[4830-01-p]   Published August 25, 2004

DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

REG-106679-04

RIN 1545-BD18

Interest-only REMIC Regular Interests

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Advance notice of proposed rulemaking.

SUMMARY: This document describes and explains rules that the

IRS and Treasury are considering and may propose in a notice of

proposed rulemaking regarding the proper timing of income or

deduction attributable to an interest-only regular interest in a

Real Estate Mortgage Investment Conduit (REMIC). This document

also invites comments from the public regarding these rules and

other alternative rules. All materials submitted will be

available for public inspection and copying.

DATES: Written or electronic comments must be received by

November 23, 2004.

ADDRESSES: Send submissions to: CC:PA:LPD:PR (REG-106679-04),

room 5203, Internal Revenue Service, PO Box 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:LPD:PR (REG-106679-04), Courier's Desk, Internal

Revenue Service, 1111 Constitution Avenue, NW., Washington, DC,

or sent electronically, via the IRS Internet site at

www.irs.gov/regs or via the Federal eRulemaking Portal at

www.regulations.gov (indicate IRS and REG-106679-04).

FOR FURTHER INFORMATION CONTACT: Concerning submissions of

comments, Treena Garrett (202) 622-7180; concerning the

proposals, Dale S. Collinson, (202) 622-3900 (not toll-free

numbers).

SUPPLEMENTARY INFORMATION:

BACKGROUND

The Tax Reform Act of 1986 (100 Stat. 2085) (1986-3

C.B. Vol. 1), created a new tax entity, the Real Estate Mortgage

Investment Conduit (REMIC), that was designed to be the

exclusive vehicle for the issuance of multi-class mortgage-

backed securities. A REMIC may issue one or more classes of

regular interests and must issue a single class of residual

interest. Section 860B(a) of the Internal Revenue Code (Code)

requires that a regular interest be treated as a debt instrument

whether or not the interest would qualify as a debt instrument

under general tax principles. The holders of the residual

interest are required to take into account their proportionate

share of the REMIC's taxable income or net loss.

Prior to 1988, the holder of a REMIC regular interest

was required to be entitled to a specified principal amount plus

interest at a fixed or variable rate. The Technical and
Miscellaneous Revenue Act of 1988 (102 Stat. 3342) (1988 C.B.
1), permits the holder of a REMIC regular interest to receive
interest that consists of a specified portion of the interest
payments on qualified mortgages if the portion does not vary
during the period the regular interest is outstanding.
Section 860G(a)(1)(B)(ii). The expanded definition of REMIC
regular interest has allowed for the issuance of interest-only
REMIC regular interests (REMIC IOs).

A REMIC IO generally provides for a nominal (or zero)
specified principal amount and stated interest consisting of a
specified portion of the interest payments on mortgages held by
the REMIC.[1] Section 860B(a) provides that a REMIC regular
interest is taxed as a debt instrument. Nevertheless, a REMIC
IO differs from a traditional debt instrument in that the
aggregate of the amounts received by the holder of a REMIC IO
may be less than the amount for which the instrument was issued.
This may occur if the underlying mortgages are prepaid at an
unexpectedly rapid rate. In that case, the amounts of interest
paid on these mortgages will be less than expected, and the

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[1]The terms of a REMIC may provide that the specified principal amount of a
REMIC IO is zero. Although section 860G(a)(1)(A) requires a regular interest
"unconditionally [to] entitle[] the holder to receive a specified principal
amount (or other similar amount)," §1.860G-1(a)(2)(iv) states, "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."

amounts payable to the holder of the REMIC IO will be correspondingly reduced. As a result, REMIC IOs present novel and difficult questions in the application of tax rules that were designed primarily to account for instruments that qualify as debt under traditional tax principles.

