

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.

[T.D. 8366, 56 FR 49516, Sept. 30, 1991; T.D. 8458, 57 FR 61301, Dec. 24, 1992]

**§ 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.

[T.D. 8458, 57 FR 61302, Dec. 24, 1992; 58 FR 8098, Feb. 11, 1993; T.D. 9004, 67 FR 47453, July 19, 2002]

### § 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