Appendix B

Internal Revenue Code and Regulations

Internal Revenue Code

Sections 860A–860G (REMICs) 2
Section 1272(a)(6) 13
Section 7701(i).................................. 14

REMIC Regulations

Section 1.860A-0 et seq. 15

Sears Regulations

Section 301.7701-4(c)...................... 58

Taxable Mortgage Pool Regulations

Section 301.7701(i)-0 et seq. 60

INTERNAL REVENUE CODE

SECTIONS 860A–860G

PART IV—REAL ESTATE MORTGAGE INVESTMENT CONDUITS

Section 860A. Taxation of REMIC's.
Section 860B. Taxation of holders of regular interests.
Section 860C. Taxation of residual interests.
Section 860D. REMIC defined.
Section 860E. Treatment of income in excess of daily accruals on residual interests.
Section 860F. Other rules.
Section 860G. Other definitions and special rules.
Section 860A. Taxation of REMIC's.

Section 860A. Taxation of REMIC's.

(a) General rule.

Except as otherwise provided in this part, a REMIC shall not be subject to taxation under this subtitle (and shall not be treated as a corporation, partnership, or trust for purposes of this subtitle).

(b) Income taxable to holders.

The income of any REMIC shall be taxable to the holders of interests in such REMIC as provided in this part.

Section 860B. Taxation of holders of regular interests.

(a) General rule.

In determining the tax under this chapter of any holder of a regular interest in a REMIC, such interest (if not otherwise a debt instrument) shall be treated as a debt instrument.

(b) Holders must use accrual method.

The amounts includible in gross income with respect to any regular interest in a REMIC shall be determined under the accrual method of accounting.

(c) Portion of gain treated as ordinary income.

Gain on the disposition of a regular interest shall be treated as ordinary income to the extent such gain does not exceed the excess (if any) of—

(1) the amount which would have been includible in the gross income of the taxpayer with respect to such interest if the yield on such interest were 110 percent of the applicable Federal rate (as defined in section 1274(d) without regard to paragraph (2) thereof) as of the beginning of the taxpayer's holding period, over

(2) the amount actually includible in gross income with respect to such interest by the taxpayer.

(d) Cross reference.

For special rules in determining inclusion of original issue discount on regular interests, see section 1272(a)(6).

Section 860C. Taxation of residual interests.

(a) Pass-thru of income or loss.

(1) In general. In determining the tax under this chapter of any holder of a residual interest in a REMIC, such holder shall take into account his daily portion of the taxable income or net loss of such REMIC for each day during the taxable year on which such holder held such interest.

(2) Daily portion. The daily portion referred to in paragraph (1) shall be determined—

(A) by allocating to each day in any calendar quarter its ratable portion of the taxable income (or net loss) for such quarter, and

(B) by allocating the amount so allocated to any day among the holders (on such day) of residual interests in proportion to their respective holdings on such day.

(b) Determination of taxable income or net loss.

For purposes of this section—

(1) Taxable income. The taxable income of a REMIC shall be determined under an accrual method of accounting and, except as provided in regulations, in the same manner as in the case of an individual, except that—

(A) regular interests in such REMIC (if not otherwise debt instruments) shall be treated as indebtedness of such REMIC,

(B) market discount on any market discount bond shall be included in gross income for the taxable years to which it is attributable as determined under the rules of section 1276(b)(2) (and sections 1276(a) and 1277 shall not apply),

(C) there shall not be taken into account any item of income, gain, loss, or deduction allocable to a prohibited transaction,

(D) the deductions referred to in section 703(a)(2) (other than any deduction under section 212) shall not be allowed, and

(E) the amount of the net income from foreclosure property (if any) shall be reduced by the amount of the tax imposed by section 860G(c).

(2) Net loss. The net loss of any REMIC is the excess of—

(A) the deductions allowable in computing the taxable income of such REMIC, over

(B) its gross income.

Such amount shall be determined with the modifications set forth in paragraph (1).

(c) Distribution.

Any distribution by a REMIC—

(1) shall not be included in gross income to the extent it does not exceed the adjusted basis of the interest, and

(2) to the extent it exceeds the adjusted basis of the interest, shall be treated as gain from the sale or exchange of such interest.

(d) Basis rules.

(1) Increase in basis. The basis of any person's residual interest in a REMIC shall be increased by the amount of the taxable income of such REMIC taken into account under subsection (a) by such person with respect to such interest.

(2) Decreases in basis. The basis of any person's residual interest in a REMIC shall be decreased (but not below zero) by the sum of the following amounts:

(A) any distributions to such person with respect to such interest, and

(B) any net loss of such REMIC taken into account under subsection (a) by such person with respect to such interest.

(e) Special rules.

(1) Amounts treated as ordinary.

Any amount taken into account under subsection (a) by any holder of a residual interest in a REMIC shall be treated as ordinary income or ordinary loss, as the case may be.

(2) Limitation on losses.

(A) In general. The amount of the net loss of any REMIC taken into account by a holder under subsection (a) with respect to any calendar quarter shall not exceed the adjusted basis of such holder's residual interest in such REMIC as of the close of such calendar quarter (determined without regard to the adjustment under subsection (d)(2)(B) for such calendar quarter).

(B) Indefinite carryforward. Any loss disallowed by reason of subparagraph (A) shall be treated as incurred by the REMIC in the succeeding calendar quarter with respect to such holder.

(3) Cross reference. For special treatment of income in excess of daily accruals, see section 860E.

Section 860D. REMIC defined.

(a) General rule.

For purposes of this title, the terms ‘‘real estate mortgage investment conduit’’ and ‘‘REMIC’’ mean any entity—

(1) to which an election to be treated as a REMIC applies for the taxable year and all prior taxable years,

(2) all of the interests in which are regular interests or residual interests,

(3) which has 1 (and only 1) class of residual interests (and all distributions, if any, with respect to such interests are pro rata),

(4) as of the close of the 3rd month beginning after the startup day and at all times thereafter, substantially all of the assets of which consist of qualified mortgages and permitted investments,

(5) which has a taxable year which is a calendar year, and

(6) with respect to which there are reasonable arrangements designed to ensure that—

(A) residual interests in such entity are not held by disqualified organizations (as defined in section 860E(e)(5)), and

(B) information necessary for the application of section 860E(e) will be made available by the entity.

In the case of a qualified liquidation (as defined in section 860F(a)(4)(A)), paragraph (4) shall not apply during the liquidation period (as defined in section 860F(a)(4)(B)).

(b) Election.

(1) In general. An entity (otherwise meeting the requirements of subsection (a)) may elect to be treated as a REMIC for its 1st taxable year. Such an election shall be made on its return for such 1st taxable year. Except as provided in paragraph (2), such an election shall apply to the taxable year for which made and all subsequent taxable years.

(2) Termination.

(A) In general. If any entity ceases to be a REMIC at any time during the taxable year, such entity shall not be treated as a REMIC for such taxable year or any succeeding taxable year

(B) Inadvertent terminations. If—

(i) an entity ceases to be a REMIC,

(ii) the Secretary determines that such cessation was inadvertent,

(iii) no later than a reasonable time after the discovery of the event resulting in such cessation, steps are taken so that such entity is once more a REMIC, and

(iv) such entity, and each person holding an interest in such entity at any time during the period specified pursuant to this subsection, agrees to make such adjustments (consistent with the treatment of such entity as a REMIC or a C corporation) as may be required by the Secretary with respect to such period, then, notwithstanding such terminating event, such entity shall be treated as continuing to be a REMIC (or such cessation shall be disregarded for purposes of subparagraph (A)) whichever the Secretary determines to be appropriate.

Section 860E. Treatment of income in excess of daily accruals on residual interests.

(a) Excess inclusions may not be offset by net operating losses.

(1) In general. 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.

(2) Special rule for affiliated groups. All members of an affiliated group filing a consolidated return shall be treated as 1 taxpayer for purposes of this subsection.

(3) Coordination with section 172. Any excess inclusion for any taxable year shall not be taken into account—

(A) in determining under section 172 the amount of any net operating loss for such taxable year, and

(B) in determining taxable income for such taxable year for purposes of the 2nd sentence of section 172(b)(2).

(4) Coordination with minimum tax. For purposes of part VI of subchapter A of this chapter—

(A) the reference in section 55(b)(2) to taxable income shall be treated as a reference to taxable income determined without regard to this subsection,

(B) the alternative minimum 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, and

(C) any excess inclusion shall be disregarded for purposes of computing the alternative tax net operating loss deduction.

(b) Organizations subject to unrelated business tax.

If the holder of any residual interest in a REMIC is an organization subject to the tax imposed by section 511, the excess inclusion of such holder for any taxable year shall be treated as unrelated business taxable income of such holder for purposes of section 511.

(c) Excess inclusion.

For purposes of this section—

(1) In general. The term ‘‘excess inclusion’’ means, with respect to any residual interest in a REMIC for any calendar quarter, the excess (if any) of—

(A) the amount taken into account with respect to such interest by the holder under section 860C(a), over

(B) the sum of the daily accruals with respect to such interest for days during such calendar quarter while held by such holder.

To the extent provided in regulations, if residual interests in a REMIC do not have significant value, the excess inclusions with respect to such interests shall be the amount determined under subparagraph (A) without regard to subparagraph (B).

(2) Determination of daily accruals.

(A) In general. For purposes of this subsection, the daily accrual with respect to any residual interest for any day in any calendar quarter shall be determined by allocating to each day in such quarter its ratable portion of the product of—

(i) the adjusted issue price of such interest at the beginning of such quarter, and

(ii) 120 percent of the long-term Federal rate (determined on the basis of compounding at the close of each calendar quarter and properly adjusted for the length of such quarter).

(B) Adjusted issue price. For purposes of this paragraph, the adjusted issue price of any residual interest at the beginning of any calendar quarter is the issue price of the residual interest (adjusted for contributions)—

(i) increased by the amount of daily accruals for prior quarters, and

(ii) decreased (but not below zero) by any distribution made with respect to such interest before the beginning of such quarter.

(C) Federal long-term rate. For purposes of this paragraph, the term ‘‘Federal long-term rate’’ means the Federal long-term rate which would have applied to the residual interest under section 1274(d) (determined without regard to paragraph (2) thereof) if it were a debt instrument.

(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 such trust, and

(2) any amount allocated to a shareholder under paragraph (1) 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.

(e) Tax on transfers of residual interests to certain organizations, etc.

(1) In general. A tax is hereby imposed on any transfer of a residual interest in a REMIC to a disqualified organization.

(2) Amount of tax. The amount of the tax imposed by paragraph (1) on any transfer of a residual interest shall be equal to the product of—

(A) the amount (determined under regulations) equal to the present value of the total anticipated excess inclusions with respect to such interest for periods after such transfer, multiplied by

(B) the highest rate of tax specified in section 11(b)(1).

(3) Liability. The tax imposed by paragraph (1) on any transfer shall be paid by the transferor; except that, where such transfer is through an agent for a disqualified organization, such tax shall be paid by such agent.

(4) Transferee furnishes affidavit. The person (otherwise liable for any tax imposed by paragraph (1) shall be relieved of liability for the tax imposed by paragraph (1) with respect to any transfer if—

(A) the transferee furnishes to such person an affidavit that the transferee is not a disqualified organization, and

(B) as of the time of the transfer, such person does not have actual knowledge that such affidavit is false.

(5) Disqualified organization. For purposes of this section, the term ''disqualified organization'' means—

(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). For purposes of subparagraph (A), the rules of section 168(h)(2)(D) (relating to treatment of certain taxable instrumentalities) shall apply; except that, in the case of the Federal Home Loan Mortgage Corporation, clause (ii) of such section shall not apply.

(6) Treatment of pass-thru entities.

(A) Imposition of tax. If, at any time during any taxable year of a pass-thru entity, a disqualified organization is the record holder of an interest in such entity, there is hereby imposed on such entity for such taxable year a tax equal to the product of—

(i) the amount of excess inclusions for such taxable year allocable to the interest held by such disqualified organization, multiplied by

(ii) the highest rate of tax specified in section 11(b)(1).

(B) Pass-thru entity For purposes of this paragraph, the term ‘‘pass-thru entity’’ means—

(i) any regulated investment company, real estate investment trust, or common trust fund,

(ii) any partnership, trust, or estate, and

(iii) any organization to which part I of subchapter T applies.

Except as provided in regulations, a person holding an interest in a pass-thru entity as a nominee for another person shall, with respect to such interest, be treated as a pass-thru entity.

(C) Tax to be deductible Any tax imposed by this paragraph with respect to any excess inclusion of any pass-thru entity for any taxable year shall, for purposes of this title (other than this subsection), be applied against (and operate to reduce) the amount included in gross income with respect to the residual interest involved.

(D) Exception where holder furnishes affidavit No tax shall be imposed by subparagraph (A) with respect to any interest in a pass-thru entity for any period if—

(i) the record holder of such interest furnishes to such pass-thru entity an affidavit that such record holder is not a disqualified organization, and

(ii) during such period, the pass-thru entity does not have actual knowledge that such affidavit is false.

(7) Waiver. The Secretary may waive the tax imposed by paragraph (1) on any transfer if—

(A) within a reasonable time after discovery that the transfer was subject to tax under paragraph (1), steps are taken so that the interest is no longer held by the disqualified organization, and

(B) there is paid to the Secretary such amounts as the Secretary may require.

(8) Administrative provisions. For purposes of subtitle F, the taxes imposed by this subsection shall be treated as excise taxes with respect to which the deficiency procedures of such subtitle apply.

(f) Treatment of variable insurance contracts.

Except as provided in regulations, with respect to any variable contract (as defined in section 817), there shall be no adjustment in the reserve to the extent of any excess inclusion.

Section 860F. Other rules.

(a) 100 percent tax on prohibited transactions.

(1) Tax imposed. There is hereby imposed for each taxable year of a REMIC a tax equal to 100 percent of the net income derived from prohibited transactions.

(2) Prohibited transaction. For purposes of this part, the term ‘‘prohibited transaction’’ means—

(A) Disposition of qualified mortgage. The disposition of any qualified mortgage transferred to the REMIC other than a disposition pursuant to—

(i) the substitution of a qualified replacement mortgage for a qualified mortgage (or the repurchase in lieu of substitution of a defective obligation),

(ii) a disposition incident to the foreclosure, default, or imminent default of the mortgage,

(iii) the bankruptcy or insolvency of the REMIC, or

(iv) a qualified liquidation.

(B) Income from nonpermitted assets. The receipt of any income attributable to any asset which is neither a qualified mortgage nor a permitted investment.

(C) Compensation for services. The receipt by the REMIC of any amount representing a fee or other compensation for services.

(D) Gain from disposition of cash flow investments. Gain from the disposition of any cash flow investment other than pursuant to any qualified liquidation.

(3) Determination of net income. For purposes of paragraph (1), the term ''net income derived from prohibited transactions'' means the excess of the gross income from prohibited transactions over the deductions allowed by this chapter which are directly connected with such transactions; except that there shall not be taken into account any item attributable to any prohibited transaction for which there was a loss.

(4) Qualified liquidation. For purposes of this part—

(A) In general. The term ''qualified liquidation'' means a transaction in which—

(i) the REMIC adopts a plan of complete liquidation,

(ii) such REMIC sells all its assets (other than cash) within the liquidation period, and

(iii) all proceeds of the liquidation (plus the cash), less assets retained to meet claims, are credited or distributed to holders of regular or residual interests on or before the last day of the liquidation period.

(B) Liquidation period. The term ''liquidation period'' means the period—

(i) beginning on the date of the adoption of the plan of liquidation, and

(ii) ending at the close of the 90th day after such date.

(5) Exceptions. Notwithstanding subparagraphs (A) and (D) of paragraph (2), the term ''prohibited transaction'' shall not include any disposition—

(A) required to prevent default on a regular interest where the threatened default resulted from a default on 1 or more qualified mortgages, or

(B) to facilitate a clean-up call (as defined in regulations).

(b) Treatment of transfers to the REMIC.

(1) Treatment of transferor.

(A) Nonrecognition gain or loss. No gain or loss shall be recognized to the transferor on the transfer of any property to a REMIC in exchange for regular or residual interests in such REMIC.

(B) Adjusted bases of interests. The adjusted bases of the regular and residual interests received in a transfer described in subparagraph (A) shall be equal to the aggregate adjusted bases of the property transferred in such transfer. Such amount shall be allocated among such interests in proportion to their respective fair market values.

(C) Treatment of nonrecognized gain. If the issue price of any regular or residual interest exceeds its adjusted basis as determined under subparagraph (B), for periods during which such interest is held by the transferor (or by any other person whose basis is determined in whole or in part by reference to the basis of such interest in the hand of the transferor)—

(i) in the case of a regular interest, such excess shall be included in gross income (as determined under rules similar to rules of section 1276(b)), and

(ii) in the case of a residual interest, such excess shall be included in gross income ratably over the anticipated period during which the REMIC will be in existence.

(D) Treatment of nonrecognized loss. If the adjusted basis of any regular or residual interest received in a transfer described in subparagraph (A) exceeds its issue price, for periods during which such interest is held by the transferor (or by any other person whose basis is determined in whole or in part by reference to the basis of such interest in the hand of the transferor)—

(i) in the case of a regular interest, such excess shall be allowable as a deduction under rules similar to the rules of section 171, and

(ii) in the case of a residual interest, such excess shall be allowable as a deduction ratably over the anticipated period during which the REMIC will be in existence.

(2) Basis to REMIC. The basis of any property received by a REMIC in a transfer described in paragraph (1)(A) shall be its fair market value immediately after such transfer.

(c) Distributions of property.

If a REMIC makes a distribution of property with respect to any regular or residual interest—

(1) notwithstanding any other provision of this subtitle, gain shall be recognized to such REMIC on the distribution in the same manner as if it had sold such property to the distributee at its fair market value, and

(2) the basis of the distributee in such property shall be its fair market value.

(d) Coordination with wash sale rules.

For purposes of section 1091—

(1) any residual interest in a REMIC shall be treated as a security, and

(2) in applying such section to any loss claimed to have been sustained on the sale or other disposition of a residual interest in a REMIC—

(A) except as provided in regulations, any residual interest in any REMIC and any interest in a taxable mortgage pool (as defined in section 7701(i)) comparable to a residual interest in a REMIC shall be treated as substantially identical stock or securities, and

(B) subsections (a) and (e) of such section shall be applied by substituting ‘‘6 months’’ for ‘‘30 days’’ each place it appears.

(e) Treatment under subtitle F.

For purposes of subtitle F, a REMIC shall be treated as a partnership (and holders of residual interests in such REMIC shall be treated as partners). Any return required by reason of the preceding sentence shall include the amount of the daily accruals determined under section 860E(c). Such return shall be filed by the REMIC. The determination of who may sign such return shall be made without regard to the first sentence of this subsection.

Section 860G. Other definitions and special rules.

(a) Definitions. For purposes of this part—

(1) Regular interest. The term ‘‘regular interest’’ means any interest in a REMIC which is issued on the startup day with fixed terms and which is designated as a regular interest if—

(A) such interest unconditionally entitles the holder to receive a specified principal amount (or other similar amount), and

(B) interest payments (or other similar amount), if any, with respect to such interest at or before maturity—

(i) are payable based on a fixed rate (or to the extent provided in regulations, at a variable rate), or

(ii) consist of a specified portion of the interest payments on qualified mortgages and such portion does not vary during the period such interest is outstanding.

The interest shall not fail to meet the requirements of subparagraph (A) merely because the timing (but not the amount) of the principal payments (or other similar amounts) may be contingent on the extent of prepayments on qualified mortgages and the amount of income from permitted investments.

An interest shall not fail to qualify as a regular interest solely because the specified principal amount of the regular interest (or the amount of interest accrued on the regular interest) can be reduced as a result of the nonoccurrence of 1 or more contingent payments with respect to any reverse mortgage loan held by the REMIC if, on the startup day for the REMIC, the sponsor reasonably believes that all principal and interest due under the regular interest will be paid at or prior to the liquidation of the REMIC.

(2) Residual interest. The term ‘‘residual interest’’ means 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.

(3) Qualified mortgage. The term ‘‘qualified mortgage’’ means—

(A) any obligation (including any participation or certificate of beneficial ownership therein) which is principally secured by an interest in real property and which—

(i) is transferred to the REMIC on the startup day in exchange for regular or residual interests in the REMIC,

(ii) is purchased by the REMIC within the 3-month period beginning on the startup day if, except as provided in regulations, such purchase is pursuant to a fixed-price contract in effect on the startup day, or

(iii) represents an increase in the principal amount under the original terms of an obligation described in clause (i) or (ii) if such increase–

(I) is attributable to an advance made to the obligor pursuant to the original terms of a reverse mortgage loan or other obligation,

(II) occurs after the startup day, and

(III) is purchased by the REMIC pursuant to a fixed price contract in effect on the startup day.

(B) any qualified replacement mortgage,

(C) any regular interest in another REMIC transferred to the REMIC on the startup day in exchange for regular or residual interests in the REMIC, and

(D) any regular interest in a FASIT which is transferred to, or purchased by, the REMIC as described in clauses (i) and (ii) of subparagraph (A) but only if 95 percent or more of the value of the assets of such FASIT is at all times attributable to obligations described in subparagraph (A) (without regard to such clauses).

For purposes of subparagraph (A) any obligation secured by stock held by a person as a tenant-stockholder (as defined in section 216) in a cooperative housing corporation (as so defined) shall be treated as secured by an interest in real property, and any reverse mortgage loan (and each balance increase on such loan meeting the requirements of subparagraph (A)(iii)) shall be treated as an obligation secured by an interest in real property. For purposes of subparagraph (A), any obligation originated by the United States or any State (or any political subdivision, agency, or instrumentality of the United States or any State) shall be treated as principally secured by an interest in real property if more than 50 percent of such obligations which are transferred to, or purchased by, the REMIC are principally secured by an interest in real property (determined without regard to this sentence).

(4) Qualified replacement mortgage. The term ‘‘qualified replacement mortgage’’ means any obligation—

(A) which would be a qualified mortgage if transferred on the startup day in exchange for regular or residual interests in the REMIC, and

(B) which is received for—

(i) another obligation within the 3-month period beginning on the startup day, or

(ii) a defective obligation within the 2-year period beginning on the startup day.

