Chapter 7, Part E.4.c (Thrift Exception to Excess Inclusion Rules)

c Thrift Exception. Certain thrift institutions are exempt from the rule (discussed above) prohibiting excess inclusions from being offset with unrelated losses.[54] The exemption applies, however, only to residual interests that have significant value.[55]. A residual interest meets this test if (1) the aggregate issue price of the residual interests in the REMIC is at least two percent of the aggregate issue price of all regular and residual interests in the REMIC, and (2) the anticipated weighted average life of the residual interest is at least 20 percent of the anticipated weighted average life of the REMIC.[56] The second part of the test prevents the two percent test from being met during only a short initial period, after which capital invested in the residual interest is withdrawn.

As indicated above, if a group of corporations files a consolidated return, the group generally is treated as one taxpayer for purposes of applying the excess inclusion rules. However, the thrift exception is applied separately to each thrift that is a member of such a group.[57] As a result, losses of a thrift generally cannot be offset against excess inclusions realized by other group members (including other thrifts) in a consolidated return. Similarly, losses of other group members generally cannot offset any excess inclusions of a thrift that exceed the losses of that thrift (determined without regard to the excess inclusions). The only exception to this rule is that a thrift and a qualified subsidiary are combined and treated as a single thrift (so that losses of one can offset excess inclusions of the other).[58] A corporation is a qualified subsidiary for this purpose

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54 See section 860E(a)(2). The relief measures are limited to thrift institutions that are eligible to calculate deductions from additions to bad debt reserves under section 593.

55 Treasury Regulation § 1.860E-1(a)(3). Section 860E(a)(2) gives the Service authority to issue regulations limiting the thrift exemption where necessary or appropriate to prevent the avoidance of tax. Although the statutory language gives no indication that a residual interest must have significant value for the thrift exemption to apply, the Blue Book (as 423, footnote 83) suggested this result. The significant value rule is, with a limited exception, effective only for residual interests acquired after September 26, 1991. See Treasury Regulation § 860A-1(b)(2)(iii).

56 Treasury Regulations § 860E-1(a)(3)(iii). The anticipated weighted average life of the REMIC is the weighted average of the anticipated weighted average lives of all regular and residual interests in the REMIC. The weighted average life calculation takes account of all anticipated payments (however denominated) in the case of residual interests and regular interests with disproportionately high interest (generally, an issue price greater than 125% of the principal amount). For all other regular interests, only anticipated principal payments are included in the calculation. Anticipated payments are based on the prepayment and reinvestment assumptions used in applying the PAC method (or that would have been used if regular interests with OID had been issued), and required or permitted clean-up calls or any required qualified liquidation provided for in the REMIC's organizational documents. It appears that anticipated defaults or delinquencies are not taken into account in determining anticipated payments. Where interest payments that are taken into account in a weighted average life calculation are variable, then it would be sensible to fix the rates for purposes of the calculation using the same principles that apply in accruing OID (see Chapter 6, Part C.4). Apparently, the weighted average life test is applied to a residual interest only as of the startup day for the REMIC, and not as of the date on which a thrift acquires the interest. This approach is consistent with the 2% value component of the significant value test, which clearly is based on initial values.

57 See section 860E(a)(3), and Treasury Regulation §§ 1.860E-l(a)(3)(i) and (ii).

58 Section 860E(a)(4)(A).

if (1) all of its stock, and substantially all of its indebtedness, is held directly by the thrift, and (2) it is organized and operated exclusively in connection with the organization and operation of one or more REMICs.[59] Thus, a qualified subsidiary apparently cannot issue non-REMIC pay-through bonds or purchase interests in REMICs in the secondary market.

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59 Section 860E(a)(4)(B). Presumably, in determining whether substantially all of the indebtedness of a subsidiary is owned by the thrift, regular interests in REMICs sponsored by the subsidiary would disregarded even if they took the legal form of debt of the subsidiary. For tax purposes, those interests would be interests in the REIC, not subsidiary debt.