Section 1275(d) authorizes regulations to modify the tax treatment prescribed by sections 163(e) and 1271 through 1275 (relating to original issue discount (OID)) if the statutory tax treatment does not carry out the purposes of those sections. The IRS and Treasury are considering whether to issue regulations, including regulations under the authority of section 1275(d), with respect to the tax treatment of REMIC IOs for issuers and initial- and secondary-market purchasers. This advance notice of proposed rulemaking sets out additional background information, including summary descriptions of possible approaches to the problems described below, and requests public comment.

CURRENT TAX TREATMENT OF REMIC IOs

As noted, the terms of a REMIC IO generally provide both for stated interest consisting of a specified portion of the interest payments on mortgages held by the REMIC and also may provide for a nominal amount of specified principal. The tax rules currently applicable to a REMIC IO depend on whether the stated interest is treated as consisting entirely of

interest or as being, in part, a return of the proceeds for which the instrument was issued.

Some taxpayers believe that, if the stated interest is respected as interest, it generally is qualified stated interest (QSI) and so is not part of the stated redemption price at maturity (SRPM). As a result, because the specified principal due on the REMIC IO is, at most, nominal, a holder generally will have paid more than the amount payable when the REMIC IO matures, and thus there will be bond premium. On the other hand, if the interest payments are recast as, in part, a return of the proceeds for which the REMIC IO was issued, the portions so recast are included in the SRPM, and the instrument is issued with OID.

Glick v. United States, 96 F. Supp. 2d 850 (S.D. Ind. 2000), weighed these competing analyses of a REMIC IO. The instrument at issue in the case had been issued for a little over $12 million. The terms of the instrument provided both for specified principal of $362,000, which was based on principal payments on the underlying mortgages, and for much larger expected amounts of stated interest, which were linked to, and contingent upon, interest payments on the underlying mortgages.

Given the terms of the mortgages and the rate at which the mortgagors were, in the aggregate, expected to prepay their mortgages, the prospectus estimated total future cash flows

under the REMIC IO of over $14 million. Basing its computation

on the specified principal amount, the prospectus identified the

resulting estimated interest rate on the REMIC IO as being

1006.7 percent. On the other hand, the prospectus further

disclosed that, if a yield computation were to be based on the

taxpayer's purchase price of over $12 million, the anticipated

yield to maturity was just under 8 percent.

Because of falling interest rates, the mortgages

underlying the instrument were prepaid at an extremely fast

rate, and the taxpayer recovered less than two thirds of the

original investment.

The Government argued that the instrument was issued

at a discount and that the taxpayer's loss on the instrument was

capital and would be recognized only in the year the instrument

was retired. The taxpayer, on the other hand, claimed that the

instrument was acquired at a premium and that ordinary

deductions were allowable under section 171 during the entire

period that the taxpayer held the instrument. Explaining that

it had resolved the question by "[e]xamining the economic

reality of the transaction," 96 F. Supp. 2d at 867, the court

issued summary judgment for the Government.

Original Issue Discount

REMIC regular interests are among the debt instruments

for which the accrual of OID is calculated taking prepayments

into account. This is accomplished by using a method commonly known as the prepayment assumption catch-up (PAC) method, which is provided in section 1272(a)(6). Under this method, it is necessary to estimate first the rate at which any outstanding principal on the underlying mortgages will be prepaid and, then, the yield to maturity of the instrument. These estimates remain constant in all PAC method computations throughout the life of the instrument.

In each accrual period, the daily accruals of OID are equal to the ratable portion of the excess (if any) of the sum of (1) the present value of the remaining payments under the debt instrument as of the close of the period (end-of-period present value) and (2) the payments during the accrual period that are included in the SRPM(accrual-period SRPM receipts), over the adjusted issue price of the debt instrument at the beginning of the period.[2]

The end-of-period present value is calculated using the two estimates referred to above. First, the amount and time of the remaining payments are determined on the basis of both the specified principal actually outstanding at the end of the accrual period (taking into account any prepayments occurring before the close of the accrual period) and the previously

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[2] For each period, interest income or expense with respect to the REMIC regular interest also includes accruals of QSI.

estimated, static assumption about the rate at which any outstanding principal will be prepaid. Second, the present value of these remaining payments is determined by discounting them at the previously estimated original yield to maturity.