(5) Permitted investments. The term ‘‘permitted investments’’ means any—

(A) cash flow investment,

(B) qualified reserve asset, or

(C) foreclosure property.

(6) Cash flow investment. The term ‘‘cash flow investment’’ means any investment of amounts received under qualified mortgages for a temporary period before distribution to holders of interests in the REMIC.

(7) Qualified reserve asset.

(A) In general. The term ‘‘qualified reserve asset’’ means any intangible property which is held for investment and as part of a qualified reserve fund.

(B) Qualified reserve fund. For purposes of subparagraph (A), the term “qualified reserve fund” means any reasonably required reserve to–

(i) provide for full payment of expenses of the REMIC or amounts due on regular interests in the event of defaults on qualified mortgages or lower than expected returns on cash flow investments, or

(ii) provide a source of funds for the purchase of obligations described in clause (ii) or (iii) of paragraph (3)(A).

The aggregate fair market value of the assets held in any such reserve shall not exceed 50 percent of the aggregate fair market value of all of the assets of the REMIC on the startup day, and the amount of any such reserve shall be promptly and appropriately reduced to the extent the amount held in such reserve is no longer reasonably required for purposes specified in clause (i) or (ii) of this subparagraph.

(C) Special rule. A reserve shall not be treated as a qualified reserve for any taxable year (and all subsequent taxable years) if more than 30 percent of the gross income from the assets in such fund for the taxable year is derived from the sale or other disposition of property held for less than 3 months. For purposes of the preceding sentence, gain on the disposition of a qualified reserve asset shall not be taken into account if the disposition giving rise to such gain is required to prevent default on a regular interest where the threatened default resulted from a default on 1 or more qualified mortgages.

(8) Foreclosure property. The term ‘‘foreclosure property’’ means property—

(A) which would be foreclosure property under section 856(e) (without regard to paragraph (5) thereof) if acquired by a real estate investment trust, and

(B) which is acquired in connection with the default or imminent default of a qualified mortgage held by the REMIC.

Solely for purposes of section 860D(a), the determination of whether any property is foreclosure property shall be made without regard to section 856(e)(4).

(9) Startup day. The term ‘‘startup day’’ means the day on which the REMIC issues all of its regular and residual interests. To the extent provided in regulations, all interests issued (and all transfers to the REMIC) during any period (not exceeding 10 days) permitted in such regulations shall be treated as occurring on the day during such period selected by the REMIC for purposes of this paragraph.

(10) Issue price. The issue price of any regular or residual interest in a REMIC shall be determined under section 1273(b) in the same manner as if such interest were a debt instrument; except that if the interest is issued for property, paragraph (3) of section 1273(b) shall apply whether or not the requirements of such paragraph are met.

(b) Treatment of nonresident aliens and foreign corporations. If the holder of a residual interest in a REMIC is a nonresident alien individual or a foreign corporation, for purposes of sections 871(a), 881, 1441, and 1442—

(1) amounts includible in the gross income of such holder under this part shall be taken into account when paid or distributed (or when the interest is disposed of), and

(2) no exemption from the taxes imposed by such sections (and no reduction in the rates of such taxes) shall apply to any excess inclusion. The Secretary may by regulations provide that such amounts shall be taken into account earlier than as provided in paragraph (1) where necessary or appropriate to prevent the avoidance of tax imposed by this chapter.

(c) Tax on income from foreclosure property.

(1) In general. A tax is hereby imposed for each taxable year on the net income from foreclosure property of each REMIC. Such tax shall be computed by multiplying the net income from foreclosure property by the highest rate of tax specified in section 11(b).

(2) Net income from foreclosure property. For purposes of this part, the term ‘‘net income from foreclosure property’’ means the amount which would be the REMIC’s net income from foreclosure property under section 857(b)(4)(B) if the REMIC were a real estate investment trust.

(d) Tax on contributions after startup date.

(1) In general. Except as provided in paragraph (2), if any amount is contributed to a REMIC after the startup day, there is hereby imposed a tax for the taxable year of the REMIC in which the contribution is received equal to 100 percent of the amount of such contribution.

(2) Exceptions. Paragraph (1) shall not apply to any contribution which is made in cash and is described in any of the following subparagraphs: (A) Any contribution to facilitate a clean-up call (as defined in regulations) or a qualified liquidation. (B) Any payment in the nature of a guarantee. (C) Any contribution during the 3-month period beginning on the startup day. (D) Any contribution to a qualified reserve fund by any holder of a residual interest in the REMIC. (E) Any other contribution permitted in regulations.

(e) Regulations.

The Secretary shall prescribe such regulations as may be necessary or appropriate to carry out the purposes of this part, including regulations—

(1) to prevent unreasonable accumulations of assets in a REMIC,

(2) permitting determinations of the fair market value of property transferred to a REMIC and issue price of interests in a REMIC to be made earlier than otherwise provided,

(3) requiring reporting to holders of residual interests of such information as frequently as is necessary or appropriate to permit such holders to compute their taxable income accurately,

(4) providing appropriate rules for treatment of transfers of qualified replacement mortgages to the REMIC where the transferor holds any interest in the REMIC, and

(5) providing that a mortgage will be treated as a qualified replacement mortgage only if it is part of a bona fide replacement (and not part of a swap of mortgages).

SECTION 1272(a)(6)

Section 1272. Current inclusion in income of original issue discount.

(a) Original issue discount on debt instruments issued after July 1, 1982, included in income on basis of constant interest rate. . . .

(6) Determination of daily portions where principal subject to acceleration.

(A) In general. In the case of any debt instrument to which this paragraph applies, the daily portion of the original issue discount shall be determined by allocating to each day in any accrual period its ratable portion of the excess (if any) of—

(i) the sum of (I) the present value determined under subparagraph (B) of all remaining payments under the debt instrument as of the close of such period, and (II) the payments during the accrual period of amounts included in the stated redemption price of the debt instrument, over

(ii) the adjusted issue price of such debt instrument at the beginning of such period.

(B) Determination of present value. For purposes of subparagraph (A), the present value shall be determined on the basis of—

(i) the original yield to maturity (determined on the basis of compounding at the close of each accrual period and properly adjusted for the length of the accrual period),

(ii) events which have occurred before the close of the accrual period, and

(iii) a prepayment assumption determined in the manner prescribed by regulations.

(C) Debt instruments to which paragraph applies This paragraph applies to—

(i) any regular interest in a REMIC or qualified mortgage held by a REMIC,

(ii) any other debt instrument if payments under such debt instrument may be accelerated by reason of prepayments of other obligations securing such debt instrument (or, to the extent provided in regulations, by reason of other events), or

(iii) any pool of debt instruments the yield on which may be affected by reason of prepayments (or to the extent provided in regulations, by reason of other events).

To the extent provided in regulations prescribed by the Secretary, in the case of a small business engaged in the trade or business of selling tangible personal property at retail, clause (iii) shall not apply to debt instruments incurred in the ordinary course of such trade or business while held by such business.

SECTION 7701(i)

Section 7701. Definitions. . . .

(i) Taxable mortgage pools.

(1) Treated as separate corporations. A taxable mortgage pool shall be treated as a separate corporation which may not be treated as an includible corporation with any other corporation for purposes of section 1501.

(2) Taxable mortgage pool defined. For purposes of this title—

(A) In general. Except as otherwise provided in this paragraph, a taxable mortgage pool is any entity (other than a REMIC) if—

(i) substantially all of the assets of such entity consists of debt obligations (or interests therein) and more than 50 percent of such debt obligations (or interests) consists of real estate mortgages (or interests therein),

(ii) such entity is the obligor under debt obligations with 2 or more maturities, and

(iii) under the terms of the debt obligations referred to in clause (ii) (or underlying arrangement), payments on such debt obligations bear a relationship to payments on the debt obligations (or interests) referred to in clause (i).

(B) Portion of entities treated as pools. Any portion of an entity which meets the definition of subparagraph (A) shall be treated as a taxable mortgage pool.

(C) Exception for domestic building and loan. Nothing in this subsection shall be construed to treat any domestic building and loan association (or portion thereof) as a taxable mortgage pool.

(D) Treatment of certain equity interests. To the extent provided in regulations, equity interest of varying classes which correspond to maturity classes of debt shall be treated as debt for purposes of this subsection.

(3) Treatment of certain REIT's. If—

(A) a real estate investment trust is a taxable mortgage pool, or

(B) a qualified REIT subsidiary (as defined in section 856(i)(2)) of a real estate investment trust is a taxable mortgage pool, under regulations prescribed by the Secretary, adjustments similar to the adjustments provided in section 860E(d) shall apply to the shareholders of such real estate investment trust.

REMIC REGULATIONS

SECTION 1.860A-0 ET SEQ.

§1.860A-0. Outline of REMIC provisions.

This section lists the paragraphs contained in §§1.860A-1 through 1.860G-3.

§1.860A-1. Effective dates and transition rules.

(a) In general.
(b) Exceptions.
 (1) Reporting regulations.
 (2) Tax avoidance rules.
  (i) Transfers of certain residual interests.
  (ii) Transfers to foreign holders.
  (iii) Residual interests that lack significant value.
 (3) Excise taxes.
 (4) Rate based on current interest rate.
  (i) In general.
  (ii) Rate based on index.
  (iii) Transition obligations.
 (5) Accounting for REMIC net income of foreign persons.

§1.860C-1. Taxation of holders of residual interests.

(a) Pass-thru of income or loss.
(b) Adjustments to basis of residual interests.
 (1) Increase in basis.
 (2) Decrease in basis.
 (3) Adjustments made before disposition.
(c) Counting conventions.
(d) Treatment of REMIC net income of foreign persons.

§1.860C-2. Determination of REMIC taxable income or net loss.

(a) Treatment of gain or loss.
(b) Deductions allowable to a REMIC.
 (1) In general.
 (2) Deduction allowable under section 163.
 (3) Deduction allowable under section 166.
 (4) Deduction allowable under section 212.
 (5) Expenses and interest relating to tax-exempt income.

§1.860D-1. Definition of a REMIC.

(a) In general.
(b) Specific requirements.
 (1) Interests in a REMIC.
  (i) In general.
  (ii) De minimis interests.
 (2) Certain rights not treated as interests.
  (i) Payments for services.
  (ii) Stripped interests.
  (iii) Reimbursement rights under credit enhancement contracts.
  (iv) Rights to acquire mortgages.
 (3) Asset test.
  (i) In general.
  (ii) Safe harbor.
 (4) Arrangements test.
 (5) Reasonable arrangements.
  (i) Arrangements to prevent disqualified organizations from holding residual interests.
  (ii) Arrangements to ensure that information will be provided.
 (6) Calendar year requirement.
(c) Segregated pool of assets.
 (1) Formation of REMIC.
 (2) Identification of assets.
 (3) Qualified entity defined.
(d) Election to be treated as a real estate mortgage investment conduit.
 (1) In general.
 (2) Information required to be reported in the REMIC's first taxable year.

(3) Requirement to keep sufficient records.

§1.860E-1. Treatment of taxable income of a residual interest holder in excess of daily accruals.

(a) Excess inclusion cannot be offset by otherwise allowable deductions.
(1) In general.
(2) Affiliated groups.
(3) Special rule for certain financial institutions.
(i) In general.
(ii) Ordering rule.
(A) In general.
(B) Example.
(iii) Significant value.
(iv) Determining anticipated weighted average life.
(A) Anticipated weighted average life of the REMIC.
(B) Regular interests that have a specified principal amount.
(C) Regular interests that have no specified principal amount or that have only a nominal principal amount, and all residual interests.
(D) Anticipated payments.
(b) Treatment of a residual interest held by REITs, RICs, common trust funds, and subchapter T cooperatives. [Reserved]
(c) Transfers of noneconomic residual interests.
(1) In general.
(2) Noneconomic residual interest.
(3) Computations.
(4) Safe harbor for establishing lack of improper knowledge.
(5) Asset test.
(6) Definitions for asset test.
(7) Formula test.
(8) Conditions and limitations on formula test.
(9) Examples.
(10) Effective dates.
(d) Transfers to foreign persons.

§1.860E-2. Tax on transfers of residual interest to certain organizations.

(a) Transfers to disqualified organizations.
(1) Payment of tax.
(2) Transitory ownership.
(3) Anticipated excess inclusions.
(4) Present value computation.
(5) Obligation of REMIC to furnish information.
(6) Agent.
(7) Relief from liability.
(i) Transferee furnishes information under penalties of perjury.
(ii) Amount required to be paid.
(b) Tax on pass-thru entities.
(1) Tax on excess inclusions.
(2) Record holder furnishes information under penalties of perjury.
(3) Deductibility of tax.
(4) Allocation of tax.

§1.860F-1. Qualified liquidations.

§1.860F-2. Transfers to a REMIC.
(a) Formation of a REMIC.
(1) In general.
(2) Tiered arrangements.
(i) Two or more REMICs formed pursuant to a single set of organizational documents.
(ii) A REMIC and one or more investment trusts formed pursuant to a single set of documents.
(b) Treatment of sponsor.
(1) Sponsor defined.
(2) Nonrecognition of gain or loss.
(3) Basis of contributed assets allocated among interests.
(i) In general.

(ii) Organizational expenses.
(A) Organizational expense defined.
(B) Syndication expenses.
(iii) Pricing date.
(4) Treatment of unrecognized gain or loss.
(i) Unrecognized gain on regular interests.
(ii) Unrecognized loss on regular interests.
(iii) Unrecognized gain on residual interests.
(iv) Unrecognized loss on residual interests.
(5) Additions to or reductions of the sponsor's basis.
(6) Transferred basis property.
(c) REMIC's basis in contributed assets.

§1.860F-4. REMIC reporting requirements and other administrative rules.

(a) In general.
(b) REMIC tax return.
(1) In general.
(2) Income tax return.
(c) Signing of REMIC return.
(1) In general.
(2) REMIC whose startup day is before November 10, 1988.
(i) In general.
(ii) Startup day.
(iii) Exception.
(d) Designation of tax matters person.
(e) Notice to holders of residual interests.
(1) Information required.
(i) In general.
(ii) Information with respect to REMIC assets.
(A) 95 percent asset test.
(B) Additional information required if the 95 percent test not met.
(C) For calendar quarters in 1987.
(D) For calendar quarters in 1988 and 1989.
(iii) Special provisions.
(2) Quarterly notice required.
(i) In general.
(ii) Special rule for 1987.
(3) Nominee reporting.
(i) In general.
(ii) Time for furnishing statement.
(4) Reports to the Internal Revenue Service.
(f) Information returns for persons engaged in a trade or business.

§1.860G-1. Definition of regular and residual interests.

(a) Regular interest.
(1) Designation as a regular interest.
(2) Specified portion of the interest payments on qualified mortgages.
(i) In general.
(ii) Specified portion cannot vary.
(iii) Defaulted or delinquent mortgages.
(iv) No minimum specified principal amount is required.
(v) Specified portion includes portion of interest payable on regular interest.
(vi) Examples.
(3) Variable rate.
(i) Rate based on current interest rate.
(ii) Weighted average rate.
(A) In general.
(B) Reduction in underlying rate.
(iii) Additions, subtractions, and multiplications.
(iv) Caps and floors.
(v) Funds-available caps.
(A) In general.
(B) Facts and circumstances test.
(C) Examples.
(vi) Combination of rates.
(4) Fixed terms on the startup day.

(5) Contingencies prohibited.
(b) Special rules for regular interests.
(1) Call premium.
(2) Customary prepayment penalties received with respect to qualified mortgages.
(3) Certain contingencies disregarded.
(i) Prepayments, income, and expenses.
(ii) Credit losses.
(iii) Subordinated interests.
(iv) Deferral of interest.
(v) Prepayment interest shortfalls.
(vi) Remote and incidental contingencies.
(4) Form of regular interest.
(5) Interest disproportionate to principal.
(i) In general.
(ii) Exception.
(6) Regular interest treated as a debt instrument for all Federal income tax purposes.
(c) Residual interest.
(d) Issue price of regular and residual interests.
(1) In general.
(2) The public.

§1.860G-2. Other rules.
(a) Obligations principally secured by an interest in real property.
(1) Tests for determining whether an obligation is principally secured.
(i) The 80-percent test.
(ii) Alternative test.
(2) Treatment of liens.
(3) Safe harbor.
(i) Reasonable belief that an obligation is principally secured.
(ii) Basis for reasonable belief.
(iii) Later discovery that an obligation is not principally secured.
(4) Interests in real property; real property.
(5) Obligations secured by an interest in real property.
(6) Obligations secured by other obligations; residual interests.
(7) Certain instruments that call for contingent payments are obligations.
(8) Release of a lien on an interest in real property securing a qualified mortgage; defeasance.
(9) Stripped bonds and coupons.
(b) Assumptions and modifications.
(1) Significant modifications are treated as exchanges of obligations.
(2) Significant modification defined.
(3) Exceptions.
(4) Modifications that are not significant modifications.
(5) Assumption defined.
(6) Pass-thru certificates.
(7) Test for determining whether an obligation continues to be principally secured following certain types of modifications.
(c) Treatment of certain credit enhancement contracts.
(1) In general.
(2) Credit enhancement contracts.
(3) Arrangements to make certain advances.
(i) Advances of delinquent principal and interest.
(ii) Advances of taxes, insurance payments, and expenses.
(iii) Advances to ease REMIC administration.
(4) Deferred payment under a guarantee arrangement.
(d) Treatment of certain purchase agreements with respect to convertible mortgages.
(1) In general.
(2) Treatment of amounts received under purchase agreements.

(3) Purchase agreement.
(4) Default by the person obligated to purchase a convertible mortgage.
(5) Convertible mortgage.
(e) Prepayment interest shortfalls.
(f) Defective obligations.
(1) Defective obligation defined.
(2) Effect of discovery of defect.
(g) Permitted investments.
(1) Cash flow investment.
(i) In general.
(ii) Payments received on qualified mortgages.
(iii) Temporary period.
(2) Qualified reserve funds.
(3) Qualified reserve asset.
(i) In general.
(ii) Reasonably required reserve.
(A) In general.
(B) Presumption that a reserve is reasonably required.
(C) Presumption may be rebutted.
(h) Outside reserve funds.
(i) Contractual rights coupled with regular interests in tiered arrangements.
(1) In general.
(2) Example.
(j) Clean-up call.
(1) In general.
(2) Interest rate changes.
(3) Safe harbor.
(k) Startup day.

§1.860G-3. Treatment of foreign persons.
(a) Transfer of a residual interest with tax avoidance potential.
(1) In general.
(2) Tax avoidance potential.
(i) Defined.
(ii) Safe harbor.
(3) Effectively connected income.
(4) Transfer by a foreign holder.
(b) Accounting for REMIC net income.
(1) Allocation of partnership income to a foreign partner.
(2) Excess inclusion income allocated by certain pass-through entities to a foreign person.

Reg. §1.860A-1. Effective dates and transition rules.

(a) In general. Except as otherwise provided in paragraph (b) of this section, the regulations under sections 860A through 860G are effective only for a qualified entity (as defined in §1.860D-1(c)(3)) whose startup day (as defined in section 860G(a)(9) and §1.860G-2(k)) is on or after November 12, 1991.

(b) Exceptions. (1) Reporting regulations—(i) Sections 1.860D-1(c)(1) and (3), and §1.860D-1(d)(1) through (3) are effective after December 31, 1986.

(ii) Sections 1.860F-4(a) through (e) are effective after December 31, 1986 and are applicable after that date except as follows:

(A) Section 1.860F-4(c)(1) is effective for REMICs with a startup day on or after November 10, 1988.

(B) Sections 1.860F-4(e)(1)(ii)(A) and (B) are effective for calendar quarters and calendar years beginning after December 31, 1988.

(C) Section 1.860F-4(e)(1)(ii)(C) is effective for calendar quarters and calendar years beginning after December 31, 1986 and ending before January 1, 1988.

(D) Section 1.860F-4(e)(1)(ii)(D) is effective for calendar quarters and calendar years beginning after December 31, 1987 and ending before January 1, 1990.

(2) Tax avoidance rules—(i) Transfers of certain residual interests. Section 1.860E-1(c) (concerning transfers of noneconomic residual interests) and

§1.860G-3 (a)(4) (concerning transfers by a foreign holder to a United States person) are effective for transfers of residual interests on or after September 27, 1991.

(ii) Transfers to foreign holders. Generally, §1.860G-3(a) (concerning transfers of residual interests to foreign holders) is effective for transfers of residual interests after April 20, 1992. However, §1.860G-3(a) does not apply to a transfer of a residual interest in a REMIC by the REMIC's sponsor (or by another transferor contemporaneously with formation of the REMIC) on or before June 30, 1992, if—

(A) The terms of the regular interests and the prices at which regular interests were offered had been fixed on or before April 20, 1992;

(B) On or before June 30, 1992, a substantial portion of the regular interests in the REMIC were transferred, with the terms and at the prices that were fixed on or before April 20, 1992, to investors who were unrelated to the REMIC's sponsor at the time of the transfer; and

(C) At the time of the transfer of the residual interest, the expected future distributions on the residual interest were equal to at least 30 percent of the anticipated excess inclusions (as defined in §1.860E-2(a)(3)), and the transferor reasonably expected that the transferee would receive sufficient distributions from the REMIC at or after the time at which the excess inclusions accrue in an amount sufficient to satisfy the taxes on the excess inclusions.

(iii) Residual interests that lack significant value. The significant value requirement in §1.860E-1(a)(1) and (3) (concerning excess inclusions accruing to organizations to which section 593 applies) generally is effective for residual interests acquired on or after September 27, 1991. The significant value requirement in 1.860E-1(a)(1) and (3) does not apply, however, to residual interests acquired by an organization to which section 593 applies as a sponsor at formation of a REMIC in a transaction described in §1.860F-2(a)(1) if more than 50 percent of the interests in the REMIC (determined by reference to issue price) were sold to unrelated investors before November 12, 1991. The exception from the significant value requirement provided by the preceding sentence applies only so long as the sponsor owns the residual interests.

