 75 Harv. L. Rev. 1352 (1962); see also Lee A. Sheppard, *Reading Section 357(c) Out of the Code*, 47 Tax Notes 1556 (Jun. 25, 1990). Other, analogous restrictions on negative basis apply with respect to partnerships and Subchapter S corporations. See §§ 705(a)(2), 1367(a)(2).

166. See, e.g., 57 Fed. Reg. 53,643 (Nov. 12, 1992) (preamble to Prop. Regs. § 1.1502-19) ("In general, an ELA is treated as negative basis for computational purposes . . .").

plus the amount of gain recognized (+\$1,000), or in other words \$0.¹⁶⁷ Since losses are not allowed to the extent that they exceed the adjusted basis of a residual interest and gain is recognized to the extent of any distributions in excess of adjusted basis, there should never be an occasion for the basis of a residual interest to dip below zero. Thus, if the up-front payment is recognized immediately, the computation of basis is straightforward and there should be no occasion to deal with the negative basis conundrum.

In sum, the Service's reluctance to accommodate a negative basis system for negative value residual interests is curious, but the issue should be academic if up-front payments remain immediately taxable in full when received. If, however, the Service should require amortization of such payments, or conclude that such amounts are not income, a negative basis system may be necessary to avoid distortions.

c. An Alternative Basis Approach.—If it is concluded that the up-front payment should not be taxable in full upon receipt and a full-blown negative basis system is not desirable, an alternative approach would be to apply the amount of the up-front payment as an adjustment to the future costs that the holder is expected to incur as a result of holding the residual interest. The total future costs that the holder will incur, economically, is the excess of value of the tax burden on account of phantom income over any cash or tax benefits the holder will enjoy. This excess amount represents the holder's cost or net investment in the residual interest. It would seem theoretically justifiable to spread the up-front payment among or across the expected excess inclusions of the REMIC (which is what generates the tax burden) and use the portion of the payment so allocated to reduce the increase in basis that would otherwise result from such excess inclusions. Of course, upon a sale or other disposition of the residual interest (or upon a distribution of cash from the REMIC), any remaining portion of the up-front payment that has not been taken into account would trigger gain or loss (much in the same way an excess loss account gives rise to income upon a trigger event).

This approach is not necessarily more administrable than a negative basis approach, but it may avoid any theological misgivings that the Service and the Code have with that concept.

3. Up-Front Payments and the Sponsor/Transferor.—If a holder of a REMIC residual interest makes an up-front payment to a transferee, one remaining issue concerns the treatment of the up-front payment by the transferor, which typically will be the REMIC sponsor. We have seen that the contribution of mortgages to a REMIC and the receipt of regular and residual

167. See, e.g., Regs. § 1.358-3(b), example (2).

interests in exchange therefor is not a taxable event. Rather, the sponsor carries over its basis in the mortgages (and in any other assets contributed to the REMIC) and allocates it among the REMIC interests based on fair market value, realizing any built-in gain or loss generally upon disposition of the REMIC interests.¹⁶⁸ The amount of built-in gain or loss is directly affected by the way one chooses to treat up-front payments. Once again, it is interesting to contrast the treatment of the sponsor under the Service's approach of not permitting the residual interest to have a negative fair market value with an approach that would permit it.

Assume a sponsor holds mortgages in which it has an aggregate bases of \$90, which it then contributes to a REMIC and receives back two classes of regular interests, class A and class B, and single residual interest class, class R. Assume that class A and class B each has a fair market value of \$50 and that the sponsor would have to make an up-front payment of \$2 to a transferee to induce it to accept ownership of class R. All would agree that at the bottom line the sponsor has parlayed its mortgages into a net gain of \$8—the net amount received of \$98 ($\$50 + \$50 - \2) less basis of \$90. But what is the basis of the regular interests in the hands of the sponsor? Since we are directed to ignore negative basis or negative fair market value concepts, the basis computations result in underallocating basis to the regular interests (and overstating the built-in gain therein). In particular, the residual interest is assigned a fair market value and basis of zero, and each regular interest takes a basis of \$45, calculated by multiplying the aggregate bases of REMIC property (\$90) by the "basis" fraction ($\$50/\100) for each regular interest. The sponsor then realizes \$5 of gain on the sale of each regular interest, for a total gain of \$10.

The total gain of \$10 is manifestly inappropriate, since all would agree that the sponsor has realized true economic gain of only \$8. However, if the sponsor is permitted an immediate deduction of \$2 for the up-front payment, then in the end the right result prevails and the sponsor will realize a net gain of only \$8. However, it is important in this respect that the \$2 deduction be of the same character as the gain on the sale of the regular interests.

The foregoing basis calculus should be contrasted with what would be the case if the Service were to permit negative basis. In that event, the numbers in the above example would change, but the ultimate result would remain the same. First, the basis of each regular interest would be determined once again by multiplying the aggregate bases of the property (\$90) by the

168. The sponsor will recognize built-in gains on retained REMIC interests ratably over the interests' estimated lives. IRC § 860F(b)(1)(C). See discussion *infra* Part IV.D.

basis fraction ($\$50/\98),¹⁶⁹ with each regular interest receiving a basis of \$45.92 and the residual interest assigned a negative basis of $-\$1.84$ ($\$90 \times -\$2/\$98$). If the sponsor promptly sold all of the REMIC interests, it would have total gain on the sale of the regular interests of \$8.16 ($\$50 - \45.92×2) and a loss on the sale of the residual interest of $-\$1.16$ ($-\$2 + \1.84), or in other words a net gain of \$8.00—which is the right result.

This equivalence of results, however, depends on the up-front payment of \$2 by the sponsor being deductible in full when paid as a capital loss (assuming gain on the sale of the regular interests is capital). The character issue is explored further below in Part IV.E.2.a. Deductibility in general should not be controversial, even if the Service should ultimately conclude that the transferee must amortize the up-front payment. This is, for example, clearly the rule with respect to up-front payments by a transferor of an out-of-the-money swap: the transferee amortizes the payment, but the transferor immediately recognizes the loss.¹⁷⁰ Moreover, with certain limited exceptions such as section 267, the Internal Revenue Code does not generally seek to establish symmetrical treatment between the two sides of a transaction.¹⁷¹

D. Treatment of the Sponsor on Retained Interests

As noted above, a REMIC sponsor recognizes no gain or loss upon the transfer of property to a REMIC, but takes an aggregate bases in the residual and regular interests received in exchange for the transferred property that is equal to the basis of the transferred property. The aggregate bases of the residual and regular interests is then allocated among the separate interests in proportion to their respective fair market values.¹⁷² The sponsor thus will recognize any gain or loss on the residual and regular interests when it sells them. However, in the event the sponsor retains REMIC interests, the statute denies the sponsor indefinite deferral of built-in gain or loss recognition. Rather, the sponsor is required to accrue such gain or loss over time.¹⁷³

169. The \$98 figure equals the fair market value of the regular interests (\$100) plus the fair market value of the residual interest ($-\$2$).

170. See Regs. § 1.446-3(h)(2), (5) ex. 2(b).

171. See generally Reed H. Shuldiner, Consistency and the Taxation of Financial Products, 70 Taxes 781, 786-87 (1992) (discussing role of symmetry in the Code).

172. IRC § 860F(b)(1)(B); Regs. § 1.860F-2(b)(3).

173. IRC § 860F(b)(1)(C), (D). It is not entirely clear what “retained” means. The term should be interpreted with an eye to Regs. § 1.860G-1(d)(1), which defines issue price for retained and publicly offered regular interests. Thus, if a regular interest is part of an issue that is publicly offered, it should not be viewed as retained, unless perhaps the sponsor is unsuccessful in selling the interests within some reasonable period of time. The author is aware of some sectors of the industry that take the view that any regular interests that remain unsold on the startup day are to be viewed as retained. Such a view is motivated less by a reasoned

Under the statute, a regular or residual interest has built-in gain or loss equal to the difference between the sponsor's basis in the interest and its issue price.¹⁷⁴ In the case of residual interests, the sponsor must accrue built-in gain or loss ratably over the anticipated weighted average life of the REMIC.¹⁷⁵ The regulations provide that built-in gain recognized by the sponsor increases its basis in the residual interest, whereas recognized built-in loss decreases it.¹⁷⁶ However, in the case of losses, it is unlikely that the Service intended that a sponsor's basis in a residual interest be reduced below zero, although technically the regulations can produce that result.¹⁷⁷

An unfortunate distortion produced by these rules arises in the case of negative value residual interests, where the sponsor retains both the residual and regular interests (an uncommon, but not unprecedented situation). Because the Service objects to a negative issue price, a negative value residual interest will not have a built-in loss to offset built-in gain on regular interests. For example, if a sponsor contributes property with a basis of \$90 to a REMIC and takes back two regular interests each with a fair market value of \$50 and a residual interest with a negative value of -\$2, it is clear that the sponsor has net built-in gain of \$8. Yet, the sponsor will be forced to accrue built-in gain of \$10 ($\$50 \times 2 - \90) and will have no offsetting accrual of built-in loss on the residual interest. The result is plainly anomalous, but likely to arise only on rare occasions.

One issue raised by the built-in gain and loss rules relates to the character of the income or loss. Since the statute does not expressly provide for capital treatment, such gains and losses are ordinary in character (there clearly is no sale or exchange of property), which is a mildly curious result since the actual realization of built-in gain or loss by way of a sale of residual or regular interest may well be capital (if the interests are not held

interpretation of the REMIC rules than by administrative expediency. For example, under the REMIC rules all REMIC formations are treated as if the regular interests were issued to the sponsor on the startup day and then sold, which would mean that all regular interests are always retained under the foregoing interpretation. Regs. § 1.860F-2(a).

174. In this context, issue price means the fair market value of an interest. See Regs. § 1.860G-1(d)(1).

175. See Regs. § 1.860F-2(b)(4)(iii), (iv). The use of weighted average life is a slight gloss on the statute (but an entirely reasonable one), which provides that built-in gain or loss is accrued over "the anticipated period during which the REMIC will be in existence." IRC § 860F(b)(1)(C)(ii). The weighted average life of a REMIC is defined for this purpose in Regs. § 1.860E-1(a)(3)(iv). See Regs. § 1.860F-4(b)(4)(iii).

176. Regs. § 1.860F-2(b)(5).

177. Section 860C(d)(2), of course, provides that basis in a residual interest may not be reduced below zero, but by its terms that section only precludes negative basis as a result of distributions to the holder or allocations of REMIC losses under § 860C(a). The recognition of built-in losses falls under neither of the foregoing categories and thus literally the statute does not preclude a negative basis in this context.

by the sponsor in its capacity as a dealer). Finally, it is worth noting that nothing in the statute or regulations limits the recognition of built-in gains or losses; thus, a sponsor is free to offset built-in gains, even on residual interests, with net operating losses or other deductions and is free to use built-in losses to offset other income. This is something of an oddity in the statutory scheme, since the accrual of built-in losses can effectively offset excess inclusions to a certain extent. Yet, it is clear that the statute and regulations impose no restrictions on the use of accrued built-in losses.

Unrestricted use of built-in losses can give rise to some planning opportunities in certain circumstances. For example, assume a taxpayer holds a pool of mortgages in which it has a basis of \$100 and the fair market value of such pool is \$90. The taxpayer contributes mortgages to a REMIC in exchange for a residual interest entitled to 99% of the cash flows on the mortgages (a super economic residual interest) and a regular interest entitled to 1%. Thus the taxpayer has a built-in loss of \$10 in the residual and regular interests. What if the REMIC by its terms is scheduled to liquidate in one year (or perhaps less) and the taxpayer retains the residual and regular interests?¹⁷⁸ Apparently, the taxpayer accrues a built-in loss of \$9.90¹⁷⁹ and then upon liquidation of the REMIC the taxpayer reclaims its mortgages. When all the dust has settled, the taxpayer has largely realized the built-in loss on its mortgages without having actually disposed of them.¹⁸⁰ Although literally nothing in the REMIC rules appears to prevent this result, one must be wary that in egregious cases the Service could utilize substance over form or “sham” transaction precedents to attempt to disallow the loss.

E. *Transfers and Terminations of Residual Interests*

An issue that remains to be considered concerning the taxation of the residual interest holder is the treatment of gain or loss realized by the holder upon the transfer of a residual interest or the termination of the REMIC. Depending on the cash flow entitlements of the residual interest, either the transferor or the transferee may realize income. In general, if the transfer or termination event is not considered a sale or exchange of property, then any gain or loss recognized by a party in connection with the transfer or termination will be ordinary in character. Alternatively, if a sale or exchange is

178. If the taxpayer sells the residual and regular interests, then the taxpayer obviously is entitled to a loss deduction to that extent, but it cannot reclaim mortgages allocable to such regular interests upon liquidation.

179. Since the REMIC is scheduled to liquidate by its terms in one year, the built-in loss attributable to the residual interest (99% of \$10) is accrued based on that one year period.

180. In effect, the taxpayer has engaged in a type of wash sale transaction, but one that should be beyond the grasp of § 1091.

considered to occur, then any gain or loss may or may not be ordinary depending on whether any of the exceptions under section 1221 apply. Finally, if a sale or other disposition of a residual interest results in a loss, the wash sale rules may apply if substantially similar securities are acquired within six months before or after the date of disposition.

The discussion below first addresses the extent to which a residual interest is property. Assuming residual interests are property, the discussion then addresses the extent to which a transfer or termination event should be considered a sale or exchange. If a residual interest is not found to constitute property, or if no sale or exchange is found to occur, then any gains or losses will be ordinary in character. The third issue is relates the application of the wash sale rules.

1. *Status as Property.*—At first blush, it would seem beyond question that a residual interest is “property” for tax purposes. For example, the statute plainly states that a holder has a basis in a residual interest and that distributions in excess of such basis are treated as gain on the sale or exchange of the residual interest.¹⁸¹ In fact, the very use of the term “interest” indicates that a residual interest is some type of property or asset. And in the case of residual interests that entitle the holder to a significant share of the cash flow from the REMIC’s assets, the status of such interests as property is not an issue. However, the answer is not as obvious in the case of residual interests that provide the holder with little or no cash flow entitlements, and under which the liabilities for future taxes may outweigh any future tax benefits. In such cases, the residual interest by its terms may lack positive economic value and, it could be argued, may represent a net liability of the holder. Traditional notions of property may not readily accommodate pure liabilities.

Yet, the residual interest is not a pure liability. Although the future tax liabilities burdening a residual interest at a given time may exceed the future benefits, the residual interest nevertheless has some elements of positive value—if nothing else, the value of future tax losses. As discussed in the next paragraph, it seems clear that an asset does not lose its status as property by virtue of being encumbered by obligations that for certain periods exceed the value of its positive attributes. Of course, one might ask whether the right to future tax losses is a cognizable property interest, but in an economic sense one must answer most certainly yes, just as net operating losses economically represent assets of a taxpayer.¹⁸² And it appears that the

181. IRC § 860C(c), (d).

182. Cf. *In re Prudential Lines, Inc.*, 928 F.2d 565 (2d Cir.), (holding that NOL carryforward was property of the debtor’s estate under § 541 of the Bankruptcy Code) cert. denied, 112 S.Ct. 82 (1991); *In re Russell*, 927 F.2d 413 (8th Cir. 1991) (irrevocable election

Service agrees. In the recently issued regulations under section 475, which are discussed in greater detail below,¹⁸³ the Service defines a positive value residual interest by reference to the present value of future distributions *and* future tax savings, thus acknowledging that expected tax savings are an economic attribute of the residual interest that should be taken into account in valuing it for tax purposes.¹⁸⁴

Even if it be accepted that an interest in future tax benefits is a type of property interest, nevertheless where a residual interest entitles the holder to minimal interest in the REMIC's cash flow and the value of future tax liabilities exceeds the value of future tax benefits, the residual interest will represent a net liability (although this will turn around in later periods as the REMIC begins to generate losses). Is the concept of property flexible enough to encompass an instrument that may have positive or negative value during a given period?

It should first be noted that the question is not novel to residual interests, but has arisen with respect to other financial instruments, such as notional principal contracts.¹⁸⁵ However, it appears that the weight of authority today is to treat derivative financial instruments as property, notwithstanding the fact that they may become liabilities during some period

to forego carryback of NOLs may constitute an avoidable transfer of property under the Bankruptcy Code). See generally Gordon D. Henderson & Stuart J. Goldring, *Failing and Failed Businesses II*, ¶ 1002.04 (1993) (discussing the treatment of NOLs as property under bankruptcy laws). It is true that NOLs are different from future tax losses on residual interests in that the latter have not actually occurred, are not fixed in amount, and are subject to contingencies affecting timing and amount. But these same points can also be made regarding the future tax liabilities of the REMIC. In short, one must either ignore both future tax benefits and burdens or take both into account. If both are ignored, then the residual interest will never have negative value; it will always have some positive administrative rights (e.g., right to vote, right to liquidate the REMIC at some point) and those rights standing alone should justify property treatment.

183. See *infra* Part VI.B.1.c.

184. Temp. Regs. § 1.475(c)-2(b).

185. See, e.g., the preamble to the proposed regulations under § 1092, which were finalized in T.D. 8491, 1993-2 C.B. 215: "There has been some question whether a financial product such as an interest rate swap, which may be either an asset or a liability depending upon the movement of interest rates, constitutes an interest in personal property that is subject to section 1092 and section 1234A." 56 Fed. Reg. 31,350 (1991). As finalized, the regulations under § 1092 provide that a notional principal contract is personal property for purposes of that section. Regs. § 1.1092(d)-1(c). See also Edward D. Kleinbard & Suzanne F. Greenberg, *Business Hedges After Arkansas Best*, 43 Tax L. Rev. 393, 438 n.139 (1988) ("An intriguing alternative analysis would be to view a swap position as a hybrid instrument that takes on the characteristics of a property interest when it has positive value and the characteristics of a liability when its value turns negative.") The Service, however, does not seem inclined to take Kleinbard's "intriguing" gambit.

of their life.¹⁸⁶ By the same reasoning, residual interests should be viewed as property as well, regardless of whether they may represent a net liability to the holder at a given period of time.

2. *Presence of a Sale or Exchange.*—Any gain or loss on an outright sale of a residual interest for cash or an exchange of it for property would clearly be gain or loss on the sale or exchange of property. But for the possible application of the wash sale rules, such gain or loss would be recognized and would be capital or ordinary based on whether any of the exceptions under section 1221 apply. The existence of a sale or exchange, however, is less clear in two situations: (i) the transferor makes an up-front payment to the transferee to accept ownership of a residual interest, and (ii) the REMIC terminates at a time when a residual interest holder has a remaining basis in its residual interest. Do the up-front payment and the loss on termination constitute amounts realized upon a sale or exchange?

a. *Up-Front Payments as Gain/Loss on a Sale or Exchange.*—The treatment by the transferor of the up-front payment is wrapped up in the fog of uncertainty that hangs heavily over the treatment of up-front payments generally. It is true that a bona fide transfer of the ownership of property occurs, and it would be an entirely sensible result that any gain or loss recognized in connection with such transfer should be treated as derived from a sale or exchange. Yet, absent a specific rule to such effect, a transfer involving an up-front payment by the transferor is not easily squared with normal concepts of a sale or exchange. The transferor is paying someone to take a piece of property that has no value or negative value. A similar issue arose with respect to assignment payments with respect to notional principal contracts, and the character question long remained unresolved in that context as well.¹⁸⁷ With respect to notional principal contracts, it has been argued that an assignment payment is not a loss from the sale or

186. See IRC § 475(c)(2) (treating all manner of derivatives as securities that may be marked to market); Temp. Regs. 1.954-2(a)(4)(iii), (iv) (providing that all manner of derivatives may be dealer property for purposes of computing foreign-based company income); Regs. § 1.1092(d)-1(c); Priv. Let. Rul. 8714023 (Dec. 31, 1986) (short sale contracts treated as assets for purpose of allocating basis thereto pursuant to a § 754 election); see also Edward O. Kleinbard, *Equity Derivative Products: Financial Innovation's Newest Challenge to the Tax System*, 69 *Tex. L. Rev.* 1319, 1338 n.61 (1991) (reviewing case law on treatment of derivative instruments as property).

187. The recently finalized notional principal contract regulations define termination payment as including a payment made to assign a contract, indicating that the payment is capital in character by virtue of § 1234A. Regs. § 1.446-3(h)(1). That would appear to reflect a conclusion by the Service that, but for the application of § 1234A, such payments cannot otherwise be viewed as capital.

exchange of property (and thus a capital loss for nondealers), but rather it is an ordinary loss, based on the authorities treating payments to be relieved of a burdensome contract as ordinary in character.¹⁸⁸ Those authorities, however, may be distinguishable since in each instance the property at issue disappears, whereas in the case of a transfer of a residual interest (or an assignment of a notional principal contracts) ownership of the property is transferred to a third party. However, from the perspective of the transferor, regardless of whether the property continues in existence, the up-front payment has the same effect—to terminate the transferor's responsibilities thereunder.

Notwithstanding the foregoing, treatment of an up-front payment as a loss on the sale or exchange of property may be better justified by analogy to authorities on short sales. If a taxpayer enters into a short sale and the securities that are the subject of the sale subsequently rise in value, the taxpayer would suffer a loss in closing out the contract. However, prior to closing out the contract, the taxpayer could pay a third party to accept an assignment of the short sale contract. The assignment payment in this circumstance would resemble closely the up-front payment made on a transfer of a residual interest. In *Stavisky v. Commissioner*,¹⁸⁹ this precise issue arose, where the taxpayer entered into "when issued" buy contracts and "when issued" sell contracts for the stock to be issued in a corporate reorganization then under consideration. When the price of the when issued stock had risen significantly, the taxpayer faced a potential loss on its when issued sell contracts, and agreed to assign a portion of them to a third party. Taxpayer paid the third party \$31,150 as consideration for the third party assuming its obligations under a portion of the when issued sell contracts. The court held that the assignment payment was a capital loss realized on the sale or exchange of property (the when issued sell contracts), rejecting the taxpayer's argument that the payment was merely one made for his release from an obligation.

Petitioner was a party to a bilateral contract with mutual rights and obligations, not a mere obligor. Had the market price of Mo-Pac shares "when issued" declined instead of risen, his rights under his contract would have outweighed his liabilities . . . and he would have been the payee rather

188. See, e.g., New York State Bar Ass'n, Tax Section, Comm. on Financial Instruments, Report on Proposed Regulations on Methods of Accounting for Notional Principal Contracts (Jan. 6, 1992), reprinted in 24 *Highlights & Documents* 633, 656 n.84 (Jan. 16, 1992); Kleinbard & Greenberg, *supra* note 185, at 438 n.139; *Olympia Harbor Lumber Co. v. Commissioner*, 30 B.T.A. 114 (1934); Rev. Rul. 69-511, 1969-2 C.B. 24.

189. 34 T.C. 140 (1960), *aff'd*, 291 F.2d 48 (2d Cir. 1961).

than the payor as the result of the transaction of December 1951. . . . We think it clear that in such case he would have been in the position of having sold a portion of his rights under the contract . . . and are not prepared to hold that a given transaction is or is not an exchange from day to day depending on the vagaries of the securities market. . . . [T]he transaction of December 1951 was in form and substance a transfer to Sutro of petitioner's rights and liabilities under the contract, not a mere cancellation or release from liability.¹⁹⁰

The holding in *Stavisky* reiterates the earlier conclusion of the Service in I.T. 3721,¹⁹¹ which also held that an assignment payment made by a taxpayer to a third party in consideration for the latter assuming the former's liability under a when issued sell contract was a loss realized on the sale or exchange of property.¹⁹²

Whether the *Stavisky* analysis would be applied by the Service in the context of up-front payments on residual interests is unclear; to date *Stavisky* has not been applied outside of the when issued contracts context.¹⁹³ However, the case involves a situation that is closely analogous and may well represent the position the Service will ultimately assert.

As a policy matter, in the case of the REMIC sponsor the up-front payment should take the same character as gain or loss on the sale of the regular interests. Otherwise the minor differences in the structure of the residual interest can give rise to character shifts. For example, assume a sponsor (who is not a dealer) holds mortgages with a basis of \$90 and contributes them to a REMIC. The REMIC issues two regular interests and a residual interest. One option available to the sponsor is to provide enough cash flow to the residual interest so that it has a value of zero and therefore may be transferred with no (or a minimal) payment to the transferee. Assume that under this first option the regular interests have an issue price of \$49 each (for a total price of \$98), and the residual interest has an issue price of \$0. A second option equally available to the sponsor is to reallocate all of the cash flows that would go to the residual interest under option one to the

190. 34 T.C. at 142-43; see also G.C.M. 35475 (Sept. 11, 1973) ("The mere fact that the obligations outweighed the rights thereunder in terms of comparative values does not prevent the transaction from constituting a sale or exchange.") (citing *Stavisky*).

191. 1945 C.B. 164, supplemented by I.T. 3858, 1947-2 C.B. 71, modified by Rev. Rul. 57-29, 1957-1 C.B. 519.

192. See also G.C.M. 37332 (Nov. 25, 1977) (affirming the conclusion of I.T. 3721).

193. This point is made by the New York State Bar Association, *supra* note 188, 24 Highlights & Documents, at 656 n.84 (Jan. 16, 1992).

regular interests. Assume that under this option the regular interests now have an issue price of \$50 each (\$100 total) and the sponsor must make an up-front payment of \$2 to the transferee to accept ownership of the residual interest. Under option two, the sponsor would have a \$10 capital gain and, under the no-sale-or-exchange view, a \$2 ordinary loss, whereas under option one the sponsor simply has an \$8 capital gain (in effect the \$2 loss on the residual interest is a capital loss).