A holder of an OID debt instrument includes in gross income the sum of the daily portions of the OID for each day during the taxable year on which it holds the debt instrument. An issuer's interest deduction for OID accruals is computed in a similar fashion.

In the case of a traditional debt instrument that is issued with OID or a REMIC regular interest that is issued for less than its specified principal amount, prepayments increase the instrument's yield to maturity. Failure to anticipate prepayments would result in uneconomic deferred accrual of OID inclusions, and the holder would recognize capital gains when the instrument is finally sold or retired. To prevent such uneconomic deferral of OID inclusions, the PAC method, in each period, recognizes more OID than would be recognized if no anticipated prepayments were taken into account. However, the PAC method may result in uneconomic acceleration of OID accruals in certain circumstances.

When section 1272(a)(6) became law, an instrument subject to it generally provided for payments of a fixed amount of specified principal, plus payments of QSI, which were based

on the amount of principal still outstanding. If the issue price of the instrument was less than the specified principal, that difference resulted in a fixed amount of OID, which had to be accrued over the life of the instrument.

For such an instrument, if actual prepayments occur at a slower rate than the original estimate, OID will be accrued more rapidly under the PAC method than the actual prepayment rate would justify. If prepayments are particularly slow, the OID remaining to be received at the end of a period may be greater than the excess of the original OID on the instrument over the amount of the OID that had been accrued in prior periods. As a result, the amount of OID for the current accrual period under the formula in the PAC method may be a negative number (Negative OID).[3] This occurs if the adjusted issue price at the beginning of an accrual period (which reflects prior OID accruals) exceeds the sum of (1) the end-of-period present value and (2) the accrual-period SRPM receipts.

Because the amount of OID to be received over the life of the instrument is fixed, and thus the OID that had been previously accrued will be received eventually, the premature accruals may be addressed by a period of nonaccrual of OID. An alternative approach would be to reverse the premature accruals

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[3] In 1986 Congress expressed its intent that Negative OID would not be currently recognized. For that reason, the term is used here to refer to a negative result for the computation required by the formula in the PAC method, not to an amount that is necessarily recognized for tax purposes.

by recognizing Negative OID in the current period and then to
accrue the OID again later.

In enacting the PAC formula, Congress expressed its
intent that the rules implementing the PAC method would use a
period of nonaccrual to correct possible premature accruals and
would not accrue and recognize Negative OID.

> The conferees intend that in no circumstances,
> would the method of accruing OID prescribed by the
> conference agreement allow for negative amounts of OID
> to be attributed to any accrual period. If the use of
> the present value computations prescribed by the
> conference agreement produce[s] such a result for an
> accrual period, the conferees intend that the amount of
> OID attributable to such accrual period would be
> treated as zero, and the computation of OID for the
> following accrual period would be made as if such
> following accrual period and the preceding accrual
> period were a single accrual period.

2 H.R. Conf. Rep. No. 841, 99th Cong., 2d Sess. II-239, 1986-3
(Vol. 4) C.B. 239. The IRS and Treasury understand that
taxpayers generally comply with this intent not only for
ordinary REMIC regular interests but also for REMIC IOs.

The quoted expression of Congressional intent
occurred before the 1988 amendment permitting REMIC IOs.
In the case of a REMIC regular interest that resembles a
traditional debt instrument (such as the regular interests
that existed before the 1988 amendment), a Negative OID
computation is evidence that unexpectedly slow prepayments
may have caused OID to accrue more rapidly than, in

hindsight, it should have. In such a situation,
disallowing Negative OID causes a timing issue. To the
extent that OID has been overaccrued, the accrual period is
extended until the computation for the extended accrual
period produces a positive result. This future positive
result of the computation has to occur eventually as
principal on the debt instrument is repaid.