(3) Excise taxes. Section 1.860E-2(a)(1) is effective for transfers of residual interests to disqualified organizations after March 31, 1988. Section 1.860E-2(b)(1) is effective for excess inclusions accruing to pass-thru entities after March 31, 1988.

(4) Rate based on current interest rate—(i) In general. Section 1.860G-1(a)(3)(i) applies to obligations (other than transition obligations described in paragraph (b)(4)(iii) of this section) intended to qualify as regular interests that are issued on or after April 4, 1994.

(ii) Rate based on index. Section 1.860G-1(a)(3)(i) (as contained in 26 CFR part 1 revised as of April 1, 1994) applies to obligations intended to qualify as regular interests that—

(A) Are issued by a qualified entity (as defined in §1.860D-1(c)(3)) whose startup date (as defined in section 860G(a)(9) and §1.860G-2(k)) is on or after November 12, 1991; and

(B) Are either—

(1) Issued before April 4, 1994; or

(2) Transition obligations described in paragraph (b)(4)(iii) of this section.

(iii) Transition obligations. Obligations are described in this paragraph (b)(4)(iii) if—

(A) The terms of the obligations and the prices at which the obligations are offered are fixed before April 4, 1994; and

(B) On or before June 1, 1994, a substantial portion of the obligations are transferred, with the terms and at the prices that are fixed before April 4, 1994, to investors who are unrelated to the REMIC's sponsor at the time of the transfer.

(5) Accounting for REMIC net income of foreign persons. Section 1.860G-3(b) is applicable to REMIC net income (including excess inclusions) of a foreign person with respect to a REMIC residual interest if the first net income allocation under section 860C(a)(1) to the foreign person with respect to that interest occurs on or after August 1, 2006).

(6) Exceptions for certain modified obligations. Paragraphs (a)(8)(i), (b)(3)(v), (b)(3)(vi), and (b)(7) of Sec. 1.860G-2 apply to modifications made to the terms of an obligation on or after September 16, 2009.

Reg. §1.860C-1. Taxation of holders of residual interests

(a) Pass-thru of income or loss. Any holder of a residual interest in a REMIC must take into account the holder's daily portion of the taxable income or net loss of the REMIC for each day during the taxable year on which the holder owned the residual interest.

(b) Adjustments to basis of residual interests. (1) Increase in basis. A holder's basis in a residual interest is increased by—

(i) The daily portions of taxable income taken into account by that holder under section 860C(a) with respect to that interest; and

(ii) The amount of any contribution described in section 860G(d)(2) made by that holder.

(2) Decrease in basis. A holder's basis in a residual interest is reduced (but not below zero) by—

(i) First, the amount of any cash or the fair market value of any property distributed to that holder with respect to that interest; and

(ii) Second, the daily portions of net loss of the REMIC taken into account under section 860C(a) by that holder with respect to that interest.

(3) Adjustments made before disposition. If any person disposes of a residual interest, the adjustments to basis prescribed in paragraph (b)(1) and (2) of this section are deemed to occur immediately before the disposition.

(c) Counting conventions. For purposes of determining the daily portion of REMIC taxable income or net loss under section 860C(a)(2), any reasonable convention may be used. An example of a reasonable convention is "30 days per month/90 days per quarter/360 days per year."

(d) For rules on the proper accounting for income from inducement fees, see §1.446-6.

§1.860C-2. Determination of REMIC taxable income or net loss

(a) Treatment of gain or loss. For purposes of determining the taxable income or net loss of a REMIC under section 860C(b), any gain or loss from the disposition of any asset, including a qualified mortgage (as defined in section 860G(a)(3)) or a permitted investment (as defined in section 860G(a)(5) and §1.860G-2(g)), is treated as gain or loss from the sale or exchange of property that is not a capital asset.

(b) Deductions allowable to a REMIC. (1) In general. Except as otherwise provided in section 860C(b) and in paragraph (b)(2) through (5) of this section, the deductions allowable to a REMIC for purposes of determining its taxable income or net loss are those deductions that would be allowable to an individual, determined by taking into account the same limitations that apply to an individual.

(2) Deduction allowable under section 163. A REMIC is allowed a deduction, determined without regard to section 163(d), for any interest expense accrued during the taxable year.

(3) Deduction allowable under section 166. For purposes of determining a REMIC's bad debt deduction under section 166, debt owed to the REMIC is not treated as nonbusiness debt under section 166(d).

(4) Deduction allowable under section 212. A REMIC is not treated as carrying on a trade or business for purposes of section 162. Ordinary and necessary operating expenses paid or incurred by the REMIC during the taxable year are deductible under section 212, without regard to section 67. Any expenses that are incurred in connection with the formation of the REMIC and that relate to the organization of the REMIC and the issuance of regular and residual interests are not treated as expenses of the REMIC for which a deduction is allowable under section 212. See §1.860F-2(b)(3)(ii) for treatment of those expenses.

(5) Expenses and interest relating to tax-exempt income. Pursuant to section 265(a), a REMIC is not allowed a deduction for expenses and interest allocable to tax-exempt income. The portion of a REMIC's interest expense that is allocable to tax-exempt interest is determined in the manner prescribed in section 265(b)(2), without regard to section 265(b)(3).

Reg. §1.860D-1. Definition of a REMIC.

(a) In general. A real estate mortgage investment conduit (or REMIC) is a qualified entity, as defined in paragraph (c)(3) of this section, that satisfies the requirements of section 860D(a). See paragraph (d)(1) of this section for the manner of electing REMIC status.

(b) Specific requirements. (1) Interests in a REMIC—(i) In general. A REMIC must have one class, and only one class, of residual interests. Except as provided in paragraph (b)(1)(ii) of this section, every interest in a REMIC must be either a regular interest (as defined in section 860G(a)(1) and §1.860G-1(a)) or a residual interest (as defined in section 860G(a)(2) and §1.860G-1(c)).

(ii) De minimis interests. If, to facilitate the creation of an entity that elects REMIC status, an interest in the entity is created and, as of the startup day (as defined in section 860G(a)(9) and §1.860G-2(k)), the fair market value of that interest is less than the lesser of $1,000 or 1/1,000 of one percent of the aggregate fair market value of all the regular and residual interests in the REMIC, then, unless that interest is specifically designated as an interest in the REMIC, the interest is not treated as an interest in the REMIC for purposes of section 860D(a)(2) and (3) and paragraph (b)(1)(i) of this section.

(2) Certain rights not treated as interests. Certain rights are not treated as interests in a REMIC. Although not an exclusive list, the following rights are not interests in a REMIC.

(i) Payments for services. The right to receive from the REMIC payments that represent reasonable compensation for services provided to the REMIC in the ordinary course of its operation is not an interest in the REMIC. Payments made by the REMIC in exchange for services may be expressed as a specified percentage of interest payments due on qualified mortgages or as a specified percentage of earnings from permitted investments. For example, a mortgage servicer's right to receive reasonable compensation for servicing the mortgages owned by the REMIC is not an interest in the REMIC.

(ii) Stripped interests. Stripped bonds or stripped coupons not held by the REMIC are not interests in the REMIC even if, in a transaction preceding or contemporaneous with the formation of the REMIC, they and the REMIC's qualified mortgages were created from the same mortgage obligation. For example, the right of a mortgage servicer to receive a servicing fee in excess of reasonable compensation from payments it receives on mortgages held by a REMIC is not an interest in the REMIC. Further, if an obligation with a fixed principal amount provides for interest at a fixed or variable rate and for certain contingent payment rights (e.g., a shared appreciation provision or a percentage of mortgagor profits provision), and the owner of the obligation contributes the fixed payment rights to a REMIC and retains the contingent payment rights, the retained contingent payment rights are not an interest in the REMIC.

(iii) Reimbursement rights under credit enhancement contracts. A credit enhancer's right to be reimbursed for amounts advanced to a REMIC pursuant to the terms of a credit enhancement contract (as defined in §1.860G-2(c)(2)) is not an interest in the REMIC even if the credit enhancer is entitled to receive interest on the amounts advanced.

(iv) Rights to acquire mortgages. The right to acquire or the obligation to purchase mortgages and other assets from a REMIC pursuant to a clean-up call (as defined in §1.860G-2(j)) or a qualified liquidation (as defined in section 860F(a)(4)), or on conversion of a convertible mortgage (as defined in §1.860G-2(d)(5)), is not an interest in the REMIC.

(3) Asset test—(i) In general. For purposes of the asset test of section 860D(a)(4), substantially all of a qualified entity's assets are qualified mortgages and permitted investments if the qualified entity owns no more than a de minimis amount of other assets.

(ii) Safe harbor. The amount of assets other than qualified mortgages and permitted investments is de minimis if the aggregate of the adjusted bases of those assets is less than one percent of the aggregate of the adjusted bases of all of the REMIC's assets. Nonetheless, a qualified entity that does not meet this safe harbor may demonstrate that it owns no more than a de minimis amount of other assets.

(4) Arrangements test. Generally, a qualified entity must adopt reasonable arrangements designed to ensure that—

(i) Disqualified organizations (as defined in section 860E(e)(5)) do not hold residual interests in the qualified entity; and

(ii) If a residual interest is acquired by a disqualified organization, the qualified entity will provide to the Internal Revenue Service, and to the persons specified in section 860E(a)(3), information needed to compute the tax imposed under section 860E(e) on transfers of residual interests to disqualified organizations.

(5) Reasonable arrangements—(i) Arrangements to prevent disqualified organizations from holding residual interests. A qualified entity is considered to have adopted reasonable arrangements to ensure that a disqualified organization (as defined in section 860E(e)(5)) will not hold a residual interest if—

(A) The residual interest is in registered form (as defined in §5f.103-1(c) of this chapter); 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.

(ii) Arrangements to ensure that information will be provided. A qualified entity is considered to have made reasonable arrangements to ensure that the Internal Revenue Service and persons specified in section 860E(e)(3) as liable for the tax imposed under section 860E(e) receive the information needed to compute the tax if the qualified entity's organizational documents require that it provide to the Internal Revenue Service and those persons a computation showing the present value of the total anticipated excess inclusions with respect to the residual interest for periods after the transfer. See §1.860E-2(a)(5) for the obligation to furnish information on request.

(6) Calendar year requirement. A REMIC's taxable year is the calendar year. The first taxable year of a REMIC begins on the startup day and ends on December 31 of the same year. If the startup day is other than January 1, the REMIC has a short first taxable year.

(c) Segregated pool of assets.(1) Formation of REMIC. A REMIC may be formed as a segregated pool of assets rather than as a separate entity. To constitute a REMIC, the assets identified as part of the segregated pool must be treated for all Federal income tax purposes as assets of the REMIC and interests in the REMIC must be based solely on assets of the REMIC.

(2) Identification of assets. Formation of the REMIC does not occur until—

(i) The sponsor identifies the assets of the REMIC, such as through execution of an indenture with respect to the assets; and

(ii) The REMIC issues the regular and residual interests in the REMIC.

(3) Qualified entity defined. For purposes of this section, the term "qualified entity" includes an entity or a segregated pool of assets within an entity.

(d) Election to be treated as a real estate mortgage investment conduit. (1) In general. A qualified entity, as defined in paragraph (c)(3) of this section, elects to be treated as a REMIC by timely filing, for the first taxable year of its existence, a Form 1066, U.S. Real Estate Mortgage Investment Conduit Income Tax Return, signed by a person authorized to sign that return under §1.860F-4(c). See §1.9100-1 for rules regarding extensions of time for making elections. Once made, this election is irrevocable for that taxable year and all succeeding taxable years.

(2) Information required to be reported in the REMIC's first taxable year. For the first taxable year of the REMIC's existence, the qualified entity, as defined in paragraph (c)(3) of this section, must provide either on its return or in a separate statement attached to its return—

(i) The REMIC's employer identification number, which must not be the same as the identification number of any other entity,

(ii) Information concerning the terms and conditions of the regular interests and the residual interest of the REMIC, or a copy of the offering circular or prospectus containing such information,

(iii) A description of the prepayment and reinvestment assumptions that are made pursuant to section 1272(a)(6) and the regulations thereunder, including a statement supporting the selection of the prepayment assumption,

(iv) The form of the electing qualified entity under State law or, if an election is being made with respect to a segregated pool of assets within an entity, the form of the entity that holds the segregated pool of assets, and

(v) Any other information required by the form.

(3) Requirement to keep sufficient records. A qualified entity, as defined in paragraph (c)(3) of this section, that elects to be a REMIC must keep sufficient records concerning its investments to show that it has complied with the provisions of sections 860A through 860G and the regulations thereunder during each taxable year.

Reg. §1.860E-1. Treatment of taxable income of a residual interest holder in excess of daily accruals

(a) Excess inclusion cannot be offset by otherwise allowable deductions. (1) In general. Except as provided in paragraph (a)(3) of this section, the taxable income of any holder of a residual interest for any taxable year is in no event less than the sum of the excess inclusions attributable to that holder's residual interests for that taxable year. In computing the amount of a net operating loss (as defined in section 172(c)) or the amount of any net operating loss carryover (as defined in section 172(b)(2)), the amount of any excess inclusion is not included in gross income or taxable income. Thus, for example, if a residual interest holder has $100 of gross income, $25 of which is an excess inclusion, and $90 of business deductions, the holder has taxable income of $25, the amount of the excess inclusion, and a net operating loss of $15 ($75 of other income - $90 of business deductions).

(2) Affiliated groups. If a holder of a REMIC residual interest is a member of an affiliated group filing a consolidated income tax return, the taxable income of the affiliated group cannot be less than the sum of the excess inclusions attributable to all residual interests held by members of the affiliated group.

(3) Special rule for certain financial institutions—(i) In general. If an organization to which section 593 applies holds a residual interest that has significant value (as defined in paragraph (a)(3)(iii) of this section), section 860E(a)(1) and paragraph (a)(1) of this section do not apply to that organization with respect to that interest. Consequently, an organization to which section 593 applies may use its allowable deductions to offset an excess inclusion attributable to a residual interest that has significant value, but, except as provided in section 860E(a)(4)(A), may not use its allowable deductions to offset an excess inclusion attributable to a residual interest held by any other member of an affiliated group, if any, of which the organization is a member. Further, a net operating loss of any other member of an affiliated group of which the organization is a member may not be used to offset an excess inclusion attributable to a residual interest held by that organization.

(ii) Ordering rule—(A) In general. In computing taxable income for any year, an organization to which section 593 applies is treated as having applied its allowable deductions for the year first to offset that portion of its gross income that is not an excess inclusion and then to offset that portion of its income that is an excess inclusion.

(B) Example. The following example illustrates the provisions of paragraph (a)(3)(ii) of this section:

Example. Corp. X**,** a corporation to which section 593 applies, is a member of an affiliated group that files a consolidated return. For a particular taxable year, Corp. X has gross income of $1,000, and of this amount, $150 is an excess inclusion attributable to a residual interest that has significant value. Corp. X has $975 of allowable deductions for the taxable year. Corp. X must apply its allowable deductions first to offset the $850 of gross income that is not an excess inclusion, and then to offset the portion of its gross income that is an excess inclusion. Thus, Corp. X has $25 of taxable income ($1,000 - $975), and that $25 is an excess inclusion that may not be offset by losses sustained by other members of the affiliated group.

(iii) Significant value. A residual interest has significant value if—

(A) The aggregate of the issue prices of the residual interests in the REMIC is at least 2 percent of the aggregate of the issue prices of all residual and regular interests in the REMIC; and

(B) The anticipated weighted average life of the residual interests is at least 20 percent of the anticipated weighted average life of the REMIC.

(iv) Determining anticipated weighted average life—(A) Anticipated weighted average life of the REMIC. The anticipated weighted average life of a REMIC is the weighted average of the anticipated weighted average lives of all classes of interests in the REMIC. This weighted average is determined under the formula in paragraph (a)(3)(iv)(B) of this section, applied by treating all payments taken into account in computing the anticipated weighted average lives of regular and residual interests in the REMIC as principal payments on a single regular interest.

(B) Regular interests that have a specified principal amount. Generally, the anticipated weighted average life of a regular interest is determined by—

(1) Multiplying the amount of each anticipated principal payment to be made on the interest by the number of years (including fractions thereof) from the startup day (as defined in section 860G(a)(9) and §1.860G-2(k)) to the related principal payment date;

(2) Adding the results; and

(3) Dividing the sum by the total principal paid on the regular interest.

(C) Regular interests that have no specified principal amount or that have only a nominal principal amount, and all residual interests. If a regular interest has no specified principal amount, or if the interest payments to be made on a regular interest are disproportionately high relative to its specified principal amount (as determined by reference to §1.860G-1(b)(5)(i)), then, for purposes of computing the anticipated weighted average life of the interest, all anticipated payments on that interest, regardless of their designation as principal or interest, must be taken into account in applying the formula set out in paragraph (a)(3)(iv)(B) of this section. Moreover, for purposes of computing the weighted average life of a residual interest, all anticipated payments on that interest, regardless of their designation as principal or interest, must be taken into account in applying the formula set out in paragraph (a)(3)(iv)(B) of this section.

(D) Anticipated payments. The anticipated principal payments to be made on a regular interest subject to paragraph (a)(3)(iv)(B) of this section, and the anticipated payments to be made on a regular interest subject to paragraph (a)(3)(iv)(C) of this section or on a residual interest, must be determined based on—

(1) The prepayment and reinvestment assumptions adopted under section 1272(a)(6), or that would have been adopted had the REMIC's regular interests been issued with original issue discount; and

(2) Any required or permitted clean up calls or any required qualified liquidation provided for in the REMIC's organizational documents.

(b) Treatment of residual interests held by REITs, RICs, common trust funds, and subchapter T cooperatives. [Reserved]

(c) Transfers of noneconomic residual interests. **(1) In general.** A transfer of a noneconomic residual interest is disregarded for all Federal tax purposes if a significant purpose of the transfer was to enable the transferor to impede the assessment or collection of tax. A significant purpose to impede the assessment or collection of tax exists if the transferor, at the time of the transfer, either knew or should have known (had "improper knowledge") that the transferee would be unwilling or unable to pay taxes due on its share of the taxable income of the REMIC.

(2) Noneconomic residual interest. A residual interest is a noneconomic residual interest unless, at the time of the transfer—

(i) The present value of the expected future distributions on the residual interest at least equals the product of the present value of the anticipated excess inclusions and the highest rate of tax specified in section 11(b)(1) for the year in which the transfer occurs; and

(ii) The transferor reasonably expects 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.

(3) Computations. The present value of the expected future distributions and the present value of the anticipated excess inclusions must be computed under the procedure specified in §1.860E-2(a)(4) for determining the present value of anticipated excess inclusions in connection with the transfer of a residual interest to a disqualified organization.

(4) Safe harbor for establishing lack of improper knowledge. A transferor is presumed not to have improper knowledge if–

(i) The transferor conducted, at the time of the transfer, a reasonable investigation of the financial condition of the transferee and, as a result of the investigation, the transferor found that the transferee had historically paid its debts as they came due and found no significant evidence to indicate that the transferee will not continue to pay its debts as they come due in the future;

(ii) The transferee represents to the transferor that it understands that, as the holder of the noneconomic residual interest, the transferee may incur tax liabilities in excess of any cash flows generated by the interest and that the transferee intends to pay taxes associated with holding the residual interest as they become due;

(iii) The transferee represents that it will not cause income from the noneconomic residual interest to be attributable to a foreign permanent establishment or fixed base (within the meaning of an applicable income tax treaty) of the transferee or another U.S. taxpayer; and

(iv) The transfer satisfies either the asset test in paragraph (c)(5) of this section or the formula test in paragraph (c)(7) of this section.

(5) Asset test. The transfer satisfies the asset test if it meets the requirements of paragraphs (c)(5)(i), (ii) and (iii) of this section.

(i) At the time of the transfer, and at the close of each of the transferee's two fiscal years preceding the transferee's fiscal year of transfer, the transferee's gross assets for financial reporting purposes exceed $100 million and its net assets for financial reporting purposes exceed $10 million. For purposes of the preceding sentence, the gross assets and net assets of a transferee do not include any obligation of any related person (as defined in paragraph (c)(6)(ii) of this section) or any other asset if a principal purpose for holding or acquiring the other asset is to permit the transferee to satisfy the conditions of this paragraph (c)(5)(i).

(ii) The transferee must be an eligible corporation (defined in paragraph (c)(6)(i) of this section) and must agree in writing that any subsequent transfer of the interest will be to another eligible corporation in a transaction that satisfies paragraphs (c)(4)(i), (ii), and (iii) and this paragraph (c)(5). The direct or indirect transfer of the residual interest to a foreign permanent establishment (within the meaning of an applicable income tax treaty) of a domestic corporation is a transfer that is not a transfer to an eligible corporation. A transfer also fails to meet the requirements of this paragraph (c)(5)(ii) if the transferor knows, or has reason to know, that the transferee will not honor the restrictions on subsequent transfers of the residual interest.

(iii) A reasonable person would not conclude, based on the facts and circumstances known to the transferor on or before the date of the transfer, that the taxes associated with the residual interest will not be paid. The consideration given to the transferee to acquire the noneconomic residual interest in the REMIC is only one factor to be considered, but the transferor will be deemed to know that the transferee cannot or will not pay if the amount of consideration is so low compared to the liabilities assumed that a reasonable person would conclude that the taxes associated with holding the residual interest will not be paid. In determining whether the amount of consideration is too low, the specific terms of the formula test in paragraph (c)(7) of this section need not be used.

(6) Definitions for asset test. The following definitions apply for purposes of paragraph (c)(5) of this section:

(i) *Eligible corporation* means any domestic C corporation (as defined in section 1361(a)(2)) other than--

(A) A corporation which is exempt from, or is not subject to, tax under section 11;

(B) An entity described in section 851(a) or 856(a);

(C) A REMIC; or

(D) An organization to which part I of subchapter T of chapter 1 of subtitle A of the Internal Revenue Code applies.

(ii) *Related person* is any person that--

(A) Bears a relationship to the transferee enumerated in section 267(b) or 707(b)(1), using “20 percent” instead of “50 percent” where it appears under the provisions; or

(B) Is under common control (within the meaning of section 52(a) and (b)) with the transferee.

