

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.

[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 al-

lowable 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 ex-

cess 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; and

(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.

(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]

§ 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,