By contrast, in the case of a REMIC IO, a Negative
OID computation may occur because unexpectedly rapid
prepayments reduce the amount of OID that will ever be
received or paid under the terms of the instrument. Rather
than the right amount of OID being accrued too fast, the
wrong amount has been accrued. In the case of a REMIC IO,
therefore, the prohibition against Negative OID may result
in denying the holder current recognition of an overall
actual loss that will not be reversed in future periods and
may only be realized upon the sale or maturity of the REMIC
IO.

There is also a corresponding distortion to the net
income or net loss of the REMIC (and thus to the income or net
loss of the holder of the residual interest). Even if one or
more holders of the REMIC IOs sell their interests and recognize
losses that correct their own overaccrual of OID income, nothing
corrects the REMIC's overaccrual of OID deductions until the

instrument is finally retired. This asymmetry may result in an understatement of the overall tax base attributable to income from mortgages held in REMICs (the total amount taxable to holders of REMIC regular interests and REMIC residual interests).

Market Discount

Section 1276(b)(3) provides that the accrual of market discount on a debt instrument the principal of which may be paid in installments shall be determined under regulations. Regulations have not yet been issued.

The legislative history of the Tax Reform Act of 1986, however, states that, until regulations are issued, if a debt instrument is issued with OID and the principal of the instrument may be paid in two or more installments, then holders of the instrument may elect to accrue market discount for the instrument either on a constant yield basis or in proportion to the OID accruals on the instrument. Under the latter method, the amount of market discount that accrues during an accrual period is determined by multiplying the total remaining amount of market discount on the instrument as of the beginning of the period by a fraction the numerator of which is the amount of OID for the period and the denominator of which is the total

remaining OID at the beginning of the period.[4] See 2 H.R. Conf.

Rep. No. 841, 99th Cong., 2d Sess. II-842 (1986), 1986-3

(Vol. 4) C.B. 842. The IRS and Treasury understand that, under

current practice, during any period for which the PAC method

produces Negative OID, the numerator of the fraction is treated

as zero, and no market discount is accrued. In some cases, this

practice may uneconomically defer recognition of market

discount.

        If the rules in section 1272(a)(6) apply to a debt

instrument (without regard to whether the instrument is issued

with OID), this legislative history indicates that accruals of

market discount on the instrument are to be determined using the

same prepayment assumption as that used under section 1272(a)(6)

(whether or not the taxpayer elects under section 1276(b)(2) to

accrue market discount on a constant-yield basis). See id.

        The IRS and Treasury are aware of several possible

methods, discussed below, for addressing the foregoing problems.

INSTRUMENTS TO WHICH NEW RULES MIGHT APPLY

        Because of the range of instruments to which

section 1272(a)(6) applies and the breadth of the new accounting

methods about which comment is being requested, any new method

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[4] If an instrument that provides for two or more principal payments is issued
without OID, Congress intended for market discount to be accrued according to
the same rule, but with stated interest playing the role of OID. See 2 H.R.
Conf. Rep. No. 841, 99th Cong., 2d Sess. II-842 (1986), 1986-3 (Vol. 4) C.B.
842.

might not necessarily be limited to REMIC IOs. For example, a new method might apply to interest-only strips from fixed investment mortgage trusts. In addition, a new method might apply to all instruments that provide for disproportionately high interest payments (as defined in §1.860G-1(b)(5)). Under this approach, the new rules would apply to REMIC regular interests whose issue price exceeds 125% of the specified principal amount and to similar non-REMIC interests.

PROPOSALS BASED ON EXISTING RULES FOR DEBT

PAC Method Without Prohibition On Recognizing Negative OID

Although the PAC method may sometimes fail to clearly reflect the income of the holder or the issuer of a REMIC IO, the method is not without merit. The method is specifically designed to deal with debt instruments that are subject to prepayments, like traditional REMIC regular interests. Under the PAC method, if loans are actually prepaid faster than expected, the projected future cash flows are adjusted immediately to more accurately reflect income. To a large extent, the problems arising from the application of the PAC method to REMIC IOs arise from the prohibition against taking Negative OID into account.