(7) Formula test. The transfer satisfies the formula test if the present value of the anticipated tax liabilities associated with holding the residual interest does not exceed the sum of--

(i) The present value of any consideration given to the transferee to acquire the interest;

(ii) The present value of the expected future distributions on the interest; and

(iii) The present value of the anticipated tax savings associated with holding the interest as the REMIC generates losses.

(8) Conditions and limitations on formula test. The following rules apply for purposes of the formula test in paragraph (c)(7) of this section.

(i) The transferee is assumed to pay tax at a rate equal to the highest rate of tax specified in section 11(b)(1). If the transferee has been subject to the alternative minimum tax under section 55 in the preceding two years and will compute its taxable income in the current taxable year using the alternative minimum tax rate, then the tax rate specified in section 55(b)(1)(B) may be used in lieu of the highest rate specified in section 11(b)(1).

(ii) The direct or indirect transfer of the residual interest to a foreign permanent establishment or fixed base (within the meaning of an applicable income tax treaty) of a domestic transferee is not eligible for the formula test.

(iii) Present values are computed using a discount rate equal to the Federal short-term rate prescribed by section 1274(d) for the month of the transfer and the compounding period used by the taxpayer.

(9) Examples. The following examples illustrate the rules of this section:

Example 1. Transfer to partnership. *X* transfers a noneconomic residual interest in a REMIC to Partnership *P* in a transaction that does not satisfy the formula test of paragraph (c)(7) of this section. *Y* and *Z* are the partners of *P*. Even if *Y* and *Z* are eligible corporations that satisfy the requirements of paragraph (c)(5)(i) of this section, the transfer fails to satisfy the asset test requirements found in paragraph (c)(5)(ii) of this section because *P* is a partnership rather than an eligible corporation within the meaning of (c)(6)(i) of this section.

Example 2. Transfer to a corporation without capacity to carry additional residual interests. During the first ten months of a year, Bank transfers five residual interests to Corporation *U* under circumstances meeting the requirements of the asset test in paragraph (c)(5) of this section. Bank is the major creditor of *U* and consequently has access to *U*’s financial records and has knowledge of *U*’s financial circumstances. During the last month of the year, Bank transfers three additional residual interests to *U* in a transaction that does not meet the formula test of paragraph (c)(7) of this section. At the time of this transfer, *U*’s financial records indicate it has retained the previously transferred residual interests. *U*’s financial circumstances, including the aggregate tax liabilities it has assumed with respect to

REMIC residual interests, would cause a reasonable person to conclude that *U* will be unable to meet its tax liabilities when due. The transfers in the last month of the year fail to satisfy the investigation requirement in paragraph (c)(4)(i) of this section and the asset test requirement of paragraph (c)(5)(iii) of this section because Bank has reason to know that *U* will not be able to pay the tax due on those interests.

Example 3. Transfer to a foreign permanent establishment of an eligible corporation. *R* transfers a noneconomic residual interest in a REMIC to the foreign permanent establishment of Corporation *T*. Solely because of paragraph (c)(8)(ii) of this section, the transfer does not satisfy the formula test of paragraph (c)(7) of this section. In addition, even if *T* is an eligible corporation, the transfer does not satisfy the asset test because the transfer fails the requirements of paragraph (c)(5)(ii) of this section.

(10) Effective dates. Paragraphs (c)(4) through (c)(9) of this section are applicable to transfers occurring on or after February 4, 2000, except for paragraphs (c)(4)(iii) and (c)(8)(iii) of this section, which are applicable for transfers occurring on or after August 19, 2002. For the dates of applicability of paragraphs (a) through (c)(3) and (d) of this section, see § 1.860A-1.

(d) Transfers to foreign persons. Paragraph (c) of this section does not apply to transfers of residual interests to which §1.860G-3(a)(1), concerning transfers to certain foreign persons, applies.

Reg. §1.860E-2. Tax on transfers of residual interests to certain organizations.

(a) Transfers to disqualified organizations. (1) Payment of tax. Any excise tax due under section 860E(e)(1) must be paid by the later of March 24, 1993, or April 15th of the year following the calendar year in which the residual interest is transferred to a disqualified organization. The Commissioner may prescribe rules for the manner and method of collecting the tax.

(2) Transitory ownership. For purposes of section 860E(e) and this section, a transfer of a residual interest to a disqualified organization in connection with the formation of a REMIC is disregarded if the disqualified organization has a binding contract to sell the interest and the sale occurs within 7 days of the startup day (as defined in section 860G(a)(9) and §1.860G-2(k)).

(3) Anticipated excess inclusions. The anticipated excess inclusions are the excess inclusions that are expected to accrue in each calendar quarter (or portion thereof) following the transfer of the residual interest. The anticipated excess inclusions must be determined as of the date the residual interest is transferred and must be based on—

(i) Events that have occurred up to the time of the transfer;

(ii) The prepayment and reinvestment assumptions adopted under section 1272(a)(6), or that would have been adopted had the REMIC's regular interests been issued with original issue discount; and

(iii) Any required or permitted clean up calls, or required qualified liquidation provided for in the REMIC's organizational documents.

(4) Present value computation. The present value of the anticipated excess inclusions is determined by discounting the anticipated excess inclusions from the end of each remaining calendar quarter in which those excess inclusions are expected to accrue to the date the disqualified organization acquires the residual interest. The discount rate to be used for this present value computation is the applicable Federal rate (as specified in section 1274(d)(1)) that would apply to a debt instrument that was issued on the date the disqualified organization acquired the residual interest and whose term ended on the close of the last quarter in which excess inclusions were expected to accrue with respect to the residual interest.

(5) Obligation of REMIC to furnish information. A REMIC is not obligated to determine if its residual interests have been transferred to a disqualified organization. However, upon request of a person designated in section 860E(e)(3), the REMIC must furnish information sufficient to compute the present value of the anticipated excess inclusions. The information must be furnished to the requesting party and to the Internal Revenue Service within 60 days of the request. A reasonable fee charged to the requestor is not income derived from a prohibited transaction within the meaning of section 860F(a).

(6) Agent. For purposes of section 860E(e)(3), the term “agent” includes a broker (as defined in section 6045(c) and §1.6045-1(a)(1)), nominee, or other middleman.

(7) Relief from liability—(i) Transferee furnishes information under penalties of perjury. For purposes of section 860E(e)(4), a transferee is treated as having furnished an affidavit if the transferee furnishes—

(A) A social security number, and states under penalties of perjury that the social security number is that of the transferee; or

(B) A statement under penalties of perjury that it is not a disqualified organization.

(ii) Amount required to be paid. The amount required to be paid under section 860E(e)(7)(B) is equal to the product of the highest rate specified in section 11(b)(1) for the taxable year in which the transfer described in section 860E(e)(1) occurs and the amount of excess inclusions that accrued and were allocable to the residual interest during the period that the disqualified organization held the interest.

(b) Tax on pass-thru entities. (1) Tax on excess inclusions. Any tax due under section 860E(e)(6) must be paid by the later of March 24, 1993, or by the fifteenth day of the fourth month following the close of the taxable year of the pass-thru entity in which the disqualified person is a record holder. The Commissioner may prescribe rules for the manner and method of collecting the tax.

(2) Record holder furnishes information under penalties of perjury. For purposes of section 860E(e)(6)(D), a record holder is treated as having furnished an affidavit if the record holder furnishes—

(i) A social security number and states, under penalties of perjury, that the social security number is that of the record holder; or

(ii) A statement under penalties of perjury that it is not a disqualified organization.

(3) Deductibility of tax. Any tax imposed on a pass-thru entity pursuant to section 860E(e)(6)(A) is deductible against the gross amount of ordinary income of the pass-thru entity. For example, in the case of a REIT, the tax is deductible in determining real estate investment trust taxable income under section 857(b)(2).

(4) Allocation of tax. Dividends paid by a RIC or by a REIT are not preferential dividends within the meaning of section 562(c) solely because the tax expense incurred by the RIC or REIT under section 860E(e)(6) is allocated solely to the shares held by disqualified organizations.

Reg. §1.860F-1. Qualified liquidations
A plan of liquidation need not be in any special form. If a REMIC specifies the first day in the 90-day liquidation period in a statement attached to its final return, then the REMIC will be considered to have adopted a plan of liquidation on the specified date.

Reg. §1.860F-2. Transfers to a REMIC
(a) Formation of a REMIC. (1) In general. For Federal income tax purposes, a REMIC formation is characterized as the contribution of assets by a sponsor (as defined in paragraph (b)(1) of this section) to a REMIC in exchange for REMIC regular and residual interests. If, instead of exchanging its interest in mortgages and related assets for regular and residual interests, the sponsor arranges to have the REMIC issue some or all of the regular and residual interests for cash, after which the sponsor sells its interests in mortgages and related assets to the REMIC, the transaction is, nevertheless, viewed for Federal income tax purposes as the sponsor's exchange of mortgages and related assets for regular and residual interests, followed by a sale of some or all of those interests. The purpose of this rule is to ensure that the tax consequences associated with the formation of a REMIC are not affected by the actual sequence of steps taken by the sponsor.

(2) Tiered arrangements—(i) Two or more REMICs formed pursuant to a single set of organizational documents. Two or more REMICs can be created pursuant to a single set of organizational documents even if for state law purposes or for Federal securities law purposes those documents create only one organization. The organizational documents must, however, clearly and expressly identify the assets of, and the interests in, each REMIC, and each REMIC must satisfy all of the requirements of section 860D and the related regulations.

(ii) A REMIC and one or more investment trusts formed pursuant to a single set of documents. A REMIC (or two or more REMICs) and one or more investment trusts can be created pursuant to a single set of organizational documents and the separate existence of the REMIC(s) and the investment trust(s) will be respected for Federal income tax purposes even if for state law purposes or for Federal securities law purposes those documents create only one organization. The organizational documents for the REMIC(s) and the investment trust(s) must, however, require both the REMIC(s) and the investment trust(s) to account for items of income and ownership of assets for Federal tax purposes in a manner that respects the separate existence of the multiple entities. See §1.860G-2(i) concerning issuance of regular interests coupled with other contractual rights for an illustration of the provisions of this paragraph.

(b) Treatment of sponsor. (1) Sponsor defined. A sponsor is a person who directly or indirectly exchanges qualified mortgages and related assets for regular and residual interests in a REMIC. A person indirectly exchanges interests in qualified mortgages and related assets for regular and residual interests in a REMIC if the person transfers, other than in a nonrecognition transaction, the mortgages and related assets to another person who acquires a transitory ownership interest in those assets before exchanging them for interests in the REMIC, after which the transitory owner then transfers some or all of the interests in the REMIC to the first person.

(2) Nonrecognition of gain or loss. The sponsor does not recognize gain or loss on the direct or indirect transfer of any property to a REMIC in exchange for regular or residual interests in the REMIC. However, the sponsor, upon a subsequent sale of the REMIC regular or residual interests, may recognize gain or loss with respect to those interests.

(3) Basis of contributed assets allocated among interests—(i) In general. The aggregate of the adjusted bases of the regular and residual interests received by the sponsor in the exchange described in paragraph (a) of this section is equal to the aggregate of the adjusted bases of the property transferred by the sponsor in the exchange, increased by the amount of organizational expenses (as described in paragraph (b)(3)(ii) of this section). That total is allocated among all the interests received in proportion to their fair market values on the pricing date (as defined in paragraph (b)(3)(iii) of this section) if any, or, if none, the startup day (as defined in section 860G(a)(9) and §1.860G-2(k)).

(ii) Organizational expenses—(A) Organizational expense defined. An organizational expense is an expense that is incurred by the sponsor or by the REMIC and that is directly related to the creation of the REMIC. Further, the organizational expense must be incurred during a period beginning a reasonable time before the startup day and ending before the date prescribed by law for filing the first REMIC tax return (determined without regard to any extensions of time to file). The following are examples of organizational expenses: legal fees for services related to the formation of the REMIC, such as preparation of a pooling and servicing agreement and trust indenture; accounting fees related to the formation of the REMIC; and other administrative costs related to the formation of the REMIC.

(B) Syndication expenses. Syndication expenses are not organizational expenses. Syndication expenses are those expenses incurred by the sponsor or other person to market the interests in a REMIC, and, thus, are applied to reduce the amount realized on the sale of the interests. Examples of syndication expenses are brokerage fees, registration fees, fees of an underwriter or placement agent, and printing costs of the prospectus or placement memorandum and other selling or promotional material.

(iii) Pricing date. The term "pricing date" means the date on which the terms of the regular and residual interests are fixed and the prices at which a substantial portion of the regular interests will be sold are fixed.

(4) Treatment of unrecognized gain or loss—(i) Unrecognized gain on regular interests. For purposes of section 860F(b)(1)(C)(i), the sponsor must include in gross income the excess of the issue price of a regular interest over the sponsor's basis in the interest as if the excess were market discount (as defined in section 1278(a)(2)) on a bond and the sponsor had made an election under section 1278(b) to include this market discount currently in gross income. The sponsor is not, however, by reason of this paragraph (b)(4)(i), deemed to have made an election under section 1278(b) with respect to any other bonds.

(ii) Unrecognized loss on regular interests. For purposes of section 860F(b)(1)(D)(i), the sponsor treats the excess of the sponsor's basis in a regular interest over the issue price of the interest as if that excess were amortizable bond premium (as defined in section 171(b)) on a taxable bond and the sponsor had made an election under section 171(c). The sponsor is not, however, by reason of this paragraph (b)(4)(ii), deemed to have made an election under section 171(c) with respect to any other bonds.

(iii) Unrecognized gain on residual interests. For purposes of section 860F(b)(1)(C)(ii), the sponsor must include in gross income the excess of the issue price of a residual interest over the sponsor's basis in the interest ratably over the anticipated weighted average life of the REMIC (as defined in §1.860E-1(a)(3)(iv)).

(iv) Unrecognized loss on residual interests. For purposes of section 860F(b)(1)(D)(ii), the sponsor deducts the excess of the sponsor's basis in a residual interest over the issue price of the interest ratably over the anticipated weighted average life of the REMIC.

(5) Additions to or reductions of the sponsor's basis. The sponsor's basis in a regular or residual interest is increased by any amount included in the sponsor's gross income under paragraph (b)(4) of this section. The sponsor's basis in a regular or residual interest is decreased by any amount allowed as a deduction and by any amount applied to reduce interest payments to the sponsor under paragraph (b)(4)(ii) of this section.

(6) Transferred basis property. For purposes of paragraph (b)(4) of this section, a transferee of a regular or residual interest is treated in the same manner as the sponsor to the extent that the basis of the transferee in the interest is determined in whole or in part by reference to the basis of the interest in the hands of the sponsor.

(c) REMIC's basis in contributed assets. For purposes of section 860F(b)(2), the aggregate of the REMIC's bases in the assets contributed by the sponsor to the REMIC in a transaction described in paragraph (a) of this section is equal to the aggregate of the issue prices (determined under section 860G(a)(10) and §1.860G-1(d)) of all regular and residual interests in the REMIC.

Reg. §1.860F-4. REMIC reporting requirements and other administrative rules.

(a) In general. Except as provided in paragraph (c) of this section, for purposes of subtitle F of the Internal Revenue Code, a REMIC is treated as a partnership and any holder of a residual interest in the REMIC is treated as a partner. A REMIC is not subject, however, to the rules of subchapter C of chapter 63 of the Internal Revenue Code, relating to the treatment of partnership items, for a taxable year if there is at no time during the taxable year more than one holder of a residual interest in the REMIC. The identity of a holder of a residual interest in a REMIC is not treated as a partnership item with respect to the REMIC for purposes of subchapter C of chapter 63.

(b) REMIC tax return. (1) In general. To satisfy the requirement under section 6031 to make a return of income for each taxable year, a REMIC must file the return required by paragraph (b)(2) of this section. The due date and any extensions for filing the REMIC's annual return are determined as if the REMIC were a partnership.

(2) Income tax return. The REMIC must make a return, as required by section 6011(a), for each taxable year on Form 1066, U.S. Real Estate Mortgage Investment Conduit Income Tax Return. The return must include—

(i) The amount of principal outstanding on each class of regular interests as of the close of the taxable year,

(ii) The amount of the daily accruals determined under section 860E(c), and

(iii) The information specified in §1.860D-1(d)(2)(i), (iv), and (v).

(c) Signing of REMIC return. (1) In general. Although a REMIC is generally treated as a partnership for purposes of subtitle F, for purposes of determining who is authorized to sign a REMIC's income tax return for any taxable year, the REMIC is not treated as a partnership and the holders of residual interests in the REMIC are not treated as partners. Rather, the REMIC return must be signed by a person who could sign the return of the entity absent the REMIC election. Thus, the return of a REMIC that is a corporation or trust under applicable State law must be signed by a corporate officer or a trustee, respectively. The return of a REMIC that consists of a segregated pool of assets must be signed by a person who could sign the return of the entity that owns the assets of the REMIC under applicable State law.

(2) REMIC whose startup day is before November 10, **1988—(i) In general.** The income tax return of a REMIC whose startup day is before November 10, 1988, may be signed by any person who held a residual interest during the taxable year to which the return relates, or, as provided in section 6903, by a fiduciary, as defined in section 7701(a)(6), who is acting for the REMIC and who has furnished adequate notice in the manner prescribed in §301.6903-1(b) of this chapter.

(ii) Startup day. For purposes of paragraph (c)(2) of this section, startup day means any day selected by a REMIC that is on or before the first day on which interests in such REMIC are issued.

(iii) Exception. A REMIC whose startup day is before November 10, 1988, may elect to have paragraph (c)(1) of this section apply, instead of paragraph (c)(2) of this section, in determining who is authorized to sign the REMIC return. See section 1006(t)(18)(B) of the Technical and Miscellaneous Revenue Act of 1988 (102 Stat. 3426) and §5h.6(a)(1) of this chapter for the time and manner for making this election.

(d) Designation of tax matters person. A REMIC may designate a tax matters person in the same manner in which a partnership may designate a tax matters partner under §301.6231(a)(7)-1T of this chapter. For purposes of applying that section, all holders of residual interests in the REMIC are treated as general partners.

(e) Notice to holders of residual interests. (1) Information required. As of the close of each calendar quarter, a REMIC must provide to each person who held a residual interest in the REMIC during that quarter notice on Schedule Q (Form 1066) of information specified in paragraphs (e)(1)(i) and (ii) of this section.

(i) In general. Each REMIC must provide to each of its residual interest holders the following information—

(A) That person's share of the taxable income or net loss of the REMIC for the calendar quarter;

(B) The amount of the excess inclusion (as defined in section 860E and the regulations thereunder), if any, with respect to that person's residual interest for the calendar quarter;

(C) If the holder of a residual interest is also a pass-through interest holder (as defined in §1.67-3T(a)(2)), the allocable investment expenses (as defined in §1.67-3T(a)(4)) for the calendar quarter, and

(D) Any other information required by Schedule Q (Form 1066).

(ii) Information with respect to REMIC assets—(A) 95 percent asset test. For calendar quarters after 1988, each REMIC must provide to each of its residual interest holders the following information—

(1) The percentage of REMIC assets that are qualifying real property loans under section 593,

(2) The percentage of REMIC assets that are assets described in section 7701(a)(19), and

(3) The percentage of REMIC assets that are real estate assets defined in section 856(c)(6)(B), computed by reference to the average adjusted basis (as defined in section 1011) of the REMIC assets during the calendar quarter (as described in paragraph (e)(1)(iii) of this section). If the percentage of REMIC assets represented by a category is at least 95 percent, then the REMIC need only specify that the percentage for that category was at least 95 percent.

(B) Additional information required if the 95 percent test not met. If, for any calendar quarter after 1988, less than 95 percent of the assets of the REMIC are real estate assets defined in section 856(c)(6)(B), then, for that calendar quarter, the REMIC must also provide to any real estate investment trust (REIT) that holds a residual interest the following information—

(1) The percentage of REMIC assets described in section 856(c)(5)(A), computed by reference to the average adjusted basis of the REMIC assets during the calendar quarter (as described in paragraph (e)(1)(iii) of this section),

(2) The percentage of REMIC gross income (other than gross income from prohibited transactions defined in section 860F (a)(2)) described in section 856(c)(3)(A) through (E), computed as of the close of the calendar quarter, and

(3) The percentage of REMIC gross income (other than gross income from prohibited transactions defined in section 860F(a)(2)) described in section 856(c)(3)(F), computed as of the close of the calendar quarter. For purposes of this paragraph (e)(1)(ii)(B)(**3**), the term "foreclosure property" contained in section 856(c)(3)(F) has the meaning specified in section 860G(a)(8).

In determining whether a REIT satisfies the limitations of section 856(c)(2), all REMIC gross income is deemed to be derived from a source specified in section 856(c)(2).

(C) For calendar quarters in 1987. For calendar quarters in 1987, the percentages of assets required in paragraphs (e)(1)(ii)(A) and (B) of this section may be computed by reference to the fair market value of the assets of the REMIC as of the close of the calendar quarter (as described in paragraph (e)(1)(iii) of this section), instead of by reference to the average adjusted basis during the calendar quarter.

(D) For calendar quarters in 1988 and 1989. For calendar quarters in 1988 and 1989, the percentages of assets required in paragraphs (e)(1)(ii)(A) and (B) of this section may be computed by reference to the average fair market value of the assets of the REMIC during the calendar quarter (as described in paragraph (e)(1)(iii) of this section), instead of by reference to the average adjusted basis of the assets of the REMIC during the calendar quarter.

(iii) Special provisions. For purposes of paragraph (e)(1)(ii) of this section, the percentage of REMIC assets represented by a specified category computed by reference to average adjusted basis (or fair market value) of the assets during a calendar quarter is determined by dividing the average adjusted bases (or for calendar quarters before 1990, fair market value) of the assets in the specified category by the average adjusted basis (or, for calendar quarters before 1990, fair market value) of all the assets of the REMIC as of the close of each month, week, or day during that calendar quarter. The monthly, weekly, or daily computation period must be applied uniformly during the calendar quarter to all categories of assets and may not be changed in succeeding calendar quarters without the consent of the Commissioner.