So much for the transferor. What is the treatment of the transferee upon receipt of the up-front payment? Whether, and if so when, the transferee should recognize income with respect to an up-front payment has already been discussed.¹⁹⁴ If it is concluded that the up-front payment is properly treated as an item of gross income, what is its character? If the transferor is viewed under the *Stavisky* line of analysis as realizing a capital loss, should the transferee have a capital gain? The answer should be yes; both parties to the transaction should be taxed consistently. To conclude otherwise would effectively grant taxpayers a degree of electivity. In the illustration in the preceding paragraph, for example, by structuring the \$2 as an up-front payment the transferee would have ordinary income, whereas if the \$2 is structured as an early distribution from the REMIC the transferee would have gain from the sale or exchange of the interest to the extent such gain exceeded basis.¹⁹⁵ This suggests that both parties to the up-front payment should be treated as deriving a gain or loss from a sale or exchange. One possible drawback to capital gain treatment, however, could be that such treatment would tend to cause up-front payment residual interests to be acquired by taxpayers with excess capital losses. In short, capital treatment could amount to a potentially significant leak in the capital loss limitation rules of sections 1211 and 1212.

In sum, probably the better view is to follow the *Stavisky* line of analysis and view the transferor as incurring a loss on the sale or exchange of property when it makes an up-front payment to a transferee. However, arguments that the payment should be ordinary based on authorities involving payments to get out of burdensome contracts are not without force. In the case of the transferee, the up-front payment should be viewed as capital, although that raises other conflicting tax policy concerns.

194. *Supra* Part IV.C.1.b.

195. The ability to cast the \$2 amount as a distribution from the REMIC in excess of basis would be affected by one's conclusion as to how distributions and basis adjustments were interrelated. If a distribution is tested against basis at the beginning of a calendar quarter, then structuring the \$2 payment as capital should be relatively easy. See discussion of the interrelationship of distributions and basis *supra* Part IV.B.3.

b. *Loss Upon REMIC Termination.*—A second situation in which the presence of a sale or exchange is uncertain arises in the event that a REMIC terminates (e.g., upon a liquidation or when the regular interests are entirely paid off) and a holder has a remaining basis in his residual interest. In general, it seems beyond question that the holder recognizes a loss under section 165(a).¹⁹⁶ However, it is unclear whether the loss would be a capital loss, since there may be no sale or exchange.¹⁹⁷ Unlike the case where an actual transfer occurs, this involves a situation in which the property disappears and, absent a special rule to the contrary, there is little basis for concluding that the loss arises from a sale or exchange. Unfortunately, if there is no sale or exchange, then an individual holder cannot claim an “above the line” deduction for such losses, unless the residual interest was held in connection with a trade or business.¹⁹⁸

3. *Wash Sale Rules.*—The wash sale rules in section 1091 provide that a loss otherwise allowable under section 165 on the “sale or other

196. The loss would be evidenced by a closed and completed transaction that is fixed by an identifiable event, as required in the regulations. Regs. § 1.165-1(b); cf. *Birkhead v. Commissioner*, 33 B.T.A. 466 (1935) (taxpayer suffered a loss upon dissolution of syndicate stock pool). The loss would not be deductible under § 165(g) as a loss upon the worthlessness of a security, since a REMIC residual interest does not fit within the definition of a security in § 165(g)(2) (applying only to securities of *corporate* issuers). As a result, the loss would not be subject to the rule in § 165(g)(1) treating a worthless stock loss as resulting from the sale or exchange of a capital asset.

197. If the termination of the residual interest is analogized to the discharge of a debt instrument or the termination of contract rights, no sale or exchange occurs for purposes of § 1221. See, e.g., *Fairbanks v. United States*, 306 U.S. 436 (1939) (holding that the redemption of a corporate bond is not a sale or exchange; superseded in part by § 1271(a)); *Riddell v. Scales*, 406 F.2d 210 (9th Cir. 1969) (same); Rev. Rul. 75-527, 1975-2 C.B. 30 (holding that the cancellation or release of a contract right does not result in a sale or exchange). See generally *Kleinbard & Greenberg*, *supra* note 185, at 393, 436-37 (discussing the so-called extinguishment doctrine). The termination should not be subject to § 1234A, since it is difficult to view a residual interest as a “right or obligation with respect to personal property.”

The REMIC termination alternatively may be analogized to a corporate liquidation, but the absence of any provision in the REMIC rules corresponding to § 331(a) (treating property received upon a corporate liquidation as full payment in exchange for stock) would suggest that no sale or exchange occurs. Further, if, as will often be likely, the residual holder receives no cash or property from the REMIC upon termination, then the corporate liquidation analogy would in fact support the conclusion that there is no sale or exchange. See, e.g., *Commissioner v. Johnson*, 131 F.2d 709 (6th Cir. 1942) (a pre-§ 165(g)(1) case holding that no sale or exchange occurs when shareholders received nothing). Rather, the stockholder has a loss deductible under § 165.

198. See IRC § 62(a)(3); Temp. Regs. § 1.62-1(c)(1), (4) (allowing an above-the-line deduction only for losses on *sales or exchanges* of property). Taxpayers, of course, can still claim an itemized deduction for such losses.

disposition” of a stock or security will not be deductible if the taxpayer acquires substantially similar stock or securities within a period beginning 30 days before and ending 30 days after the date of disposition. In applying section 1091 in the case of residual interests, section 860F(d) provides three special rules. First, a residual interest is treated as a security. Second, the prohibited period is extended to a period beginning six months before and ending six months after the date of disposition. Third, any residual interest in any REMIC and any interest in a “taxable mortgage pool”¹⁹⁹ is treated as a substantially similar stock or security, except as provided in regulations. To date, no regulations have been issued under section 860F(d).

In general, the application of the wash sale rules is relatively clearcut, but also harsh. Several points can be made. First, the wash sale rules are triggered by losses on sales or “other dispositions,” a term that should be viewed as broader than a sale or exchange and likely would include the termination of a REMIC residual interest.²⁰⁰ Second, the regulations under section 1091 clarify that a taxpayer is considered to “acquire” substantially similar stock or securities only where the stock or securities are acquired by purchase or by an exchange upon which the entire amount of gain or loss was recognized by law.²⁰¹ Thus, the receipt of a residual interest by a REMIC sponsor upon the formation of a REMIC would not be viewed as an “acquisition” triggering the wash sale rules.²⁰² Third and finally, the wash sales are inapplicable to taxpayers that are dealers if the loss is incurred in transaction undertaken in the ordinary course of such business.

V. EXCESS INCLUSIONS

Perhaps the most complicated aspect of the REMIC tax rules is the

199. A taxable mortgage pool is defined in § 7701(i)(2)(A) as any non-REMIC entity if (i) substantially all of the assets of which are debt obligations and more than 50% of such debt obligations are mortgages, (ii) such entity is the obligor under debt obligations with two or more maturities, and (iii) the payments on such debt obligations bear a relationship to payments on the underlying debt obligations held by such entity. The purpose of the taxable mortgage pool provisions is to force multiple class securitizations of mortgages to utilize the REMIC provisions. To this end, any entity that becomes a taxable mortgage pool is subject to adverse tax treatment.

200. Cf. Temp. Regs. § 1.1092(b)-5(a) (“The term ‘disposing,’ ‘disposes,’ or ‘disposed’ includes the sale, exchange, cancellation, lapse, expiration, or other termination of a right or obligation with respect to personal property.”).

201. Regs. § 1.1091-1(f).

202. The statute and regulations are explicit that the sponsor does not recognize gain or loss upon the exchange. IRC § 860F(b)(1)(A); Regs. § 1.860F-2(b)(2). It is true that the sponsor may have to accrue built-in gain or loss on a retained residual interest. IRC § 860F-2(b)(1)(C), (D). This does not change the fact that the sponsor does not recognize gain or loss on the exchange itself.

so-called "excess inclusion" rules. This is because some knowledge of basic financial analysis is essential to understanding the origin and purpose of the rules. Until now, we have been content to refer offhandedly to the matter as one involving "phantom income," a useful and evocative term, but one with little analytical content. It is time to look more carefully at the notion of phantom income and the response to the problem that the REMIC rules adopt.

A. "Phantom Income": A Closer Look

1. *In General.*—The essence of a securitization is the segregation of debt assets and the sale of interests in the future income stream from those assets to investors. As illustrated below, however, the tax treatment of a debt instrument as whole can differ in significant respects from the treatment of the separate pieces of which it is comprised. That difference in treatment can result in phantom income or phantom loss in a given period, which may be defined, in a mechanical sense, as simply the excess of the interest income accrued on the debt assets in a given period over the interest expense accrued on the investor's interests for that period. But a mismatch between income and deductions can arise for a number of mundane, and for our purposes irrelevant, reasons.²⁰³ The nub of the phantom income (or loss) issue in securitization is the mismatch that occurs as a result of the so-called "term structure" of interest rates.²⁰⁴

The term structure of interest rates, or more succinctly the yield curve, refers to the relationship between the yield on a series of different bonds that differ only with respect to the length of time until maturity. The market will likely require a different yield on a one-year zero coupon bond than on a ten-year zero coupon bond. Graphically, the array of different yields associated with different maturities may slope upward (long-term rates exceed short-term rates), downward (vice versa) or be largely flat. The relevance of the yield curve to a bond providing for cashflows prior to its

203. For example, if the REMIC has a qualified reserve fund, earnings thereon that are retained for future use will give rise to income for the residual interest without a corresponding deduction. Similarly, on rare occasions there may be a write-down of regular interests that occurs prior to the time that underlying mortgages are written down, which can give rise to cancellation of indebtedness income to the residual interest without an offsetting deduction.

204. A discussion of the term structure of interest rates can be found in most basic finance texts. See, e.g., Frank J. Fabozzi, *Bond Markets, Analysis and Strategies* 187-213 (2d ed. 1993). For a legal discussion of the phenomenon and the tax issues it raises, see Joseph Bankman & William A. Klein, *Accurate Taxation of Long-Term Debt: Taking into Account the Term Structure of Interest*, 44 *Tax L. Rev.* 335 (1989); Theodore S. Sims, *Long-Term Debt, the Term Structure of Interest and the Case for Accrual Taxation*, 47 *Tax. L. Rev.* 313 (1992).

maturity (e.g., a coupon paying bond) is that such a bond can be analyzed as an assemblage of zero coupon bonds. That is, another way to view a bond is as an aggregation of a series of promises to pay specified amounts at specified times. The weighted average of the yields for the several cashflows should equal the overall yield to maturity of the bond as a whole, yet the timing of interest accruals for tax purposes can differ significantly.

In general, interest on a bond accrues for tax purposes based on the single, overall yield to maturity for the bond; the tax laws do not require the bond to be broken up into its component cashflows. Yet, if the holder chooses to sell the separate cashflows due under the bond to different investors, the tax laws treat (and must treat) the separate cashflows as individual bonds. The most elementary example of breaking up a bond into its pieces is stripping off the coupons and selling them.²⁰⁵ Simple coupon stripping transactions, however, do not give rise strictly speaking to phantom income or loss, although they do generate a mismatch between the issuer's interest expense accruals and a holder's interest income accruals.²⁰⁶ True phantom income or loss arises when the division of bond cashflows is effected through an intermediary entity, which is what happens in a "pay through" form of securitization.

A simple illustration of phantom income or loss can be constructed by assuming a corporation holds a single debt asset. The asset is issued to the corporation on January 1, 1993 for a price of \$1,000 and under the terms of the bond the issuer promises to make the following series of payments:

| <u>Year (12/31)</u> | <u>Debt Asset</u> | |
|---------------------|-------------------|------------------|
| | <u>Interest</u> | <u>Principal</u> |
| 1993 | \$ 80 | |
| 1994 | 80 | |
| 1995 | 80 | |
| 1996 | 80 | |
| 1997 | 80 | \$1,000 |
| Total | \$400 | \$1,000 |

Given the issue price of \$1,000, the yield on this bond (assuming annual compounding) is 8% and the corporation would have interest income each year in the amount of \$80. Assume the corporation securitizes the debt asset

205. On coupon stripping, see generally Joseph P. McGrath, *Coupon Stripping Under Section 1286: Trees, Fruits, and Felines*, 38 *Tax Law.* 267 (1985). See also George C. Howell III & Cameron N. Cosby, *Exotic Coupon Stripping: A Voyage to the Frontier Between Debt and Option*, 12 *Va. Tax Rev.* 531 (1993).

206. See Bruce Kayle, *Where Has All the Income Gone? The Mysterious Relocation of Interest and Principal in Coupon Stripping and Related Transactions*, 7 *Va. Tax Rev.* 303 (1987).

by pledging it to secure a series of debt instruments issued to five investors (investors A through D). Each debt instrument entitles the holder to an amount equal to one of the cash flows due under the debt asset. For example, investor A would be entitled to receive \$80 at the end of 1993, investor B would be entitled to \$80 at the end of 1994, and so on. Assuming the yield curve listed below, each investor's debt instrument would have the following issue prices:

| Year (12/31) | Yield curve | Investors | | | | |
|-----------------|----------------|-----------|---------|---------|---------|-----------|
| | | A | B | C | D | E |
| 1993 | 5.50% | \$80.00 | | | | |
| 1994 | 6.03 | | 80.00 | | | |
| 1995 | 6.40 | | | 80.00 | | |
| 1996 | 7.45 | | | | 80.00 | |
| 1997 | 8.25 | | | | | 1080.00 |
| Issue Prices | | \$75.83 | \$71.16 | \$66.41 | \$60.12 | \$ 726.58 |

Based on the foregoing issue prices and yields, the holders will accrue interest income on the debt instruments in each period as set forth below:

| | Interest Accruals | | | | | Totals |
|-----------------|-------------------|--------|--------|--------|---------|----------|
| | A | B | C | D | E | |
| 1993 | \$4.17 | \$4.29 | \$4.25 | \$4.47 | \$59.94 | \$ 77.12 |
| 1994 | | 4.55 | 4.52 | 4.80 | 64.89 | 78.76 |
| 1995 | | | 4.81 | 5.16 | 70.24 | 80.21 |
| 1996 | | | | 5.55 | 76.04 | 81.59 |
| 1997 | | | | | 82.31 | 82.31 |
| Total interest: | | | | | | \$400.00 |

The total interest accruals for the holders, however, will not match the interest accruals for the corporation on the underlying debt asset, with the difference representing phantom income or loss:

| | Total Accruals (Investors) | Total Accruals (Corporation) | Phantom Income or (Loss) |
|--------|-------------------------------|---------------------------------|-----------------------------|
| 1993 | \$ 77.12 | \$ 80.00 | \$2.88 |
| 1994 | 78.76 | 80.00 | 1.24 |
| 1995 | 80.21 | 80.00 | (0.21) |
| 1996 | 81.59 | 80.00 | (1.59) |
| 1997 | 82.31 | 80.00 | (2.31) |
| Totals | \$400.00 | \$400.00 | \$0.00 |

Thus, in this example, the corporation will have phantom income in 1993 and 1994 of \$2.88 and \$1.24, meaning that the interest that the corpora-

tion accrues on the bond will exceed the interest expense it accrues on the investors' debt instruments by these amounts. Of course, the phenomenon turns around beginning in 1995 and the corporation begins to recognize phantom losses. In the aggregate, the phantom income and losses of the corporation sum to zero, showing that in the aggregate the total amount of interest accrued by the investors will equal the total interest accrued by the corporation on the underlying bond. The only difference is one of timing. In general, given an upward sloping yield curve, the holder-investors will accrue less interest income in the early periods and more in the later periods.

2. *Phantom Income and Losses in Securitizations.*—The preceding subsection described in general terms the phantom income and loss phenomenon. What remains to be considered before describing the REMIC excess inclusion rules is why special rules dealing with phantom income or loss were considered necessary in the case of REMICs. The starting point for the discussion is the distinction between coupon stripping transactions and pay-through securitizations. Both are conceptually alike—the substance of each is to carve up cash flows on debt assets and sell interests in them to investors. In a stripping transaction, however, investors directly acquire interests in the debt asset and the curious, Janus-faced situation arises of investors being taxed as if they held separate bonds and the issuer being taxed as if it had issued a single, unified debt instrument. Thus, the issuer deducts interest based on a single rate, but the holders report interest income based on their different respective yields.

A stripping transaction thus involves the same yield curve v. single rate distortion described above, but it does not give rise to phantom income and loss for tax purposes. On the contrary, phantom income or loss escapes from the tax system altogether. In the example described above, if it is assumed that the transaction involved a coupon strip instead of a pay-through securitization, the result is that instead of issuing debt backed by the cash flows on the bond, the corporation sells the actual cashflows and thus the corporation is no longer a “holder” of the rights to those cashflows. Since the corporation no longer holds the debt asset, there are no longer interest income accruals matching the issuer's interest deductions. Accordingly, for tax purposes, the issuer of the debt asset deducts interest at 8% per year (\$80), but the new holders report interest income, in aggregate, of less than \$80 per year in the first two years and more than \$80 per year in the remaining three years. Thus, the phantom income or loss drops out of the tax system entirely.

This feature of coupon stripping may help explain restrictions that currently exist on the ability of a holder to engage in coupon stripping transactions. In general, the tax laws permit a straightforward strip of a fixed portion of cashflows due on a bond, notwithstanding the resulting asymmetry of tax treatment between the debt issuer and the “stripees.” However, the tax

laws treat more complicated or sophisticated divisions of cash flows (“synthetic coupon stripping”) as necessarily giving rise to a separate taxable entity, thus requiring that phantom income and loss be picked up by some intermediary entity that resides between the issuer and the ultimate investors that have bought the cashflows.²⁰⁷

This goal of ensuring that phantom income and loss is swept into the tax system for more complex stripping transactions is defeated, however, if the income of the securitization entity is not subject to tax.²⁰⁸ This is where the excess inclusion rules enter in.

B. *The Excess Inclusion Rules*

Given the foregoing background, the thrust of the excess inclusion rules is manifest. These rules are designed to identify an amount of income of a REMIC that approximates, albeit in a rough and imperfect way, the phantom income of a REMIC (the “excess inclusion”) and ensure that such income is subject to tax. The rules ensure taxation of excess inclusion amounts by prohibiting transfers of residual interests to entities that are not subject to any U.S. taxation (this aspect is discussed below) and imposing a blanket rule that in the hands of taxable holders excess inclusion amounts are subject to tax in all events, i.e., such amounts cannot be offset by losses or deductions. Each aspect is discussed below.

1. *Measuring Excess Inclusions.*—An excess inclusion amount is measured as of a calendar quarter and is defined, with respect to each residual interest holder, as the excess of the holder’s share of the taxable income of the REMIC for that quarter over the sum of the “daily accruals” for such residual interest based on the number of days during that quarter that the interest was held by the holder.²⁰⁹ Daily accruals are calculated by multiplying the “adjusted issue price” of the residual interest at the beginning of a calendar quarter by 120% of the long term federal rate,²¹⁰ and allocating the

207. Synthetic coupon stripping cannot be done on a pass-through basis by use of a grantor trust because such transactions will give rise to an impermissible second class of ownership interests in the trust. In the case of mortgage loans, synthetic coupon stripping generally must be done in a REMIC or in a separate taxable entity; this is the effect of the taxable mortgage pool rules. For nonmortgage debt, synthetic coupon stripping, in a broad sense of the term, could be done on a pass-through basis with a partnership. However, this approach carries a certain amount of baggage with it. See generally Howell & Cosby, *supra* note 205, at 550-60 (discussing different structures to accomplish coupon stripping, broadly construed).

208. See Kayle, *supra* note 206, at 345, 349-50.

209. IRC § 860E(c)(1).

210. The long term federal rate means the federal long-term rate, determined on the basis of quarterly compounding, which would have applied to the residual interest under

result ratably among the days of the quarter. The adjusted issue price of a residual interest is its initial issue price (adjusted for any contributions after the start-up date), increased by the amount of daily accruals for prior quarters and decreased (but not below zero) by any distributions before the beginning of the quarter.²¹¹

The daily accrual mechanism is intended to impute to a residual interest a minimum return on a holder's investment (i.e., 120% of the long term federal rate) and treat the excess of REMIC taxable income over that minimum return as a proxy for phantom income. The proxy, however, is a rough one at best. For example, the calculation is a one way street; excess inclusions are taken into account, but there is no concept of an "excess" or phantom loss that is deductible in all events. In theory, the failure of a REMIC to realize taxable income at least equal to daily accruals would represent such phantom losses, but such is not permitted in practice.²¹²

A second criticism along these same lines relates to the fact that excess inclusion amounts are taxable in all events. Although this is intended to ensure that phantom income is subject to tax and not lost from the system through transfers to entities with tax losses, it is a problematic solution to that concern. This is because the phantom income/loss problem is one of timing; by definition the phantom income will be matched by offsetting losses. Since the issue is one of timing, recognition of income in all events should be matched with rules permitting recognition of some form of excess losses in all events as well—at least as a carryback or carryforward against prior or future excess inclusions.

The statute also grants to the Service regulatory authority to provide that all of a REMIC's taxable income allocable to a residual interest holder will be treated as excess inclusion amounts if the residual interest lacks significant value. The Service has not exercised this authority and it is

§ 1274(d) (without regard to § 1274(d)(2)) if it were a debt instrument. IRC § 860E(c)(2)(C). The legislative history provides that the applicable rate is determined at the time the residual interest is issued. H.R. Rep. No. 841, *supra* note 31, at II-235, reprinted in 1986 U.S.C.A.N. at 4323. In practice, the Service releases the applicable federal rates for a given month on or about the 20th day of the preceding month.

211. "Issue price" for this purpose is defined in Regs. § 1.860G-1(d)(1), which provides that, if the interest is publicly offered, the issue price equals the initial offering price to the public at which a substantial amount of the class is sold. If the interest is not publicly offered, the issue price is the first price paid by the first buyer, and if the interest is retained by the sponsor the issue price is the fair market value on the pricing date. *Id.* As we have seen, a negative issue price is not permitted. *Supra* text accompanying note 164-65.

212. The roughness is further evident from the fact that the residual interest in a lower-tier REMIC that is part of a double REMIC structure can experience excess inclusions, even though no tranching occurs. See Regs. § 1.1275-2(c)(4) ex. 2 (treating regular interests of such a lower-tier REMIC as a single debt instrument). In theory, that result is indefensible.

unlikely that it will, since the rule makes little sense. If a residual interest lacks significant value, the interest will likely have small or zero issue price and thus the amount of the daily accruals will be minimal. In sum, the computation formula described above already has the effect of treating an increasing portion of a residual holder's allocable share of REMIC taxable income as excess inclusion amounts.²¹³

2. *Taxability of Excess Inclusions.*—Having identified the amount of excess inclusions with respect to a residual interest, the true core of the excess inclusion rules is reached: “the taxable income of any holder of a residual interest in a REMIC for any taxable year shall in no event be less than the excess inclusion for such taxable year.”²¹⁴ In the case of an affiliated group of corporations that file a consolidated return, consolidated taxable income of the group may not be less than the sum of the excess inclusions of the members.²¹⁵ In the case of tax-exempt organizations, excess inclusion amounts are treated as unrelated business taxable income for purposes of section 511.²¹⁶ Requiring taxation in all events reflects a concern that absent such a rule residual interests would be issued in all cases to tax-exempt entities, with the net result being that phantom income again escapes the system.

The effect of the foregoing rule is that otherwise available deductions may not offset excess inclusion amounts. Moreover, as touched on above, excess inclusion amounts are computed on a quarterly basis and may not be offset by losses of the REMIC in other quarters, even if for the taxable year the residual holder recognizes a net loss from the REMIC.²¹⁷ Deductions that cannot be used because of the existence of excess inclusion amounts are treated as being in excess of gross income and give rise to a net operating loss under section 172.²¹⁸

The rule, however, simply requires *taxable income* to be no less than excess inclusion amounts; the rule does not limit a taxpayer's ability to zero out its *tax liability* through available tax credits. Thus, excess inclusion amounts cannot be offset by deductions, but the resulting tax liability can be offset by credits. The logic of the rule in distinguishing between credits and

213. See Peaslee & Nirenberg, *supra* note 8, at 184.

214. IRC § 860E(a)(1).

215. IRC § 860E(a)(3); Regs. § 1.860E-1(a)(2).

216. IRC § 860E(b).

217. For example, if a REMIC residual holder realized \$1,000 of taxable income from a REMIC in the first quarter, \$800 of which was an excess inclusion amount, and in the next three quarters realized net losses totalling \$1,000, the holder would have to report minimum taxable income of \$800, even though for the year the REMIC broke even.

218. See IRC § 860E(a)(5).

deductions is indeed elusive; the allowance of the use of credits may have been an oversight. In any event, there may not be many taxpayers with excess credits that desire or are able to invest in residual interests. Thus, the significance of the issue may be minimal.²¹⁹

Special excess inclusion rules for certain residual interest holders are discussed below.

3. *Special Rule for Thrifts*

a. *In General.*—An exception to the general rule that excess inclusion amounts may not be offset by deductions applies with respect to thrift institutions.²²⁰ Thus, a thrift institution holding a residual interest may use its losses to offset excess inclusion amounts.²²¹ The stated reason for the thrift exception is “the difficulties currently being experienced by such industry.”²²² And so, the thrift exception joins the long parade of special tax expenditures bestowed by Congress in the 1980s on the ailing thrift industry.

Logically, one would think that this advantageous rule would drive most residual interests into the hands of thrifts. However, two factors (among others) have conspired to render the special thrift exception of limited utility. First, thrift regulators have adopted rules that, as practical matter, make it very difficult for thrifts to hold residual interests.²²³ Second, prompted by

219. One case where the issue could take on some magnitude would be the case of residual interests in foreign REMICs. Depending on which basket foreign-source excess inclusion amounts would be placed in, they could generate income to soak up excess foreign tax credits. Although the passive income basket would seem the most likely candidate, technical deficiencies in the definition make it uncertain whether excess inclusion amounts would necessarily fit thereunder. However, since foreign REMICs are a relatively uncommon phenomenon, the issue may be left for another day.