Because REMIC IOs did not exist when the 1986 legislative history discussing Negative OID was drafted, that discussion related to a Negative OID computation that would

indicate that the affected taxpayers had accrued some OID too soon, rather than that they had accrued OID that would never be paid or received. Congress might have articulated a different intent concerning Negative OID if it had addressed the issue once REMIC IOs were permitted.

Accordingly, the IRS and Treasury are considering whether to propose a regulation that would follow the section 1272(a)(6) formula in the current PAC method, except that the regulation would specifically allow holders of regular interests to accrue Negative OID deductions and would require the REMIC (and thus the holder of the REMIC residual interest) to accrue and recognize income from Negative OID.

The considerations supporting recognition of Negative OID by initial purchasers may not apply with equal force to secondary-market purchasers. Secondary market prices are likely to reflect both prepayment history and revised expectations regarding future prepayments, with the result that the Negative OID deduction that might be appropriate for an initial purchaser may exceed any actual economic loss sustained by a particular secondary-market purchaser. The secondary-market purchaser's depressed purchase price, however, is likely to result in a substantial amount of market discount. See section 1278(a)(2). The rules for accruing Negative OID and market discount will

have to be coordinated to produce a net result that is
economically sensible.

Accordingly, it may be appropriate either to develop
explicit rules to effect this coordination or to limit
recognition of Negative OID in the case of secondary-market
purchasers. For example, recognition of accrued Negative OID
might be limited to the aggregate of amounts that the secondary-
market holder previously included in income as accrued OID or
accrued market discount. However, in the case of a secondary-
market holder who has suffered a real economic loss on a REMIC
IO, such a limitation could uneconomically defer recognition of
that loss.

Moreover, if a limitation on the allowance of Negative
OID is applied to secondary-market purchasers, perhaps a similar
limitation for initial purchasers will be needed to avoid
disparate treatment of similarly situated holders (for example,
initial purchasers and secondary-market purchasers that purchase
shortly after original issuance at a price substantially the
same as the issue price). However, such a limitation would also
perpetuate many of the problems previously described.

Any rule recognizing Negative OID would have to deal
with a variety of collateral consequences, such as adjustments
to the instrument's adjusted issue price and the holder's basis
in the instrument to reflect any deduction for Negative OID.

Comments are requested concerning both the range of collateral consequences of recognizing Negative OID and the ways in which these consequences should be dealt with.

<u>Allowing Section 166 Bad Debt Deduction</u>

Another way to more clearly reflect the income of holders of REMIC IOs would be to issue regulations under section 166 (which concerns deductions for bad debts). These rules might both determine when (prior to realization) a holder has sustained an economic loss and also allow a deduction for the loss under section 166.[5] Section 166(a) provides a deduction for any debt that becomes wholly or partially worthless during the taxable year. Indeed, some holders of REMIC IOs have claimed deductions for partial worthlessness under section 166(a)(2) and §1.166-3. The rules for determining worthlessness and partial worthlessness, however, were developed with reference to debts that become worthless or partially worthless because of the issuer's anticipated failure ever to make required payments, not because certain contingencies (such as rapid prepayments) have reduced the amounts required to be paid. Thus the existing regulations under section 166 focus on whether a debt instrument is uncollectible and cannot be fully satisfied

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[5]Section 165(g) allows a deduction for losses on worthless "securities," as defined in section 165(g)(2)(C). REMIC regular interests, however, fall outside this definition, because they are not issued by a government, a political subdivision, or a corporation. (Under section 860A(a), a REMIC is not treated as a corporation.)

through foreclosure on collateral. See, for example, §§1.166-2
and 1.166-6. By contrast, the existence of Negative OID for a
REMIC IO is evidence that the amounts contractually owed under
the terms of the instrument are being reduced, not that the
holder cannot collect whatever amounts are so owed.