(2) Quarterly notice required—(i) In general. Schedule Q must be mailed (or otherwise delivered) to each holder of a residual interest during a calendar quarter no later than the last day of the month following the close of the calendar quarter.

(ii) Special rule for 1987. Notice to any holder of a REMIC residual interest of the information required in paragraph (e)(1) of this section for any of the four calendar quarters of 1987 must be mailed (or otherwise delivered) to each holder no later than March 28, 1988.

(3) Nominee reporting—

(i) In general. If a REMIC is required under paragraphs (e)(1) and (2) of this section to provide notice to an interest holder who is a nominee of another person with respect to an interest in the REMIC, the nominee must furnish that notice to the person for whom it is a nominee.

(ii) Time for furnishing statement. The nominee must furnish the notice required under paragraph (e)(3)(i) of this section to the person for whom it is a nominee no later than 30 days after receiving this information.

(4) Reports to the Internal Revenue Service. For each person who was a residual interest holder at any time during a REMIC's taxable year, the REMIC must attach a copy of Schedule Q to its income tax return for that year for each quarter in which that person was a residual interest holder. Quarterly notice to the Internal Revenue Service is not required.

(f) Information returns for persons engaged in a trade or business. See §1.6041-1(b)(2) for the treatment of a REMIC under sections 6041 and 6041A.

Reg. §1.860G-1. Definition of regular and residual interests.

(a) Regular interest. (1) Designation as a regular interest. For purposes of section 860G(a)(1), a REMIC designates an interest as a regular interest by providing to the Internal Revenue Service the information specified in §1.860D-1(d)(2)(ii) in the time and manner specified in §1.860D-1(d)(2).

(2) Specified portion of the interest payments on qualified mortgages—

(i) In general. For purposes of section 860G(a)(1)(B)(ii), a specified portion of the interest payments on qualified mortgages means a portion of the interest payable on qualified mortgages, but only if the portion can be expressed as—

(A) A fixed percentage of the interest that is payable at either a fixed rate or at a variable rate described in paragraph (a)(3) of this section on some or all of the qualified mortgages;

(B) A fixed number of basis points of the interest payable on some or all of the qualified mortgages; or

(C) The interest payable at either a fixed rate or at a variable rate described in paragraph (a)(3) of this section on some or all of the qualified mortgages in excess of a fixed number of basis points or in excess of a variable rate described in paragraph (a)(3) of this section.

(ii) Specified portion cannot vary. The portion must be established as of the startup day (as defined in section 860G(a)(9) and §1.860G-2(k)) and, except as provided in paragraph (a)(2)(iii) of this section, it cannot vary over the period that begins on the startup day and ends on the day that the interest holder is no longer entitled to receive payments.

(iii) Defaulted or delinquent mortgages. A portion is not treated as varying over time if an interest holder's entitlement to a portion of the interest on some or all of the qualified mortgages is dependent on the absence of defaults or delinquencies on those mortgages.

(iv) No minimum specified principal amount is required. If an interest in a REMIC consists of a specified portion of the interest payments on the REMIC's qualified mortgages, no minimum specified principal amount need be assigned to that interest. The specified principal amount can be zero.

(v) Specified portion includes portion of interest payable on regular interest. (A) The specified portions that meet the requirements of paragraph (a)(2)(i) of this section include a specified portion that can be expressed as a fixed percentage of the interest that is payable on some or all of the qualified mortgages where—

(1) Each of those qualified mortgages is a regular interest issued by another REMIC; and

(2) With respect to that REMIC in which it is a regular interest, each of those regular interests bears interest that can be expressed as a specified portion as described in paragraph (a)(2)(i)(A), (B), or (C) of this section.

(B) See §1.860A-1(a) for the effective date of this paragraph (a)(2)(v).

(vi) Examples. The following examples, each of which describes a pass-thru trust that is intended to qualify as a REMIC, illustrate the provisions of this paragraph (a)(2).

Example 1. (i) A sponsor transferred a pool of fixed rate mortgages to a trustee in exchange for two classes of certificates. The Class A certificate holders are entitled to all principal payments on the mortgages and to interest on outstanding principal at a variable rate based on the current value of One-Month LIBOR, subject to a lifetime cap equal to the weighted average rate payable on the mortgages. The Class B certificate holders are entitled to all interest payable on the mortgages in excess of the interest paid on the Class A certificates. The Class B certificates are subordinate to the Class A certificates so that cash flow shortfalls due to defaults or delinquencies on the mortgages will be borne first by the Class B certificate holders.

(ii) The Class B certificate holders are entitled to all interest payable on the pooled mortgages in excess of a variable rate described in paragraph (a)(3)(vi) of this section. Moreover, the portion of the interest payable to the Class B certificate holders is not treated as varying over time solely because payments on the Class B certificates may be reduced as a result of defaults or delinquencies on the pooled mortgages. Thus, the Class B certificates provide for interest payments that consist of a specified portion of the interest payable on the pooled mortgages under paragraph (a)(2)(i)(C) of this section.

Example 2. (i) A sponsor transferred a pool of variable rate mortgages to a trustee in exchange for two classes of certificates. The mortgages call for interest payments at a variable rate based on the current value of the One-Year Constant Maturity Treasury Index (hereinafter "CMTI") plus 200 basis points, subject to a lifetime cap of 12 percent. Class C certificate holders are entitled to all principal payments on the mortgages and interest on the outstanding principal at a variable rate based on the One-Year CMTI plus 100 basis points, subject to a lifetime cap of 12 percent. The interest rate on the Class C certificates is reset at the same time the rate is reset on the pooled mortgages.

(ii) The Class D certificate holders are entitled to all interest payments on the mortgages in excess of the interest paid on the Class C certificates. So long as the One-Year CMTI is at 10 percent or lower, the Class D certificate holders are entitled to 100 basis points of interest on the pooled mortgages. If, however, the index exceeds 10 percent on a reset date, the Class D certificate holders' entitlement shrinks, and it disappears if the index is at 11 percent or higher.

(iii) The Class D certificate holders are entitled to all interest payable on the pooled mortgages in excess of a qualified variable rate described in paragraph (a)(3) of this section. Thus, the Class D certificates provide for interest payments that consist of a specified portion of the interest payable on the qualified mortgages under paragraph (a)(2)(i)(C) of this section.

Example 3. (i) A sponsor transferred a pool of fixed rate mortgages to a trustee in exchange for two classes of certificates. The fixed interest rate payable on the mortgages varies from mortgage to mortgage, but all rates are between 8 and 10 percent. The Class E certificate holders are entitled to receive all principal payments on the mortgages and interest on outstanding principal at 7 percent. The Class F certificate holders are entitled to receive all interest on the mortgages in excess of the interest paid on the Class E certificates.

(ii) The Class F certificates provide for interest payments that consist of a specified portion of the interest payable on the mortgages under paragraph (a)(2)(i) of this section. Although the portion of the interest payable to the Class F certificate holders varies from mortgage to mortgage, the interest payable can be expressed as a fixed percentage of the interest payable on each particular mortgage.

(3) Variable rate. A regular interest may bear interest at a variable rate. For purposes of section 860G(a)(1)(B)(i), a variable rate of interest is a rate described in this paragraph (a)(3).

(i) Rate based on current interest rate. A qualified floating rate as defined in §1.1275-5(b)(1) (but without the application of paragraph (b)(2) or (3) of that section) set at a current value, as defined in §1.1275-5(a)(4), is a variable rate. In addition, a rate equal to the highest, lowest, or average of two or more qualified floating rates is a variable rate. For example, a rate based on the average cost of funds of one or more financial institutions is a variable rate.

(ii) Weighted average rate—(A) In general. A rate based on a weighted average of the interest rates on some or all of the qualified mortgages held by a REMIC is a variable rate. The qualified mortgages taken into account must, however, bear interest at a fixed rate or at a rate described in this paragraph (a)(3). Generally, a weighted average interest rate is a rate that, if applied to the aggregate outstanding principal balance of a pool of mortgage loans for an accrual period, produces an amount of interest that equals the sum of the interest payable on the pooled loans for that accrual period. Thus, for an accrual period in which a pool of mortgage loans comprises $300,000 of loans bearing a 7 percent interest rate and $700,000 of loans bearing a 9.5 percent interest rate, the weighted average rate for the pool of loans is 8.75 percent.

(B) Reduction in underlying rate. For purposes of paragraph (a)(3)(ii)(A) of this section, an interest rate is considered to be based on a weighted average rate even if, in determining that rate, the interest rate on some or all of the qualified mortgages is first subject to a cap or a floor, or is first reduced by a number of basis points or a fixed percentage. A rate determined by taking a weighted average of the interest rates on the qualified mortgage loans net of any servicing spread, credit enhancement fees, or other expenses of the REMIC is a rate based on a weighted average rate for the qualified mortgages. Further, the amount of any rate reduction described above may vary from mortgage to mortgage.

(iii) Additions, subtractions, and multiplications. A rate is a variable rate if it is—

(A) Expressed as the product of a rate described in paragraph (a)(3)(i) or (ii) of this section and a fixed multiplier;

(B) Expressed as a constant number of basis points more or less than a rate described in paragraph (a)(3)(i) or (ii) of this section; or

(C) Expressed as the product, plus or minus a constant number of basis points, of a rate described in paragraph (a)(3)(i) or (ii) of this section and a fixed multiplier (which may be either a positive or a negative number).

(iv) Caps and floors. A rate is a variable rate if it is a rate that would be described in paragraph (a)(3)(i) through (iii) of this section except that it is—

(A) Limited by a cap or ceiling that establishes either a maximum rate or a maximum number of basis points by which the rate may increase from one accrual or payment period to another or over the term of the interest; or

(B) Limited by a floor that establishes either a minimum rate or a maximum number of basis points by which the rate may decrease from one accrual or payment period to another or over the term of the interest.

(v) Funds-available caps—(A) In general. A rate is a variable rate if it is a rate that would be described in paragraph (a)(3)(i) through (iv) of this section except that it is subject to a "funds-available" cap. A funds-available cap is a limit on the amount of interest to be paid on an instrument in any accrual or payment period that is based on the total amount available for the distribution, including both principal and interest received by an issuing entity on some or all of its qualified mortgages as well as amounts held in a reserve fund. The term "funds-available cap" does not, however, include any cap or limit on interest payments used as a device to avoid the standards of paragraph (a)(3)(i) through (iv) of this section.

(B) Facts and circumstances test. In determining whether a cap or limit on interest payments is a funds-available cap within the meaning of this section and not a device used to avoid the standards of paragraph (a)(3)(i) through (iv) of this section, one must consider all of the facts and circumstances. Facts and circumstances that must be taken into consideration are—

(1) Whether the rate of the interest payable to the regular interest holders is below the rate payable on the REMIC's qualified mortgages on the start-up day; and

(2) Whether, historically, the rate of interest payable to the regular interest holders has been consistently below that payable on the qualified mortgages.

(C) Examples. The following examples, both of which describe a pass-thru trust that is intended to qualify as a REMIC, illustrate the provisions of this paragraph (a)(3)(v).

Example 1. (i) A sponsor transferred a pool of mortgages to a trustee in exchange for two classes of certificates. The pool of mortgages has an aggregate principal balance of $100**x.** Each mortgage in the pool provides for interest payments based on the eleventh district cost of funds index (hereinafter COFI) plus a margin. The initial weighted average rate for the pool is COFI plus 200 basis points. The trust issued a Class X certificate that has a principal amount of $100**x** and that provides for interest payments at a rate equal to One-Year LIBOR plus 100 basis points, subject to a cap described below. The Class R certificate, which the sponsor designated as the residual interest, entitles its holder to all funds left in the trust after the Class X certificates have been retired. The Class R certificate holder is not entitled to current distributions.

(ii) At the time the certificates were issued, COFI equalled 4.874 percent and One-Year LIBOR equalled 3.375 percent. Thus, the initial weighted average pool rate was 6.874 percent and the Class X certificate rate was 4.375 percent. Based on historical data, the sponsor does not expect the rate paid on the Class X certificate to exceed the weighted average rate on the pool.

(iii) Initially, under the terms of the trust instrument, the excess of COFI plus 200 over One-Year LIBOR plus 100 (excess interest) will be applied to pay expenses of the trust, to fund any required reserves, and then to reduce the principal balance on the Class X certificate. Consequently, although the aggregate principal balance of the mortgages initially matched the principal balance of the Class X certificate, the principal balance on the Class X certificate will pay down faster than the principal balance on the mortgages as long as the weighted average rate on the mortgages is greater than One-Year LIBOR plus 100. If, however, the rate on the Class X certificate (One-Year LIBOR plus 100) ever exceeds the weighted average rate on the mortgages, then the Class X certificate holders will receive One-Year LIBOR plus 100 subject to a cap based on the current funds that are available for distribution.

(iv) The funds available cap here is not a device used to avoid the standards of paragraph (a)(3)(i) through (iv) of this section. First, on the date the Class X certificates were issued, a significant spread existed between the weighted average rate payable on the mortgages and the rate payable on the Class X certificate. Second, historical data suggest that the weighted average rate payable on the mortgages will continue to exceed the rate payable on the Class X certificate. Finally, because the excess interest will be applied to reduce the outstanding principal balance of the Class X certificate more rapidly than the outstanding principal balance on the mortgages is reduced, One-Year LIBOR plus 100 basis points would have to exceed the weighted average rate on the mortgages by an increasingly larger amount before the funds available cap would be triggered. Accordingly, the rate paid on the Class X certificates is a variable rate.

Example 2. (i) The facts are the same as those in Example 1, except that the pooled mortgages are commercial mortgages that provide for interest payments based on the gross profits of the mortgagors, and the rate on the Class X certificates is 400 percent of One-Year LIBOR (a variable rate under paragraph (a)(3)(iii) of this section), subject to a cap equal to current funds available to the trustee for distribution.

(ii) Initially, 400 percent of One-Year LIBOR exceeds the weighted average rate payable on the mortgages. Furthermore, historical data suggest that there is a significant possibility that, in the future, 400 percent of One-Year LIBOR will exceed the weighted average rate on the mortgages.

(iii) The facts and circumstances here indicate that the use of 400 percent of One-Year LIBOR with the above-described cap is a device to pass through to the Class X certificate holder contingent interest based on mortgagor profits. Consequently, the rate paid on the Class X certificate here is not a variable rate.

(vi) Combination of rates. A rate is a variable rate if it is based on—

(A) One fixed rate during one or more accrual or payment periods and a different fixed rate or rates, or a rate or rates described in paragraph (a)(3)(i) through (v) of this section, during other accrual or payment periods; or

(B) A rate described in paragraph (a)(3)(i) through (v) of this section during one or more accrual or payment periods and a fixed rate or rates, or a different rate or rates described in paragraph (a)(3)(i) through (v) of this section in other periods.

(4) Fixed terms on the startup day. For purposes of section 860G(a)(1), a regular interest in a REMIC has fixed terms on the startup day if, on the startup day, the REMIC's organizational documents irrevocably specify—

(i) The principal amount (or other similar amount) of the regular interest;

(ii) The interest rate or rates used to compute any interest payments (or other similar amounts) on the regular interest; and

(iii) The latest possible maturity date of the interest.

(5) Contingencies prohibited. Except for the contingencies specified in paragraph (b)(3) of this section, the principal amount (or other similar amount) and the latest possible maturity date of the interest must not be contingent.

(b) Special rules for regular interests. **(1) Call premium.** An interest in a REMIC does not qualify as a regular interest if the terms of the interest entitle the holder of that interest to the payment of any premium that is determined with reference to the length of time that the regular interest is outstanding and is not described in paragraph (b)(2) of this section.

(2) Customary prepayment penalties received with respect to qualified mortgages. An interest in a REMIC does not fail to qualify as a regular interest solely because the REMIC's organizational documents provide that the REMIC must allocate among and pay to its regular interest holders any customary prepayment penalties that the REMIC receives with respect to its qualified mortgages. Moreover, a REMIC may allocate prepayment penalties among its classes of interests in any manner specified in the REMIC's organizational documents. For example, a REMIC could allocate all or substantially all of a prepayment penalty that it receives to holders of an interest-only class of interests because that class would be most significantly affected by prepayments.

(3) Certain contingencies disregarded. An interest in a REMIC does not fail to qualify as a regular interest solely because it is issued subject to some or all of the contingencies described in paragraph (b)(3)(i) through (vi) of this section.

(i) Prepayments, income, and expenses. An interest does not fail to qualify as a regular interest solely because—

(A) The timing of (but not the right to or amount of) principal payments (or other similar amounts) is affected by the extent of prepayments on some or all of the qualified mortgages held by the REMIC or the amount of income from permitted investments (as defined in §1.860G-2(g)); or

(B) The timing of interest and principal payments is affected by the payment of expenses incurred by the REMIC.

(ii) Credit losses. An interest does not fail to qualify as a regular interest solely because the amount or the timing of payments of principal or interest (or other similar amounts) with respect to a regular interest is affected by defaults on qualified mortgages and permitted investments, unanticipated expenses incurred by the REMIC, or lower than expected returns on permitted investments.

(iii) Subordinated interests. An interest does not fail to qualify as a regular interest solely because that interest bears all, or a disproportionate share, of the losses stemming from cash flow shortfalls due to defaults or delinquencies on qualified mortgages or permitted investments, unanticipated expenses incurred by the REMIC, lower than expected returns on permitted investments, or prepayment interest shortfalls before other regular interests or the residual interest bear losses occasioned by those shortfalls.

(iv) Deferral of interest. An interest does not fail to qualify as a regular interest solely because that interest, by its terms, provides for deferral of interest payments.

(v) Prepayment interest shortfalls. An interest does not fail to qualify as a regular interest solely because the amount of interest payments is affected by prepayments of the underlying mortgages.

(vi) Remote and incidental contingencies. An interest does not fail to qualify as a regular interest solely because the amount or timing of payments of principal or interest (or other similar amounts) with respect to the interest is subject to a contingency if there is only a remote likelihood that the contingency will occur. For example, an interest could qualify as a regular interest even though full payment of principal and interest on that interest is contingent upon the absence of significant cash flow shortfalls due to the operation of the Soldiers and Sailors Civil Relief Act, 50 U.S.C. app. §526 (1988).

(4) Form of regular interest. A regular interest in a REMIC may be issued in the form of debt, stock, an interest in a partnership or trust, or any other form permitted by state law. If a regular interest in a REMIC is not in the form of debt, it must, except as provided in paragraph (a)(2)(iv) of this section, entitle the holder to a specified amount that would, were the interest issued in debt form, be identified as the principal amount of the debt.

(5) Interest disproportionate to principal—

(i) In general. An interest in a REMIC does not qualify as a regular interest if the amount of interest (or other similar amount) payable to the holder is disproportionately high relative to the principal amount or other specified amount described in paragraph (b)(4) of this section (specified principal amount). Interest payments (or other similar amounts) are considered disproportionately high if the issue price (as determined under paragraph (d) of this section) of the interest in the REMIC exceeds 125 percent of its specified principal amount.

(ii) Exception. A regular interest in a REMIC that entitles the holder to interest payments consisting of a specified portion of interest payments on qualified mortgages qualifies as a regular interest even if the amount of interest is disproportionately high relative to the specified principal amount.

(6) Regular interest treated as a debt instrument for all Federal income tax purposes. In determining the tax under chapter 1 of the Internal Revenue Code, a REMIC regular interest (as defined in section 860G(a)(1)) is treated as a debt instrument that is an obligation of the REMIC. Thus, sections 1271 through 1288, relating to bonds and other debt instruments, apply to a regular interest. For special rules relating to the accrual of original issue discount on regular interests, see section 1272(a)(6).

(c) Residual interest. A residual interest is an interest in a REMIC that is issued on the startup day and that is designated as a residual interest by providing the information specified in §1.860D-1(d)(2)(ii) at the time and in the manner provided in §1.860D-1(d)(2). A residual interest need not entitle the holder to any distributions from the REMIC.

(d) Issue price of regular and residual interests. (1) In general. The issue price of any REMIC regular or residual interest is determined under section 1273(b) as if the interest were a debt instrument and, if issued for property, as if the requirements of section 1273(b)(3) were met. Thus, if a class of interests is publicly offered, then the issue price of an interest in that class is the initial offering price to the public at which a substantial amount of the class is sold. If the interest is in a class that is not publicly offered, the issue price is the price paid by the first buyer of that interest regardless of the price paid for the remainder of the class. If the interest is in a class that is retained by the sponsor, the issue price is its fair market value on the pricing date (as defined in §1.860F-2(b)(3)(iii)), if any, or, if none, the startup day, regardless of whether the property exchanged therefor is publicly traded.

(2) The public. The term “the public” for purposes of this section does not include brokers or other middlemen, nor does it include the sponsor who acquires all of the regular and residual interests from the REMIC on the startup day in a transaction described in §1.860F-2(a).

§Reg. 1.860G-2. Other rules.

(a) Obligations principally secured by an interest in real property. (1) Tests for determining whether an obligation is principally secured. For purposes of section 860G(a)(3)(A), an obligation is principally secured by an interest in real property only if it satisfies either the test set out in paragraph (a)(1)(i) or the test set out in paragraph (a)(1)(ii) of this section.

(i) The 80-percent test. An obligation is principally secured by an interest in real property if the fair market value of the interest in real property securing the obligation—

(A) Was at least equal to 80 percent of the adjusted issue price of the obligation at the time the obligation was originated (see paragraph (b)(1) of this section concerning the origination date for obligations that have been significantly modified); or

(B) Is at least equal to 80 percent of the adjusted issue price of the obligation at the time the sponsor contributes the obligation to the REMIC.

(ii) Alternative test. For purposes of section 860G(a)(3)(A), an obligation is principally secured by an interest in real property if substantially all of the proceeds of the obligation were used to acquire or to improve or protect an interest in real property that, at the origination date, is the only security for the obligation. For purposes of this test, loan guarantees made by the United States or any state (or any political subdivision, agency, or instrumentality of the United States or of any state), or other third party credit enhancement are not viewed as additional security for a loan. An obligation is not considered to be secured by property other than real property solely because the obligor is personally liable on the obligation.