220. IRC § 860E(a)(2). Specifically, the exception applies in the case of a corporation to which § 593 applies, which encompasses any domestic building and loan association (as defined in § 7701(a)(19)), any mutual savings bank, or any “cooperative bank,” provided in each case the 60% asset test of § 7701(a)(19)(C) is met. IRC § 860E(a)(4).

A § 593 corporation is lumped together with each qualified subsidiary and treated as a single § 593 corporation. *Id.* A qualified subsidiary is a corporation “(i) all the stock of which, and substantially all of the debt of which, is held directly by the corporation to which § 593 applies, and (ii) which is organized and operated exclusively in connection with the organization and operation of one or more REMIC’s.” IRC § 860E(a)(4)(B).

221. A thrift may not be able to entirely zero out its tax liability, since under the alternative minimum tax, among other adjustments, a corporation is entitled to offset only 90% of its alternative minimum taxable income with a deduction for net operating loss carryovers. IRC § 56(d)(1).

222. See 1986 Act Bluebook, *supra* note 29, at 422.

223. Under risk-based capital requirements, thrift institutions must maintain a minimum amount of capital against their assets, depending on the risk weight attributed to them. REMIC residuals are among the riskiest class of assets and receive a 100% risk

the legislative history the Service issued regulations restricting the application of the thrift exception to residual interests that have "significant value."²²⁴ The net result is that today only a small proportion of residual interests finds its way into the hands of thrifts. Nevertheless, some discussion of the contours of the thrift exception is appropriate.

b. *The Significant Value Requirement.*—Unless a residual interest has significant value, a thrift is not entitled to use deductions to offset excess inclusion amounts. The regulations define in some detail what significant value means, providing computation rules that allow a high level of certainty about whether a residual interest has significant value. In general, a residual interest possesses significant value if (i) the aggregate of the "issue prices" of the residual interests in the REMIC is at least 2% of the aggregate of the "issue prices" of all residual and regular interests in the REMIC (the "2% test"), and (ii) the anticipated weighted average life of the residual interests is at least 20% of the anticipated weighted average life of the REMIC (the "20% test").²²⁵

weighting. In short, many thrifts simply find investment in REMIC residual interests an unattractive use of scarce capital.

224. Section 860E(a)(2) provides regulatory authority for the significant value rule: "The Secretary may by regulations provide that the preceding sentence shall not apply where necessary or appropriate to prevent avoidance of tax imposed by this chapter." The legislative history indicates that in case of a residual lacking "significant value," the thrift exception should not apply. H.R. Rep. No. 841, *supra* note 31, at II-235, reprinted in 1986 U.S.C.C.A.N. at 4323; 1986 Act Bluebook, *supra* note 29, at 423 n.83. As to the meaning of significant value, the legislative history states that a residual should be considered to have significant value where its value equals at least 2% of the combined value of the REMIC's regular and residual interests. *Id.*

Before regulations were proposed, in order to meet the significant value requirement foreshadowed in the legislative history, some would structure REMIC residual interests to have the minimum 2% percent value, but only for a short period. Thus, for a time it was not uncommon to see residual interests that provided for a relatively large amount of distributions to be paid out within the first month or two of the REMIC. These were referred to in some quarters as short-term amortization residuals ("STARS") and amounted to no more than the residual holder momentarily passing a large amount of cash through the REMIC in order to convert the residual interest into a significant value residual. That the significant value requirement could be so facily skirted seemed too good to be true. STARS died when the proposed regulations were issued containing the 20% requirement discussed below.

It is interesting that legislative history specifically envisioned that the Service would apply the significant value requirement retroactively, yet the Service chose not to do so in the case of STARS. This helped set a trend for prospectivity in the regulations and served to reward some quite aggressive tax stratagems.

225. Regs. § 1.860E-1(a)(3)(iii). As originally proposed, the regulations required that the weighted average life of a significant value residual equal at least 20% of the "anticipated life" of the REMIC, which would generally be some 15 or 30 years (depending on the

The 2% test measures the relative value of the REMIC residual interest and is essentially mechanical in operation. The operative element is the issue price of the REMIC's residual and regular interests, which is defined in the regulations generally as, in the case of publicly offered interests, the initial offering price to the public at which a substantial amount of the class is sold.²²⁶ Unfortunately, this definition is imprecise in some respects and somewhat out of touch with the reality of the marketplace. In a public offering, the underwriter initially may not sell any, or may sell only minimal portions, of one or more classes of regular interests in a REMIC. Absent actual prices on substantial sales of these classes the status of the residual interest may not be determinable with precision at the time it is sold. At least for purposes of applying the significant value rule, the regulations should have adopted a safe harbor based on reasonable belief, under which parties could rely on an underwriter's reasonable estimate of the initial price at which a substantial amount of REMIC interests of a class will be sold in treating a residual interest as meeting the 2% test.

What the 2% test lacks in exactitude is made up for by the preciseness of the 20% test. In general, the first step in applying the 20% test is to determine the anticipated weighted average life of the residual interests and each class of regular interests. For regular interests that have specified principal amounts and do not provide for disproportionately high interest,²²⁷ the calculation is based on the dates on which it is anticipated that payments of specified principal amounts will be made.²²⁸ For residual interests and regular interests that do not have a specified principal amount (i.e., an IO) or that provide for disproportionately high interest, all anticipated payments are taken into account in the calculation, regardless of whether they are denominated as principal or interest.²²⁹

weighted average maturities of the underlying mortgages). 56 Fed. Reg. 49537 (1991) (proposed Sept. 30, 1991). That made little sense, and, as finalized, the regulations refer to the REMIC's weighted average life—a considerably shorter period of time.

226. Regs. § 1.860G-1(d)(1). Thus, in the case of regular interest classes, each class has a single issue price. However, by referring to the "aggregate of the issue prices of the residual interests," the regulations appear to contemplate adding all of the separate prices at which the residual interests have been sold, rather than simply using the first price at which a substantial portion was sold. Regs. § 1.860E-1(a)(3)(iii).

227. A regular interest is considered to provide for disproportionately high interest if its issue price exceeds 125% of the specified principal amount. Regs. § 1.860G-1(b)(5).

228. Regs. § 1.860E-1(a)(3)(iv)(B).

229. Regs. § 1.860E-1(a)(3)(iv)(C). As originally proposed, the regulations stated that the weighted average life of a residual that provided for a specified principal amount is always determined by taking into account only payments of such amounts. 56 Fed. Reg. 49537 (1991) (proposed Sept. 30, 1991). This provided for easy manipulation of the 20% test; one need simply structure a residual to pay a large proportion of specified principal late in the life of the REMIC to produce a high weighted average life. This curiosity was pointed out by

The key to determining weighted average lives, once the proper payments have been identified, is the meaning of the term "anticipated." Fortunately, the regulations are quite specific: anticipated payments are determined based on the prepayment and reinvestment assumption adopted under section 1272(a)(6), and any required or permitted clean up calls or any required qualified liquidation provided for in the REMIC's organizational documents.²³⁰ Absent from this formulation is any reference to anticipated delinquencies or nonpayments on the REMIC mortgages, which can give rise to interesting planning possibilities. For example, assume a REMIC holds residential mortgages. Statistically, it is certain that there will be defaults on some of the mortgages. Consequently certificate holders (regular and residual interest holders) may not receive the full value to which they are entitled, absent some form of credit support. If one structures a residual interest with a significant specified principal balance, payable at the end of the REMIC after all regular interests have been retired, the result would be to increase greatly the weighted average life of the residual interest, but at the economic cost of "wasting" cash flow on the residual interest class—typically not the most efficient use of such cash flow. However, if one specified that this principal balance was subordinate to all other interestholders and absorbed all losses of the REMIC first before any other credit support or subordination was utilized, then (depending on the size of the principal balance), the likelihood that the residual interestholder will ever actually receive its promised principal balance may well be zero. In essence, one has assigned to the residual interest a deeply subordinate (i.e., empty) right to cash, but this right nevertheless is taken into account testing for significant value since the likelihood of defaults plays no role in the test.²³¹

commentators and corrected in the final regulations.

230. Regs. § 1.860E-1(a)(3)(iv)(D).

231. The author is aware of the possible argument that the determination of anticipated payments is based on a prepayment assumption and that anticipated defaults could be construed as a type of prepayment that one must take into account as part of this assumption. Although the Service is, of course, free to adopt any definition of a prepayment assumption that it wants under § 1272(a)(6), until such time taxpayers are expressly permitted to adopt an accepted industry prepayment assumption. See H.R. Rep. No. 841, *supra* note 31, at II-239, reprinted in 1986 U.S.C.C.A.N. at 4327 ("The conferees intend that unless otherwise provided by regulations, the use of a prepayment assumption based on a recognized industry standard would be permitted."). In this regard, under no accepted industry prepayment assumption are defaults taken into account. On the broader point of whether the Service should adopt a definition of a prepayment assumption under § 1272(a)(6), it should be noted that doing so would have collateral consequences that far outstrip the discrete issue of how a significant value residual interest is defined. For example, REMIC regular interest holders (and holders of other prepayable instruments) would be able to accrue OID based on assumed defaults and delinquencies—a rather startling notion. Cf. Prop. Regs. § 1.1275-4(b) (stating that a payment under a debt instrument is not contingent merely because of the risk of

Once the anticipated weighted average lives of the regular and residual interests have been calculated, the second step is to compute the weighted average life of the REMIC. This is determined by reference to all payments taken into account in computing the weighted average lives of the regular and residual interests, which are treated as principal payments on a single regular interest. The final step in applying the 20% test is to compare the weighted average life of the residual interest, as computed above, to the weighted average life of the REMIC. The anticipated weighted average life of the residual must equal at least 20% of the anticipated weighted average life of the REMIC.

Although the significant value requirement was not wholly unanticipated,²³² the Service decided that it should apply only on a prospective basis. Thus, only residual interests acquired by a thrift on or after September 27, 1991 (the date the proposed regulations were released) are subject to the significant value rule; residual interests acquired before that date qualify for the thrift exception regardless of whether they have significant value.²³³

4. *Special Rules for REITs and RICs.*—REITs and RICs are corporations that are subject to corporate tax on their income, but such entities are able to achieve pass-through treatment by virtue of being allowed a dividends-paid deduction.²³⁴ Consistent with the intent that these entities function as conduits, however, Congress has imposed minimum distribution requirements on them, forcing them to disgorge virtually all of their income to their shareholders each year.²³⁵ Yet, a RIC or a REIT can retain some income and, to the extent that it does so, it will be subject to tax at the normal corporate tax rates.²³⁶ Given this rudimentary background, how should a RIC or REIT be taxed with respect to excess inclusions?

It could be argued that the minimum taxable income of a RIC or REIT cannot be less than the excess inclusion income that it accrues, i.e., it is effectively denied a dividends paid deduction for excess inclusions. That

insolvency or default). On the tax policy implications of the failure of current law to take into account default risk, particularly in the case of the issuer of a debt instrument, see the provocative discussion in Robert Scarborough, *Risk Diversification and the Design of Loss Limitations Under a Realization-Based Income Tax*, 48 *Tax L. Rev.* 677, 686-90 (1994).

232. See *supra* note 224.

233. Regs. § 1.860A-1(b)(2)(iii). Further, a special transition rule exempts residual interests acquired by a thrift as a sponsor at the formation of a REMIC if more than 50% of the interests in the REMIC (determined by reference to issue price) were sold to unrelated investors before November 21, 1991. This exception, however, applies only for so long as the thrift-sponsor owns the residual interest.

234. See generally subchapter M of subtitle A.

235. *Id.*

236. *Id.*

result makes little sense; there is no policy reason why the conduit function of the RIC or REIT should be curtailed on account of excess inclusions. RICs and REITs should be able to pass through such amounts to their shareholders, provided that the character of excess inclusion amounts is preserved. This is, in fact, the general approach outlined in section 860E(d), which provides:

- (d) Treatment of Residual Interests Held by Real Estate Investment Trusts.—If a residual interest in a REMIC is held by a real estate investment trust, under regulations prescribed by the Secretary—
- (1) any excess of —
 - (A) the aggregate excess inclusions determined with respect to such interests, over
 - (B) the real estate investment trust taxable income (within the meaning of section 857(b)(2), excluding any net capital gain), shall be allocated among the shareholders of such trust in proportion to the dividends received by such shareholders from trust, and
 - (2) any amount allocated to a shareholder under paragraph (a) shall be treated as an excess inclusion with respect to a residual interest held by such shareholder.

Rules similar to the rules of the preceding sentence shall apply also in the case of regulated investment companies, common trust funds, and organizations to which part I of subchapter T applies.

There are several elements at work in section 860E(d). First, the REIT must identify its excess inclusion amounts. This should be a straightforward matter of examining the Schedule Q that the REIT will receive from the REMIC for each quarter. However, just like any other corporate taxpayer, a REIT's taxable income may not be less than its excess inclusion, i.e., a REIT may not offset such amounts with other deductions.

Second, the REIT must identify the amount of what may be termed its "distributed" excess inclusions. This determination involves subtracting the REIT's taxable income (excluding capital gain) from the amount of excess inclusions. The REIT's taxable income, it will be recalled, is the amount of its income that the REIT chooses to retain for the taxable year. Thus, the effect of the section 860E(d) calculus is to treat the REIT's retained income

as being attributable to excess inclusions; only to the extent that excess inclusions exceed retained income are they treated as distributed to shareholders.²³⁷ The exclusion of capital gains from REIT taxable income is sensible, since such amounts are already required to be segregated and separately accounted for by the REIT, and are passed through to shareholders as capital gains dividends.²³⁸

Third, once the amount of distributed excess inclusions is identified, the REIT must allocate them among its shareholders based on their relative share of the dividends of the REIT that they receive. Dividends for this purpose should include ordinary dividends as well as capital gain dividends.

Finally, an excess inclusion amount allocated to a shareholder by a REIT is to be treated as an excess inclusion amount accrued on a residual interest held by the shareholder. Thus, the REIT effectively passes on to its shareholders such amounts for them to account for on their own tax returns. It should be emphasized that, at least in the absence of regulations, section 860E(d)(2) does not deem the REIT shareholder to be a residual interest holder except for the limited purpose of forcing the shareholder to account for its share of excess inclusions in accordance with the REMIC rules. In particular, the REIT shareholder is not treated as a residual interest holder for purposes of the transfer restrictions described in greater detail below. Thus, a REIT shareholder is generally free to sell its REIT shares without concern that in doing so it might be treated as selling a proportionate interest in the residual interests held by the REIT.²³⁹

The foregoing rules were enacted in 1986 solely with an eye to REITs, but in 1988 Congress amended section 860E(d) to provide that similar rules should apply to registered investment companies and other conduit entities. To date, no regulations have been issued implementing section 860E(d) and is unclear what the law is in the interim. Although a literal reading of the statute might suggest that until regulations are issued no rules apply to REITs and RICs with respect to preserving the character of excess inclusion amounts in the hands of its shareholders, that reading is probably

237. Regulations, when issued, will no doubt add more flesh to the bones of § 860E(d). For example, to the extent that excess inclusions are not treated as distributed in a given year, such amounts should carry over and be added to the excess inclusions that accrue in the subsequent year, although nothing in the § 860E(d) calculation mandates such a carryover.

238. IRC § 857(b)(3).

239. A limited exception, discussed further in Part VII.E.3. on penalty taxes, applies in the case of an acquisition of REIT shares by a disqualified organization, which is treated effectively as a transfer to such holder of a portion of a residual interest held by the REIT. This rule, however, should serve to underline the fact that an acquiror of an interest in a pass-through entity is not otherwise treated as becoming a holder of a residual interest that the entity holds among its assets.

incorrect; in other contexts involving similar language the statute has been viewed as self-executing.²⁴⁰ Moreover, the latter reading would lead to excess inclusions escaping tax altogether (although regulations, if and when issued, could apply retroactively). In short, the prudent course is for RICs and REITs to take reasonable steps to attempt to apply section 860E(d).

Stepping back from the details of section 860E(d), it is difficult to gauge as a practical matter to what extent REITs and RICs actually will choose to invest significantly in residual interests. This is because these entities are subject to minimum distribution rules that require them to distribute in dividends the greater part of their taxable income each year. Excess inclusions, of course, are items of taxable income for which little or no cash is received. Thus, in order to meet the minimum distribution requirements, a REIT or RIC holding residual interests may have to distribute capital to its shareholders. This detriment, however, may be balanced by the benefit of having phantom losses in later years from a residual interest that offset taxable income and thereby lower the minimum distribution requirements.²⁴¹

C. *Excess Inclusions and the Alternative Minimum Tax*

Under current law, no special provisions exist with respect to the calculation of the alternative minimum tax ("AMT") and excess inclusions from REMIC residual interests. Excess inclusions are simply part of a taxpayer's taxable income and, as such, they are part of the starting point for applying the AMT.²⁴² Although at first blush it is not apparent why this situation is at all problematic, as a policy matter a question exists whether this AMT calculus is appropriate. Take a simple, but extreme example:

X holds a residual interest and derives excess inclusions for 1994 in the amount of \$1,000. In 1994, X also realizes deductions of \$2,000, \$1,000 of which would be added back into income under the AMT rules. X has no other income or deductions. For regular tax purposes, X has regular taxable income of \$1,000. For AMT purposes, X must adjust its regular taxable income by adding back the \$1,000 of deduc-

240. See Robert J. Crnkovich & Kenneth H. Heller, "To the Extent" Provisions: When Do They Operate Without Regulations?, 76 J. Tax'n 176 (1992).

241. Some discussion of tax considerations for RICs investing in REMIC residual interests can be found in Steven D. Conlon & Suzanne M. Russell, *Tax Considerations for Mutual Funds Investing in Asset-Backed and Derivative Securities*, 71 Taxes 12 (1993).

242. Under § 55(b)(2), alternative minimum taxable income is defined as the taxable income for the year (which would include excess inclusion amounts) subject to certain adjustments and add-backs of certain tax preferences.

tions, thus producing AMTI of \$2,000. Is it appropriate for X to be subject to additional tax under the AMT in this case?

Interestingly, in an unusual display of solicitude toward holders of residual interests, Congress is considering (and probably will pass someday) legislation aimed at changing the above result. Specifically, proposed legislation would add a new section 860E(a)(6), which would provide for rules coordinating the AMT with the excess inclusion rules.²⁴³ The first aspect of the legislation would be to provide that, for purposes of applying the AMT, taxpayers may compute taxable income by offsetting excess inclusions with deductions, including net operating loss carryovers.²⁴⁴ Thus, in the above example, the taxpayer would compute its taxable income by subtracting the deductions of \$2,000 from its income of \$1,000, producing a loss of \$1,000. Under the AMT, \$1,000 of deductions are added back, thereby producing AMTI of \$0 and no AMT liability for X.

The proposed legislation, however, would provide a second, independent rule that the AMTI of a taxpayer may not be less than its excess inclusion for the taxable year.²⁴⁵ The stated effect of this rule is that even if a taxpayer has been able to utilize nonrefundable tax credits to eliminate its tax liability for regular tax purposes,²⁴⁶ it will not be able to do so for AMT purposes and will therefore always be liable at the AMT rate on its excess inclusions. It is hard to quibble too much with this provision from a policy perspective, since it is difficult to reconcile the allowance of credits against excess inclusion liability for regular tax purposes with the objective of ensuring such amounts were taxable in all events.

A third and final rule that proposed legislation would create would be that in computing the alternative tax net operating loss deduction, excess inclusions are ignored. According to the accompanying description of the rule, "[t]his provision insures that net operating losses will not reduce any income attributable to any excess inclusions."²⁴⁷ It is not entirely clear whether this rule is necessary to achieve that purpose, given the second rule described above (AMTI may not be less than the excess inclusion for the taxable year). However, it would have the collateral effect of ensuring that not only does the taxpayer pay tax on its excess inclusion, but that the taxpayer pays some tax on its non-excess inclusion income.

243. Tax Simplification and Technical Corrections Act of 1993, H.R. 3419, 103d Cong., 1st Sess. (1993) (proposing § 860E(a)(6) in § 1003(i)(1)).

244. *Id.*

245. *Id.* (Section 1003(i)(1) adds proposed § 860E(a)(6)(B)).

246. See *supra* Part V.B.2.

247. H.R. Rep. No. 353, 103d Cong., 1st Sess. 225 (1993).

As currently drafted, the legislation would carry a retroactive effective date and apply to taxable years beginning on or after December 31, 1986 (the general effective date of the original REMIC provisions), but taxpayers would be permitted to elect to apply the provision only to taxable years beginning after the date of enactment.²⁴⁸ The entire discussion above rests, of course, on the enactment of new section 860E(a)(6), an event that is inherently uncertain and unpredictable.

VI. TAX TREATMENT OF SPECIAL HOLDERS

A. Foreign Residual Interest Holders

As described below, certain restrictions apply to the transfer of a residual interest to a foreign person, the result of which is to constrain significantly those instances in which a foreign person can ever hold a residual interest. Yet, the transfer restrictions are not absolute; with appropriate structuring a residual interest can be transferred to a foreign person.²⁴⁹ Further, the transfer restrictions seemingly do not apply to a foreign sponsor that retains a residual interest. However, it must be acknowledged that, absent a change in law, the incidence of foreign-owned residual interests is likely to be quite small. Thus, it may seem something of an academic exercise to discuss the rules applicable to foreign holders of residual interests, but since some foreign holders do exist and likely always will, it is nevertheless appropriate to consider the tax rules that apply to them.²⁵⁰

In discussing the taxation of the foreign residual interest holder, the focus is on the application of U.S. withholding taxes. In general, three issues are presented. First, to what extent is income on a residual interest subject to withholding. Second, when does withholding apply. Third, how does withholding apply.

1. *Applicability of U.S. Withholding Taxes.*—In general, U.S. withholding taxes apply at a 30% rate (except as reduced by treaty) to U.S. source “fixed or determinable annual or periodic” (“FDAP”) income of a foreign person that is not effectively connected with the conduct of a U.S. trade or business.²⁵¹ One would have to acknowledge that the precise character of income under a residual interest is not at all obvious, although certainly it has every indicia of FDAP income. However, merely classifying

248. H.R. Rep. No. 3419, supra note 243, at 225.

249. One possibility is for a foreign person to hold a residual interest through a U.S. pass-through entity, such as a partnership. See infra Part VII.D.1.

250. On the definition of a foreign holder, see infra note 440.

251. See §§ 871(a), 1441.

income as FDAP is not enough; various exemptions and special rules apply based on the type of FDAP income at issue. For example, interest income is generally treated favorably and frequently enjoys the benefit of withholding tax exemptions or rate reductions, whereas dividend income generally is less favorably treated. In this respect, were one writing on a clean slate, one might be inclined to characterize residual income as analogous to dividends, since such income represents the profits of the entity.

Congress, however, has not left the slate clean. In the legislative history of the REMIC provisions, it is specifically stated that "amounts paid to foreign persons with respect to residual interests should be considered to be interest for purposes of applying the withholding rules."²⁵² While income on residual interests may bear little resemblance to interest income, this treatment is consistent with the treatment of residual interests as debt instruments for purposes of section 582(c).²⁵³ Thus, once it is determined that an amount received by a foreign person is received "with respect to a residual interest," the character of such amount is settled.²⁵⁴ However, once again the issue arises of how to treat up-front payments. In economic substance, such amounts are part of a holder's investment return on a residual interest and, as noted above, any distinction between such payment and actual distributions would be highly artificial. More importantly, the legislative history, whether deliberately or not, uses the phrase "amounts paid . . . with respect to residual interests" and it does no violence to that language to construe it as encompassing up-front payments.²⁵⁵ Accordingly, it is probably a fair reading of the legislative history to construe up-front payments as amounts that are to be characterized as interest. However, until and unless the Service issues further guidance, the matter must be considered somewhat uncertain.

252. H.R. Conf. Rep. No. 841, supra note 31, at II-238, reprinted in 1986 U.S.C.C.A.N. at 4326; cf. Regs. § 1.856-3(b)(2) (providing that amounts includible in gross income on a REMIC residual interests are treated as "interest on obligations secured by mortgages on real property."). Under the principle *expressio unius est exclusio alterius* (mention of one thing is the exclusion of another), one may be tempted to argue that residual interest payments are not interest for purposes other than withholding taxes. However, without more, it is probably reading too much into the legislative history to attribute such an intent to Congress.

253. H.R. Conf. Rep. No. 841, supra note 31, at II-233, reprinted in 1986 U.S.C.C.A.N. at 4321.

254. The legislative history addresses the character of amounts paid by the REMIC, raising the question whether a different analysis applies to taxable income on residual interest which accrues but is not paid. The language of the legislative history, however, merely reflects the fact that withholding generally does not attach before an amount is treated as paid to a foreign person. Thus, the issue of character prior to payment is essentially irrelevant.