Comments are invited regarding (1) whether, in the
absence of any default by the issuer, the policy underlying the
allowance of a deduction for worthlessness and partial
worthlessness should be extended to a change in the amount that
the issuer is required to pay, and (2) whether any rule allowing
a deduction under section 166 can be extended to, or combined
with, rules respecting corresponding income inclusions for
REMICs and the timing of the inclusions.

ALTERNATIVE PROPOSAL SPECIFIC TO REMIC IOS AND SIMILAR
INSTRUMENTS

The foregoing discussion attempts to provide a method
for recognizing interest income and deduction from a REMIC IO by
altering an existing method applicable to traditional debt
instruments. Although it may be possible to alter an existing
method, doing so is difficult because existing methods are
designed to apply to debt and a REMIC IO is unlike most debt.
Furthermore, as previously indicated, altering an existing
method often leads to collateral problems that must be
addressed. Therefore, an alternative method created especially

for REMIC IOs, and similar instruments, may better reflect the income and deductions for these instruments.

Economically a holder of a REMIC IO (like other investors) has invested cash in an instrument and expects to receive cash flows from that investment. What is distinctive about a REMIC IO is that the amount and duration of the cash flows are unknown at the time of making the investment. Given the economics of the REMIC IO, a method for distinguishing between receipt of income and recovery of the amount originally invested could be based on the projected (but uncertain) cash flows under the instrument and not on the expectation of a fixed return. The following method attempts to achieve that objective.

First, the holder of a REMIC IO would include payments made on the REMIC IO in income as they are received. The holder would then be allowed an offset to any payments included in income for the period. The offset would be equal to an amount that bears the same ratio to the investment as the payments for the period bears to the total expected payments (based on a prepayment speed assumption). The total expected payments would be calculated each period taking into account both an updated prepayment-speed assumption and any payments made on the REMIC IO. For this purpose, the investment is the total investment cost (i.e., the issue price).

Offset Formula: Offset = Investment ✘ <u>Payments for period</u>
                                         Total expected payments

At the maturity of the IO, and perhaps at earlier times, a look-
back regime may be appropriate to correct any under- or over-
accrual of interest. See section 167(g)(2).

For an example of this method, see the appendix.

Comments are requested on two aspects of this IO-
specific method in particular. First, can a variation of the
method be applied to determine appropriate interest deductions
for the REMIC? Second, in the typical REMIC IO, cash-flows
start high and then decline to zero. For these instruments, the
new method may clearly reflect income. One of the method's
weaknesses, however, is that, unlike OID accrual generally, the
method does not accrue OID prior to the receipt of the cash
representing the OID. An issue exists as to what regime should
apply if the application of existing regulations to tiered
structures produces REMIC IOs the cash flows on which are not
expected to begin until well after the issue date.

SECONDARY-MARKET PURCHASERS

Unlike initial purchasers, taxpayers who acquire REMIC
regular interests subsequent to issue may have to take into
account not merely accruals of OID but a combination of OID and
market discount or a combination of OID and acquisition premium.
As discussed above, the issues concerning OID accruals and the

possible recognition of Negative OID require separate

consideration with respect to secondary-market acquisitions.

The IRS and Treasury are considering alternative rules

for the accrual of market discount attributable to REMIC IOs.

One possible rule is to require accruals under a formula similar

to the PAC method, including the use of a prepayment assumption

and discount rate that remain static. However, instead of the

projected prepayment speed and the projected yield to maturity

being fixed as of the date on which the REMIC issues all of its

regular interests, they would be fixed for a subsequently

acquired REMIC IO at the time of the acquisition. Essentially a

holder of a REMIC IO would apply the same methodology regardless

of whether its acquisition was on the issue date (with the

holder calculating OID based on estimates that were fixed on

that date) or on a subsequent date (with the holder calculating

market discount based on estimates that were fixed on the

subsequent acquisition date).