(2) Treatment of liens. For purposes of paragraph (a)(1)(i) of this section, the fair market value of the real property interest must be first reduced by the amount of any lien on the real property interest that is senior to the obligation being tested, and must be further reduced by a proportionate amount of any lien that is in parity with the obligation being tested.

(3) Safe harbor—(i) Reasonable belief that an obligation is principally secured. If, at the time the sponsor contributes an obligation to a REMIC, the sponsor reasonably believes that the obligation is principally secured by an interest in real property within the meaning of paragraph (a)(1) of this section, then the obligation is deemed to be so secured for purposes of section 860G(a)(3). A sponsor cannot avail itself of this safe harbor with respect to an obligation if the sponsor actually knows or has reason to know that the obligation fails both of the tests set out in paragraph (a)(1) of this section.

(ii) Basis for reasonable belief. For purposes of paragraph (a)(3)(i) of this section, a sponsor may base a reasonable belief concerning any obligation on—

(A) Representations and warranties made by the originator of the obligation; or

(B) Evidence indicating that the originator of the obligation typically made mortgage loans in accordance with an established set of parameters, and that any mortgage loan originated in accordance with those parameters would satisfy at least one of the tests set out in paragraph (a)(1) of this section.

(iii) Later discovery that an obligation is not principally secured. If, despite the sponsor's reasonable belief concerning an obligation at the time it contributed the obligation to the REMIC, the REMIC later discovers that the obligation is not principally secured by an interest in real property, the obligation is a defective obligation and loses its status as a qualified mortgage 90 days after the date of discovery. See paragraph (f) of this section, relating to defective obligations.

(4) Interests in real property; real property. The definition of “interests in real property” set out in §1.856-3(c), and the definition of “real property” set out in §1.856-3(d), apply to define those terms for purposes of section 860G(a)(3) and paragraph (a) of this section.

(5) Obligations secured by an interest in real property. Obligations secured by interests in real property include the following: mortgages, deeds of trust, and installment land contracts; mortgage pass-thru certificates guaranteed by GNMA, FNMA, FHLMC, or CMHC (Canada Mortgage and Housing Corporation); other investment trust interests that represent undivided beneficial ownership in a pool of obligations principally secured by interests in real property and related assets that would be considered to be permitted investments if the investment trust were a REMIC, and provided the investment trust is classified as a trust under §301.7701-4(c) of this chapter; and obligations secured by manufactured housing treated as single family residences under section 25(e)(10) (without regard to the treatment of the obligations or the properties under state law).

(6) Obligations secured by other obligations; residual interests. Obligations (other than regular interests in a REMIC) that are secured by other obligations are not principally secured by interests in real property even if the underlying obligations are secured by interests in real property. Thus, for example, a collateralized mortgage obligation issued by an issuer that is not a REMIC is not an obligation principally secured by an interest in real property. A residual interest (as defined in section 860G(a)(2)) is not an obligation principally secured by an interest in real property.

(7) Certain instruments that call for contingent payments are obligations. For purposes of section 860G(a)(3) and (4), the term “obligation” includes any instrument that provides for total noncontingent principal payments that at least equal the instrument’s issue price even if that instrument also provides for contingent payments. Thus, for example, an instrument that was issued for $100**x** and that provides for noncontingent principal payments of $100**x,** interest payments at a fixed rate, and contingent payments based on a percentage of the mortgagor’s gross receipts, is an obligation.

(8) Release of a lien on an interest in real property securing a qualified mortgage; defeasance. If a REMIC releases its lien on real property that secures a qualified mortgage, that mortgage ceases to be a qualified mortgage on the date the lien is released unless—

(i) The REMIC releases its liens in a modification that—

(A) Either is not a significant modification as defined in paragraph (b)(2) of this section or is one of the listed exceptions set forth in paragraph (b)(3) of this section; and

(B) Following that modification, the obligation continues to be principally secured by an interest in real property as determined by paragraph (b)(7) of this section; or

(ii) The mortgage is defeased in the following manner—

(A) The mortgagor pledges substitute collateral that consists solely of government securities (as defined in section 2(a)(16) of the Investment Company Act of 1940 as amended (15 U.S.C. 80a-1));

(B) The mortgage documents allow such a substitution;

(C) The lien is released to facilitate the disposition of the property or any other customary commercial transaction, and not as part of an arrangement to collateralize a REMIC offering with obligations that are not real estate mortgages; and

(D) The release is not within 2 years of the startup day.

(iii) The lien is released to facilitate the disposition of the property or any other customary commercial transaction, and not as part of an arrangement to collateralize a REMIC offering with obligations that are not real estate mortgages; and

(iv) The release is not within 2 years of the startup day.

(9) Stripped bonds and coupons. The term "qualified mortgage" includes stripped bonds and stripped coupons (as defined in section 1286(e)(2) and (3)) if the bonds (as defined in section 1286(e)(1)) from which such stripped bonds or stripped coupons arose would have been qualified mortgages.

(b) Assumptions and modifications. **(1) Significant modifications are treated as exchanges of obligations.** If an obligation is significantly modified in a manner or under circumstances other than those described in paragraph (b)(3) of this section, then the modified obligation is treated as one that was newly issued in exchange for the unmodified obligation that it replaced. Consequently—

(i) If such a significant modification occurs after the obligation has been contributed to the REMIC and the modified obligation is not a qualified replacement mortgage, the modified obligation will not be a qualified mortgage and the deemed disposition of the unmodified obligation will be a prohibited transaction under section 860F(a)(2); and

(ii) If such a significant modification occurs before the obligation is contributed to the REMIC, the modified obligation will be viewed as having been originated on the date the modification occurs for purposes of the tests set out in paragraph (a)(1) of this section.

(2) Significant modification defined. For purposes of paragraph (b)(1) of this section, a "significant modification" is any change in the terms of an obligation that would be treated as an exchange of obligations under section 1001 and the related regulations.

(3) Exceptions. For purposes of paragraph (b)(1) of this section, the following changes in the terms of an obligation are not significant modifications regardless of whether they would be significant modifications under paragraph (b)(2) of this section—

(i) Changes in the terms of the obligation occasioned by default or a reasonably foreseeable default;

(ii) Assumption of the obligation;

(iii) Waiver of a due-on-sale clause or a due on encumbrance clause; and

(iv) Conversion of an interest rate by a mortgagor pursuant to the terms of a convertible mortgage.

(v) A modification that releases, substitutes, adds, or otherwise alters a substantial amount of the collateral for, a guarantee on, or other form of credit enhancement for, a recourse or nonrecourse obligation, so long as the obligation continues to be principally secured by an interest in real property following the release, substitution, addition, or other alteration as determined by paragraph (b)(7) of this section; and

(vi) A change in the nature of the obligation from recourse (or substantially all recourse) to nonrecourse (or substantially all nonrecourse), or from nonrecourse (or substantially all nonrecourse) to recourse (or substantially all recourse), so long as the obligation continues to be principally secured by an interest in real property following such a change as determined by paragraph (b)(7) of this section.

(4) Modifications that are not significant modifications. If an obligation is modified and the modification is not a significant modification for purposes of paragraph (b)(1) of this section, then the modified obligation is not treated as one that was newly originated on the date of modification.

(5) Assumption defined. For purposes of paragraph (b)(3) of this section, a mortgage has been assumed if—

(i) The buyer of the mortgaged property acquires the property subject to the mortgage, without assuming any personal liability;

(ii) The buyer becomes liable for the debt but the seller also remains liable; or

(iii) The buyer becomes liable for the debt and the seller is released by the lender.

(6) Pass-thru certificates. If a REMIC holds as a qualified mortgage a pass-thru certificate or other investment trust interest of the type described in paragraph (a)(5) of this section, the modification of a mortgage loan that backs the pass-thru certificate or other interest is not a modification of the pass-thru certificate or other interest unless the investment trust structure was created to avoid the prohibited transaction rules of section 860F(a).

(7) Test for determining whether an obligation continues to be principally secured following certain types of modifications.

(i) For purposes of paragraphs (a)(8)(i), (b)(3)(v), and (b)(3)(vi) of this section, the obligation continues to be principally secured by an interest in real property following the modification only if, as of the date of the modification, the obligation satisfies either paragraph (b)(7)(ii) or paragraph (b)(7)(iii) of this section.

(ii) The fair market value of the interest in real property securing the obligation, determined as of the date of the modification, must be at least 80 percent of the adjusted issue price of the modified obligation, determined as of the date of the modification. If, as of the date of the modification, the servicer reasonably believes that the obligation satisfies the criterion in the preceding sentence, then the obligation is deemed to do so. A reasonable belief does not exist if the servicer actually knows, or has reason to know, that the criterion is not satisfied. For purposes of this paragraph (b)(7)(ii), a servicer must base a reasonable belief on—

(A) A current appraisal performed by an independent appraiser;

(B) An appraisal that was obtained in connection with the origination of the obligation and, if appropriate, that has been updated for the passage of time and for any other changes that might affect the value of the interest in real property;

(C) The sales price of the interest in real property in the case of a substantially contemporary sale in which the buyer assumes the seller's obligations under the mortgage; or

(D) Some other commercially reasonable valuation method.

(iii) If paragraph (b)(7)(ii) of this section is not satisfied, the fair market value of the interest in real property that secures the obligation immediately after the modification must equal or exceed the fair market value of the interest in real property that secured the obligation immediately before the modification. The criterion in the preceding sentence must be established by a current appraisal, an original (and updated) appraisal, or some other commercially reasonable valuation method; and the servicer must not actually know, or have reason to know, that the criterion in the preceding sentence is not satisfied.

(iv) Example. The following example illustrates the rules of this paragraph (b)(7).

Example (). **(i)** S services mortgage loans that are held by R, a REMIC. Borrower B is the issuer of one of the mortgage loans held by R. The original amount of B's mortgage loan was $100,000, and the loan was secured by real property X. At the time the loan was contributed to R, property X had a fair market value of $90,000. Sometime after the loan was contributed to R, B experienced financial difficulties such that it was reasonably foreseeable that B might default on the loan if the loan was not modified. Accordingly, S altered various terms of B's loan to substantially reduce the risk of default. The alterations included the release of the lien on property X and the substitution of real property Y for property X as collateral for the loan. At the time the loan was modified, its adjusted issue price was $100,000. The fair market value of property X immediately before the modification (as determined by a commercially reasonable valuation method) was $70,000, and the fair market value of property Y immediately after the modification (as determined by a commercially reasonable valuation method) was $75,000.

(ii) The alterations to B's loan are a significant modification within the meaning of Sec. 1.1001-3(e). The modification, however, is described in paragraphs (a)(8)(i) and (b)(3) of this section. Accordingly, the modified loan continues to be a qualified mortgage if, immediately after the modification, the modified loan continues to be principally secured by an interest in real property, as determined by paragraph (b)(7) of this section.

(iii) Because the modification includes the release of the lien on property X and substitution of property Y for property X, the modified loan must satisfy paragraph (b)(7)(i) of this section (which requires satisfaction of either paragraph (b)(7)(ii) or paragraph (b)(7)(iii) of this section). The modified loan does not satisfy paragraph (b)(7)(ii) of this section because property Y is worth less than $80,000 (the amount equal to 80 percent of the adjusted issue price of the modified mortgage loan). The modified loan, however, satisfies paragraph (b)(7)(iii) of this section because the fair market value of the interest in real estate (real property Y) that secures the obligation immediately after the modification ($75,000) exceeds the fair market value of the interest in real estate (real property X) that secured the obligation immediately before the modification ($70,000). Accordingly, the modified loan satisfies paragraph (b)(7)(i) of this section and continues to be principally secured by an interest in real property.

(c) Treatment of certain credit enhancement contracts. **(1) In general.** A credit enhancement contract (as defined in paragraph (c)(2) and (3) of this section) is not treated as a separate asset of the REMIC for purposes of the asset test set out in section 860D(a)(4) and §1.860D-1(b)(3), but instead is treated as part of the mortgage or pool of mortgages to which it relates. Furthermore, any collateral supporting a credit enhancement contract is not treated as an asset of the

REMIC solely because it supports the guarantee represented by that contract. See paragraph (g)(1)(ii) of this section for the treatment of payments made pursuant to credit enhancement contracts as payments received under a qualified mortgage.

(2) Credit enhancement contracts. For purposes of this section, a credit enhancement contract is any arrangement whereby a person agrees to guarantee full or partial payment of the principal or interest payable on a qualified mortgage or on a pool of such mortgages, or full or partial payment on one or more classes of regular interests or on the class of residual interests, in the event of defaults or delinquencies on qualified mortgages, unanticipated losses or expenses incurred by the REMIC, or lower than expected returns on cash flow investments. Types of credit enhancement contracts may include, but are not limited to, pool insurance contracts, certificate guarantee insurance contracts, letters of credit, guarantees, or agreements whereby the REMIC sponsor, a mortgage servicer, or other third party agrees to make advances described in paragraph (c)(3) of this section.

(3) Arrangements to make certain advances. The arrangements described in this paragraph (c)(3) are credit enhancement contracts regardless of whether, under the terms of the arrangement, the payor is obligated, or merely permitted, to advance funds to the REMIC.

(i) Advances of delinquent principal and interest. An arrangement by a REMIC sponsor, mortgage servicer, or other third party to advance to the REMIC out of its own funds an amount to make up for delinquent payments on qualified mortgages is a credit enhancement contract.

(ii) Advances of taxes, insurance payments, and expenses. An arrangement by a REMIC sponsor, mortgage servicer, or other third party to pay taxes and hazard insurance premiums on, or other expenses incurred to protect the REMIC's security interest in, property securing a qualified mortgage in the event that the mortgagor fails to pay such taxes, insurance premiums, or other expenses is a credit enhancement contract.

(iii) Advances to ease REMIC administration. An agreement by a REMIC sponsor, mortgage servicer, or other third party to advance temporarily to a REMIC amounts payable on qualified mortgages before such amounts are actually due to level out the stream of cash flows to the REMIC or to provide for orderly administration of the REMIC is a credit enhancement contract. For example, if two mortgages in a pool have payment due dates on the twentieth of the month, and all the other mortgages have payment due dates on the first of each month, an agreement by the mortgage servicer to advance to the REMIC on the fifteenth of each month the payments not yet received on the two mortgages together with the amounts received on the other mortgages is a credit enhancement contract.

(4) Deferred payment under a guarantee arrangement. A guarantee arrangement does not fail to qualify as a credit enhancement contract solely because the guarantor, in the event of a default on a qualified mortgage, has the option of immediately paying to the REMIC the full amount of mortgage principal due on acceleration of the defaulted mortgage, or paying principal and interest to the REMIC according to the original payment schedule for the defaulted mortgage, or according to some other deferred payment schedule. Any deferred payments are payments pursuant to a credit enhancement contract even if the mortgage is foreclosed upon and the guarantor, pursuant to subrogation rights set out in the guarantee arrangement, is entitled to receive immediately the proceeds of foreclosure.

(d) Treatment of certain purchase agreements with respect to convertible mortgages. (1) In general. For purposes of sections 860D(a)(4) and 860G(a)(3), a purchase agreement (as described in paragraph (d)(3) of this section) with respect to a convertible mortgage (as described in paragraph (d)(5) of this section) is treated as incidental to the convertible mortgage to which it relates. Consequently, the purchase agreement is part of the mortgage or pool of mortgages and is not a separate asset of the REMIC.

(2) Treatment of amounts received under purchase agreements. For purposes of sections 860A through 860G and for purposes of determining the accrual of original issue discount and market discount under sections 1272(a)(6) and 1276, respectively, a payment under a purchase agreement described in paragraph (d)(3) of this section is treated as a prepayment in full of the mortgage to which it relates. Thus, for example, a payment under a purchase agreement with respect to a qualified mortgage is considered a payment received under a qualified mortgage within the meaning of section 860G(a)(6) and the transfer of the mortgage is not a disposition of the mortgage within the meaning of section 860F(a)(2)(A).

(3) Purchase agreement. A purchase agreement is a contract between the holder of a convertible mortgage and a third party under which the holder agrees to sell and the third party agrees to buy the mortgage for an amount equal to its current principal balance plus accrued but unpaid interest if and when the mortgagor elects to convert the terms of the mortgage.

(4) Default by the person obligated to purchase a convertible mortgage. If the person required to purchase a convertible mortgage defaults on its obligation to purchase the mortgage upon conversion, the REMIC may sell the mortgage in a market transaction and the proceeds of the sale will be treated as amounts paid pursuant to a purchase agreement.

(5) Convertible mortgage. A convertible mortgage is a mortgage that gives the obligor the right at one or more times during the term of the mortgage to elect to convert from one interest rate to another. The new rate of interest must be determined pursuant to the terms of the instrument and must be intended to approximate a market rate of interest for newly originated mortgages at the time of the conversion.

(e) Prepayment interest shortfalls. An agreement by a mortgage servicer or other third party to make payments to the REMIC to make up prepayment interest shortfalls is not treated as a separate asset of the REMIC and payments made pursuant to such an agreement are treated as payments on the qualified mortgages. With respect to any mortgage that prepays, the prepayment interest shortfall for the accrual period in which the mortgage prepays is an amount equal to the excess of the interest that would have accrued on the mortgage during that accrual period had it not prepaid, over the interest that accrued from the beginning of that accrual period up to the date of the prepayment.

(f) Defective obligations. **(1) Defective obligation defined.** For purposes of sections 860G(a)(4)(B)(ii) and 860F(a)(2), a defective obligation is a mortgage subject to any of the following defects.

(i) The mortgage is in default, or a default with respect to the mortgage is reasonably foreseeable.

(ii) The mortgage was fraudulently procured by the mortgagor.

(iii) The mortgage was not in fact principally secured by an interest in real property within the meaning of paragraph (a)(1) of this section.

(iv) The mortgage does not conform to a customary representation or warranty given by the sponsor or prior owner of the mortgage regarding the characteristics of the mortgage, or the characteristics of the pool of mortgages of which the mortgage is a part. A representation that payments on a qualified mortgage will be received at a rate no less than a specified minimum or no greater than a specified maximum is not customary for this purpose.

(2) Effect of discovery of defect. If a REMIC discovers that an obligation is a defective obligation, and if the defect is one that, had it been discovered before the startup day, would have prevented the obligation from being a qualified mortgage, then, unless the REMIC either causes the defect to be cured or disposes of the defective obligation within 90 days of discovering the defect, the obligation ceases to be a qualified mortgage at the end of that 90 day period. Even if the defect is not cured, the defective obligation is, nevertheless, a qualified mortgage from the startup day through the end of the 90 day period. Moreover, even if the REMIC holds the defective obligation beyond the 90 day period, the REMIC may, nevertheless, exchange the defective obligation for a qualified replacement mortgage so long as the requirements of section 860G(a)(4)(B) are satisfied. If the defect is one that does not affect the status of an obligation as a qualified mortgage, then the obligation is always a qualqualified mortgage regardless of whether the defect is or can be cured. For example, if a sponsor represented that all mortgages transferred to a REMIC had a 10 percent interest rate, but it was later discovered that one mortgage had a 9 percent interest rate, the 9 percent mortgage is defective, but the defect does not affect the status of that obligation as a qualified mortgage.

(g) Permitted investments. (1) Cash flow investment—(i) In general. For purposes of section 860G(a)(6) and this section, a cash flow investment is an investment of payments received on qualified mortgages for a temporary period between receipt of those payments and the regularly scheduled date for distribution of those payments to REMIC interest holders. Cash flow investments must be passive investments earning a return in the nature of interest.

(ii) Payments received on qualified mortgages. For purposes of paragraph (g)(1) of this section, the term "payments received on qualified mortgages" includes—

(A) Payments of interest and principal on qualified mortgages, including prepayments of principal and payments under credit enhancement contracts described in paragraph (c)(2) of this section;

(B) Proceeds from the disposition of qualified mortgages;

(C) Cash flows from foreclosure property and proceeds from the disposition of such property;

(D) A payment by a sponsor or prior owner in lieu of the sponsor's or prior owner's repurchase of a defective obligation, as defined in paragraph (f) of this section, that was transferred to the REMIC in breach of a customary warranty; and

(E) Prepayment penalties required to be paid under the terms of a qualified mortgage when the mortgagor prepays the obligation.

(iii) Temporary period. For purposes of section 860G(a)(6) and this paragraph (g)(1), a temporary period generally is that period from the time a REMIC receives payments on qualified mortgages and permitted investments to the time the REMIC distributes the payments to interest holders. A temporary period may not exceed 13 months. Thus, an investment held by a REMIC for more than 13 months is not a cash flow investment. In determining the length of time that a REMIC has held an investment that is part of a commingled fund or account, the REMIC may employ any reasonable method of accounting. For example, if a REMIC holds mortgage cash flows in a commingled account pending distribution, the first-in, first-out method of accounting is a reasonable method for determining whether all or part of the account satisfies the 13 month limitation.

(2) Qualified reserve funds. The term qualified reserve fund means any reasonably required reserve to provide for full payment of expenses of the REMIC or amounts due on regular or residual interests in the event of defaults on qualified mortgages, prepayment interest shortfalls (as defined in paragraph (e) of this section), lower than expected returns on cash flow investments, or any other contingency that could be provided for under a credit enhancement contract (as defined in paragraph (c)(2) and (3) of this section).

(3) Qualified reserve asset—(i) In general. The term "qualified reserve asset" means any intangible property (other than a REMIC residual interest) that is held both for investment and as part of a qualified reserve fund. An asset need not generate any income to be a qualified reserve asset.

(ii) Reasonably required reserve—(A) In general. In determining whether the amount of a reserve is reasonable, it is appropriate to consider the credit quality of the qualified mortgages, the extent and nature of any guarantees relating to either the qualified mortgages or the regular and residual interests, the expected amount of expenses of the REMIC, and the expected availability of proceeds from qualified mortgages to pay the expenses. To the extent that a reserve exceeds a reasonably required amount, the amount of the reserve must be promptly and appropriately reduced. If at any time, however, the amount of the reserve fund is less than is reasonably required, the amount of the reserve fund may be increased by the addition of payments received on qualified mortgages or by contributions from holders of residual interests.