255. H.R. Conf. Rep. No. 841, supra note 31, at II-238, reprinted in 1986 U.S.C.C.A.N. at 4326 (emphasis added).

Given that amounts paid on residual interests (including, one can argue, up-front payments) are to be treated as interest for withholding tax purposes, such amounts may therefore qualify for the withholding tax relief that is available for interest payments. The first such relief provision that may apply is the so-called "portfolio interest" exemption. The second general form of relief is by tax treaty. Each is addressed in turn below.

a. *The Portfolio Interest Exemption.*—Concerning the portfolio interest exemption, one confronts a confusing, and perhaps contradictory, array of statutory provisions and statements in the legislative history. Beginning first with what is known with certainty, "interest" paid to a residual interest holder is treated for portfolio interest purposes as paid on or with respect to the obligations held by the REMIC, and not on or with respect to the residual interest itself.²⁵⁶ This statement indicates that payments under a residual interest can qualify for the portfolio interest exemption, but only to the extent that the interest on the underlying mortgages held by the REMIC would so qualify had the foreign person held them directly. This "look-through" approach has two significant consequences. First, portfolio interest treatment is available only to the extent the REMIC mortgages were issued after July 18, 1984 (the general effective date of the portfolio interest rules). Second, the mortgages must be in registered form²⁵⁷—a requirement that typically will not be met in the case of traditional residential mortgages.

As an aside, the look-through approach may make sense from a tax policy perspective insofar as it limits the portfolio exemption to mortgages issued after the July 18, 1984 effective date. And such look-through treatment is in fact the approach taken with respect to pass-through certificates for purposes of the July 18, 1984 effective date.²⁵⁸ However, the rationale for following a look-through approach with respect to the registration requirement is suspect. First, the residual interest itself is, and must be, in registered form,²⁵⁹ making it difficult to perceive the tax policy goal at stake in looking through to the mortgages. Second, the burden of meeting the registration requirement imposed under the look-through approach is readily skirted by establishing a double REMIC structure (the REMIC regular interests are in

256. Regs. § 35a.9999-5(e), A-21(ii). The regulation does not substantively define when payments under a residual interest are treated as interest; rather, it merely declares that any payments that do constitute interest are eligible for portfolio interest treatment as described in the text. However, as noted above, the legislative history fills in this gap by stating that all payments on a residual interest constitute interest. See *supra* notes 252-53 and accompanying text.

257. IRC § 871(h)(2) (requiring debt to be in registered form unless it meets the so-called "TEFRA D" rules). On the definition of registered, see Regs. § 5f.103-1(c)(1).

258. Regs. § 35a.9999-5(e) A-21(i).

259. Regs. § 1.860D-1(b)(5)(i)(A).

registered form and are treated as newly issued debt instruments). It is certainly a grand exaltation of form over substance that would distinguish between a single REMIC and double REMIC structure in applying the registration requirement.²⁶⁰ Third, and related to the second point, the look-through approach in this context would have the effect of distinguishing between REMIC collateral in the form of residential mortgages and collateral in the form of pass-through certificates based on those same residential mortgages—indeed a subtle and ethereal distinction.²⁶¹ Fourth and finally, the regulations expressly reject a look-through approach with respect to the registration requirement in the case of pass-through certificates.²⁶²

Assuming, however, that a residual interest is able to satisfy the effective date and registration requirements for portfolio interest treatment, a host of other definitional elements must also be met. In general, however, with two potential exceptions, these other elements should not pose a problem.²⁶³ The first such definitional element that warrants further attention is the rule that portfolio interest does not include any interest received

260. Of course, the double REMIC structure can also be used to skirt the look-through approach to the July 18, 1984 effective date.

261. This point is made in A.B.A. Sec. Tax'n, Comments on Proposed Regulations Governing Real Estate Mortgage Investment Conduits (June 16, 1992), reprinted in 26 Highlights & Documents 1325, 1330 (July 24, 1992) [hereinafter American Bar Association Comments on Proposed Regulation].

262. Pass-through certificates are treated as separate debt instruments for purposes of the registration requirement and thus they, and not the underlying obligations to which they relate, must be in registered form. The regulations take this approach because pass-through certificates would not otherwise be treated as debt instruments subject to the registration requirement and would present potential compliance problems. See Staff of the Joint Comm. on Taxation, 98th Cong., General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984, 396 n.19 (Joint Comm. Print 1984). REMIC residual interests present no such compliance problems since, by virtue of Regs. § 1.860D-1(b)(5)(i)(A), they are registration-required obligations. It is something of a perverse twist of logic that the regulations ignore the mortgages and apply the registration requirement at the level of the pass-through certificate, but in the case of a residual interest, which is a registration-required obligation, they ignore the actual security held by investors and look through to the underlying mortgages.

263. Were a foreign bank to acquire a REMIC residual interest, one additional hurdle, which is not addressed in the text, is the potential treatment of payments on such interest as received by a bank on an extension of credit made pursuant to a loan agreement entered into in the ordinary course of its trade or business. See IRC § 881(c)(3)(A). In effect, by purchasing the residual interest, one might argue that the bank owns the REMIC assets subject to the liability represented by the regular interests, and, as the owner of the assets, the bank could be viewed as the lender under the REMIC mortgages. Although the scope of the bank exception is unclear, it is difficult to argue for its application in such circumstances (e.g., the residual interest holder does not receive basis for the liabilities represented by regular interests).

by a "10% shareholder" of the payor entity.²⁶⁴ A 10% shareholder is specifically defined as a person that owns 10% or more of the total combined voting power of all classes of stock of a payor-corporation, or, in the case of a partnership, a person that owns 10% or more of the capital or profits interest in such partnership.²⁶⁵ Although a residual interest holder is certainly an equity holder in the REMIC, it is clear that the REMIC is not viewed as a corporation or a partnership (or a trust) for purposes of the subtitle of the Code that includes the withholding tax provisions.²⁶⁶ This fact, perhaps together with the full-fledged look-through approach that is adopted elsewhere with respect to residual interests, indicates that even the sole residual interest holder in a REMIC should not run afoul of the 10% rule,²⁶⁷ unless perhaps the holder is a 10% shareholder with respect to one or more of the obligors under the mortgages held by the REMIC.²⁶⁸

A second exception concerns the newly enacted section 871(h)(4), which excludes from portfolio interest treatment certain contingent interest obligations. In general, subject to the application of certain exceptions, amounts paid on a residual interest would literally constitute interest that is determined by reference to "income or profits of the debtor"²⁶⁹ and therefore would be contingent interest for this purpose. However, such interest may escape contingent interest treatment by virtue of the exception for "interest all or substantially all of which is determined by reference to any other interest not described in subparagraph (A) (or by reference to the principal amount of indebtedness on which such other interest is paid)."²⁷⁰ The amounts paid on a residual interest will be determined in large part by the timing and amount of payments of interest and principal on regular interests and to this extent payments on a residual interest may fall within the

264. IRC §§ 871(h)(3), 881(c)(3)(B).

265. IRC § 871(h)(3)(B).

266. See IRC § 860A(a). The subtitle of the Code for purposes of which the classification rule applies is subtitle A, which encompasses §§ 1-1563.

267. A collateral issue concerns the application of the 10% shareholder rule to interest paid on a REMIC regular interest that is held by a person who also holds a 10% or greater interest of the residual interests in the REMIC.

268. In addition to the 10% rule, a similar question could be raised regarding the exclusion of interest received by a controlled foreign corporation ("CFC") from a related person (as defined in § 864(d)(4)). Once again, read literally, a residual interest holder that constituted a controlled foreign corporation does not fall within the categories of a related person vis-a-vis the REMIC, as set forth in § 267(b). Absent further guidance, the best interpretation may be to apply the CFC rule on a look-through approach and focus on the relationship of the obligors under the REMIC mortgages and the residual interest holder.

269. IRC § 871(h)(4)(A)(i)(II).

270. IRC § 871(h)(4)(C)(iii).

foregoing exception.²⁷¹ Certainly it would be sensible—and consistent with the look-through approach described above—to look through to the REMIC assets and take the position that, to the extent that such assets earned a return that was not contingent within the meaning of section 871(h)(4), payments on the residual interest would be viewed as noncontingent. This approach has the virtue of protecting the fisc against use of a residual interest, in effect, to pass through contingent interest (e.g., mortgagor profits), but it is unclear whether this interpretation would prevail under section 871(h)(4).²⁷²

A final issue raised by the portfolio interest rules concerns the treatment of excess inclusions. As described above, such amounts are intended to be taxed in all events and section 860G(b)(2) provides that “no exemption from the taxes imposed by [sections 871(a), 881, 1441, and 1442] (and no reduction in the rates of such taxes) shall apply to any excess inclusion.”²⁷³ It is thus clear that excess inclusions are not intended to be eligible for portfolio interest treatment. Were withholding taxes applied at the time that income accrued under a residual interest, applying this rule would be straightforward; to the extent that the current accruals were excess inclusion amounts no exemption would apply. However, as discussed in greater detail below, withholding taxes do not apply at the time of accrual, but rather at the time an actual payment is made on a residual interest. There is no provision in the statute or regulations for tracing a payment or distribution under a REMIC to specific income accruals. Thus, no rule exists for identifying payments as payments of excess inclusion amounts or other amounts (a curious void in the statute and regulations). The nub of the problem, therefore, is the lack of an accounting rule (LIFO, FIFO, et al.) to determine to what extent distributions on a residual interest are considered distributions of excess inclusions.

On the one hand, it could be forcefully argued that to the extent that excess inclusions truly are phantom income accruals, then by definition there never will be any cash attributable to them for the REMIC to distribute.²⁷⁴

271. Payments on a residual interest can be influenced by other factors that do not fit within the exception, such as profitable dispositions of foreclosure property and equity kickers or other contingent payment provision of a mortgage. Typically, however, such features play only a small role, if any, in the amount of income on a residual interest.

272. Cf. Regs. § 1.856-3(b)(2)(iii) (providing that the look-through approach applies if the residual interest is held for the primary purpose of passing through mortgagor net profits or shared appreciation).

273. The legislative history echoes this, providing that excess inclusions are “not eligible for any reduction in the rate of withholding tax (by treaty or otherwise) in the case of a nonresident alien holder.” H.R. Conf. Rep. No. 841, *supra* note 31, at II-234, reprinted in 1986 U.S.C.C.A.N. at 4322.

274. This point is recognized in American Bar Association Comments on Proposed Regulations, *supra* note 261, 26 Highlights & Documents at 1329 (July 24, 1992).

Cash distributions in this sense will always be attributable to nonexcess inclusion amounts. However, as we have seen, excess inclusions only imperfectly capture the phantom income phenomenon and it would be an overstatement to conclude that REMIC distributions can never consist of excess inclusion amounts. Certainly Congress thought that some portion of REMIC payments would be excess inclusions; otherwise, its statement that withholding exemptions would not apply to such amounts is meaningless.

What should the accounting rule be? The harshest rule would be to assert that all distributions are first treated as excess inclusions, to the extent such amounts have accrued, and only amounts distributed in excess thereof are eligible for withholding exemptions. Nothing in the statute or regulations or in tax policy can be said to compel that rule, other than a visceral desire to further punish residual interests.²⁷⁵ The opposite rule would be to treat a distribution as consisting of excess inclusion amounts only to the extent that the amount of the distribution exceeds the amount of nonexcess inclusion amounts that have accrued. That approach also lacks any support, although it can be viewed as consistent with the point made above that generally there will be no cash attributable to phantom income to distribute. Perhaps the more neutral answer would be to craft some form of pro rata rule under which only a portion of REMIC distributions is allocated to excess inclusion amounts.

b. *Tax Treaty Relief.*—Apart from the possible application of the portfolio interest exemption, payments on a residual interest may be subject to withholding tax relief under tax treaties. A full discussion of tax treaties as they might apply to a foreign holder of a residual interest is beyond the scope of this article, although in many respects residual interests present the same treaty issues and concerns that any financial instrument presents. Two particular treaty aspects, however, warrant further discussion. First, what is the character of residual interest payments under tax treaties? Second, how do treaty relief provisions interact with the special rules in the Code regarding excess inclusions?

It was observed above that for U.S. withholding tax purposes, payments on a residual interest are considered “interest,” but it remains to be investigated whether this characterization applies for treaty purposes as well. In general, U.S. tax treaties deal with the threshold issue of what is interest in different respects. The U.S. Model Treaty, for example, provides a specific definition of “interest” as follows:²⁷⁶

275. This is, however, the recommendation of the American Bar Association. *Id.*

276. U.S. Department of the Treasury, Proposed Model Convention Between the United States of America and ____ for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital, June 16, 1981, art. 11, para.

[I]ncome from debt claims of every kind, whether or not secured by mortgage, and whether or not carrying a right to participate in the debtor's profits, and in particular, income from government securities, and income from bonds or debentures, including premiums or prizes attaching to such securities, bonds, or debentures. Penalty charges for late payment shall not be regarded as interest for the purposes of this Convention.

Although resort may be had to U.S. tax laws in interpreting such terms as "debt claims" or "bonds or debentures,"²⁷⁷ no firm basis can be found in such laws for treating a REMIC residual interest as a debt instrument, except for certain specifically defined purposes.²⁷⁸ Thus, notwithstanding the intention of the legislative history that payments on residual interests constitute interest for withholding tax purposes, there is reason to doubt whether the U.S. Model Treaty and tax treaties with similar definitions of "interest" in fact would so treat residual interest payments.²⁷⁹ Example of a treaties that present this potential problem are the treaties with India and Hungary.²⁸⁰

Although the scope of the definition of "interest" in the U.S. Model Treaty is uncertain regarding payments on residual interests, many recent treaties contain a broader definition.²⁸¹ For example, in the recent treaty

3 [hereinafter U.S. Model Treaty]. The U.S. Model Treaty definition is identical to the definition of interest in The Organization for Economic Co-Operation and Development (OECD) Model Double Taxation Convention on Income and Capital (1977), art. 11, para. (3).

277. U.S. Model Treaty, *supra* note 276, art. 3, para. 2 (allowing undefined terms to be interpreted by a contracting state in accordance with the law of that state concerning the taxes to which the treaty applies).

278. See *supra* note 253 and accompanying text (stating that residual interests are treated as a debt obligation for purposes of § 582(c)); see also *infra* note 383 and accompanying text (stating that residual interests are treated as qualifying real property loans for thrifts).

279. Disparate definitions of interest would not represent a conflict between treaty and statute, such that one must trump the other. Rather, it would merely be a case where the United States and the other contracting party have decided to extend treaty benefits to a class of interest receipts that is narrower than the U.S. definition of interest.

280. Convention Between the Government of the United States of America and the Government of the Republic of India for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, Sept. 12, 1989, U.S.-India, art. 11, para. 4, S. Treaty Doc. No. 101-5; Convention Between the Government of the United States of America and the Government of the Hungarian People's Republic for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, Feb. 12, 1979, U.S.-Hung., art. 10, para. 2, 30 U.S.T. 6357.

281. Some treaties contain no definition of interest, in which case, in applying U.S. withholding taxes to the interest receipts of a treaty country resident, the U.S. domestic definition applies (i.e., payments on residual interests constitute interest). See, e.g., Convention Between the United States of America and New Zealand for the Avoidance of Double

with Germany, interest is defined as including "all other income that is treated as income from money lent by the taxation law of the Contracting State in which the income arises."²⁸² The latter type of definition clearly is intended to make the treaty definition of interest co-extensive with the U.S. domestic definition of interest (subject to any specific exceptions noted in the treaty). Thus, to the extent that, under general U.S. tax principles, payments on a residual interest are treated as interest, they are to be so treated in applying the treaty.²⁸³

Of course, even where the treaty definition of "interest" does not clearly encompass residual interest payments, it may be that such payments are covered by the "other income" article of the treaty. In many cases, other income is treated as favorably as interest and entitled to exemption from the imposition withholding taxes by the source country.²⁸⁴ Residual interest payments may also fall within the treaty definition of "dividends," and therefore be entitled to different, less favorable treaty benefits.²⁸⁵

Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, July 23, 1982, U.S.-N.Z., art. 11, T.I.A.S. 10772.

282. Convention Between the United States of America and the Federal Republic of Germany for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital and to Certain Other Taxes, August 29, 1989, U.S.-G.D.R., art. 11, para. 2, S. Treaty Doc. No. 101-10; see also Convention Between the United States and Mexico for Avoidance of Double Taxation and Prevention of Fiscal Evasion with Respect to Income Taxes, Including Protocol, Sept. 18, 1992, U.S.-Mex., art. 11, para. 5, S. Treaty Doc. No. 103-7; Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, Dec. 18, 1992, U.S.-Neth., art. 12, para. 2, S. Treaty Doc. No. 103-6. Some older treaties contain a slightly different wording: "all other income assimilated to income from money lent by the taxation laws of the Contracting State." See, e.g., Convention Between the United States of America and Canada with Respect to Taxes on Income and on Capital, Sept. 26, 1980, U.S.-Can., art. 11, para. 4, T.I.A.S. 11087; Convention Between the United States of America and Japan for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, Mar. 8, 1971, U.S.-Jap., art. 13, para. 7, 23 U.S.T. 967. It does not appear that the "assimilated" vs. "treated" distinction leads to any material difference in interpretation.

283. The interest treatment, in fact, is confirmed in certain recent treaties, which contain provisions in the article on interest that expressly withdraw treaty benefits for excess inclusions on REMIC residual interests. See, e.g., U.S.-Mex. Treaty, supra note 282, Protocol 10(a), S. Treaty, Doc. No. 103-7; U.S.-Neth Treaty, supra note 282, art. 11, para. 7, S. Treaty Doc. No. 103-6. The existence of such provisions serves to confirm that payments on residual interests otherwise constitute interest under the broader definition of interest in most recent treaties.

284. See, e.g., U.S.-Hung. Treaty, supra note 280, art. 19, 30 U.S.T. 6357.

285. For example, the definition of dividends in art. 10, para. 3, of the treaty with India could be interpreted broadly to encompass payments on a REMIC residual interest. U.S.-India Treaty, supra note 280, S. Treaty Doc. No. 101-50.

If a non-U.S. person that is a resident of a treaty country receives residual interest payments and such payments are safely viewed as interest under the applicable treaty, a further issue that arises is whether the treaty benefits that are otherwise available to interest will apply. The principal concern in this regard is the treatment of excess inclusion amounts. Section 860G(b)(2) proclaims that “no exemption from the taxes imposed by [sections 871(a), 881, 1441, and 1442] (and no reduction in the rates of such taxes) shall apply to any excess inclusion.” Although the statute makes no specific reference to tax treaties, the legislative history clarifies that section 860G(b)(2) is intended to trump “any reduction in rate of withholding (by treaty or otherwise) in the case of a nonresident alien holder.”²⁸⁶

Assuming for the moment that one can identify the portion of residual interest payments that represent excess inclusion amounts,²⁸⁷ the intent of section 860G(b) is clearly to override contrary treaty provisions that would otherwise provide an exemption or reduced withholding rate for such income. And at least with respect to treaties in force at the time of the 1986 Act, section 860G(b) is doubtlessly effective in overriding contrary treaty provisions.²⁸⁸ However, for treaties that entered into force after the 1986 Act, the answer must be that section 860G(b) is not effective, absent express treaty language indicating that no override of section 860G(b) is intended. Under the “later in time” rule, subsequent treaty provisions, to the extent in conflict with section 860G(b)(2), are controlling.²⁸⁹ Although this may not be the

286. H.R. Conf. Rep. No. 841, *supra* note 31, at II-234, reprinted in 1986 U.S.C.C.A.N. at 4322.

287. See *supra* text accompanying notes 273-75 (discussing when a payment is attributable to excess inclusion accruals).

288. That subsequently enacted legislation can override prior contradictory treaty provisions is well established. *Reid v. Covert*, 354 U.S. 1, 18 (1956). Additionally, § 7852(d)(1) states that neither a treaty or law is to be preferred. In order for subsequent legislation to effect an override, it has been held that Congress must clearly express such intent. *Cook v. United States*, 288 U.S. 102, 120 (1933). But see S. Rep. No. 445, 100th Cong., 2d Sess. (1988), reprinted in 1988 U.S.C.C.A.N. at 4885-88 (questioning the need for Congress to advert to contrary treaty provisions). The validity of this treaty override doctrine has been questioned. See, e.g., David Sachs, *Is the 19th Century Doctrine of Treaty Override Good Law for Modern Day Tax Treaties?*, 47 *Tax Law.* 867 (1994) (criticizing the doctrine of treaty override). The legislative history of § 860G(b) probably represents a clear expression of Congressional intent to override inconsistent treaty provisions, although in 1988 when Congress attempted to list provisions of the 1986 Act that contradicted treaty provisions it overlooked § 860G(b). See Technical and Miscellaneous Revenue Act of 1988, Pub. L. No. 100-647, § 1012(aa)(2), (3), 102 Stat. 3342, 3531.

289. The “later in time” rule provides that a subsequent statute overrides a conflicting treaty provisions, but, conversely, a subsequent treaty provision overrides a conflicting prior statute. The legislative history of § 7852(d) expressly states that Congress intended to codify this rule in the 1988 amendments to this section. S. Rep. No. 445, *supra* note 39, at 318, reprinted in 1988 U.S.C.C.A.N. at 4829-30.

result the drafters intended, it can hardly be considered surprising; the Treasury Department clearly retains the power to bargain away section 860G(b)(2) if it so desires in future tax treaties. Of course, it may be argued that in enacting section 860G(b), Congress intended not only to override *existing* treaties, but also any *future* treaties as well. Two responses may be made to that argument. First, the existence of such intent is questionable, since no express statement to this effect was made.²⁹⁰ Second, even if such intent were evidenced, it is doubtful whether it would have any effect.²⁹¹

The issue is somewhat academic, since the Treasury Department now recognizes that the interest article in recent treaties, absent special provision, will operate to override section 860G(b) and has taken steps to prevent that result. For example, in the recent tax treaty between the United States and the Netherlands it is expressly stated that the United States retains its right to impose full withholding on excess inclusions under REMIC residual interests.²⁹² A similar provision exists in the treaty with Mexico.²⁹³ Yet, the Treasury Department was slow to realize the relationship of the REMIC provisions to its treaty program and, as a result, a few recent treaties entered into force without any restriction on the availability of treaty benefits for REMIC excess inclusion amounts. Such treaties would include those with the Federal Republic of Germany, Finland, Spain and Tunisia.

In sum, for treaties that entered into force after the effective date of the 1986 Act, payments on residual interests are entitled to the full benefits under the treaty, notwithstanding section 860G(b), unless the treaty specifically excludes them. Although recently the Treasury Department has negotiated treaties that do specifically exclude excess inclusions, a few post-1986 treaties apparently slipped through. Thus, for example, it appears that under the U.S.-Federal Republic of Germany treaty, which entered into force on August 21, 1991, all payments on residual interests (including excess inclusions) should

290. This is in contrast to other instances where Congress expressly stated that a Code provision is to override any future inconsistent treaty provisions. See Tax Reform Act of 1986, Pub. L. No. 99-514, § 1810(a)(4), 100 Stat. 2085, 2821 (relating to IRC § 904(g)).

291. In the first place, it would be contrary to the established "later in time" principle. Second, the attempt of Congress to tie the hands of the Executive Branch and the Senate in future treaty negotiations might well be unconstitutional. The American Law Institute, *Proposals on United States Income Tax Treaties*, Federal Income Tax Project 71 (1991).

292. U.S.-Neth. Treaty, *supra* note 283, art. 12, para. 7, S. Treaty Doc. No. 103-6; Protocol, Dec. 30, 1993, S. Treaty Doc. No. 103-19. Similar provisions are contained in other recently ratified treaties, including treaties with France, S. Treaty Doc. No. 103-32; Russia, S. Treaty Doc. No. 102-39; Israel, S. Treaty Doc. No. 103-16; Czechoslovakia, S. Treaty Doc. No. 103-17; the Slovak Republic, S. Treaty Doc. No. 103-18; and the protocol to the treaty with Barbados, S. Treaty Doc. No. 102-41.

293. See *supra* note 282.

be fully exempt from U.S. withholding taxes under Article 11(1), to the extent the recipient otherwise qualifies for the benefits of that article.²⁹⁴

2. *Time and Manner of Withholding.*—Section 860G(b)(1) provides that amounts includible in the gross income of a nonresident alien holder are to be taken into account for U.S. withholding tax purposes when such amounts are paid or distributed (or when the interest is disposed of).²⁹⁵ Thus, a foreign holder is subject to withholding taxes on REMIC income only when, and to the extent that, amounts are actually paid or distributed by the REMIC (or upon disposition).²⁹⁶ Thus, if the REMIC never distributes any cash, then there is nothing to which withholding taxes can attach. Alternatively, if cash distributions are delayed, for example, until the end of the life of the REMIC, substantial deferral can be obtained.²⁹⁷

By tying the application of withholding taxes to actual distributions, Congress was not adopting a novel approach, but was merely applying the general rule that withholding taxes do not apply until amounts are actually paid to the foreign person.²⁹⁸ Moreover, this treatment comports specifically with the treatment of debt instruments issued with original issue discount, a closely analogous situation.

Notwithstanding the general timing rule of section 860G(b)(1), the legislative history provides that a different rule may be appropriate in certain tax avoidance situations:

The conference agreement also provides that under regulations, the amounts includible may be taken into account earlier than otherwise provided where necessary to prevent avoidance of tax. The conferees intend that this regulatory

294. *Id.*

295. IRC § 860G(b)(1).

296. *Id.*

297. As discussed *infra* Part VII.D., however, transfer restrictions substantially eliminate these strategies now.

298. See IRC §§ 871(a), 881(a), (withholding tax equals “30 percent of the amount received”) (emphasis added); Regs. § 1.1441-1 (withholding taxes apply “when such income is paid to a nonresident”). See generally Harvey P. Dale, *Withholding Tax on Payments to Foreign Persons*, 36 *Tax L. Rev.* 49, 73-74 (1980) (noting that withholding generally applies on a cash basis). A statutory exception to this cash basis approach is provided for partnerships, under which withholding applies to a foreign partner’s distributive share, whether or not actually distributed. IRC § 1441(b); Regs. § 1.1441-3(f). Significantly, Congress opted not to adopt such a rule for REMICs.

authority may be exercised where the residual interest in the REMIC does not have significant value.²⁹⁹

The Service to date has chosen not to exercise this authority. Instead, it has chosen to attempt to combat tax avoidance transfers to foreign persons through substantive restrictions on the type of residual interest that may be transferred to a foreign person.³⁰⁰ Although the legislative history quoted above is not clear about how much earlier one could take amounts into account, one approach that could be taken is to impose withholding at the time of "distributions" (as expansively defined), but impose it on the present value of anticipated excess inclusion amounts.³⁰¹ Thus, for example, if negative value residual interest is transferred by a sponsor on the startup day to a foreign person along with an up-front payment, under the foregoing rule withholding could attach to the up-front payment in an amount equal to 30% of the anticipated excess inclusions.

