Chapter 11, Part A.2 (OID Legends)

2. OID Legends

Under regulations,[60] the issuer of a REMIC regular interest or pay-through bond with OID must set forth the following information relating to the instrument on its face: (1) the aggregate amount of OID; (2) the issue date;[61] (3) the initial interest rate;[62] (4) the Prepayment Assumption used in accruing OID under the PAC method; (5) the yield to maturity;[63] and (6) if the instrument has a "short accrual period" (generally a short period until the first interest payment date), the method used to determine the yield to maturity and the amount of OID allocable to that short period.[64] A sample form of OID legend may be found in Appendix E.

If any portion of the stated interest on a pay-through bond or regular interest is includable in its stated redemption price at maturity, the aggregate amount of OID on the instrument, and the portion thereof allocable to any short accrual period, will depend on (1) the assumed rate of principal prepayments, and (2) in the case of an instrument that pays interest at a rate based on an interest rate index, the assumed value of the index. It would make sense to calculate these amounts for legending purposes using the same assumptions that will be used in figuring accruals of OID.[65] The legend generally must be set forth on the face of an instrument on its issue date. However, if that is not possible, the issuer may instead deliver to the holder of the instrument a sticker containing the required information within 10 days of the issue date. All instruments issued thereafter (such as upon registration of an instrument in the name of a new owner) should include the legend or have the sticker attached.[66]

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60 See Treasury Regulation § l.6049-7(g).

61 The issue date of a debt instrument issued for cash is the first settlement date or closing date on which a substantial amount of the debt instruments in the issue is sold, disregarding sales to underwriters, placement agents, or wholesalers. See Treasury Regulation §§ 1.1273-2(a)(2) and (e). This definition is discussed in Chapter 6, footnote 27.

62 Treasury Regulation § l.6049-7(g)(l)(iii) describes this rate as the "rate at which interest is payable (if any) as of the issue date." Apparently, the legend must include the initial interest rate even if interest is always payable at the same fixed rate.

63 Under Treasury Regulation § 1.1272-l(b)(l)(i), the yield to maturity of a debt instrument, when expressed as a percentage, must be calculated to at least two decimal places. For a general discussion of the yield to maturity, see Chapter 6, Part C.2.

64 The methods for calculating the yield to maturity in the case of a debt instrument that has a short accrual period are discussed in Chapter 6, footnote 41.

65 For a discussion of the situations in which stated interest is included in a debt instrument's stated redemption price at maturity, see Chapter 6, Part C.l. b. Methods of accruing OID on variable rate debt instruments are discussed in Chapter 6, Part C.4.

66 The regulations do not say how the legending requirement can be satisfied in the case of securities issued only in book-entry form, although presumably it would suffice, if legending is required, to deliver one physical certificate with the legend attached to the party maintaining the book-entry system. The more limited legending requirement applicable to debt instruments generally applies only to instruments in physical form. See text accompanying footnote 1, above. The rule in section 1275(c)(l)(B) that allows an

An issuer that fails to meet the legending requirement, and does not show that such failure is due to reasonable cause and not willful neglect, is subject, under section 6706(a), to a penalty of $50 for each debt instrument for which the failure exists.[67] Arguably, this penalty would apply separately to each physical debt instrument (so that, for example, a further penalty would apply if a new unlegended security was issued in connection with the registration of an instrument in the name of a transferee).

The legending requirement for REMIC regular interests and pay-through bonds is both superfluous and ineffective. The same information (and more) is made available through the ongoing information reporting system that applies to these securities (described in Part B.l). Also, information on physical securities (which, when they exist, are typically held by custodians) is not readily available to tax return preparers. Hopefully, in the fullness of time, the Service will reassess whether any legending is warranted for regular interests and pay-through bonds.

To avoid misunderstanding, many issuers of REMIC interests set forth on their face a legend stating that the security is a regular interest or a residual interest, as the case may be. There is no specific tax requirement that there be such legends. As discussed in Chapter 4, Part A.3, a residual interest may include a statement describing restrictions on transfers to disqualified organizations to ensure compliance with the REMIC arrangements test.

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issuer to delay legending a privately placed debt instrument until the disposition of the instrument by the first holder is not found in Treasury Regulation § 1.6049-7(g). Apparently, the Service believes that its authority to impose a legending requirement is broader under section 6049(d)(7)(D) than under section 1275(c)(l). See footnote 5, above.

67 Treasury Regulation § l.6049-7(g)(l) includes a cross-reference to section 6706(a). Although section 6706(a) applies to legends required under section 1275(c)(l), which was not cited by the Service as the source of authority for the legending requirement for REMIC regular interests and pay-through bonds (see footnote 5, above), there is considerable overlap between the two legending rules. There is no rule treating a sponsor of a REMIC as the "issuer" for purposes of section 6706(a), so it appears that any penalties would be imposed on the REMIC itself. Compare the special rule treating sponsors of REMICs and pass-through certificates as issuers for purposes of the section 4701 excise tax (see Chapter 10, footnotes 4 and 18).