

proper timing and source of income from fees received to induce the acquisition of noneconomic residual interests in Real Estate Mortgage Investment Conduits (REMICs). The proposed regulations would apply to taxpayers who receive inducement fees in connection with becoming the holder of a noneconomic REMIC residual interest. This document also provides notice of a public hearing on the proposed regulations.

**DATES:** Written or electronic comments must be received by October 20, 2003. Outlines of topics to be discussed at the public hearing scheduled for November 18, 2003, at 10 a.m. must be received by October 28, 2003.

**ADDRESSES:** Send submissions to CC:PA:RU (REG-162625-02), room 5226, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand delivered Monday through Friday between the hours of 8 a.m. and 4 p.m. to: CC:PA:RU (REG-162625-02), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW., Washington, DC. Alternatively, taxpayers may submit electronic comments via the IRS Internet site at: <http://www.irs.gov/regs>. The public hearing will be held in the IRS Auditorium, 1111 Constitution Avenue, NW., Washington, DC.

**FOR FURTHER INFORMATION CONTACT:** Concerning the proposed regulations, John W. Rogers III at (202) 622-3950; concerning submissions of comments, the hearing, and/or to be placed on the building access list to attend the hearing, Treena Garrett, at (202) 622-7180 (not toll-free numbers).

#### **SUPPLEMENTARY INFORMATION:**

##### **Background**

This document contains proposed amendments to the Income Tax Regulations (26 CFR part 1) under sections 446(b) (relating to general rules for methods of accounting), 860C (relating to other definitions and special rules applicable to REMICs), and 863(a) (relating to special rules for determining source) of the Internal Revenue Code of 1986 (Code). The proposed regulations prescribe certain accounting rules for taking an inducement fee into income over a period that is related to the period during which the applicable REMIC is expected to generate taxable income or net loss allocable to the holder of the noneconomic residual interest. The proposed regulations set forth two safe harbor methods of accounting for inducement fees. The proposed regulations also contain a rule clarifying that an inducement fee is

income from sources within the United States.

##### **Explanation of Provisions**

Final regulations governing REMICs, issued in 1992, contain rules governing the transfer of noneconomic residual interests. Those regulations do not, however, contain rules that address the transferee's treatment of the fee received to induce the acquisition of a REMIC noneconomic residual interest.

An inducement fee is paid to a transferee of a noneconomic residual interest because, under sections 860C(a)(1) and 860E(a)(1) of the Code, the holder of a REMIC residual interest must take into account the REMIC's taxable income or net loss. The holder of a noneconomic residual interest will receive insufficient distributions to cover the resulting tax liabilities, and a transferee will, therefore, require an inducement fee to become the holder of the noneconomic residual interest.

In its earlier years, a REMIC typically accrues more taxable interest income than deductible interest expense. As a result, in its earliest years, the REMIC will have net income (generally referred to as phantom income) taxable to the residual holder. This phenomenon generally will reverse, resulting in REMIC net loss (phantom loss) in later years.

Following release of the final REMIC regulations, the IRS and the Treasury Department received requests for guidance on the proper method of accounting to be used by taxpayers for inducement fee income. The proposed regulations provide rules relating to the proper timing and source of income from an inducement fee received in connection with becoming the holder of a noneconomic residual interest in a REMIC.

The proposed regulations provide that, to clearly reflect income, an inducement fee must be included in income over a period that is reasonably related to the period during which the applicable REMIC is expected to generate taxable income or net loss allocable to the holder of the noneconomic residual interest. The proposed regulations provide that an inducement fee generally may not be taken into account in a single tax year.

The proposed regulations set forth two safe harbor methods of accounting for inducement fees. These safe harbor methods are:

(1) A book method, under which an inducement fee is recognized for federal income tax purposes in the same amounts and over the same period in which that inducement fee is included in income by the taxpayer for financial

reporting purposes, provided that the period is not shorter than the period over which the applicable REMIC is expected to generate taxable income; and

(2) A method under which the inducement fee is recognized for federal income tax purposes ratably over the remaining anticipated weighted average life of the REMIC determined as of the time the noneconomic residual interest is transferred to the taxpayer. This method is based on rules in the final REMIC regulations for taking into account a REMIC sponsor's unrecognized gain or loss on a REMIC residual interest upon the formation of a REMIC.

Additionally, the proposed regulations contain a rule that applies if a holder of a residual interest sells or otherwise disposes of the residual interest. Under this rule, the holder must take into account, at the time of the sale or other disposition, any unrecognized portion of the inducement fee for that residual interest. Transactions to which section 381(c)(4) applies are excluded from this rule because section 381 and the regulations thereunder provide for the carryover of tax attributes, including methods of accounting. The IRS and the Treasury Department considered excluding other non-recognition transactions, such as contributions under sections 351 or 721. These other transactions, however, do not provide for the carryover of tax attributes. The proposed regulations, therefore, do not permit continued deferral of the unrecognized portion of an inducement fee following these other transactions.

The proposed regulations also contain a rule clarifying that an inducement fee is income from sources within the United States.

The IRS and the Treasury Department request comments on other possible safe harbor methods of accounting for these inducement fees. In particular, comments are requested on whether a safe harbor method that recognizes inducement fees proportionally to the anticipated future financing costs for funding the net tax liabilities of the noneconomic residual interest would be of general use to taxpayers and, if so, what factors should be used under that safe harbor method for determining a taxpayer's anticipated future financing costs.

The proposed regulations state that the treatment of inducement fees is a method of accounting that must be applied consistently to all inducement fees received in connection with noneconomic REMIC residual interests. Thus, if a taxpayer uses a safe harbor