Apart from the time at which withholding attaches, a related question is the manner in which withholding is accomplished. On this score, neither the statute nor the legislative history provides specific guidance. Probably the most reasonable approach is to follow the rules that apply in the case of debt instruments with OID.³⁰² In this regard, the Code specifies that when payments are made on a bond, tax is withheld therefrom in an amount equal to the lesser of (i) 30% (or such lesser treaty rate) of the OID accruals to date for the period that the foreign person has held the bond, and (ii) the amount of such payment as reduced by any withholding on such payment.³⁰³

In the case of a sale or exchange of a residual interest, an amount of the proceeds of such sale equal to the income on the residual interest accruing while the foreign person held it is subject to withholding taxes, even if such amount is in excess of the gain realized on the disposition.³⁰⁴ Of course, if the foreign holder has no proceeds from the sale, then there is nothing to

299. H.R. Conf. Rep. No. 841, *supra* note 31, at II-236, reprinted in 1986 U.S.C.C.A.N. at 4324.

300. See *infra* Part VII.D.

301. The rule thus would be analogous to the tax in § 860E(e) on transfers of residual interests to disqualified persons.

302. The legislative history specifically provides that in the case of a disposition of a residual interest, the withholding rules are to apply in the same manner they apply upon the disposition of an instrument with OID. See H.R. Conf. Rep. No. 841, *supra* note 31, at II-236 n.18, reprinted in 1986 U.S.C.C.A.N. at 4324. It would be reading too much into this statement to conclude that the withholding rules applicable to OID instruments prior to disposition are not to apply, although it is a bit puzzling that Congress focused on the need for rules for dispositions of residual interests, but overlooked the need for rules in all other cases.

303. IRC §§ 1441(a), (b); 871(a)(1)(C).

304. IRC § 871(a)(1)(C)(i).

which withholding can apply. It is unclear what rule should apply if a foreign holder makes a payment to a person to take ownership of the residual interest.

B. Securities Dealers

One type of residual interest holder that warrants special attention is securities dealers. The recent enactment of section 475³⁰⁵ has broadened the concept of a securities dealer and sharpened the consequences of that status, but it has also complicated and confused the analysis. Although a comprehensive discussion of the tax rules relevant to securities dealers is beyond the scope of this article, several selected issues warrant special attention.

One principal issue that arises is whether REMIC residual interests actually are "securities" in the first place. In general, there seems to be no question that residual interests may be securities at least in some instances, but the Service currently is unwilling to treat what it terms "negative value" residual interests as securities for some purposes. However, even if one assumes that residual interests are securities in some instances, a second issue that arises relates to how the rules applicable to securities dealers should apply in the case of residual interests. Finally, apart from the status of residual interests as securities and the rules applicable thereto, an issue arises regarding when a person should be considered a dealer with respect to residual interests.

1. REMIC Residual Interests as Securities

a. *In general.*—The Code and regulations do not contain a comprehensive definition of a "security," but rather provide several discrete definitions tailored to specific Code provisions.³⁰⁶ The REMIC rules give

305. Section 475 was enacted as part of the Omnibus Budget Reconciliation Act of 1993, Pub. L. No. 103-66, § 13223, 107 Stat. 312, 481. In general terms, § 475 provides that a dealer in securities must include all securities carried in inventory at their fair market value or, in the case of securities not included in inventory, mark such securities to market unless (among other exceptions) it has specifically identified the securities as held for investment. Section 475 has received an unusual amount of attention by the Service since its enactment. Shortly after enactment of § 475, the Service issued I.R.S. Notice 93-45, 1993-2 C.B. 334, extending the effective date for the identification. The Service subsequently issued Rev. Rul. 93-76, 1993-2 C.B. 235, providing limited guidance on certain issues under § 475. Then on December 28, 1993, in an unusual display of alacrity, the Service released temporary and proposed regulations under § 475. Temp. Regs. §§ 475(b), (c), 1994-4 I.R.B. 4 (Dec. 28, 1993), and immediately thereafter issued Rev. Rul. 94-7, 1994-3 I.R.B. 6, amending Rev. Rul. 93-76 in light of the regulations.

306. See, e.g., IRC § 165(g)(2) (defining security for purposes of a deduction upon worthlessness); IRC § 475(c)(2) (defining a security for purposes of the mark-to-market

only minimal guidance on when residual interests are to be treated as securities under Code. For example, section 860F(d)(1) provides that all residual interests are to be treated as securities for purposes of the wash sale rules.³⁰⁷ Similarly, section 582(c) provides that residual interests are to be treated as evidences of indebtedness for purposes of the rule applicable to banks and thrifts treating gain or loss from the sale or exchange of evidences of indebtedness as ordinary in character.³⁰⁸ Beyond that, the REMIC provisions are silent as to the status of residual interests as securities for other purposes under the Code.

Two distinct definitions of a security that are of particular importance for securities dealers are those contained in section 475 and section 1236. The status of a residual interest under each is discussed below.

b. *Section 1236(c)*.—Section 1236 provides that gain by a dealer on the sale or exchange of any security will not be treated as capital gain unless the dealer has timely identified the security as held for investment and the security was not at any time held primarily for sale to customers in the ordinary course of business.³⁰⁹ Similarly, no loss will be treated as ordinary if at any time it was identified as held for investment.³¹⁰ However, mere failure to identify does not mean securities are automatically treated as inventory,³¹¹ rather, in such case, gains will be ordinary (because of the failure to identify), but losses will be capital if the facts indicate that the security was in fact held for investment.

Section 1236(c) broadly defines a “security” for this purpose as:

requirement); IRC § 852(b)(3) (adopting the lengthy definition of a security in the Investment Advisors Act of 1940); IRC § 1091(c) (defining a security for wash sale purposes); IRC § 1236(c) (defining a security for purposes of the identification requirement for securities held for investment by securities dealers); Regs. § 1.864-2(c)(2) (defining a security for purposes of the securities trading exemption in § 864(b)(2)); Regs. § 1.864-4(c)(5)(v) (defining security for purposes of determining the effectively connected income of foreign banks).

307. See IRC §§ 860F(d)(1), 1091.

308. IRC § 582(a). See also § 593(d)(4) (treating both residual and regular interests as qualifying real property loans in computing the bad debt reserve deduction for thrift institutions); see *infra* Part VI.C.1. (discussing § 593(d)(4)).

309. IRC § 1236(a). The temporary regulations provide that a timely identification for purposes of § 1236, that was in effect as of the close of the last taxable year ending before December 31, 1993, is treated as a timely identification for purposes of § 475. Temp. Regs. § 1.475(b)-2(a)(1).

310. IRC § 1236(b). An exception to this rule exists for losses on evidences of indebtedness held by a bank or thrift, which are always ordinary (as are gains). IRC § 582(c). A REMIC residual interest is an evidence of indebtedness for this purpose. *Id.*

311. *Stephens, Inc. v. United States*, 464 F.2d 53, 61 (8th Cir. 1972), cert. denied, 409 U.S. 1118 (1973).

[A]ny share of stock in any corporation, certificate of stock or interest in any corporation, note, bond, debenture, or evidence of indebtedness, or any evidence of an interest in or right to subscribe to or purchase any of the foregoing.³¹²

That mortgages are securities for purposes of the foregoing definition is settled.³¹³ That a residual interest is an “evidence of an interest in” the mortgages held by the REMIC seems equally clear. Accordingly, based on the literal language, residual interests would appear unquestionably to be securities for purposes of section 1236. Further, nothing in the language of section 1236 indicates that only residual interests that meet some minimum economic threshold are to be so treated. Even residual interests that entitle the holder to zero cash seemingly qualify as securities.

One might argue that in the case of the latter type of residual interest, the holder has effectively surrendered any interest in the mortgages (i.e., all of the cash flows have been sold to the regular interest holders). Yet, it would be something of a stretch to assert that the residual holder has *no* evidence of any interest in the mortgages. If nothing else, the holder often may have the right to instruct the trustee to liquidate the REMIC at some point and may have the right to purchase the remaining mortgages. Further, the income and losses of the holder (albeit largely phantom income and losses) directly flow from the underlying mortgages and in this sense the holder certainly does have a type of interest in the mortgages.

In sum, a straightforward reading of section 1236(c) indicates that all residual interests, regardless of their economic attributes, should be viewed as securities for purposes of that section.

c. Section 475

In general.—Newly enacted section 475 provides, in general, that securities held by a dealer in securities must (i) if they constitute inventory, be included in inventory at fair market value, or (ii) if they are not inventory, be “marked to market” at year-end.³¹⁴ An exception is provided for securities held for investment, provided they are timely identified as such by the dealer.³¹⁵ A “security” for this purpose is broadly defined to include *any*:

312. IRC § 1236(c).

313. See Rev. Rul. 72-523, 1972-2 C.B. 242.

314. IRC § 475(a)(1), (2). Section 475 was enacted as part of the Omnibus Budget Reconciliation Act of 1993, *supra* note 305, at § 13223, 107 Stat. at 481.

315. IRC § 475(b)(1)(A). Other exceptions apply to securities that are a hedge with respect to investment securities or to nonsecurities, and securities that are acquired or originated in the ordinary course of the taxpayer’s trade or business and which are not held

- (A) share of stock in a corporation;
- (B) partnership or beneficial ownership interest in a widely held or publicly traded partnership or trust;
- (C) note, bond, debenture, or other evidence of indebtedness;
- (D) interest rate, currency, or equity notional principal contract;
- (E) evidence of an interest in, or a derivative financial instrument in, any security described in (A), (B), (C), or (D), or any currency, including any option, forward contract, short position, and any similar financial instrument in such a security or currency; and
- (F) position which is—
 - (i) not a security described in (A), (B), (C), (D), or (E),
 - (ii) is a hedge with respect to such a security, and
 - (iii) is clearly identified in the dealer's records as being described in this subparagraph before the close of the day on which it was acquired or entered into (or such other time as the Secretary may by regulations prescribe).³¹⁶

Notwithstanding this sweeping definition of a security, in recently issued temporary regulations³¹⁷ the Service has acted to rein in the broad statutory definition in certain respects. In particular, the temporary regulations provide that the term "security" in section 475(c)(2) does not include REMIC residual interests that have "negative value,"³¹⁸ effective for taxable years

for sale. IRC § 475(b)(1)(B), (C).

316. IRC § 475(c)(2). An instrument that would otherwise be a security under (E) is not so treated if it is a contract to which § 1256 applies. *Id.*

317. Temp. Regs. § 1.475(c)-1, -2, 58 Fed. Reg. 68,747, 68,750 (1993).

318. Temp. Regs. § 1.475(c)-2(a)(3). In addition to negative value residual interests, the regulations exclude from the definition of a security (i) stock (including treasury stock) of the taxpayer and any option to buy or sell its stock (including treasury stock), or (ii) a liability of the taxpayer. *Id.*

ending on or after December 31, 1993.³¹⁹ A negative value residual interest is defined as any residual interest if, on the date the taxpayer acquires the residual interest, the present value of the anticipated tax liabilities associated with holding the interest exceeds the sum of (i) the present value of the expected future distributions on the interest, and (ii) the present value of the anticipated tax savings associated with holding the interest as the REMIC generates losses.³²⁰ For this purpose, anticipated tax liabilities, expected future distributions, and anticipated tax savings are determined under the rules in Regulations section 1.860E-2(a)(3) (and without regard to the operation of section 475),³²¹ and present values are determined under the rules in Regulations section 1.860E-2(a)(4).³²² Moreover, if a person acquires a residual interest in a “carryover” basis transaction, then such person is considered to have acquired it when the transferor acquired the residual interest (or is deemed to have acquired it under this rule).³²³

In addition to negative value residual interests as defined above, the regulations state that the term “security” will not include “an interest or arrangement that is determined by the Commissioner to have substantially the same economic effect [as a negative value residual interest].”³²⁴ The preamble to the regulations provides some elaboration on this, giving as an example—“a widely held partnership that holds noneconomic REMIC residual

319. The effective date has retroactive effect since taxpayers having purchased residual interests prior to the issuance of regulations with view to marking them to market will not be permitted to do so. This is harsh; some taxpayers bought residual interests at a price calculated by reference to the applicability of mark to market treatment in reasonable reliance on the broad definition of a security in the statute. Such taxpayers had no notice that negative value residuals would be excluded from the definition of security.

320. Temp. Regs. § 1.475(c)-2(b), (c).

321. Temp. Regs. § 1.475(c)-2(c)(2). That is, one computes these anticipated or expected items “based on (i) [e]vents that have occurred up to the time of the transfer; (ii) [t]he prepayment and reinvestment assumptions adopted under section 1272(a)(6) or that would have been adopted if the REMIC’s regular interests had been issued with original issue discount and (iii) [a]ny required or permitted clean up calls, or required qualified liquidation provided for in the REMIC’s organizational documents.” Regs. § 1.860E-2(a)(3). In computing anticipated tax savings, apparently one would refer to the particular tax rate applicable to a holder and any peculiar facts that relate to a holder’s ability to utilize tax losses from the residual interest.

322. Temp. Regs. § 1.475(c)-2(c)(3). Under these rules, future tax savings and future distributions are discounted by the applicable federal rate (as specified in § 1274(d)(1)) that would apply to a debt instrument issued on the day the dealer acquired the residual interest and whose term ended presumably when the residual interest is expected to be retired. Regs. § 1.860E-2(a)(4). The discounting of future tax savings probably is done from the end of each calendar quarter, but the discounting of future distributions should be from the time such distributions are expected to occur.

323. Temp. Regs. § 1.475(c)-2(c)(1).

324. Temp. Regs. § 1.475(c)-2(a)(3).

interests.”³²⁵ This evidences a concern that one could get around the negative value residual rule by “wrapping” the negative value residual within some other type of security (i.e., a widely held partnership interest), although it is unclear how much of a threat such a ruse would otherwise be. The preamble, moreover, goes on to solicit comments on whether additional rules are needed for taxpayers that hold economic residual interests or interests in other pass through entities (including subchapter S corporations or widely held partnerships).³²⁶

In short, the Service does not necessarily believe that it has solved the perceived problem by simply banishing negative value residual interests from section 475. Thus, the Service is making ominous rumblings about excluding from section 475 other residual interests that can have substantially the same economic effect, whatever that may be. This has created a fair amount of confusion and uncertainty in the marketplace regarding marking residual interests to market and no doubt this in terrorem effect was intended.

One issue that arises in surveying the impact of the temporary regulations under section 475 is the existence of regulatory authority for excluding negative value residuals. The statutory definition of a “security” clearly encompasses REMIC residual interests (they are “an evidence of an interest in” debt instruments)³²⁷ and the regulatory authority granted to the Service under section 475 does not specifically contemplate adjusting the definition of a security.³²⁸ However, the grant of regulatory authority does generally instruct the Service to issue “such regulations as may be necessary or appropriate to carry out the purposes of the section,”³²⁹ which is potentially broad enough to justify regulations restricting the definition of a security. In any event, according to the preamble, the basis for excluding negative value residuals is not only to carry out the purposes of section 475, but also to carry out the purposes of section 860E,³³⁰ although it is interesting to note that the Service was not specifically granted regulatory authority under the REMIC rules to prevent avoidance of the excess inclusion rules in section 860E.³³¹

Rethinking the concept of a “negative value” residual interest.—The regulations under section 475 single out the so-called “negative value”

325. 58 Fed. Reg. 68,747, 68,749 (1993).

326. *Id.* In the case of arrangements involving partnerships, it appears the Service has given itself a potent weapon in the new anti-abuse rule in Prop. Regs. § 1.701-2. See *infra* note 448 and accompanying text.

327. IRC § 475(c)(2).

328. IRC § 475(e).

329. IRC § 7805(a).

330. 58 Fed. Reg. 68,747, 68,749 (1993).

331. See IRC § 860G(e) (setting forth the Service’s regulatory authority).

residual interest and exclude it from the definition of a security for purpose of section 475.³³² On closer analysis, the notion of a residual interest being treated as having negative value is rather arbitrary and detached from the reality of the marketplace. The regulations seem to recognize this fact in that they provide that a residual interest that is outside the definition of a negative value residual nevertheless may be recharacterized as a negative value residual interest if the Service judges it to have substantially the same economic effect.³³³ This open-ended statement is something of a shot across the bow of securities dealers, warning them to move cautiously in marking "positive value" residual interests to market under section 475. It also, however, betrays the Service's uncertainty about what should be the correct target and its uneasiness about its own definition of a negative value residual interest.

The Service's apparent anxiety is well justified; its attempt to define a class of residual interests that are somehow distinguishable from other residual interests by possessing negative value is doomed to fail. As noted above in the discussion of up-front payments, residual interests that provide for up-front payments are easily restructured as residual interests that provide for distributions, with little or no effect on the true economics of a transaction.³³⁴ Similarly, a negative value residual interest often can be painlessly transformed into an positive value residual through minor tinkering with the structure. For example, the up-front payment that would always accompany a transfer of a negative value residual interest often can be built into the terms of the residual interest and paid out as cash distributions thereon during the first three months, or the first six months, or perhaps even the first year. By doing so, the negative value residual interest often can be metamorphosized into a positive value residual interest with little or no inconvenience. In short, negative value status is virtually elective. Surely that cannot be acceptable to the Service.

The Service seems to recognize this situation and has included broad, deterrent language in the regulations.³³⁵ Yet, it seems equally clear that the Service is not entirely certain of what the abuse is that it should be aiming at. At the root of the problem is the failure of the Service to come to grips with up-front payments. Perhaps a different perspective is in order.

It has become passé to observe that residual interests may have zero or negative value and that they may in effect represent no more than a net liability for the holder. If one simply focusses on the cash entitlements under a residual interest and the anticipated future tax burdens, then indeed residual

332. Temp. Regs. § 1.475(c)-2(a)(3), -2(b).

333. See Temp. Regs. § 1.475(c)-2(a)(3).

334. See *supra* text accompanying note 154.

335. See Temp. Regs. § 1.475(c)-2(a)(3).

interests frequently, if not most of the time, will lack positive value. Yet, this is only half of the story. In assessing the economic character of a residual interest it is necessary not only to take into account the cash entitlements and the future tax burdens, but also the future tax benefits and the amount of any the up-front payment. All of these elements are integral parts of the issuance or transfer of a residual interest.³³⁶

The correct approach in analyzing the economics of a residual interest is to add the amount of any up-front payment to the present value of anticipated future tax benefits and cash distributions and subtract the present value of anticipated future tax burdens. This approach recognizes that the up-front payment is incident to the issuance or transfer of a residual interest and that it should offset the amount of the future tax burdens. The approach, hardly a novel one, amounts to treating the up-front payment, in essence, like a payment incident to a lending transaction (e.g., points) in the context of the issuance of a debt instrument.³³⁷ Viewed in this manner, of course, no residual interest can be said to have been issued or transferred with negative value; by taking the up-front payment into account a residual interest will always have economic value in the eyes of the parties, since no rationale holder dealing on an arm's length basis would enter into a transaction in which it only stood to lose money.

The bottom line is that there is no true dividing line between so-called negative value and positive value residual interests; generally, all residual interests are issued or transferred in transactions in the holder anticipates earning some minimum, positive return on its investment. Some residuals are designed to provide the holder with a greater portion of its overall return in cash, whereas many others are designed to provide most or all of the return in kind through tax benefits. There would not appear to be any stopping point along the spectrum of residual interests that could serve to distinguish some residual interests from others based on the positiveness or negativeness of their economics.

How then should the Service decide which residual interests should and which should not be subject to mark to market treatment under section 475? One approach would be to abandon attempts to identify residual interests as having negative or positive value and focus on the real issue at

336. The regulations under § 475 recognize the need to weigh future tax burdens against future tax benefits when assessing the economics of a residual interest, but nowhere does the up-front payment figure into the calculation. See Temp. Regs. § 1.475(c)-2(b) (defining negative value residual interest).

337. Analogous treatment is provided in the original issue discount regulations for payments incident to a lending transaction. See Regs. § 1.1273-2(g)(2) (providing that payments by the borrower to the lender reduce the issue price of a debt instrument); see also *supra* Part IV.C.1.a.

stake. In general, the Service's principal concern is that marking residual interests to market will give rise to deductions that will effectively offset excess inclusions. And in fact, the Service's concern is correct.³³⁸ However,

338. A simple illustration, one which builds on our earlier example, indicates the problem. Consider a hypothetical REMIC residual interest, which carries zero principal and interest entitlement and which generates the income and losses indicated below. Given these income and losses, the tax benefits/burdens, year-end values, and the holder's bases are readily determinable as set forth below:

| Hypothetical Residual Interest (issued January 1 of Year 1) | | | | |
|--|------------------------------------|-------------------------------|-----------|-------|
| Year | Residual Interest income/(loss) | Tax (liability) /benefit** | Value* | Basis |
| Issuance | -- | -- | \$(23.01) | 0 |
| 1 | \$100.00 | \$(35.00) | 10.61 | 100 |
| 2 | 75.00 | (26.25) | 37.69 | 175 |
| 3 | 50.00 | (17.50) | 57.71 | 225 |
| 4 | 25.00 | (8.75) | 69.43 | 250 |
| 5 | 0 | 0 | 73.59 | 250 |
| 6 | (25.00) | 8.75 | 69.26 | 225 |
| 7 | (50.00) | 17.50 | 55.91 | 175 |
| 8 | (75.00) | 26.25 | 31.15 | 100 |
| 9 | (100.00) | 35.00 | 0 | 0 |

*/Value = present value of future tax benefits less future tax liabilities.

**/Assuming 35% tax rate.

If this hypothetical residual interest were subject to the mark to market rules of § 475, it would be treated as if it were sold at year-end for its fair market value. However, its fair market value will equal the present value of the future tax benefits less the present value of future tax burdens, and the value of the future tax benefits in turn will be affected by the availability of mark to market. This is because marking to market will have the effect of using up the holder's basis, which will then limit the holder's ability to use REMIC losses. After a series of iterative calculations, the result is that the holder can expect to receive no tax benefits from the losses. When all is said and done, the holder ends up with the following array of gains and losses on holding the hypothetical residual interest:

| Year | Residual Inc./Deds | Tax (liab.)/ Benefits | Value Gain | Basis | M-to-M |
|----------|-----------------------|--------------------------|---------------|--------|------------|
| Issuance | -- | -- | \$(78.01) | \$ 0 | -- |
| 1 | \$100.00 | \$(35.00) | (47.69) | 100.00 | \$(147.69) |
| 2 | 75.00 | (26.35) | (24.30) | 27.31 | (51.61) |
| 3 | 50.00 | (17.50) | (8.25) | 25.70 | (33.96) |
| 4 | 25.00 | (8.75) | 0 | 16.75 | (16.75) |
| 5 | 0 | 0 | 0 | 0 | 0 |
| 6 | 0 | 0 | 0 | 0 | 0 |
| 7 | 0 | 0 | 0 | 0 | 0 |
| 8 | 0 | 0 | 0 | 0 | 0 |
| 9 | 0 | 0 | 0 | 0 | 0 |
| Totals | \$250.00 | 0 | 0 | 0 | \$(250.00) |

the only way that marking a residual interest to market will not have this effect, to some degree, is to permit a residual interest to be marked to market only if the value of future benefits under the REMIC (tax benefits and cash distributions) at the end of each year when the mark would occur equals or exceeds the increase in the basis of the residual interest on account of excess inclusions.³³⁹ Such a test should ensure that losses from marking to market are exclusive of excess inclusions.

Although the test may appear complicated, in reality the technology largely already exists in the REMIC rules. Taxpayers are currently required to project the stream of anticipated excess inclusions for purposes of the definition of a noneconomic residual interest. Further, the regulations under section 475 now require the taxpayers to project the present value of future tax benefits.³⁴⁰ It would not be that significant an increase in administrative burdens to require the taxpayer to compute the present value of future benefits (cash distributions and tax benefits) at the end of each future taxable year and require that such present values equal or exceed the basis of the residual interest at the beginning of year, as increased by the amount of excess inclusions that accrue for the year.³⁴¹ Under such a test, unless the residual interest had an adequate stream of future benefits, based on an assumed prepayment rate, it would not be permitted to be marked to market by securities dealers.

2. Selected Rules Applicable to Securities Dealers

a. *Applying the Current Mark to Market Rules.*—As described above, the current mark to market rules provide that mark to market accounting does not apply to a negative value residual interest. This means that “positive value” residual interests must be treated as securities for purposes of section 475 and must be marked to market if held by a dealer in its capacity as such. Further, taxpayers that are dealers with respect to some type of security, but which do not hold residual interests in their dealer capacity, must identify positive value residual interests as held for invest-

The net result is that the holder of the hypothetical residual interest is able to offset almost completely the phantom income from the REMIC as it accrues.

339. The reason marking residual interests to market produces a tax loss to offset excess inclusion income is that basis is increased by such excess inclusions, and such basis increase is not commensurate with any real increase in the residual interest's value.