(B) Presumption that a reserve is reasonably required. The amount of a reserve fund is presumed to be reasonable (and an excessive reserve is presumed to have been promptly and appropriately reduced) if it does not exceed—

[(1) The amount required by a nationally recognized independent rating agency as a condition of providing the rating for REMIC interests desired by the sponsor; or

(2)][1] The amount required by a third party insurer or guarantor, who does

1 Bracketed language here and in next paragraph below deleted under a temporary regulation adopted by T.D. 9533 and effective July 6, 2011.

not own directly or indirectly (within the meaning of section 267(c)) an interest in the REMIC (as defined in §1.860D-1(b)(1)), as a condition of providing credit enhancement.

(C) Presumption may be rebutted. The presumption in paragraph (g)(3)(ii)(B) [of this section] may be rebutted if the amounts required by [the rating agency or by] the third party insurer are not commercially reasonable considering the factors described in paragraph (g)(3)(ii)(A) [of this section].

(h) Outside reserve funds. A reserve fund that is maintained to pay expenses of the REMIC, or to make payments to REMIC interest holders is an outside reserve fund and not an asset of the REMIC only if the REMIC's organizational documents clearly and expressly—

(1) Provide that the reserve fund is an outside reserve fund and not an asset of the REMIC;

(2) Identify the owner(s) of the reserve fund, either by name, or by description of the class (**e.g.**, subordinated regular interest holders) whose membership comprises the owners of the fund; and

(3) Provide that, for all Federal tax purposes, amounts transferred by the REMIC to the fund are treated as amounts distributed by the REMIC to the designated owner(s) or transferees of the designated owner(s).

(i) Contractual rights coupled with regular interests in tiered arrangements. **(1) In general.** If a REMIC issues a regular interest to a trustee of an investment trust for the benefit of the trust certificate holders and the trustee also holds for the benefit of those certificate holders certain other contractual rights, those other rights are not treated as assets of the REMIC even if the investment trust and the REMIC were created contemporaneously pursuant to a single set of organizational documents. The organizational documents must, however, require that the trustee account for the contractual rights as property that the trustee holds separate and apart from the regular interest.

(2) Example. The following example, which describes a tiered arrangement involving a pass-thru trust that is intended to qualify as a REMIC and a pass-thru trust that is intended to be classified as a trust under §301.7701-4(c) of this chapter, illustrates the provisions of paragraph (i)(1) of this section.

Example. (i) A sponsor transferred a pool of mortgages to a trustee in exchange for two classes of certificates. The pool of mortgages has an aggregate principal balance of $100**x.** Each mortgage in the pool provides for interest payments based on the eleventh district cost of funds index (hereinafter COFI) plus a margin. The trust (hereinafter REMIC trust) issued a Class N bond, which the sponsor designates as a regular interest, that has a principal amount of $100**x** and that provides for interest payments at a rate equal to One-Year LIBOR plus 100 basis points, subject to a cap equal to the weighted average pool rate. The Class R interest, which the sponsor designated as the residual interest, entitles its holder to all funds left in the trust after the Class N bond has been retired. The Class R interest holder is not entitled to current distributions.

(ii) On the same day, and under the same set of documents, the sponsor also created an investment trust. The sponsor contributed to the investment trust the Class N bond together with an interest rate cap contract. Under the interest rate cap contract, the issuer of the cap contract agrees to pay to the trustee for the benefit of the investment trust certificate holders the excess of One-Year LIBOR plus 100 basis points over the weighted average pool rate (COFI plus a margin) times the outstanding principal balance of the Class N bond in the event One-Year LIBOR plus 100 basis points ever exceeds the weighted average pool rate. The trustee (the same institution that serves as REMIC trust trustee), in exchange for the contributed assets, gave the sponsor certificates representing undivided beneficial ownership interests in the Class N bond and the interest rate cap contract. The organizational documents require the trustee to account for the regular interest and the cap contract as discrete property rights.

(iii) The separate existence of the REMIC trust and the investment trust are respected for all Federal income tax purposes. Thus, the interest rate cap contract is an asset beneficially owned by the several certificate holders and is not an asset of the REMIC trust. Consequently, each certificate holder must allocate its purchase price for the certificate between its undivided interest in the Class N bond and its undivided interest in the interest rate cap contract in accordance with the relative fair market values of those two property rights.

(j) Clean-up call. (1) In general. For purposes of section 860F(a)(5)(B), a clean-up call is the redemption of a class of regular interests when, by reason of prior payments with respect to those interests, the administrative costs associated with servicing that class outweigh the benefits of maintaining the class. Factors to consider in making this determination include—

(i) The number of holders of that class of regular interests;

(ii) The frequency of payments to holders of that class;

(iii) The effect the redemption will have on the yield of that class of regular interests;

(iv) The outstanding principal balance of that class; and

(v) The percentage of the original principal balance of that class still outstanding.

(2) Interest rate changes. The redemption of a class of regular interests undertaken to profit from a change in interest rates is not a clean-up call.

(3) Safe harbor. Although the outstanding principal balance is only one factor to consider, the redemption of a class of regular interests with an outstanding principal balance of no more than 10 percent of its original principal balance is always a clean-up call.

(k) Startup day. The term “startup day” means the day on which the REMIC issues all of its regular and residual interests. A sponsor may, however, 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. The day so designated is then the startup day, and all interests are treated as issued on that day.

Reg. §1.860G-3. Treatment of foreign persons.

(a) Transfer of a residual interest with tax avoidance potentia. (1) In general. A transfer of a residual interest that has tax avoidance potential is disregarded for all Federal tax purposes if the transferee is a foreign person. Thus, if a residual interest with tax avoidance potential is transferred to a foreign holder at formation of the REMIC, the sponsor is liable for the tax on any excess inclusion that accrues with respect to that residual interest.

(2) Tax avoidance potential—(i) Defined. A residual interest has tax avoidance potential for purposes of this section unless, at the time of the transfer, the transferor reasonably expects that, for each excess inclusion, the REMIC will distribute to the transferee residual interest holder an amount that will equal at least 30 percent of the excess inclusion, and that each such amount will be distributed at or after the time at which the excess inclusion accrues and not later than the close of the calendar year following the calendar year of accrual.

(ii) Safe harbor. For purposes of paragraph (a)(2)(i) of this section, a transferor has a reasonable expectation if the 30-percent test would be satisfied were the REMIC's qualified mortgages to prepay at each rate within a range of rates from 50 percent to 200 percent of the rate assumed under section 1272(a)(6) with respect to the qualified mortgages (or the rate that would have been assumed had the mortgages been issued with original issue discount).

(3) Effectively connected income. Paragraph (a)(1) of this section will not apply if the transferee's income from the residual interest is subject to tax under section 871(b) or section 882.

(4) Transfer by a foreign holder. If a foreign person transfers a residual interest to a United States person or a foreign holder in whose hands the income from a residual interest would be effectively connected income, and 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 purposes of section 871(a), 881, 1441, or 1442.

(b) Accounting for REMIC net income -- (1) Allocation of partnership income to a foreign partner. A domestic partnership shall separately state its allocable share of REMIC taxable income or net loss in accordance with § 1.702-1(a)(8). If a domestic partnership allocates all or some portion of its allocable share of REMIC taxable income to a partner that is a foreign person, the amount allocated to the foreign partner shall be taken into account by the foreign partner for purposes of sections 871(a), 881, 1441, and 1442 as if that amount were received on the last day of the partnership's taxable year, except to the extent that some or all of the amount is required to be taken into account by the foreign partner at an earlier time under section 860G(b) as a result of a distribution by the partnership to the foreign partner or a disposition of the foreign partner's indirect interest in the REMIC residual interest. A disposition in whole or in part of the foreign partner's indirect interest in the REMIC residual interest may occur as a result of a termination of the REMIC, a disposition of the partnership's residual interest in the REMIC, a disposition of the foreign partner's interest in the partnership, or any other reduction in the foreign partner's allocable share of the portion of the REMIC net income or deduction allocated to the partnership. See § 1.871-14(d)(2) for the treatment of interest received on a regular or residual interest in a REMIC. For a partnership's withholding obligations with respect to excess inclusion amounts described in this paragraph (b)(1), see § 1.1441-2(b)(5), § 1.1441-2(d)(4), § 1.1441-5(b)(2)(i)(A) and §§ 1.1446-1 through 1.1446-7.

(2) Excess inclusion income allocated by certain pass-through entities to a foreign person. If an amount is allocated under section 860E(d)(1) to a foreign person that is a shareholder of a real estate investment trust or a regulated investment company, a participant in a common trust fund, or a patron of an organization to which part I of subchapter T applies and if the amount so allocated is governed by section 860E(d)(2) (treating it "as an excess inclusion with respect to a residual interest held by" the taxpayer), the amount shall be taken into account for purposes of sections 871(a), 881, 1441, and 1442 at the same time as the time prescribed for other income of the shareholder, participant, or patron from the trust, company, fund, or organization.

SEARS REGULATIONS

SECTION 301.7701-4(c).

Reg. §301.7701-4 Trusts. . . .
(c) Certain investment trusts. (1) An "investment" trust will not be classified as a trust if there is a power under the trust agreement to vary the investment of the certificate holders. *See Commissioner v. North American Bond Trust*, 122 F. 2d 545 (2d Cir. 1941), *cert. denied*, 314 U.S. 701 (1942). An investment trust with a single class of ownership interests, representing undivided beneficial interests in the assets of the trust, will be classified as a trust if there is no power under the trust agreement to vary the investment of the certificate holders. An investment trust with multiple classes of ownership interests ordinarily will be classified as a business entity under §301.7701-2; however, an investment trust with multiple classes of ownership interests, in which there is no power under the trust agreement to vary the investment of the certificate holders, will be classified as a trust if the trust is formed to facilitate direct investment in the assets of the trust and the existence of multiple classes of ownership interests is incidental to that purpose.

(2) The provisions of paragraph (c)(1) of this section may be illustrated by the following examples:

Example (1). A corporation purchases a portfolio of residential mortgages and transfers the mortgages to a bank under a trust agreement. At the same time, the bank as trustee delivers to the corporation certificates evidencing rights to payments from the pooled mortgages; the corporation sells the certificates to the public. The trustee holds legal title to the mortgages in the pool for the benefit of the certificate holders but has no power to reinvest proceeds attributable to the mortgages in the pool or to vary investments in the pool in any other manner. There are two classes of certificates. Holders of class A certificates are entitled to all payments of mortgage principal, both scheduled and prepaid, until their certificates are retired; holders of class B certificates receive payments of principal only after all class A certificates have been retired. The different rights of the class A and class B certificates serve to shift to the holders of the class A certificates, in addition to the earlier scheduled payments of principal, the risk that mortgages in the pool will be prepaid so that the holders of the class B certificates will have "call protection" (freedom from premature termination of their interests on account of prepayments). The trust thus serves to create investment interests with respect to the mortgages held by the trust that differ significantly from direct investment in the mortgages. As a consequence, the existence of multiple classes of trust ownership is not incidental to any purpose of the trust to facilitate direct investment, and, accordingly, the trust is classified as a business entity under §301.7701-2.

Example (2). Corporation M is the originator of a portfolio of residential mortgages and transfers the mortgages to a bank under a trust agreement. At the same time, the bank as trustee delivers to M certificates evidencing rights to payments from the pooled mortgages. The trustee holds legal title to the mortgages in the pool for the benefit of the certificate holders, but has no power to reinvest proceeds attributable to the mortgages in the pool or to vary investments in the pool in any other manner. There are two classes of certificates. Holders of class C certificates are entitled to receive 90 percent of the payments of principal and interest on the mortgages; class D certificate holders are entitled to receive the other ten percent. The two classes of certificates are identical except that, in the event of a default on the underlying mortgages, the payment rights of class D certificate holders are subordinated to the rights of class C certificate holders. M sells the class C certificates to investors and retains the class D certificates. The trust has multiple classes of ownership interests, given the greater security provided to holders of class C certificates. The interests of certificate holders, however, are substantially equivalent to undivided interest in the pool of mortgages, coupled with a limited recourse guarantee running from M to the holders of class C certificates. In such circumstances, the existence of multiple classes of ownership interests is incidental to the trust's purpose of facilitating direct investment in the assets of the trust. Accordingly, the trust is classified as a trust.

Example (3). A promoter forms a trust in which shareholders of a publicly traded corporation can deposit their stock. For each share of stock deposited with the trust, the participant receives two certificates that are initially attached, but may be separated and traded independently of each other. One certificate represents the right to dividends and the value of the underlying stock up to a specified amount; the other certificate represents the right to appreciation in the stock's value above the specified amount. The separate certificates represent two different classes of ownership interest in the trust, which effectively separate dividend rights on the stock held by the trust from a portion of the right to appreciation in the value of such stock. The multiple classes of ownership interests are designed to permit investors, by transferring one of the certificates and retaining the other, to fulfill their varying investment objectives of seeking primarily either dividend income or capital appreciation from the stock held by the trust. Given that the trust serves to create investment interests with respect to the stock held by the trust that differ significantly from direct investment in such stock, the trust is not formed to facilitate direct investment in the assets of the trust. Accordingly, the trust is classified as a business entity under §301.7701-2.

Example (4). Corporation N purchases a portfolio of bonds and transfers the bonds to a bank under a trust agreement. At the same time, the trustee delivers to N certificates evidencing interests in the bonds. These certificates are sold to public investors. Each certificate represents the right to receive a particular payment with respect to a specific bond. Under section 1286, stripped coupons and stripped bonds are treated as separate bonds for federal income tax purposes. Although the interest of each certificate holder is different from that of each other certificate holder, and the trust thus has multiple classes of ownership, the multiple classes simply provide each certificate holder with a direct interest in what is treated under section 1286 as a separate bond. Given the similarity of the interests acquired by the certificate holders to the interests that could be acquired by direct investment, the multiple classes of trust interests merely facilitate direct investment in the assets held by the trust. Accordingly, the trust is classified as a trust.

TAXABLE MORTGAGE POOL REGULATIONS

SECTION 301.7701(i)-0.

Reg. §301.7701(i)-0. Outline of taxable mortgage pool provisions.
This section lists the major paragraphs contained in §§301.7701(i)-1 through 301.7701(i)-4.

Reg. §301.7701(i)-1. Definition of a taxable mortgage pool.

(a) Purpose.
(b) In general.
(c) Asset composition tests.
  (1) Determination of amount of assets.
  (2) Substantially all.
    (i) In general.
    (ii) Safe harbor.
  (3) Equity interests in pass-through arrangements.
  (4) Treatment of certain credit enhancement contracts.
    (i) In general.
    (ii) Credit enhancement contract defined.
  (5) Certain assets not treated as debt obligations.
    (i) In general.
    (ii) Safe harbor.
    (A) In general.
    (B) Payments with respect to a mortgage defined.
    (C) Entity treated as not anticipating payments.
(d) Real estate mortgages or interests therein defined.
  (1) In general.
  (2) Interests in real property and real property defined.
    (i) In general.
    (ii) Manufactured housing.
  (3) Principally secured by an interest in real property.
    (i) Tests for determining whether an obligation is principally secured.
    (A) The 80 percent test.
    (B) Alternative test.
    (ii) Obligations secured by real estate mortgages (or interests therein), or by combinations of real estate mortgages (or interests therein) and other assets.
    (A) In general.
    (B) Example.
(e) Two or more maturities.
  (1) In general.
  (2) Obligations that are allocated credit risk unequally.
  (3) Examples.
(f) Relationship test.
  (1) In general.
  (2) Payments on asset obligations defined.
  (3) Safe harbor for entities formed to liquidate assets.
(g) Anti-avoidance rules.
  (1) In general.
  (2) Certain investment trusts.
  (3) Examples.

§301.7701(i)-2. Special rules for portions of entities.

(a) Portion defined.
(b) Certain assets and rights to assets disregarded.
  (1) Credit enhancement assets.
  (2) Assets unlikely to service obligations.
  (3) Recourse.
(c) Portion as obligor.
  (1) In general.
  (2) Example.

§301.7701(i)-3. Effective dates and duration of taxable mortgage pool classification.

(a) Effective dates.
(b) Entities in existence on December 31, 1991.
  (1) In general.
  (2) Special rule for certain transfers.
  (3) Related debt obligation.
  (4) Example.
(c) Duration of taxable mortgage pool classification.
  (1) Commencement and duration.
  (2) Testing day defined.

§301.7701(i)-4. Special rules for certain entities.

(a) States and municipalities.
  (1) In general.
  (2) Governmental purpose.
  (3) Determinations by the Commissioner.
(b) REITs. [Reserved]
(c) Subchapter S corporations.
  (1) In general.
  (2) Portion of an S corporation treated as a separate corporation.

Reg. §301.7701(i)-1. Definition of a taxable mortgage pool

(a) Purpose. This section provides rules for applying section 7701(i), which defines taxable mortgage pools. The purpose of section 7701(i) is to prevent income generated by a pool of real estate mortgages from escaping Federal income taxation when the pool is used to issue multiple class mortgage-backed securities. The regulations in this section and in §§301.7701(i)-2 through 301.7701(i)-4 are to be applied in accordance with this purpose. The taxable mortgage pool provisions apply to entities or portions of entities that qualify for REMIC status but do not elect to be taxed as REMICs as well as to certain entities or portions of entities that do not qualify for REMIC status.

(b) In general. (1) A taxable mortgage pool is any entity or portion of an entity (as defined in §301.7701(i)-2) that satisfies the requirements of section 7701(i)(2)(A) and this section as of any testing day (as defined in §301.7701(i)-3(c)(2)). An entity or portion of an entity satisfies the requirements of section 7701(i)(2)(A) and this section if substantially all of its assets are debt obligations, more than 50 percent of those debt obligations are real estate mortgages, the entity is the obligor under debt obligations with two or more maturities, and payments on the debt obligations under which the entity is obligor bear a relationship to payments on the debt obligations that the entity holds as assets.

(2) Paragraph (c) of this section provides the tests for determining whether substantially all of an entity's assets are debt obligations and for determining whether more than 50 percent of its debt obligations are real estate mortgages. Paragraph (d) of this section defines real estate mortgages for purposes of the 50 percent test. Paragraph (e) of this section defines two or more maturities and paragraph (f) of this section provides rules for determining whether debt obligations bear a relationship to the assets held by an entity. Paragraph (g) of this section provides anti-avoidance rules. Section 301.7701(i)-2 provides rules for applying section 7701(i) to portions of entities and §301.7701(i)-3 provides effective dates. Section 301.7701(i)-4 provides special rules for certain entities. For purposes of the regulations under section 7701(i), the term entity includes a portion of an entity (within the meaning of section

7701(i)(2)(B)), unless the context clearly indicates otherwise.

(c) Asset composition tests. **(1) Determination of amount of assets.** An entity must use the Federal income tax basis of an asset for purposes of determining whether substantially all of its assets consist of debt obligations (or interests therein) and whether more than 50 percent of those debt obligations (or interests) consist of real estate mortgages (or interests therein). For purposes of this paragraph, an entity determines the basis of an asset with the assumption that the entity is not a taxable mortgage pool.

(2) Substantially all—(i) In general. Whether substantially all of the assets of an entity consist of debt obligations (or interests therein) is based on all the facts and circumstances.

(ii) Safe harbor. Notwithstanding paragraph (c)(2)(i) of this section, if less than 80 percent of the assets of an entity consist of debt obligations (or interests therein), then less than substantially all of the assets of the entity consist of debt obligations (or interests therein).

(3) Equity interests in pass-through arrangements. The equity interest of an entity in a partnership, S corporation, trust, REIT, or other pass-through arrangement is deemed to have the same composition as the entity's share of the assets of the pass-through arrangement. For example, if an entity's stock interest in a REIT has an adjusted basis of $20,000, and the assets of the REIT consist of equal portions of real estate mortgages and other real estate assets, then the entity is treated as holding $10,000 of real estate mortgages and $10,000 of other real estate assets.

(4) Treatment of certain credit enhancement contracts—(i) In general. A credit enhancement contract (as defined in paragraph (c)(4)(ii) of this section) is not treated as a separate asset of an entity for purposes of the asset composition tests set forth in section 7701(i)(2)(A)(i), but instead is treated as part of the asset to which it relates. Furthermore, any collateral supporting a credit enhancement contract is not treated as an asset of an entity solely because it supports the guarantee represented by that contract.

(ii) Credit enhancement contract defined. For purposes of this section, a credit enhancement contract is any arrangement whereby a person agrees to guarantee full or partial payment of the principal or interest payable on a debt obligation (or interest therein) or on a pool of such obligations (or interests), or full or partial payment on one or more classes of debt obligations under which an entity is the obligor, in the event of defaults or delinquencies on debt obligations, unanticipated losses or expenses incurred by the entity, or lower than expected returns on investments. Types of credit enhancement contracts may include, but are not limited to, pool insurance contracts, certificate guarantee insurance contracts, letters of credit, guarantees, or agreements whereby an entity, a mortgage servicer, or other third party agrees to make advances (regardless of whether, under the terms of the agreement, the payor is obligated, or merely permitted, to make those advances). An agreement by a debt servicer to advance to an entity out of its own funds an amount to make up for delinquent payments on debt obligations is a credit enhancement contract. An agreement by a debt servicer to pay taxes and hazard insurance premiums on property securing a debt obligation, or other expenses incurred to protect an entity's security interests in the collateral in the event that the debtor fails to pay such taxes, insurance premiums, or other expenses, is a credit enhancement contract.

(5) Certain assets not treated as debt obligations—(i) In general. For purposes of section 7701(i)(2)(A), real estate mortgages that are seriously impaired are not treated as debt obligations. Whether a mortgage is seriously impaired is based on all the facts and circumstances including, but not limited to: the number of days delinquent, the loan-to-value ratio, the debt service coverage (based upon the operating income from the property), and the debtor's financial position and stake in the property. However, except as provided in paragraph (c)(5)(ii) of this section, no single factor in and of itself is determinative of whether a loan is seriously impaired.