340. Temp. Regs. § 1.475(c)-2(b).

341. No special provision would be needed for up-front payments, because they would be reflected in the basis of the REMIC residual interest.

ment.³⁴² The taxpayer has no option to not apply the mark to market rules to positive value residuals.

As noted above, however, the Service has indicated that other residual interests (i.e., those that have positive value) in the future may be excluded from the definition of a security for purposes of section 475, if the Service determines that they have substantially the same economic effect as a negative value residual. In essence, the taxpayer is required to apply the mark to market rules to positive value residual interests, but the taxpayer is put on notice that the Service may determine that section 475 is not to apply, and any such determination may have retroactive effect. This is particularly problematic since it is anyone's guess what "substantially the same economic effect" means. As discussed in the preceding section, the Service is concerned primarily about taxpayer's being able to offset excess inclusions by mark to market losses. But how much of an offset is necessary in order to have substantially the same economic effect? Given the vagueness of the standard, hopefully if the Service chooses to exercise its discretion to broaden the definition of a negative value residual interest, it will do so on a prospective basis or will limit retroactivity to those cases that truly are abusive.³⁴³

How then should taxpayers proceed in the interim while the Service mulls over its next step? In particular, how should issuers structure positive value residual interests in order to reduce the potential for having that status overturned by future Service guidance? On the one hand, the definition of a negative value residual interest is purely a function of mathematical computations of anticipated distributions, tax liabilities, and tax savings. As such, the definition is easily manipulated. For example, as discussed above in connection with significant value residual interests, a positive value residual can be created relatively painlessly by simply granting to the residual interest deeply subordinate rights to cash flow that are effectively worthless since they absorb the first losses on the mortgage pool.³⁴⁴ Similarly, a positive value residual interest can be created by converting the up-front payment that would otherwise be paid in connection with a negative value residual into a cash distribution from the REMIC during the first year.

Other variations on the foregoing are no doubt possible, but in each such case the possible threat of retroactive guidance by the Service overturn-

342. If the taxpayer does not so identify, and the residual interest is not otherwise exempt from the mark to market rules, then the residual interest must be marked to market. See Temp. Regs. § 1.475(b)-1. Any gain or loss, however, will be capital. See Temp. Regs. § 1.475(d)-1.

343. For example, retroactive application may be appropriate where a residual interest provided for a sizable cash entitlement and qualified as a positive value residual, but the cash was scheduled to be paid out within three months.

344. See *supra* text accompanying notes 230-31.

ing positive value status looms large. The existence of this threat makes it difficult to rely on structuring techniques to produce positive value residuals that are not significantly different, by some economic standard, from negative value residuals. Accordingly, it is probably desirable in structuring a positive value residual interest to place some meaningful distance between it and the negative value residual interest. For example, the cash entitlement of a residual interest should not be front-loaded (i.e., it should not pay out quickly). To take a very conservative position, the cash should pay out pro rata with principal payments on the regular interests or it should pay out only after a significant portion of the principal balance of the regular interests has been paid down. The most troublesome case, of course, is where substantially all of the cash pays out within one year. Those cases must be considered extremely vulnerable to recharacterization.

b. *Inventory Accounting*.—As noted above, the regulations under section 475 provide that negative value residual interests are not considered securities for purposes of that section and, hence, they may not be marked to market under that section. This leaves unanswered, however, the issue of whether residual interests, including negative value residual interests, are securities that are subject to inventory accounting. The issue is potentially a significant one since securities includible in inventory may be carried in inventory at cost, at the lower of cost or market, or at market.³⁴⁵ This is unlike other types of property which generally are never permitted to be carried at market.³⁴⁶ Obviously, by carrying securities in inventory at market, one is effectively marking them to market.

Neither section 471 nor the regulations contain a definition of “securities” for this purpose, but the long-standing position of the Service has been that the definition of a security for purposes of section 1236(c) applies as well for purposes of section 471.³⁴⁷ As described above, residual interests—both positive and negative value—are securities under section 1236(c), prima facie indicating that they are capable of inventory accounting. A couple of considerations indicate caution in embracing that conclusion.

First, presumably the Service in some manner will clarify eventually that the exclusions from the definition of a security in regulations under section 475 will also apply for purposes of section 471. Otherwise, as noted above, such excluded securities could be simply inventoried at market value under section 471 and a dealer could thus achieve the precise mark to market

345. Regs. § 1.471-5; Rev. Rul. 74-227, 1974-1 C.B. 120.

346. See Regs. § 1.471-2(c).

347. See, e.g., Rev. Rul. 72-523, 1972-2 C.B. 242, modifying Rev. Rul. 65-95, 1965-1 C.B. 208; G.C.M. 34965 (July 28, 1972) (relating to Rev. Rul. 72-523); Priv. Let. Rul. 8141035 (June 30, 1981); Priv. Let. Rul. 6308205670A (Aug. 20, 1963).

effect that the regulations under section 475 were trying to stop. That would be an absurd result. Since the regulations under section 475 were issued with retroactive effect as to negative value residual interests, it would take an intrepid soul to attempt to exploit this apparent glitch in the system.

Second, inventory accounting is permitted, indeed required, "in every case in which the production, purchase, or sale of merchandise is an income producing factor."³⁴⁸ This language reflects an important point. Inventory accounting is appropriate for "merchandise" or property, and many types of derivative financial instruments have not been considered inventoriable. For example, apparently neither futures nor forward contracts are considered inventoriable, nor short sale contracts,³⁴⁹ although options are.³⁵⁰ Like residual interests, each of the foregoing may at a given time have a zero or negative value and may become a liability to the holder. In the case of notional principal contracts, for example, commentators have speculated whether inventory accounting is permissible in view of the potential for them to become negative in value.³⁵¹ Yet, the reason such derivative instruments are not inventoriable appears to have nothing to do with their potential for negative value, but rather it seemingly is based on the rigid transfer of title requirements³⁵² or on the notion that the holder cannot truly be a dealer in such instruments. Nevertheless, it is probably true that inventory accounting never envisioned the possibility of negative market values, although ultimately the matter must be considered uncertain.³⁵³

348. Regs. § 1.471-1.

349. See 1 CCH Internal Revenue Manual, Audit § 4232.5, ¶ 314(4) (Dec. 14, 1976); Mark Rachleff & Herman M. Schneider, *Security And Commodity Dealers* ¶ 206 (1992).

350. Priv. Let. Rul. 8141035 (June 30, 1981).

351. See, e.g., 2 Andrea S. Kramer, *Financial Products: Taxation, Regulation, and Design*, § 60.2(b)(2)(ii), at 1437-38 (1991).

352. See Regs. § 1.471-1 ("Merchandise should be included in the inventory only if title thereto is vested in the taxpayer . . . A purchaser . . . should not include in goods ordered for future delivery, transfer of title to which has not yet been effected.").

353. One area under the current inventory accounting rules where negative values are possible with respect to merchandise relates to "subnormal" goods. In general, a taxpayer is entitled to value subnormal goods at their bona fide selling price minus direct disposition costs. Regs. § 1.471-2(c). If disposition costs equal or exceed the selling price, a zero or negative value would result. There appears to be no direct authority on this issue, although one commentator has recognized the issue:

Presumably, the offset for the costs of disposition enables a taxpayer to reduce inventory carrying values to a zero cost in some cases. It would not seem appropriate to permit a taxpayer to create a negative scrap value and deduct currently the excess disposition costs not yet incurred as an inventory writedown.

1 Leslie J. Schneider, *Federal Income Taxation of Inventories*, ¶ 6.03[3], at 6-15 (1994).

A third consideration is that, even if one accepts that residual interests are securities capable in theory of being inventoried, generally only property the sales of which are expected to generate a profit are properly inventoriable.³⁵⁴ In the case of securities dealer that acquires residual interests from REMIC sponsors or other third parties for the purpose of then marketing them at a mark-up to customers, this point is not an issue.³⁵⁵ Manifestly, such a dealer is seeking to turn a profit and inventory treatment in such a case would seem entirely appropriate. However, a less clear case concerns the REMIC sponsor that "originates" residual interests and is considered a dealer therein by virtue of the fact that it regularly creates and sells them.³⁵⁶ In this case, if the residual interests are not being sold at a gain (e.g., the sponsor must make an up-front payment to the transferor), then the sponsor will not earn, and will have no expectation of earning, any profit on the transfer of the residual interest itself. It is true that overall the sponsor may expect to earn a net profit on the creation and sale of both the residual and regular interests, and it could be argued the loss on the transfer of the residual interest is part of earning that overall profit. Yet, inventory accounting authorities suggest that the residual interest in and of itself must be held with the requisite profit expectation.³⁵⁷

An alternative way in which residual interests that will not be sold at a profit may be accounted for, at least theoretically, is by integrating the loss on the transfer of them with the gain on the sale of the regular interests. That is, to the extent that the regular interests in the REMIC are held in inventory, a portion of the loss on the residual interest transfer is an adjustment to the inventory of such regular interests. In essence, the loss is capitalized into the cost or basis the regular interests.³⁵⁸ Although this type

354. See, e.g., *United States v. Ingredient Technology Corp.*, 698 F.2d 88, 94-95 (2d Cir. 1983).

355. Query: How many taxpayers actually act as this type of dealer?

356. On the treatment of originators of securities as dealers therein, see *infra* text accompanying note 371.

357. For example, an analogous situation concerns promotional goods, where a merchant will take a loss on certain giveaways or below cost sales in order to realize an overall profit on a tie-in product (e.g., get a free refrigerator on the purchase of a new car). It appears settled that promotional goods that are being sold at a loss may not be inventoried, although the issue is less clear if they are themselves the subject of profitable sales (e.g., buy one refrigerator, get a second one at half price). See, e.g., *Francisco Sugar Co. v. Commissioner*, 47 F.2d 555 (2d Cir. 1935); see generally 1 *Schneider*, *supra* note 353, ¶ 1.03[6], at 1-62 to 1-65 (discussing the authorities).

358. The principle is similar to the uniform capitalization rules in § 263A, which technically would not appear to apply to the creation of REMIC regular interests. See IRC § 263A(b)(1) (providing that uniform capitalization rules only apply to real or tangible property produced by the taxpayer); cf. Regs. § 1.263A-1(b)(13) (stating that the origination of loans is not considered the acquisition of intangible property for resale).

of integration has been recognized for hedging gains or losses,³⁵⁹ there appears to be no authority outside that context for such integration.

c. *Section 1236(c)*.—Since all residual interests, regardless of their economic attributes, should be viewed as securities for purposes of section 1236(c), this means that a securities dealer must identify such securities as held for investment in order to obtain capital gain treatment. Failure to so identify would cause the dealer to recognize ordinary income, yet any loss would be capital if, in fact, the residual interest is held for investment.³⁶⁰

d. *Sales or Exchanges of Residual Interests*.—Even if REMIC residual interests are not securities or are not otherwise inventoriable, the issue arises whether gain or loss recognized by a dealer on the transfer of residual interests will be ordinary in character. In general, section 1221(1)³⁶¹ provides that a loss on the sale or exchange of property will not be a capital loss if the property constitutes:

stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxpayer year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business.

It is clear that gain or loss on property may be ordinary under section 1221(1) even if such property is not, or cannot be, held in inventory.³⁶² Moreover, the taxpayer need not actually be a dealer with respect to the property at issue, so long as the property is nevertheless held primarily for sale to customers in the ordinary course of the taxpayer's trade or business.³⁶³

359. See, e.g., Prop. Regs. § 1.446-4(e)(2); *Monfort of Colorado, Inc. v. United States*, 561 F.2d 190, 196 (10th Cir. 1977).

360. *Stephens, Inc. v. United States*, 464 F.2d 53, 60-61 (8th Cir. 1972).

361. IRC § 1221(1). Apart from the application of § 1221(1), there would appear to be no basis to treat gain or loss on a sale or exchange of a REMIC residual interest as ordinary in character. Section 1221(4) would not apply because it does not appear possible to stretch the term "notes or accounts receivable" far enough to encompass a residual interest.

362. See Rev. Rul. 60-346, 1960-2 C.B. 217; G.C.M. 34965 (July 28, 1972) (relating to Rev. Rul. 72-523, 1972-2 C.B. 242). Real estate, for example, is a common type of § 1221(1) property even though it is not inventoriable. See, e.g., *Keeney v. Commissioner*, 17 B.T.A. 560, 566 (1929).

363. See, e.g., *Katz v. Commissioner*, 19 T.C. Memo (CCH) 200, T.C. Memo (P-H) ¶ 60,200 (1960); *Girard Trust Corn Exchange Bank v. Commissioner*, 22 T.C. 1343, 1360-61 (1954).

Accordingly, a sale or exchange of residual interest may produce ordinary gain or loss under section 1221(1), based on whether it is held "primarily for sale to customers." Several points can be made regarding this standard. First, the Supreme Court has held that in this context "primarily" means "of first importance" or "principally."³⁶⁴ Further, the "to customers" requirement is satisfied even if the taxpayer only has one customer.³⁶⁵ This can be important in the context of residual interests, since the number of buyers is relatively small and a REMIC sponsor may well sell all of its residual interests to a single buyer. Finally, property can be considered held primarily for sale even if the taxpayer has no expectation of making a profit on the sales.³⁶⁶ This is also potentially important in the REMIC context since frequently residual interests are sold at a loss by the REMIC sponsor.

The application of section 1221(1) is not an issue for banks and thrift institutions, since section 582(c) already provides that sales or exchanges of residual interests produce ordinary gain or loss. However, for other holders, the application of section 1221(1) can be critical.

e. *Wash Sales*.—In general, securities dealers are not subject to deferral of losses on dispositions of securities where identical securities are considered acquired within 30 days before or after the date of disposition, provided that the dealer incurs such losses in sales made in the ordinary course of its business.³⁶⁷ A "dealer" for purposes of the wash sale rules is defined by reference to the definition under section 471.³⁶⁸ As discussed below,³⁶⁹ however, it is highly uncertain whether a REMIC sponsor can be a dealer with respect to residual interests that by their terms have negative value. In such cases, taxpayers that are not otherwise securities dealers may have reason to be concerned about the possible application of the wash sale rules.

3. *Who are Dealers in Residual Interests?*—Assuming that residual interests are indeed a type of security, at least for some purposes under the

364. *Malat v. Riddell*, 383 U.S. 569, 572 (1966).

365. See, e.g., *Belcher v. Commissioner*, 24 T.C. Memo (CCH) 1, T.C. Memo (P-H) ¶ 65,001 (1965); see also *Sykes v. Commissioner*, 57 T.C. 618 (1972) (holding seller of leafcutter bee larvae to have sold in the ordinary course of business where half of total sales were to one customer).

366. See *Girard Trust*, 22 T.C. at 1360-61; see also I.T. 3648, 1944 C.B. 268.

367. IRC § 1091(a). In addition, securities dealers are not subject to the modified wash sales rules for losses on sales of securities that are part of a straddle. See IRC § 1092(b)(1); Temp. Regs. § 1.1092(b)-1(d)(2).

368. *Donander Co. v. Commissioner*, 29 B.T.A. 312, 314 (1933) (involving the predecessors of § 1091 and Regs. § 1.471-5).

369. See *infra* Part VI.B.3.

Code, it remains to be considered in what circumstances a taxpayer can qualify as a dealer in residual interests. The primary definition of a securities dealer in this regard is found in the regulations under section 471:

[A] dealer in securities is a merchant of securities, whether an individual, partnership, or corporation, with an established place of business, regularly engaged in the purchase of securities and their resale to customers; that is, one who as a merchant buys securities and sells them to customers with a view to the gains and profits that may be derived therefrom.³⁷⁰

Like the foregoing definition, authorities defining a dealer tend to invoke the quaint image of the dealer as a merchant or middleman who stands by with a warehouse or inventory of goods ready to make a profit by marking up his merchandise and selling it retail to customers.³⁷¹ The dealer-merchant is to be distinguished from the mere trader or speculator in securities, who strives to profit from hoped for increases in the market value of a security.³⁷²

In the context of residual interests that by their terms have positive economic value, the determination of dealer status should be no different than with respect to other types of securities. However, unlike other types of stocks or bonds, it should be noted that a taxpayer may be a dealer not only where it purchases and resells REMIC residual (or regular) interests, but also

370. Regs. § 1.471-5.

371. See, e.g., *Kemon v. Commissioner*, 16 T.C. 1026, 1032-33 (1951), in which the court stated:

Those who sell "to customers" are comparable to a merchant in that they purchase their stock in trade, in this case securities, with the expectation of reselling at a profit, not because of a rise in value during the interval of time between purchase and resale, but merely because they have or hope to find a market of buyers who will purchase from them at a price in excess of their cost. This excess or mark-up represents remuneration for their labors as a middle man bringing together buyer and seller, and performing the usual services of retailer or wholesaler of goods.

See also *Stokes v. Rothensies*, 61 F. Supp. 444, 448 (E.D. Pa. 1945), *aff'd*, 154 F.2d 1022 (3d Cir. 1946) ("There must be an offering of wares to customers with a primary view to a distributing profit which may be derived from a middleman operation in securities.").

372. This is not to say that a dealer may not also seek to maximize its profit by holding securities with an eye to cashing in on increases in market value. See, e.g., *Stokes*, 61 F. Supp. at 450; Rev. Rul. 72-523, 1972-2 C.B. 242 (holding a taxpayer is a dealer in mortgages even though it expects to profit not only from sales, but also from future servicing fees with respect to the sold mortgages). However, such market returns cannot be the sole basis on which the purported dealer hopes to profit. See, e.g., *Brown v. United States*, 426 F.2d 355, 364 (Ct. Cl. 1970); Priv. Let. Rul. 9345003 (July 15, 1993).

where the taxpayer originates REMIC interests (i.e., the sponsor). For example, a bank that regularly packages its mortgages and contributes them to REMICs and sells the resulting residual and regular interests certainly should be viewed as a dealer in such REMIC interests.³⁷³

The matter is less clear with respect to residual interests that by their terms do not have positive value. If a sponsor contributes mortgages to a REMIC in exchange for regular interests and a negative value residual interest, can the sponsor be a dealer in the residual interest? The sponsor may regularly create and sell REMIC interests, but focussing solely on the residual interest it is clear that the sponsor will derive no profit (and has no expectation of deriving a profit) from sales thereof. In fact, it will have to pay someone to accept ownership, thus taking a loss on the transaction. From a tax policy vantage point, it would seem untenable to permit the sponsor to be a dealer with respect to the regular interests, but not with respect to the residual interests. Yet the caselaw does not clearly support dealer status for negative value or loss property. In general, the authorities indicate that the taxpayer must have a specific profit expectation with respect to sales of property in order to be a dealer in that property.³⁷⁴ It is true that overall the sponsor may anticipate a net profit on the combined sales of both the regular interests and the residual interests, but that does not appear to be a sufficient basis under the caselaw for being a dealer with respect to property that is inherently loss property.³⁷⁵

373. Some commentators suggest that securitization of receivables and the sale of the resulting interests therein to investors should not be viewed as dealer transactions. See, e.g., NYSBA Analyzes Mark-to-Market Rules, 32 Highlights & Documents 3920 (Mar. 4, 1994). No authorities or analysis for that puzzling conclusion are provided. Under longstanding law, a bank that in the ordinary course of its business regularly originates receivables and sells them is a dealer therein. Rev. Rul. 81-200, 1981-2 C.B. 81; Rev. Rul. 72-523, 1972-2 C.B. 242; cf. Rev. Rul. 60-346, 1960-2 C.B. 217 (involving § 1221(1)). Why would the conclusion be different merely because a bank chooses to securitize these receivables first and then sell separate interests in the underlying receivables? If anything, this further enhances the merchandising function that the bank is performing, i.e., it is taking raw receivables and tailoring them for retail sale to customers. See Andrew H. Braiterman, Temporary Mark-to-Market Regulations: A Small Step in the Right Direction, 63 Tax Notes 467, 469 (Apr. 25, 1994). Braiterman appears to agree with this conclusion, although he states that "good arguments can be made" that such securitization transactions by banks are not dealer transactions. *Id.* Though arguments to this end can be made, they are probably not either good or persuasive.

374. *Brown*, 426 F.2d at 364 (holding taxpayer not to be a dealer where "[t]here was no hope or expectation of selling the securities at a profit. Instead, the obligations were purchased in anticipation of selling them at a loss."); *Girard Trust Corn Exchange Bank v. Commissioner*, 22 T.C. 1343, 1361 (1954) (stating definition of dealer includes the requirement of buying as well as selling for purposes of profit).

375. See, e.g., *Stephens, Inc. v. United States*, 464 F.2d 53, 59-60 (8th Cir. 1972). Compare the discussion of the inventorability of negative value residuals *supra* Part VI.B.2.b.

C. Thrift Institutions and REITs

1. *Thrift Institutions.*—Thrift institutions are required to meet certain asset tests under the Code and regulations in order to qualify for special tax treatment.³⁷⁶ In particular, if a thrift institution meets the so-called “60%” asset test, it may deduct a reasonable addition to bad debt reserves, which deductions other taxpayers generally are not permitted.³⁷⁷ Moreover, in computing the deductible addition to its bad debt reserves, a more generous methodology applies with respect to loan assets that constitute “qualifying real property loans.”³⁷⁸ How are REMIC residual interests treated for purposes of these tests?

Under the 60% test of section 7701(a)(19)(C), at the close of the taxable year at least 60% of the institution’s total assets must consist of specified assets (e.g., cash, residential real property loans, property used in the institution’s trade or business, et al.) (“qualifying assets”).³⁷⁹ For purposes of the 60% test, the statute treats REMIC regular and residual interests as qualifying assets, but only in the proportion which the assets of the REMIC consist of such qualifying assets.³⁸⁰ However, if 95% or more of the REMIC’s assets consist of qualifying assets, then the entire residual or regular interest at issue is considered a qualifying asset.³⁸¹ Moreover, if a REMIC holds a regular interest in another REMIC, such other interest is treated as qualifying asset, once again based on the proportion of the REMIC’s assets that are qualifying assets. If, however, the two REMICs are part of a “tiered structure,” both are treated as one REMIC for purposes of the 60% test.³⁸²

376. A thrift institution, in general, is any domestic building and loan association, mutual savings bank, or cooperative bank without capital stock organized and operated for mutual purpose and without profit. IRC § 593(a).

377. IRC § 593(a)(2).

378. See IRC § 593(b)(1)(B).

379. Regs. § 301.7701-13A(d), (e).

380. IRC § 7701(a)(19)(C)(xi); Regs. § 301.7701-13A(e)(12).

381. *Id.* The REMIC is required to report to the residual interest holders on the quarterly Schedule Q the extent to which its assets are qualifying assets under § 7701(a)(19). Regs. § 1.860F-4(e)(1)(ii)(A)(2). The 95% computation is based on adjusted tax basis. Regs. § 1.860F-4(e)(1)(iii). As noted above, § 7701(a)(19)(C) only requires that the test be met as of the close of the taxable year, although the regulations thereunder permit the taxpayer to use the monthly, quarterly or semiannual average and permit the taxpayer to change the basis of its averaging from year to year. Regs. § 301.7701-13A(d). Accordingly, the taxpayer has flexibility at the end of the year to determine whether year-end or some average of Schedule Q data is most appropriate.

382. IRC § 7701(a)(19)(C). According to the legislative history, a tiered REMIC structure exists if it was contemplated (apparently by the sponsor) when both REMICs were formed that some or all of the regular interests in one REMIC would be held by the other. S.

In addition to the 60% asset test, in computing bad debt reserves it is important to determine whether the more favorable rules applicable to "qualifying real property loans" apply. On this point, once again the statute provides that any REMIC regular or residual interest is treated as a qualifying real property loan in the same proportion that the assets of the REMIC so qualify, provided that if 95% of the REMIC assets are qualified real property loans, then the entire regular or residual interests are so treated.³⁸³

In applying the 60% qualifying asset test and in testing for qualifying real property loan status, it is thus necessary for the REMIC to categorize its assets. Generally, the definition of a "qualified mortgage" is such that all of the REMIC's assets that consist of qualified mortgages typically will be both qualifying assets and qualified real property loans. For example, with respect to the 60% test, a REMIC's qualified mortgages would typically constitute loans secured by an interest in real property for purposes of section 7701(a)(19)(C), although the match is not an entirely perfect one.³⁸⁴ With respect to qualifying real property loan status, few issues should arise with respect to REMIC qualified mortgages,³⁸⁵ except possibly with respect to the explicit requirement in the statute that a mortgage must constitute debt within the meaning of section 166.³⁸⁶

Rep. No. 445, *supra* note 39, at 91-92, reprinted in 1988 U.S.C.C.A.N. at 4609-10. The computations where a tiered structure is involved can become quite complicated if, for example, the REMIC owns a medley of other REMIC regular interests.

383. IRC § 593(d)(4); Regs. § 1.593-11(e).

384. IRC § 7701(a)(19)(C). For example, a REMIC may hold mortgages secured by commercial real estate or agricultural property, but these are not qualified assets under the 60% test. IRC § 7701(a)(19)(C)(v) (requiring that loans primarily be secured by residential real property, with certain exceptions). Mortgages secured by shares in a cooperative are a qualified mortgage for REMIC purposes, but the statute and regulations are unclear regarding the 60% test. However, the Service has ruled that such mortgages constitute a qualifying asset under the 60% test and are a qualifying real property loan. Rev. Rul. 89-59, 1989-1 C.B. 317.

385. One minor interpretive issue concerns loans secured by manufactured housing. In general, under the literal instructions in the regulations, when testing whether a REMIC's assets are qualifying real property loans for purposes of the 95% test, qualified mortgages held by a REMIC that are secured by manufactured housing are treated as qualified real property loans if the manufactured housing constitutes a single family residence under § 25(e)(10). Regs. § 1.593-11(e)(2)(i) (stating § 25(e)(10) manufactured houses are "qualified real property" for purposes of the 95% test). Yet, the actual definition of a qualifying real property loan in Regs. § 1.593-11(b) also independently defines when a mortgage secured by a "mobile unit" (which largely overlaps manufactured housing) qualifies, and it imposes a more elaborate and stringent set of requirements than § 25(e)(10). It appears, however, that the Service intends that § 25(e)(10), where different, controls with respect to the REMIC 95% test.

386. IRC § 593(d)(3). This should rarely, if ever, be an issue for a residential mortgage. In the case of a commercial mortgage with an equity kicker or other contingent feature, it is possible that the loan would be bifurcated into a part-debt, part-equity instrument or, less likely, recast as equity in its entirety.

Even if a REMIC's qualified mortgage qualifies as a valid *type* of mortgage under the foregoing tests, a further issue arises regarding the *extent* to which it may qualify. A mortgage is a qualified mortgage for REMIC purposes if, either at the time of origination or at the time of contribution to the REMIC, the value of the real property interest securing a mortgage is at least 80% of the mortgage's adjusted issue price.³⁸⁷ The test is an all or nothing one; if the 80% threshold is met, then the entire mortgage is treated as a qualified mortgage for REMIC purposes, otherwise the entire mortgage is disqualified for REMIC purposes.³⁸⁸

For purposes of the 60% test, section 7701(a)(19)(C) and the current regulations thereunder are silent regarding the extent to which a loan must be secured by a qualifying real property interest, although prior regulations contained elaborate rules for measuring this.³⁸⁹ In general, under the former regulations a loan was treated as a loan secured by an interest in real property only to the extent the loan did not exceed the "loan value" of the real property interest.³⁹⁰ However, if the loan value of the real property interest exceeded 85% of the loan amount, then the loan was treated in its entirety as secured by a real property interest.³⁹¹ The former regulations are not controlling and it is probably reasonable to simply follow the all or nothing approach of the REMIC rules absent further guidance. The issue in any event is not an acute one, since even if the principles of the former regulations were followed, a REMIC's qualified mortgages will generally constitute qualified assets in their entirety for purposes of the 60% test.

The case is slightly different with respect to the definition of a qualifying real property loan, which specifically directs that the principles of section 7701(a)(19) be applied to determine the portion of a loan that constitutes a qualified real property loan.³⁹² As noted, there are no such principles under section 7701(a)(19); the reference in the section 593 regulations is an obsolete one that was meant to incorporate the former regulations under section 7701(a)(19)(C). Notwithstanding this confusion, one probably should simply follow the approach of the former regulations.³⁹³

387. Regs. § 1.860G-2(a)(1)(i).

388. *Id.*

389. Regs. § 301.7701-13(k) (T.D. 6766, Oct. 31, 1964) (applicable for pre-1970 taxable years).

390. Regs. § 301.7701-13(k)(1)(i). Loan value for these purposes is the maximum amount that an institution is permitted to lend on such property under applicable law, but not in excess of its fair market value. Regs. § 301.7701-13(k)(4). Generally, the determination is made at origination. Regs. § 301.7701-13(k)(3).

391. Regs. § 301.7701-13(k)(1)(i).

392. Regs. § 1.593-11(d)(2).

393. See 1 Peat, Marwick, Main, Taxation of Financial Institutions § 16.01[1][e] (1993) ("Presumably, the pre-1970 regulations still have precedential value.").

As described above, the loan is treated as a qualifying real property loan up to the value of the real property security, except that if the value of the real property equals 85% of the amount of loan, then the entire loan is treated as secured by such property.³⁹⁴ Once again, it is unlikely that this would prove problematic with respect to a REMIC's qualified mortgages.

In sum, it is altogether possible that some of the qualified mortgages of a REMIC may be secured by collateral other than real property; the definition of a REMIC qualified mortgage affords significant flexibility in this respect. Nonreal property collateral can arise, for example, in the case of REMIC mortgages secured by hotel or motel property, or REMIC mortgages that have a buy-down fund where, as is typical, the buy-down fund is viewed as additional collateral for the loan. Nevertheless, unless the real property collateral for the loan slips below 85% generally no issue should arise.

Apart from the status of a REMIC's qualified mortgages, a REMIC may hold certain types of nonmortgage assets, such as cash flow investments, foreclosure property, or a qualified reserve fund.³⁹⁵ With certain exceptions, nonmortgage assets can count against the REMIC in applying the foregoing 95% test. An exception, however, is provided for REMIC cash flow investments, which are defined as investments of payments received on qualified mortgages for a temporary period pending distribution to interest holders, so long as such investments are passive investments earning a return in the nature of interest.³⁹⁶ The regulations under section 593, but curiously not under section 7701(a)(19)(C), expressly provide that cash flow investments are treated as qualifying real property loans.³⁹⁷ Further, foreclosure property is treated by statute as a qualifying asset for purposes of the 60% asset test,³⁹⁸ although not surprisingly such property is not a qualifying real property loan under section 593.

In sum, REMICs must identify the nature of their qualified mortgages and determine on a quarterly basis the breakdown of their assets in order to report to residual interest holders to what extent their assets are qualifying

394. Regs. § 301.7701-13(k)(1)(i).

395. IRC § 860G(a)(5).

396. Regs. § 1.860G-2(g)(1)(i).

397. Regs. § 1.593-11(e)(2)(ii). It is unclear why such a rule was not included in Regs. § 301.7701-13A(e). It is true that § 7701(a)(19)(C) already includes, as qualifying assets for purposes of applying the 60% test, items such as cash and time or demand deposits, but these cash-like items fall short of covering the spectrum of cash flow investments permitted for a REMIC. For example, the list of permitted investments for a REMIC typically includes federal funds and bankers acceptances, which would not be qualified assets under § 7701(a)(19)(C). Rev. Rul. 66-318, 1966-2 C.B. 522 (stating that bankers acceptances are not cash items); cf. G.C.M. 39531 (July 16, 1986) (concluding that federal funds are not cash items for purposes of § 851(b)(4)).

398. IRC § 7701(a)(19)(C)(viii).

assets under the foregoing tests. As the discussion above indicates, the determination is not necessarily an easy one and one wonders how precise of a job REMIC administrators do, given the welter of different standards and rules.

2. *REITs*.—Like thrift institutions, REITs are also subject to rules relating to the composition of their assets, and in addition they must meet certain gross income tests. In particular, as of the close of each quarter of the taxable year, at least 75% of the total assets of a REIT must be represented by “real estate assets,” cash and cash items (including receivables, and government securities),³⁹⁹ and at least 75% of the gross income of a REIT must be derived from real estate assets. Gross income derived from real estate assets includes interest on obligations secured by mortgages on real property (“real estate mortgages”).⁴⁰⁰ For this purpose, the statute provides that REMIC residual and regular interests are treated as a real estate asset in their entirety, and any income thereon is treated in its entirety as interest on a real estate mortgage, if at least 95% of the assets of the REMIC qualify as real estate assets.⁴⁰¹ However, if the REMIC assets do not meet this 95% test, then a REIT residual interest holder is treated as holding directly its proportionate share of the REMIC’s assets and income.⁴⁰² The rule thus is virtually identical to the rule described above with respect to thrifts.⁴⁰³ As in the case of thrift institutions, special rules provide that manufactured housing and cash flow investments are treated as real estate assets.⁴⁰⁴ In addition, as in the case of thrifts a special rule applies to treat tiered REMICs as one REMIC.⁴⁰⁵

Once again, the status of REMIC residual and regular interests ultimately requires an analysis of the assets (and in this context, income as well) of the REMIC. In general, it appears that all REMIC qualified mortgages will constitute real estate assets for purposes of section 856(c)(6)(B).⁴⁰⁶

399. IRC § 856(c)(5)(A).

400. IRC § 856(c)(3).

401. IRC § 856(c)(6)(E). The 95% test focuses solely on the proportion of the REMIC’s assets which constitute real estate assets; there is no additional requirement that 95% of the REMIC’s gross income constitute interest income on real estate mortgages.

402. *Id.*

403. Unlike § 593(d)(4) and § 7701(a)(19)(C), § 856(c)(6)(E) provides that the REIT is treated as holding directly and receiving directly its proportionate share of the assets and income of the REMIC if less than 95% of the REMIC’s assets constitute real estate assets. This is necessary since at issue is not only the type of asset that the REMIC interests represent, but also the type of income.

404. Regs. § 1.856-3(b)(2)(ii).

405. IRC § 856(c)(6)(E).

406. Stock in a cooperative, for example, has been held to be an interest in real property which are “real estate assets” under § 856(c)(6)(B). *Priv. Let. Rul. 8628038* (Apr. 14,

Foreclosure property generally will also be a real estate asset, although non-real property items that may be swept up in the foreclosure (such as furniture or other nonfixtures) would not be.

A final issue with respect to REITs concerns the definition of a real estate mortgage for purpose of the 75% income test in section 856(c)(3). In general, a REIT is limited in its ability to receive contingent interest amounts under mortgages (e.g., interest based on mortgagor profits),⁴⁰⁷ whereas a qualified mortgage for REMIC purposes can include mortgages that provide for such contingent interest.⁴⁰⁸ To prevent REITs from avoiding the limitations on contingent interest, the regulations provide that even if a REMIC satisfies the 95% test (95% or more of its assets are real estate assets and 95% or more of its gross income is interest on real estate mortgages), nevertheless in abusive cases the REIT will be treated as holding directly and receiving directly its share of the REMIC assets and income.⁴⁰⁹

VII. REGULATING TRANSFERS OF RESIDUAL INTERESTS

A. *In General*

Given the desire to ensure that excess inclusion amounts be currently taxable in all events, it is not enough to provide simply that holders may not utilize losses or other deductions. Some holders are exempt altogether from U.S. income taxation and others are de facto taxable only on a cash basis (i.e., taxable only to the extent of actual receipts). Thus, the goal of ensuring current taxation of excess inclusion amounts would be thwarted if no provision were made for special taxpayers that are in some sense outside the normal U.S. tax system. This is where the special rules regarding transfers of residual interests come into play. In essence, as described below, these rules disregard or penalize transfers of residual interests in circumstances where avoidance of current tax on excess inclusion amounts can arise.

B. *Prolegomenon: What is a Transfer?*

All of the various rules restricting transfers of residual interests that are described below utilize the operative term "transfer," which is nowhere defined. Since adverse consequences flow from violative transfers, it is

1986). The Service also has ruled that interest on debt secured by cooperative stock is treated as interest on an obligation secured by a mortgage on real property. Rev. Rul. 76-101, 1976-1 C.B. 186.

407. IRC § 856(f), (g).

408. Regs. § 1.860G-2(a)(7).

409. Regs. § 1.856-3(b)(2)(iii).

necessary to obtain as much precision as possible about what is and is not a transfer. The universe of events that could lead to a new person or legal entity becoming, in some sense, a new owner of a residual interest is indeed a large one. A residual interest could be obtained, for example, by gift, bequest, tax-free contribution, merger, liquidation, reincorporation, distribution, foreclosure, not to mention the paradigmatic type of transfer—by sale or exchange. All of these events apparently would be transfers for purposes of the REMIC rules, although that approach seems needlessly formalistic.

The potentially broad concept of a transfer should prove less troublesome in the case of transfers of noneconomic residual interests than in the case of transfers involving foreign persons. In the former case, as discussed in greater detail below, the transfer will be respected unless the transferor had “improper knowledge,” a subjective enough standard that taxpayers should always have some room to argue. The matter is less promising for transfers involving foreign persons, where any event involving a foreign persons that should cross the threshold of being a “transfer” in most cases will automatically result in a violation.

As a tax policy matter, changes in ownership that are in some sense involuntary should not be transfers. For example, transfers of ownership incident to bankruptcy or foreclosure hardly seem appropriate candidates for triggering transfer penalties. Similarly, formal transfers of ownership that occur incident to transactions that do not effect any real change in beneficial ownership are also inappropriate targets. For example, to take the clearest case, a transfer incident to a reincorporation (i.e., an “F” reorganization) should not be a “transfer.” In addition, transfers within a consolidated group of corporations, where each corporation remains jointly and severally liable for the taxes of the entire group,⁴¹⁰ should be ignored. Finally, a transfer that occurs as a part of a deemed distribution and recontribution of partnership assets upon a section 708(b) termination also should not be a transfer. Yet, in the absence of further guidance, which guidance is unlikely to be forthcoming, one must be concerned that all of the foregoing events could be transfers for purposes of the REMIC rules.

C. *Noneconomic Residual Interests*

As we have seen, residual interests frequently may be structured with minimal or negative value. Thus, although the holder may receive an up-front payment, he may receive little, or no other cash under the residual interest to cover the future tax liability. When the tax liability arises, a naive holder or a deadbeat holder may no longer have assets to cover the liability, having

410. Regs. § 1.1502-6(a).

long since spent the up-front payment, and thus may decide to walk away from the liability or seek shelter in bankruptcy. Although the tax collector may seize the residual interest, such interest may have no real value. Further, the backup withholding regime is of no help, since there will be little or no distributions of cash by the REMIC on the residual interest. In short, de facto avoidance of current tax can arise.

In order to prevent this situation, the Service decided to place a burden of due diligence on the transferor of so-called a "noneconomic" residual interest.⁴¹¹ In essence, the transferor must take steps to ascertain that the transferee will likely pay the tax liability associated with the residual interest as it becomes due. If the transferor fails to do this, then the transfer is disregarded for federal income tax purposes, thus causing the transferor to remain the owner.⁴¹² These due diligence rules regarding transfers of noneconomic residual interests only apply to transfers to domestic persons.⁴¹³ Separate rules (discussed below) apply in the case of transfers of certain types of residual interests to foreign holders.⁴¹⁴

There are three aspects to the rules regarding transfers of noneconomic residual interests: (i) the definition of a noneconomic residual, (ii) the scope of the transferor's required due diligence, and (iii) the consequences of failing to meet the requirements. Each aspect is discussed in turn below.

1. *The Definition of a Noneconomic Residual Interest.*—The status of a residual interest as a noneconomic residual interest is tested as of the time of a transfer.⁴¹⁵ In general, a residual interest is a considered noneconomic residual if it fails either of the following tests.⁴¹⁶ First, at the time of a transfer the present value of expected future distributions on the residual

411. A noneconomic residual interest and its counterpart, an economic residual interest, are unrelated to a significant value residual interest and its counterpart, an insignificant value residual interest. In theory, for example, a residual interest that has significant value under Regs. § 1.860E-1(a)(3)(iii) could well be noneconomic; e.g., insufficient REMIC distributions are expected to occur after excess inclusion tax liabilities attach.

412. Presumably the transfer of a noneconomic residual interest to a holder other than the sponsor is treated as a transfer by the sponsor. See Regs. § 1.860F-2(a)(1) (providing all REMIC formations are treated as a transfer of mortgages by the sponsor to the REMIC in exchange for the regular and residual interests). Thus, the REMIC is never a transferor; the sponsor is responsible for due diligence in this circumstance and liable in the event the transfer is disregarded. This is explicitly stated in Regs. § 1.860G-3(a)(1) regarding transfers of residual interests to foreign persons.

413. Regs. § 1.860E-1(d). Transfers of residual interests by foreign holders to domestic persons are also potentially subject to the rules regarding noneconomic residual interests because no reference to Regs. § 1.860G-3(a)(4) is present in Regs. § 1.860E-1(d).

414. Regs. § 1.860G-3.

415. Regs. § 1.860E-1(c)(2).

416. *Id.*

interest must at least equal the product of the present value of the anticipated excess inclusions and the highest corporate marginal tax rate (currently 35%) for the year in which the transfer occurs.⁴¹⁷ Second, the transferor must reasonably expect that, for each anticipated excess inclusion, the transferee will receive distributions from the REMIC at or after the time at which the taxes accrue on the anticipated excess inclusion in an amount sufficient to satisfy the accrued taxes.⁴¹⁸

As to the first test, the determination is purely a mathematical one. Upon a transfer, one discounts back to the transfer date the amount of "anticipated" excess inclusions from the end of each remaining calendar quarter to the date of the transfer and multiplies the sum of the present values by the applicable tax rate.⁴¹⁹ Next, one discounts back expected distributions from the REMIC, presumably from the date each distribution is expected to occur (e.g., at the end of each month) and not as of the end of each calendar quarter.⁴²⁰ Finally, the two figures so computed are compared and the present value of expected distributions must equal or exceed the present value of the future taxes.⁴²¹ The determination of anticipated excess inclusions and distributions is based (i) events that have occurred up to the time of the transfer, (ii) the prepayment and reinvestment assumptions adopted under section 1272(a)(6), and (iii) any required or permitted clean up calls, or required qualified liquidation provided for in the REMIC organizational documents.⁴²²

The second test relates to the timing of distributions from the REMIC.⁴²³ Even if a residual interest has sufficient expected distributions to cover the future tax liability on excess inclusions, this is not enough.⁴²⁴ The transferor must reasonably expect that the holder will receive sufficient cash from the REMIC to pay the excess inclusion tax liability at or after it accrues.⁴²⁵ It is interesting that this second test is not a strictly quantitative one; one could imagine an objective rule that requires that the stream of taxes due on anticipated excess inclusions at no point in time exceed the sum of

417. Regs. § 1.860E-1(c)(2)(i).

418. Regs. § 1.860E-1(c)(2)(ii).

419. Regs. § 1.860E-1(c)(3), -2(a)(4).

420. The procedure set forth in Regs. § 1.860E-2(a)(4) refers to discounting on the basis of calendar quarters. It would seem distortionary to use that method for expected distributions, but compare the discussion *supra* Part IV.B.3. on the timing of distributions and basis calculations.

421. In performing the discounting, the regulations require use of the applicable federal rate as specified in § 1274(d)(1). Regs. § 1.860E-2(a)(4).

422. Regs. § 1.860E-2(a)(3).

423. See Regs. § 1.860E-2(c)(2)(ii).

424. *Id.*

425. *Id.*

expected future distributions (as calculated in the first test). Yet, the test does not purport to be a strictly mathematical one, but rather one that turns on the subjective concept of a transferor's reasonable expectations.⁴²⁶

Although, all things being equal, one would prefer generally that a residual interest not be noneconomic, it does not appear that a great deal of pressure to avoid this status exists in the structuring of REMIC residuals. This is no doubt largely because, as discussed below, the status of a residual interest as noneconomic has little bearing on the REMIC itself or the REMIC regular interest holders and the transfer restrictions that accompany noneconomic status are not all that onerous. However, for those instances where noneconomic status is a sensitive structuring point, it is worthwhile exploring how to cope with the definition of a noneconomic residual. Regarding the first test, the same point that was made with respect to significant value residual interests can be made here. To wit, the expected future distributions encompass all future cash to which the REMIC residual holder is entitled, regardless of the credit quality of that entitlement. Thus, by assigning to the residual interest deeply subordinate rights to cash,⁴²⁷ one can bump up the present value of expected future distributions to meet the first test. With respect to the second test, future distributions are required to come on or after the accrual of tax liabilities, but there is no requirement that the distributions match up in any way with such tax liabilities.⁴²⁸ Thus, by scheduling a sufficient distribution at or near the end of the REMIC, one can satisfy the timing test. However, since the transferor must "reasonably expect" that the transferee will actually receive sufficient distributions from the REMIC, merely assigning deeply subordinate rights to cash would not seem to pass muster.

A final point to note regarding the definition of a noneconomic residual interest is that noneconomic status is tested at the time of transfer.⁴²⁹ Thus, noneconomic status at issuance is not necessarily relevant in the case of later, secondary transfers of a residual interest. For example, if a residual interest is noneconomic at issuance, but subsequently the REMIC begins experiencing losses and such losses are projected to continue, then even a residual interest that provides for no distributions will not be a noneconomic residual interest. The result is entirely sensible; since the purpose of the noneconomic test is to prevent tax avoidance, there is no need for such a rule if there is no tax to avoid.

426. *Id.*

427. See *supra* Part V.B.3.b.

428. See Regs. § 1.860E-1(c)(2)(ii). This is in contrast with rule for transfers of certain residual interests to foreign persons. See *infra* Part VII.D.1.

429. Regs. § 1.860E-1(c)(2).

2. *Transferor Due Diligence.*—The regulations provide that a transfer of a noneconomic residual interest is disregarded if a significant purpose of the transfer was to impede the assessment or collection of tax.⁴³⁰ As originally proposed, this was all that the regulations stated, and a number of comments were made requesting further elaboration on this subjective and vague mens rea standard. For example, it was unclear whether the “purpose” at issue was that of the transferor in transferring the residual interest, that of the transferee in acquiring it, or both. Thus, it was common to have both the transferor and the transferee certify that they had no illicit motive in the transaction.

As finalized, the regulations expound further on the standard and, more importantly, provide a safe harbor rule. Under the regulations significant purpose exists if, at the time of the transfer, the transferor either knew or should have known that the transferee would be unwilling or unable to pay taxes due on its share of the taxable income of the REMIC.⁴³¹ The existence of such knowledge is referred to in the regulations as “improper knowledge.”⁴³² Thus, the focus is on what the transferor knows or should have known about the transferee; secret purposes of, or suspicious facts regarding the transferee are irrelevant if the transferor is ignorant of them and such ignorance is reasonable.

Although this refinement of the meaning of a “significant purpose” is helpful, it is still fraught with uncertainty. Fortunately, however, the regulations go on to provide a safe harbor that, as a practical matter, transferors of noneconomic residuals generally will always seek to satisfy. Under the safe harbor rule, a transferor will not be considered to have improper knowledge if the transferor conducts a credit investigation of the transferor and obtains certain representations.⁴³³ Specifically, the regulations provide that the transferor must conduct, at the time of transfer, a reasonable investigation of the financial condition of the transferee and, as a result of the investigation, find that the transferee has historically paid its debts as they came due and find no significant evidence to indicate that the transferee will not continue to pay its debts as they come due in the future.⁴³⁴ In addition, the transferor must obtain from the transferee a representation that it understands that, as a holder of a noneconomic residual interest, it may incur tax liabilities in excess of any cash flows generated by the interest and that it

430. Regs. § 1.860E-1(c)(1).

431. *Id.*

432. *Id.*; cf. Regs. § 1.856-6(a)(3) (setting out an “improper knowledge” test for foreclosure property).

433. Regs. § 1.860E-1(c)(4)(i).

434. *Id.*

intends to pay taxes associated with holding the residual interest as they become due.⁴³⁵

As noted above, in most instances the transferor of a noneconomic residual interest will seek to come within the safe harbor rule. As a practical matter, complying with the safe harbor rule has not proved exceedingly onerous, since many REMIC sponsors had been undertaking comparable due diligence anyway before the safe harbor rule was issued in December 1992. Although the precise extent of the requisite credit investigation is not certain, transferors should not be too cursory in their investigation and should take particular care in documenting it. Inevitably, the day will come when a transferee will fail to pay the REMIC's taxes and just as certain, when that day arrives the Service, armed with hindsight, will look to the transferor and attempt to assert that it should have known this was going to occur. Obviously, the more thorough and documented the credit investigation, the better able will the transferor be to prevail.

3. *Failed Transfers*.—If a noneconomic residual interest is transferred with a “significant purpose” of enabling the transferor to impede the collection or assessment of tax, the resulting penalty is that the transfer is disregarded for all federal income tax purposes.⁴³⁶ In short, the transferor is still considered to own the residual interest and remains liable for the income thereon (and is entitled to claim the associated deductions). Disregarding a transfer can have obvious and severe consequences to the transferor, but it is also an event that is easier said than done. Trying to unwind a transfer that may have occurred years before would be a complicated undertaking. However, the purpose of the regulations doubtlessly is that the mere threat of this will have sufficient in terrorem effect so as to obviate any need for the Service to actually implement the penalty on a regular basis.

In addition, disregarding the transfer is an option available to the Service, but not the taxpayer. Thus, a transferee should be stuck with the form of the transaction and should not be able in retrospect to disregard the transfer, perhaps arguing that the transferor should have known that it, the transferee, had no intention of paying the tax.

Finally, while perhaps obvious, it is worth stressing that the rules regarding transfers of noneconomic residual interests are the concern of the transferor and the transferee. There are no direct REMIC level tax consequences that flow from “failed” transfers of noneconomic residual interests; the REMIC is never considered a transferor.⁴³⁷ Thus, no express penalty

435. Regs. § 1.860E-1(c)(4)(ii).

436. Regs. § 1.860E-1(c)(1).

437. See *supra* note 412.

taxes apply to the REMIC in these circumstances nor is REMIC qualification at all affected by such transfers. In short, the REMIC has no duty to monitor transfers of its noneconomic residual interests.⁴³⁸ However, though not expressly required, the REMIC probably is under an obligation to provide, upon request, the necessary information to determine whether at the time of a proposed transfer a residual interest is a noneconomic residual or not.⁴³⁹

D. *Special Rules on Transfers to Foreign Holders*

1. *Transfers to Foreign Holders.*—Rules roughly analogous to those relating to noneconomic residual interests are provided with respect to transfers of residual interests to holders that are “foreign persons.”⁴⁴⁰ These rules apply to transfers of residual interests that have “significant tax avoidance potential” and, once again, the penalty for failed transfers is that they are disregarded for all federal tax purposes.⁴⁴¹ Although similar to the noneconomic residual rules, the foreign transferee restrictions are distinct and have a different focus.

In general, foreign persons that are not engaged in a U.S. trade or business are taxable in the United States only through withholding on payments from United States sources. If no actual cash is paid out to the foreign holder, then no tax is collected.⁴⁴² Thus, excess inclusion amounts effectively escape current taxation—becoming taxable only when and if cash is paid out—and thereby result in de facto avoidance of current tax. For example, if a residual interest paid out cash in the first two years and thereafter all distributions ceased, the Service would never collect tax on excess inclusion amounts after the residual interest ceased to pay out cash—a loophole of potentially gargantuan proportions.