(ii) Safe harbor—(A) In general. Unless an entity is receiving or anticipates receiving payments with respect to a mortgage, a single family residential real estate mortgage is seriously impaired if payments on the mortgage are more than 89 days delinquent, and a multifamily residential or commercial real estate mortgage is seriously impaired if payments on the mortgage are more than 59 days delinquent. Whether an entity anticipates receiving payments with respect to a mortgage is based on all the facts and circumstances.

(B) Payments with respect to a mortgage defined. For purposes of paragraph (c)(5)(ii)(A) of this section, payments with respect to a mortgage mean any payments on the mortgage as defined in paragraph (f)(2)(i) of this section if those payments are substantial and relatively certain as to amount and any payments on the mortgage as defined in paragraph (f)(2)(ii) or (iii) of this section.

(C) Entity treated as not anticipating payments. With respect to any testing day (as defined in §301.7701(i)-3(c)(2)), an entity is treated as not having anticipated receiving payments on the mortgage as defined in paragraph (f)(2)(i) of this section if 180 days after the testing day, and despite making reasonable efforts to resolve the mortgage, the entity is not receiving such payments and has not entered into any agreement to receive such payments.

(d) Real estate mortgages or interests therein defined. **(1) In general.** For purposes of section 7701(i)(2)(A)(i), the term real estate mortgages (or interests therein) includes all—

(i) Obligations (including participations or certificates of beneficial ownership therein) that are principally secured by an interest in real property (as defined in paragraph (d)(3) of this section);

(ii) Regular and residual interests in a REMIC; and

(iii) Stripped bonds and stripped coupons (as defined in section 1286(e)(2) and (3)) if the bonds (as defined in section 1286(e)(1)) from which such stripped bonds or stripped coupons arose would have qualified as real estate mortgages or interests therein.

(2) Interests in real property and real property defined—(i) In general. The definition of interests in real property set forth in §1.856-3(c) of this chapter and the definition of real property set forth in §1.856-3(d) of this chapter apply to define those terms for purposes of paragraph (d) of this section.

(ii) Manufactured housing. For purposes of this section, the definition of real property includes manufactured housing, provided the properties qualify as single family residences under section

25(e)(10) and without regard to the treatment of the properties under state law.

(3) Principally secured by an interest in real property—(i) Tests for determining whether an obligation is principally secured. For purposes of paragraph (d)(1) of this section, an obligation is principally secured by an interest in real property only if it satisfies either the test set out in paragraph (d)(3)(i)(A) of this section or the test set out in paragraph (d)(3)(i)(B) of this section.

(A) The 80 percent test. An obligation is principally secured by an interest in real property if the fair market value of the interest in real property (as defined in paragraph (d)(2) of this section) securing the obligation was at least equal to 80 percent of the adjusted issue price of the obligation at the time the obligation was originated (that is, the issue date). For purposes of this test, the fair market value of the real property interest is first reduced by the amount of any lien on the real property interest that is senior to the obligation being tested, and is reduced further by a proportionate amount of any lien that is in parity with the obligation being tested.

(B) Alternative test. An obligation is principally secured by an interest in real property if substantially all of the proceeds of the obligation were used to acquire, improve, or protect an interest in real property that, at the origination date, is the only security for the obligation. For purposes of this test, loan guarantees made by Federal, state, local governments or agencies, or other third party credit enhancement, are not viewed as additional security for a loan. An obligation is not considered to be secured by property other than real property solely because the obligor is personally liable on the obligation.

(ii) Obligations secured by real estate mortgages (or interests therein), or by combinations of real estate mortgages (or interests therein) and other assets—(A) In general. An obligation secured only by real estate mortgages (or interests therein), as defined in paragraph (d)(1) of this section, is treated as an obligation secured by an interest in real property to the extent of the value of the real estate mortgages (or interests therein). An obligation secured by both real estate mortgages (or interests therein) and other assets is treated as an obligation secured by an interest in real property to the extent of both the value of the real estate mortgages (or interests therein) and the value of so much of the other assets that constitute real property. Thus, under this paragraph, a collateralized mortgage obligation may be an obligation principally secured by an interest in real property. This section is applicable only to obligations issued after December 31, 1991.

(B) Example. The following example illustrates the principles of this paragraph (d)(3)(ii):

Example. At the time it is originated, an obligation has an adjusted issue price of $300,000 and is secured by a $70,000 loan principally secured by an interest in a single family home, a fifty percent co-ownership interest in a $400,000 parcel of land, and $80,000 of stock. Under paragraph (d)(3)(ii)(A) of this section, the obligation is treated as secured by interests in real property and under paragraph (d)(3)(i)(A) of this section, the obligation is treated as principally secured by interests in real property.

(e) Two or more maturities. (1) In general. For purposes of section 7701(i)(2)(A)(ii), debt obligations have two or more maturities if they have different stated maturities or if the holders of the obligations possess different rights concerning the acceleration of or delay in the maturities of the obligations.

(2) Obligations that are allocated credit risk unequally. Debt obligations that are allocated credit risk unequally do not have, by that reason alone, two or more maturities. Credit risk is the risk that payments of principal or interest will be reduced or delayed because of a default on an asset that supports the debt obligations.

(3) Examples. The following examples illustrate the principles of this paragraph (e):

Example 1. (i) Corporation M transfers a pool of real estate mortgages to a trustee in exchange for Class A bonds and a certificate representing the residual beneficial ownership of the pool. All Class A bonds have a stated maturity of March 1, 2002, but if cash flows from the real estate mortgages and investments are sufficient, the trustee may select one or more bonds at random and redeem them earlier.

(ii) The Class A bonds do not have different maturities. Each outstanding Class A bond has an equal chance of being redeemed because the selection process is random. The holders of the Class A bonds, therefore, have identical rights concerning the maturities of their obligations.

Example 2. (i) Corporation N transfers a pool of real estate mortgages to a trustee in exchange for Class C bonds, Class D bonds, and a certificate representing the residual beneficial ownership of the pool. The Class D bonds are subordinate to the Class C bonds so that cash flow shortfalls due to defaults or delinquencies on the real estate mortgages are borne first by the Class D bond holders. The terms of the bonds are otherwise identical in all relevant aspects except that the Class D bonds carry a higher coupon rate because of the subordination feature.

(ii) The Class C bonds and the Class D bonds share credit risk unequally because of the subordination feature. However, neither this difference, nor the difference in interest rates, causes the bonds to have different maturities. The result is the same if, in addition to the other terms described in paragraph (i) of this Example 2, the Class C bonds are accelerated as a result of the issuer becoming unable to make payments on the Class C bonds as they become due.

(f) Relationship test. (1) In general. For purposes of section 7701(i)(2)(A)(iii), payments on debt obligations under which an entity is the obligor (liability obligations) bear a relationship to payments (as defined in paragraph (f)(2) of this section) on debt obligations an entity holds as assets (asset obligations) if under the terms of the liability obligations (or underlying arrangement) the timing and amount of payments on the liability obligations are in large part determined by the timing and amount of payments or projected payments on the asset obligations. For purposes of the relationship test, any payment arrangement, including a swap or other hedge, that achieves a substantially similar result is treated as satisfying the test. For example, any arrangement where the timing and amount of payments on liability obligations are determined by reference to a group of assets (or an index or other type of model) that has an expected payment experience similar to that of the asset obligations is treated as satisfying the relationship test.

(2) Payments on asset obligations defined. For purposes of section

7701(i)(2)(A)(iii) and this section, payments on asset obligations include—

(i) A payment of principal or interest on an asset obligation, including a prepayment of principal, a payment under a credit enhancement contract (as defined in paragraph (c)(4)(ii) of this section) and a payment from a settlement at a discount (other than a substantial discount);

(ii) A payment from a settlement at a substantial discount, but only if the settlement is arranged, whether in writing or otherwise, prior to the issuance of the liability obligations; and

(iii) A payment from the foreclosure on or sale of an asset obligation, but only if the foreclosure or sale is arranged, whether in writing or otherwise, prior to the issuance of the liability obligations.

(3) Safe harbor for entities formed to liquidate assets. Payments on liability obligations of an entity do not bear a relationship to payments on asset obligations of the entity if—

(i) The entity's organizational documents manifest clearly that the entity is formed for the primary purpose of liquidating its assets and distributing proceeds of liquidation;

(ii) The entity's activities are all reasonably necessary to and consistent with the accomplishment of liquidating assets;

(iii) The entity plans to satisfy at least 50 percent of the total issue price of each of its liability obligations having a different maturity with proceeds from liquidation and not with scheduled payments on its asset obligations; and

(iv) The terms of the entity's liability obligations (or underlying arrangement) provide that within three years of the time it first acquires assets to be liquidated the entity either—

(A) Liquidates; or

(B) Begins to pass through without delay all payments it receives on its asset obligations (less reasonable allowances for expenses) as principal payments on its liability obligations in proportion to the adjusted issue prices of the liability obligations.

(g) Anti-avoidance rules. **(1) In general.** For purposes of determining whether an entity meets the definition of a taxable mortgage pool, the Commissioner can disregard or make other adjustments to a transaction (or series of transactions) if the transaction (or series) is entered into with a view to achieving the same economic effect as that of an arrangement subject to section 7701(i) while avoiding the application of that section. The Commissioner's authority includes treating equity interests issued by a non-REMIC as debt if the entity issues equity interests that correspond to maturity classes of debt.

(2) Certain investment trusts. Notwithstanding paragraph (g)(1) of this section, an ownership interest in an entity that is classified as a trust under §301.7701-4(c) will not be treated as a debt obligation of the trust.

(3) Examples. The following examples illustrate the principles of this paragraph (g):

Example 1. (i) Partnership P, in addition to its other investments, owns $10,000,000 of mortgage pass-through certificates guaranteed by FNMA (FNMA Certificates). On May 15, 1997, Partnership P transfers the FNMA Certificates to Trust 1 in exchange for 100 Class A bonds and Certificate 1. The Class A bonds, under which Trust 1 is the obligor, have a stated principal amount of $5,000,000 and bear a relationship to the FNMA Certificates (within the meaning of §301.7701(i)-1(f)). Certificate 1 represents the residual beneficial ownership of the FNMA Certificates.

(ii) On July 5, 1997, with a view to avoiding the application of section 7701(i), Partnership P transfers Certificate 1 to Trust 2 in exchange for 100 Class B bonds and Certificate 2. The Class B bonds, under which Trust 2 is the obligor, have a stated principal amount of $5,000,000, bear a relationship to the FNMA Certificates (within the meaning of §301.7701(i)-1(f)), and have a different maturity than the Class A bonds (within the meaning of §301.7701(i)-1(e)). Certificate 2 represents the residual beneficial ownership of Certificate 1.

(iii) For purposes of determining whether Trust 1 is classified as a taxable mortgage pool, the Commissioner can disregard the separate existence of Trust 2 and treat Trust 1 and Trust 2 as a single trust.

Example 2. (i) Corporation Q files a consolidated return with its two wholly-owned subsidiaries, Corporation R and Corporation S. Corporation R is in the business of building and selling single family homes. Corporation S is in the business of financing sales of those homes.

(ii) On August 10, 1998, Corporation S transfers a pool of its real estate mortgages to Trust 3, taking back Certificate 3 which represents beneficial ownership of the pool. On September 25, 1998, with a view to avoiding the application of section 7701(i), Corporation R issues bonds that have different maturities (within the meaning of §301.7701(i)-1(e)) and that bear a relationship (within the meaning of §301.7701(i)-1(f)) to the real estate mortgages in Trust 3. The holders of the bonds have an interest in a credit enhancement contract that is written by Corporation S and collateralized with Certificate 3.

(iii) For purposes of determining whether Trust 3 is classified as a taxable mortgage pool, the Commissioner can treat Trust 3 as the obligor of the bonds issued by Corporation R.

Example 3. (i) Corporation X, in addition to its other assets, owns $110,000,000 in Treasury securities. From time to time, Corporation X acquires pools of real estate mortgages, which it immediately uses to issue multiple-class debt obligations.

(ii) On October 1, 1996, Corporation X transfers $20,000,000 in Treasury securities to Trust 4 in exchange for Class C bonds, Class D bonds, Class E bonds, and Certificate 4. Trust 4 is the obligor of the bonds. The different classes of bonds have the same stated maturity date, but if cash flows from the Trust 4 assets exceed the amounts needed to make interest payments, the trustee uses the excess to retire the classes of bonds in alphabetical order. Certificate 4 represents the residual beneficial ownership of the Treasury securities.

(iii) With a view to avoiding the application of section 7701(i), Corporation X reserves the right to replace any Trust 4 asset with real estate mortgages or guaranteed mortgage pass-through certificates. In the event the right is exercised, cash flows on the real estate mortgages and guaranteed pass-through certificates will be used in the same manner as cash flows on the Treasury securities. Corporation X exercises this right of replacement on February 1, 1997.

(iv) For purposes of determining whether Trust 4 is classified as a taxable mortgage pool, the Commissioner can treat February 1, 1997, as a testing day (within the meaning of §301.7701(i)-

3(c)(2)). The result is the same if Corporation X has an obligation, rather than a right, to replace the Trust 4 assets with real estate mortgages and guaranteed pass-through certificates.

Example 4. (i) Corporation Y, in addition to its other assets, owns $1,900,000 in obligations secured by personal property. On November 1, 1995, Corporation Y begins negotiating a $2,000,000 loan to individual A. As security for the loan, A offers a first deed of trust on land worth $1,700,000.

(ii) With a view to avoiding the application of section 7701(i), Corporation Y induces A to place the land in a partnership in which A will have a 95 percent interest and agrees to accept the partnership interest as security for the $2,000,000 loan. Thereafter, the loan to A, together with the $1,900,000 in obligations secured by personal property, are transferred to Trust 5 and used to issue bonds that have different maturities (within the meaning of §301.7701(i)-1(e)) and that bear a relationship (within the meaning of §301.7701(i)-1(f)) to the $1,900,000 in obligations secured by personal property and the loan to A.

(iii) For purposes of determining whether Trust 5 is a taxable mortgage pool, the Commissioner can treat the loan to A as an obligation secured by an interest in real property rather than as an obligation secured by an interest in a partnership.

Example 5. (i) Corporation Z, in addition to its other assets, owns $3,000,000 in notes secured by interests in retail shopping centers. Partnership L, in addition to its other assets, owns $20,000,000 in notes that are principally secured by interests in single family homes and $3,500,000 in notes that are principally secured by interests in personal property.

(ii) On December 1, 1995, Partnership L asks Corporation Z for two separate loans, one in the amount of $9,375,000 and another in the amount of $625,000. Partnership L offers to collateralize the $9,375,000 loan with $10,312,500 of notes secured by interests in single family homes and the $625,000 loan with $750,000 of notes secured by interests in personal property. Corporation Z has made similar loans to Partnership L in the past.

(iii) With a view to avoiding the application of section 7701(i), Corporation Z induces Partnership L to accept a single $10,000,000 loan and to post as collateral $7,500,000 of the notes secured by interests in single family homes and all $3,500,000 of the notes secured by interests in personal property. Ordinarily, Corporation Z would not make a loan on these terms. Thereafter, the loan to Partnership L, together with the $3,000,000 in notes secured by interests in retail shopping centers, are transferred to Trust 6 and used to issue bonds that have different maturities (within the meaning of §301.7701(i)-1(e)) and that bear a relationship (within the meaning of §301.7701(i)-1(f)) to the loans secured by interests in retail shopping centers and the loan to Partnership L.

(iv) For purposes of determining whether Trust 6 is a taxable mortgage pool, the Commissioner can treat the $10,000,000 loan to Partnership L as consisting of a $9,375,000 obligation secured by interests in real property and a $625,000 obligation secured by interests in personal property. Under §301.7701(i)-1(d)(3)(ii)(A), the notes secured by single family homes are treated as $7,500,000 of interests in real property. Under

§301.7701(i)-1(d)(3)(i)(A), $7,500,000 of interests in real property are sufficient to treat a $9,375,000 obligation as principally secured by an interest in real property ($7,500,000 equals 80 percent of $9,375,000).

Reg. §301.7701(i)-2. Special rules for portions of entities.

(a) Portion defined. Except as provided in paragraph (b) of this section and §301.7701(i)-1, a portion of an entity includes all assets that support one or more of the same issues of debt obligations. For this purpose, an asset supports a debt obligation if, under the terms of the debt obligation (or underlying arrangement), the timing and amount of payments on the debt obligation are in large part determined, either directly or indirectly, by the timing and amount of payments or projected payments on the asset or a group of assets that includes the asset. Indirect payment arrangements include, for example, a swap or other hedge, or arrangements where the timing and amount of payments on the debt obligations are determined by reference to a group of assets (or an index or other type of model) that has an expected payment experience similar to that of the assets. For purposes of this paragraph, the term payments includes all proceeds and receipts from an asset.

(b) Certain assets and rights to assets disregarded. (1) Credit enhancement assets. An asset that qualifies as a credit enhancement contract (as defined in §301.7701(i)-1(c)(4)(ii)) is not included in a portion as a separate asset, but is treated as part of the assets in the portion to which it relates under §301.7701(i)-1(c)(4)(i). An asset that does not qualify as a credit enhancement contract (as defined in §301.7701(i)-1(c)(4)(ii)), but that nevertheless serves the same function as a credit enhancement contract, is not included in a portion as a separate asset or otherwise.

(2) Assets unlikely to service obligations. A portion does not include assets that are unlikely to produce any significant cash flows for the holders of the debt obligations. This paragraph applies even if the holders of the debt obligations are legally entitled to cash flows from the assets. Thus, for example, even if the sale of a building would cause a series of debt obligations to be redeemed, the building is not included in a portion if it is not likely to be sold.

(3) Recourse. An asset is not included in a portion solely because the holders of the debt obligations have recourse to the holder of that asset.

(c) Portion as obligor.—(1) In general. For purposes of section 7701(i)(2)(A)(ii), a portion of an entity is treated as the obligor of all debt obligations supported by the assets in that portion.

(2) Example. The following example illustrates the principles of this section:

Example. (i) Corporation Z owns $1,000,000,000 in assets including an office complex and $90,000,000 of real estate mortgages.

(ii) On November 30, 1998, Corporation Z issues eight classes of bonds, Class A through Class H. Each class is secured by a separate letter of credit and by a lien on the office complex. One group of the real estate mortgages supports Class A through Class D, another group supports Class E through Class G, and a third group supports Class H. It is anticipated that the cash flows from each group of mortgages will service its related bonds.

(iii) Each of the following constitutes a separate portion of Corporation Z:

the group of mortgages supporting Class A through Class D; the group of mortgages supporting Class E through Class G; and the group of mortgages supporting Class H. No other asset is included in any of the three portions notwithstanding the lien of the bonds on the office complex and the fact that Corporation Z is the issuer of the bonds. The letters of credit are treated as incidents of the mortgages to which they relate.

(iv) For purposes of section 7701(i)(2)(A)(ii), each portion described above is treated as the obligor of the bonds of that portion, notwithstanding the fact that Corporation Z is the legal obligor with respect to the bonds.

Reg. §301.7701(i)-3. Effective dates and duration of taxable mortgage pool classification.

(a) Effective dates. Except as otherwise provided, the regulations under section 7701(i) are effective and applicable September 6, 1995.

(b) Entities in existence on December 31, 1991. (1) In general. For transitional rules concerning the application of section 7701(i) to entities in existence on December 31, 1991, see section 675(c) of the Tax Reform Act of 1986.

(2) Special rule for certain transfers. A transfer made to an entity on or after September 6, 1995, is a substantial transfer for purposes of section 675(c)(2) of the Tax Reform Act of 1986 only if—

(i) The transfer is significant in amount; and

(ii) The transfer is connected to the entity's issuance of related debt obligations (as defined in paragraph (b)(3) of this section) that have different maturities (within the meaning of §301.7701-1(e)).

(3) Related debt obligation. A related debt obligation is a debt obligation whose payments bear a relationship (within the meaning of §301.7701-1(f)) to payments on debt obligations that the entity holds as assets.

(4) Example. The following example illustrates the principles of this paragraph (b):

Example. On December 31, 1991, Partnership Q holds a pool of real estate mortgages that it acquired through retail sales of single family homes. Partnership Q raises $10,000,000 on October 25, 1996, by using this pool to issue related debt obligations with multiple maturities. The transfer of the $10,000,000 to Partnership Q is a substantial transfer (within the meaning of §301.7701(i)-3(b)(2)).

(c) Duration of taxable mortgage pool classification. (1) Commencement and duration. An entity is classified as a taxable mortgage pool on the first testing day that it meets the definition of a taxable mortgage pool. Once an entity is classified as a taxable mortgage pool, that classification continues through the day the entity retires its last related debt obligation.

(2) Testing day defined. A testing day is any day on or after September 6, 1995, on which an entity issues a related debt obligation (as defined in paragraph (b)(3) of this section) that is significant in amount.

Reg. §301.7701(i)-4. Special rules for certain entities.

(a) States and municipalities. (1) In general. Regardless of whether an entity satisfies any of the requirements of section 7701(i)(2)(A), an entity is not classified as a taxable mortgage pool if—

(i) The entity is a State, territory, a possession of the United States, the District of Columbia, or any political subdivision thereof (within the meaning of

§1.1031(b) of this chapter), or is empowered to issue obligations on behalf of one of the foregoing;

(ii) The entity issues the debt obligations in the performance of a governmental purpose; and

(iii) The entity holds the remaining interests in all assets that support those debt obligations until the debt obligations issued by the entity are retired.

(2) Governmental purpose. The term governmental purpose means an essential governmental function within the meaning of section 115. A governmental purpose does not include the mere packaging of debt obligations for re-sale on the secondary market even if any profits from the sale are used in the performance of an essential governmental function.

(3) Determinations by the Commissioner. If an entity is not described in paragraph (a)(1) of this section, but has a similar purpose, then the Commissioner may determine that the entity is not classified as a taxable mortgage pool.

(b) REITs. [Reserved]

(c) Subchapter S corporations. (1) In general. An entity that is classified as a taxable mortgage pool may not elect to be an S corporation under section 1362(a) or maintain S corporation status.

(2) Portion of an S corporation treated as a separate corporation. An S corporation is not treated as a member of an affiliated group under section 1361(b)(2)(A) solely because a portion of the S corporation is treated as a separate corporation under section 7701(i).