438. Cf. Regs. § 1.860E-2(a)(5). Of course, if the REMIC had actual knowledge that a transfer of a noneconomic residual interest was invalid, a concern might arise. Although it is not clear how the REMIC would acquire such knowledge.

439. Regs. § 1.860E-1(c)(3) (describing how noneconomic status is calculated) probably should be viewed as incorporating § 1.860E-2(a)(5) (obligating a REMIC to provide information upon request in order to compute tax due on transfers to disqualified organizations).

440. See Regs. § 1.860G-3. A “foreign person” is indirectly defined by the Code as any nonresident alien individual, foreign partnership, foreign corporation, or foreign estate or trust. IRC §§ 7701(a)(1), (a)(30). A foreign corporation or partnership generally is one that is organized under the laws of a foreign country. See IRC § 7701(a)(5). A foreign trust or estate is one that is not taxable in the United States on a net basis on its worldwide income. See IRC § 7701(a)(31).

441. Regs. § 1.860G-3(a)(1).

442. See discussion of withholding *supra* Part VI.A.2.

The Service's eventual solution to this concern is to prohibit transfers to foreign persons unless the residual interest is structured in such a way that the associated tax liability can be satisfied through withholding as it becomes due. In general, a residual interest may be transferred to a foreign person if, at the time of transfer, the transferor "reasonably expects" that for each excess inclusion, (i) the REMIC will distribute to the foreign transferee an amount that will equal at least 30% of the excess inclusion, and (ii) each such amount will be distributed at or after the time at which the excess inclusions accrues and no later than the close of the calendar year following the calendar year of accrual.⁴⁴³

As originally proposed, the regulations did not specify when the requisite cash amounts needed to be distributed, other than that they be distributed at some point in time after the excess inclusion tax liability accrued. While this approach would ensure that tax on excess inclusion amounts would be collected someday, it granted generous deferral. REMICs soon began to issue residual interests that paid out sufficient cash distributions, but paid it out late in the life of the REMIC—for example, a bullet payment of cash in year thirty. True, the foreign holder would pay tax, but only after many years of deferral.

It was somewhat surprising that the Service initially failed to anticipate this situation; the marketplace, however, seized on it. In very short order, a large proportion of REMIC residual interests began to flow offshore into the hands of foreign holders. With some prompting from jealous domestic residual buyers (as rumor has it), the Service reacted by amending the proposed regulations, as described above, to provide that the requisite cash distributions must be made by the end of the calendar year following the calendar year in which the tax liability for excess inclusion amounts accrued.

Although the intent of the Service was not to impose an outright prohibition on transfers to foreign persons, in actuality its restrictions on the type of residual interests that can be so transferred has largely had that effect. The author is aware of few situations where the parties were willing to go through the inconvenience of structuring a residual interest that could be held by foreign persons. For those that are inclined to structure such residual interests, however, the thrust of the regulations is on what characteristics the transferor reasonably expects a residual interest to have. Although not specifically stated, to be reasonable an expectation probably must be one that is based on the assumed prepayment and reinvestment assumptions, events that have occurred up to the time of the transfer, and any required or

443. Regs. § 1.860G-3(a)(2)(i).

permitted clean up calls or any required qualified liquidation.⁴⁴⁴ Under a special safe harbor, a transferor will be considered to have a reasonable expectation if the residual interest would have the requisite characteristics were the REMIC's qualified mortgages to prepay at each rate within a range of rates from 50% to 200% of the assumed prepayment speed.⁴⁴⁵

Some interesting or odd features of the rules relating to foreign transfers are worth noting. First, the rules literally apply to any transfer of a residual interest to a foreign person, and they apply even if the transferor is itself a foreign person.⁴⁴⁶ Thus, if a residual interest was transferred to a foreign person prior to the effective date of the regulations, that grandfathering is lost upon a subsequent transfer to another foreign person. More significantly, the rule is automatic and therefore is a double-edged sword. If a foreign person obtains a residual interest, then apparently the Service is not able to pursue or assert any unpaid REMIC taxes directly against the foreign person,⁴⁴⁷ since for tax purposes no transfer occurred. That seems to be a silly result.

Second, the rules only apply to direct transfers of ownership interests. A foreign person that holds an interest in a domestic pass through entity (such as a partnership, RIC or REIT) the assets of which include a residual interest is not deemed to acquire or transfer a residual interest merely by acquiring or transferring an interest in the pass-through entity. Since each of these entities clearly are U.S. persons, the rules for transfers to foreign persons would not apply. A partnership would appear to be a particularly attractive vehicle for foreign persons to hold residual interests, since the character of the partnership's income items would flow through to the holder.⁴⁴⁸ A foreign holder would be subject to withholding at the partner-

444. Cf. Regs. § 1.860E-1(a)(3)(iv)(D) (providing method for determining value of anticipated payments); Regs. § 1.860E-2(a)(3) (providing method for calculating anticipated excess inclusions).

445. Regs. § 1.860G-3(a)(2)(ii).

446. Regs. § 1.860G-3(a)(1), (4).

447. The foreign person may be subject to transferee liability, but that would seem to be a rather slender reed.

448. The recently proposed anti-abuse rule under § 701 should be considered in this context. See Prop. Regs. § 1.701-2. The heart of the anti-abuse rule is that "if a partnership is formed or availed of in connection with a transaction or series of related transactions . . . with a principal purpose of substantially reducing the present value of the partners' aggregate federal tax liability in a manner that is inconsistent with the intent of Subchapter K, . . . the Commissioner can recast the transaction for federal tax purposes as appropriate." Prop. Regs. § 1.701-2(b). One way a partnership transaction may be recast is to treat the partners as owning their respective shares of partnership assets directly, a penalty that if applied would preclude ownership of a residual interest by a foreign person through a partnership. Prop. Regs. § 1.701-2(b)(3). The author does not believe that use of a U.S. partnership to hold residual interests in this context is in any sense abusive; the concern underlying the foreign

ship level, regardless of distributions, although the importance of this issue may be diminished or eliminated if the foreign holder is a qualified resident of a treaty country. As noted above,⁴⁴⁹ certain treaties would exempt all income under a residual interest—excess inclusion and nonexcess inclusions income—from U.S. withholding taxes. To date, however, it does not appear that many foreign persons have chosen to hold residual interests through partnerships.

2. *Exception for Residual Interests Generating ECI.*—The foregoing restrictions on transfers to foreign persons do not apply if the income from the residual interest in the hands of the foreign holder would be treated as effectively connected with the conduct of a U.S. trade or business (“ECI”).⁴⁵⁰ Although not specifically stated, in the case of foreign holders eligible to claim treaty benefits, this ECI exception should apply where the income would be attributable to a U.S. permanent establishment of the holder.

As a practical matter, it would seem an unusual case where a foreign person that is not bank would be able to demonstrate that a income on a residual interest is effectively connected with a U.S. trade or business.⁴⁵¹ For foreign banks, the matter may be different; income from a residual interest is treated as ECI if the U.S. office of the foreign actively and materially participated in the acquisition of the residual interest⁴⁵²—a test that allows more planning flexibility.⁴⁵³ It is unclear, however, to what

holder transfer restrictions was that generous deferral or tax avoidance could be obtained due to the fact that withholding taxes would not apply until actual distributions under a residual interest occurred (not as income thereunder accrued). But these concerns do not exist in the case of a U.S. partnership; all income under a residual interest is reported by a U.S. entity and any amounts attributable to foreign partners are subject to withholding on a current basis regardless of partnership distributions. See Regs. § 1.1441-3(f). It is true that foreign partners may be able to claim treaty benefits for excess inclusions, but that can scarcely be characterized as abusive; the treaty represents a decision by the Treasury to bargain away the tax on excess inclusions and taking advantage of that bargain is hardly abusive. Nevertheless, out of caution, practitioners may want to ensure that in addition to residual interests the partnership holds some cognizable business assets which can independently justify the partnership's existence.

449. See discussion *supra* Part VI.A.1.

450. Regs. § 1.860G-3(a)(3). However, the rules regarding noneconomic residual interests would apply.

451. In general, interest income on a security is effectively connected with the conduct of a trade or business in the United States based on the application of either an asset-use test or a business-activities test. Regs. § 1.864-4(c)(1)(i).

452. See Regs. § 1.864-4(c)(5)(ii), (iii). See generally Yaron Z. Reich, U.S. Federal Income Taxation of U.S. Branches of Foreign Banks: Selected Issues and Perspectives, 2 Fla. Tax Rev. 1, 6-15 (1994) (discussing the ECI rules for interest income of foreign banks).

453. In the hands of a foreign bank, a residual interest would qualify as a “security”

extent (if at all) U.S. branches of foreign banks actually participate in the residual interest marketplace.

3. *Transfers by Foreign Persons to U.S. Persons.*—A special rule is prescribed in the case of transfers of residual interests by a foreign person to a U.S. person (or to a foreign person in whose hands income from the residual interest would be ECI).⁴⁵⁴ In such cases, if the transfer has the effect of allowing the transferor to avoid tax on accrued excess inclusions, then the transfer is disregarded and the transferor continues to be treated as the owner of the residual interest for U.S. withholding tax purposes.⁴⁵⁵ For example, if a foreign holder of a residual interest (*viz.*, a residual interest that did not have tax avoidance potential) had accrued income tax liability for excess inclusion amounts and had not yet received cash distributions from the REMIC on which withholding could attach, a transfer of the residual interest to a U.S. person would mean that withholding taxes may never be collected.⁴⁵⁶

To prevent this result, the regulations provide that the transfer is disregarded and the foreign transferor remains liable.⁴⁵⁷ Thus, when cash is distributed, withholding taxes attach, even though the residual interest is now “held” by a U.S. person. Unfortunately, the regulations are somewhat vague in establishing a standard of whether the transfer will have the effect of avoiding tax on excess inclusions; seemingly they envision a strict liability type standard under which intent is irrelevant.

E. *Penalty Tax on Transfers to Disqualified Organizations*

1. *In General.*—In TAMRA, Congress amended provisions to restrict the ownership of residual interests by disqualified organizations.⁴⁵⁸ To accomplish this goal, it required a REMIC to have in place “reasonable arrangements” to prevent such ownership.⁴⁵⁹ However, in recognition of the

within the meaning of Regs. § 1.864-4(c)(5)(v) (it is an “evidence of an interest in” evidences of indebtedness) and as an “other security” within the meaning of Regs. § 1.864-4(c)(5)(ii)(b)(3). Because residual interests involving up-front payments by definition do not have positive value, they would have a book value of no more than zero (query whether they could have a negative book value) for purposes of Regs. § 1.864-4(c)(5)(ii). Thus, acquiring such residual interests could produce ECI, but without affecting the “other security” ratio in Regs. § 1.864-4(c)(5)(ii)(b)(3).

454. See Regs. § 1.860G-3(a)(4).

455. *Id.*

456. Typically gain on the sale of the residual will not be subject to U.S. withholding tax because the gain will not be from U.S. sources. See IRC §§ 865(a)(2), 871(a), 1441(a).

457. Regs. § 1.860G-3(a)(4).

458. See *supra* Part III.C.1.

459. See IRC § 860D(a)(6); Regs. §§ 1.860D-1(a)(4), (5).

practical limitations that necessarily exist on the ability of a REMIC to police ownership of its residual interests, Congress also enacted a special penalty to apply in the event that, notwithstanding the REMIC's best efforts, a residual interest does come into the hands of a disqualified organization.⁴⁶⁰ In general, the penalty is a one time tax that applies at the time of a transfer to the transferor or, if the transfer is effected through an agent of a disqualified organization, to such agent.⁴⁶¹ The amount of the penalty is described below.

In general, the transferor (or agent) can escape liability for the tax if it obtains from the transferee an affidavit that the transferee is not a disqualified organization, provided the transferor has no actual knowledge that the affidavit is false.⁴⁶² In short, if a disqualified organization acquires a residual interest through chicanery or ineptitude, the penalty tax is waived as to the transferor or agent, and apparently the disqualified organization can continue to own the interest without further tax consequence.⁴⁶³ An affidavit for this purpose is defined in the regulations as either the furnishing of a social security number and a statement under penalties of perjury that the number is that of the transferee, or a statement under penalties of perjury by the transferee that it is not a disqualified organization.⁴⁶⁴

If a transferor or agent fails to get an acceptable affidavit (or has actual knowledge that an affidavit is false) and it turns out the transferee is a disqualified organization, the Code does provide a waiver provision whereby the transferor can obtain some relief from the penalty described above.⁴⁶⁵ Under the waiver procedure, if within a reasonable period of time

460. See IRC § 860E(e). The regulations provide a special exception for transitory ownership situations, under which ownership of a residual interest by a disqualified organization is ignored if it arises incident to the formation of the REMIC, the disqualified organization has a binding contract to sell the interest, and the sale occurs within seven days of the startup day. Regs. § 1.860E-2(a)(2).

461. IRC § 860E(e)(3). An agent for this purpose is defined in the regulations as including a broker (as defined under § 6045(c) and Regs. § 1.6045-1(a)(1)), nominee or other middleman. Regs. § 1.860E-2(a)(6).

462. IRC § 860E(e)(4).

463. Frequently, however, the REMIC organizational documents will provide that any transfer of a residual interest to a disqualified organization is null and void and ownership reverts with the transferor. This approach, however, simply invites a lawsuit from the transferor, who may want nothing more to do with the residual interest and may be an innocent dupe of the transferee. In short, what sense does it make to punish the transferor for the transferee's transgressions? A better approach would be for REMIC organizational documents to prohibit ownership by disqualified organizations and leave it at that, with no provision for nullifying the transfer.

464. Regs. § 1.860E-2(a)(7)(i). Thus, it is not necessary, and something of an inconvenience, to require a notarized affidavit as is all too frequently required in REMIC organizational documents.

465. See IRC § 860E(e)(7).

after discovery of the situation steps are taken so that the disqualified organization no longer holds the residual interest and if the transferor agrees to pay an amount prescribed by the Service, the penalty tax will be waived.⁴⁶⁶ If the waiver is granted, the regulations provide that the transferee will only have to pay a penalty tax based on the actual excess inclusions that accrued while the disqualified organization held the residual interest.⁴⁶⁷

Of course, the transferor no longer owns the residual interest, so it is not entirely clear what steps the statute envisions the transferor taking to divest the transferee of ownership. Unless the transferor can coax the transferee to sell its newly acquired residual interest, the rational transferor will not choose to reveal the error to the Service. However, if the transferor succeeds in inducing the transferee to sell the residual interest, then transferor's risk of being assessed a penalty drops precipitously and the wily transferor may well choose to let sleeping dogs lie at this point. In short, the waiver provision seems ill designed to accomplish its goal of encouraging taxpayers to come clean.

2. *Calculation of the Penalty Tax.*—The amount of the penalty tax equals the product of the highest rate of tax imposed under section 11(b)(1) (currently 35%) and the present value of the total anticipated excess inclusions with respect to such interest for periods after the transfer.⁴⁶⁸ For this purpose, anticipated excess inclusions are those that are expected to accrue at each future quarter-end, discounted back to the date of transfer by the applicable federal rate.⁴⁶⁹ The computation of anticipated excess inclusions, which has been described previously, must be based on events that have occurred up to the time of the transfer, the prepayment and reinvestment assumptions adopted under section 1272(a)(6) (or that would have been adopted if the regular interests were issued with OID), and any required or permitted clean up call or any qualified liquidation provided for in the REMIC organizational documents.⁴⁷⁰

The amount of penalty tax reflects an assumption that the residual interest will be held by a disqualified organization from the date of transfer until maturity. If the penalty tax is asserted on audit against a transferor and the disqualified organization has previously disposed of the residual interest, the unfortunate transferor must still pay the full penalty tax.⁴⁷¹

466. *Id.*

467. Regs. § 1.860E-2(a)(7)(ii).

468. IRC § 860E(e)(2). This penalty tax is to be distinguished from the § 860E(e)(7)(B) waiver tax previously discussed.

469. Regs. § 1.860E-2(a)(3).

470. *Id.* For a discussion of the computation, see *supra* Part VII.C.1.

471. See IRC § 860E(e).

Application of the penalty tax depends on calculation of the anticipated excess inclusions amounts and in order to ensure that such information is available to the transferor, the Code requires that the REMIC has reasonable arrangements in place to ensure that this information will be provided.⁴⁷²

3. *Special Rules for Pass-Through Entities.*—The penalty tax on transfers to disqualified organizations could be easily avoided by simply having the disqualified entity hold an interest in a residual interest through a “pass through entity.” For example, two disqualified organizations could enter into a partnership and have the partnership acquire residual interests. The partnership would not itself be a disqualified entity, and upon passing its income through to the partners no tax would be collected since the partners would not be subject to tax. Congress had the foresight to anticipate this possibility and it provided that in this event a penalty tax would be imposed on the pass through entity itself.⁴⁷³

The penalty tax on pass through entities applies if during any taxable year of the entity a disqualified organization is the record holder of an interest in such entity.⁴⁷⁴ A pass through entity for this purpose is defined as a RIC, REIT, partnership, trust, estate, or subchapter T cooperative.⁴⁷⁵ In addition, if any person holds an interest in a pass through entity as a nominee for another person, such holder will be treated as itself a pass through entity with respect to the interest it holds in the pass through entity.⁴⁷⁶ In effect, the pass through entity becomes a withholding agent and is used as a tool for exacting the tax on excess inclusions that would otherwise escape. A pass through entity can avoid the penalty tax for any period if it obtains an affidavit from the record owner of an interest that such holder is not a disqualified organization, provided that during such period the

472. See IRC § 860D(a)(6)(B). See also *supra* Part III.C.

473. See IRC § 860E(e)(6).

474. IRC § 860E(e)(6)(A). Proposed legislation would modify the application of the penalty tax on pass-through entities in the case of so-called “large” partnerships. See Tax Simplification and Technical Corrections Act of 1993, *supra* note 243 (proposing new §§ 771-777). In general, a large partnership would be defined as one with 250 or more partners (or one with 100 or more partners that affirmatively elects large partnership status). See proposed § 775(a). Under the proposed legislation, if a large partnership holds a residual interest, it would be taxed as if all of its partners were disqualified organizations (the net result being that tax on excess inclusions is collected at the partnership level at the highest corporate tax rate). See proposed § 774(e). The amount of excess inclusions subject to the penalty tax, however, would be excluded from partnership gross income (thus avoiding a second tax at the partner level). By all accounts, few large partnerships exist that hold residual interests.

475. IRC § 860E(e)(6)(B).

476. *Id.*

pass-through entity does not have actual knowledge that the affidavit is false.⁴⁷⁷ The affidavit is the same as that described above for transferors to avoid liability for a penalty tax on a direct transfer of a residual interest to a disqualified organization.⁴⁷⁸

One final aspect of the penalty tax on pass through entities concerns the effect of payment of the penalty on the entity. In this regard, the statute provides that the amount of the penalty is deductible by a pass-through entity in computing its taxable income.⁴⁷⁹ This is important for corporate entities, such as the REIT or RIC, which formally are taxable on their net income. By allowing a deduction, the statute is recognizing that the entity is being forced to pay the tax of its shareholder and some credit for the payment of that tax should be provided. The allowance of a deduction, however, is not entirely satisfactory to other holders of interests in a RIC or REIT, since the effect of collecting the tax from the entity is to reduce their respective shares of the net profits of the entity that they would otherwise receive. In effect, each is asked to shoulder the burden of paying the tax due from one or more of the interest holders that are disqualified entities. This injustice is soothed in the regulations, which permit a RIC or REIT to specially allocate the penalty tax to the income payable on interests held by disqualified organizations.⁴⁸⁰

VIII. POSTSCRIPT: RESIDUAL INTERESTS- PARADIGM FOR THE FUTURE?

As this article shows, the tax treatment of REMIC residual interests is a complicated topic involving an impressive array of rules that permit, prohibit, or require all manner of acts. Since the residual interest is a pure creature of statute, it carries with it no common law baggage that inevitably accompanies other financial instruments that build off the venerable tax foundations of debt, equity, option, etc. This can be a blessing in one sense; the government has fairly tight control over how the residual interest will be taxed. But it is a curse in another sense; the government must painstakingly integrate the tax rules applicable to residual interests into the general tax rules in the Code. As we have seen, much work remains to be done on the latter score. Too many questions remain unanswered about how general tax provisions in the Code relate to residual interests. Yet, stepping back from the fray for a moment, it seems clear that the REMIC statute as whole has been

477. IRC § 860E(e)(6)(D).

478. The necessary affidavit is described in Regs. § 1.860E-2(b)(2).

479. IRC § 860E(e)(6)(C); Regs. § 1.860E-2(b)(3).

480. See Regs. § 1.860E-2(b)(4). Absent this special rule, a concern could arise as to whether this special allocation violates the general prohibition against RICs and REITs paying preferential dividends.

a huge success and there is little likelihood in the near term that REMIC transactions will fall out of favor. In short, the residual interest is here to stay.

The success of the REMIC legislation has led to calls for similar securitization vehicles for other types of receivables.⁴⁸¹ Recently, independent sectors of the financial community have developed proposals for two different types of new securitization vehicles. The first such vehicle is the "financial asset securitization trust" or "FASIT," which is designed for the securitization of any type of debt asset.⁴⁸² The second is the "tax exempt municipal investment conduit" or "TEMIC," which is designed specifically for the securitization of tax exempt debt instruments.⁴⁸³ Although it is too early to predict whether either or both proposals will be enacted in some form, it is clear that asset securitization in general has been growing exponentially in recent years. As more and more financial receivables are drawn into securitization vehicles, the prospects seem good that eventually a REMIC analogue or analogues will be developed for nonmortgage receivables. If so, any new securitization vehicle will likely draw heavily on the REMIC provisions in general (as indeed both the FASIT and TEMIC proposals do) and the REMIC residual interest in particular. It is therefore appropriate to examine and attempt to distill what lessons our experience with the REMIC residual interest can have for such new securitization vehicles.

Resolving the treatment of up-front payments. As we have seen, one aspect of the taxation of residual interests that has continued to plague the REMIC community with uncertainty after almost eight years is the treatment of up-front payments. It is likely that any future securitization vehicle, like the REMIC, will be permitted to have an equity interest that has little or no cash entitlement. If so, then such other vehicles will also have to grapple with the up-front payment phenomenon. Thus, it is imperative that the Service come to grips with the admittedly complicated tax issues that negative value property or equity present and devise a reasoned approach to taxing them.

Taxing phantom income and loss. Much of the complexity in the tax treatment of residual interests can be traced to the stubborn resolve on the part of the government to ensure that it exacts at least one layer of tax on phantom income. The goal is laudable, to be sure, and were it possible with reasonable administrative effort to identify accurately phantom income, then perhaps the elaborate rules aimed at taxing it would be more justifiable.

481. One of the first such proposals was by the American Bar Association. See American Bar Association, Legislative Proposal, *supra* note 4.

482. A draft of the FASIT rules was introduced in Congress last year. See H.R. Conf. Rep. 2065, 103d Cong., 1st Sess. (1993). However, the legislation has undergone numerous changes since its introduction and likely will be introduced in a revised form.

483. The TEMIC proposal has not been introduced in Congress, although a draft of the TEMIC legislative proposal is currently circulating among interested parties.

However, the excess inclusion rules are admittedly an inaccurate, rough justice solution that has neither the benefit of administrative ease nor the virtue of accuracy.⁴⁸⁴

In other words, if it be decided that accuracy is to be sacrificed or that it be unattainable, then surely some more straightforward tollcharge or other surcharge would be preferable than the excess inclusion apparatus and collateral rules. In short, the excess inclusion rules represent a theory in search of a practical application. Hopefully, future securitization legislation will find a simpler compromise that will meet the government's concerns for obtaining one layer of tax and the financial community's concerns of reducing mindless transaction costs and inefficiencies.

Regulating transfers. Growing out of the government's fixation on phantom income and its desire to ensure that such income is taxed, are a panoply of rules regulating who may own REMIC residual interests. In essence, the government exacts its desired tax by forcing the residual interest to be held by taxable entities and by limiting the extent to which income may be reduced by deductions. Thus, the transfer rules are in reality an ad hoc set of rules patched together when and as the government perceived loopholes in its excess inclusion scheme. The problem with erecting transfer restrictions is that they are hard to enforce or audit and they amount to interposing the Service into the financial marketplace. One alternative to transfer restrictions is for the government to exact some form of minimal entity level tax as the price of admission. Such entity level taxes, however, tend to scare off investors and rating agencies. Yet, there is much to be said for simply imposing a one time tax on the startup date to be paid by the sponsor out of the proceeds of the sale of the interests in the securitization vehicle and abandoning any effort to regulate who may own an interest in the vehicle.

* * *

In conclusion, it does not augur well for the goal of simplifying the tax system that it should take an article of this length to review the tax aspects of a single financial instrument. Yet, complexity—where it advances accuracy and equity in taxation—is an acceptable, if not welcome outcome. It is questionable, however, whether the rules regarding residual interests achieve an appropriate trade-off between complexity and these goals. Certainly there is much room for simplification at little cost to the government, and it is to be hoped that in considering future securitization legislation

484. Only IRC § 809 comes to mind as a provision that surpasses the REMIC excess inclusion rules in terms of having a worse ratio of complexity to accuracy. Section 809 sets forth an elaborate formula for limiting the deductibility of policyholder dividends by mutual life insurance companies.

decisionmakers take away this lesson, if no other, from the tax treatment of REMIC residual interests.