If the amount of market discount is based on the

revised issue price, as provided in section 1276(a)(2) and (4),

the rules will need to integrate accrual of market discount

(which will be specific to each holder) and accrual of OID

(which will be the same for all holders). If the amount of

market discount is based on remaining SRPM at the time of

acquisition, accrual of the market discount will be a substitute

for any OID accrual. In either case, a holder with any market

discount will need substantial amounts of individualized data

from the REMIC servicer. Comments are requested as to the REMIC

servicer's ability to provide the necessary individualized data.

It would be possible to revise the rules for accrual

of market discount without adopting a rule recognizing Negative

OID. As described above, however, if this recognition is

permitted generally and is made available to secondary-market

purchasers as well as initial purchasers, additional questions

will be presented for secondary-market purchasers. These would

include whether the amount of market discount should be

redetermined and, if so, what the effect of that determination

would be on collateral consequences of market discount such as

the deferral of interest deductions under section 1277. One

possibility would be to condition the recognition of Negative

OID for secondary-market purchasers on an election by the holder

to be taxable under the OID rules on both OID and market

discount or premium. (See the election under §1.1272-3.)

NEGATIVE YIELD INSTRUMENTS

The IRS and Treasury are aware that there are some

REMIC IOs for which the prepayment speed that the servicer

projected at the pricing date produces a projected negative

yield. Arms-length investors do not voluntarily enter

transactions with anticipated negative yields. Rather, such an

investor may subjectively anticipate a different prepayment speed, or the investor may be "making a bet" on the occurrence of a prepayment scenario with a rate of return that more than compensates for its low probability of occurring. Mathematically, "discounting" a cash flow at a negative yield produces a present value that is greater than the sum of the future values of the cash flow. Unmodified application of the PAC method would therefore be unreasonable because it would require the holder to include amounts in income that are based on unrealistically high deemed present values of future cash flows. Comments are requested on whether the PAC method should be altered by requiring the use of a discount rate that is no less than an economically reasonable discount rate or whether some other adjustment would be more appropriate.

REQUEST FOR COMMENTS

        The IRS and Treasury request comments on the desirability of adopting special rules for taxing REMIC IOs, high-yield REMIC regular interests, and apparent negative-yield instruments, and whether those special rules should also be applied to other similar instruments (including how to identify such similar instruments). Comments and suggestions are also requested regarding possible approaches to what additional special rules may be desirable, including the possible recognition of Negative OID, the formulation of special

guidelines for the application of section 166 to REMIC IOs and similar instruments, and the adoption of a new alternative method applicable to REMIC IOs and similar instruments.

Persons providing comments may want to consider, among other things, the following questions. Should recognition of Negative OID be limited to prior inclusions of OID, to prior inclusions of OID and market discount, or to some other amount? If any limit is imposed, should the limit apply to all holders or only to those who do not acquire their interests at original issue? If recognition of Negative OID by initial purchasers is limited to prior OID inclusions, should recognition of Negative OID be permitted for secondary-market purchasers to the extent of prior market discount inclusions as well as OID inclusions? If recognition of Negative OID is unlimited for initial purchasers, should it be limited for secondary-market purchasers? Should recognition of Negative OID for secondary-market purchasers result in a redetermination of a purchaser's market discount and, if so, should the redetermination affect the application of the interest deferral provisions in section 1277? Alternatively, is the situation addressed adequately by currently recognizing both Negative OID and currently accruing market discount? Should recognition of Negative OID by

secondary-market purchasers be conditioned on an election to treat all discount and premium on the instrument as OID?

Acting Deputy Commissioner for Services and Enforcement.

APPENDIX

Examples

Issue Price $8.97   Expected Yield 8.455%

Expected Cash Flows:
Year 0   (8.97)
Year 1   5.00
Year 2   2.50
Year 3   1.50
Year 4   1.00
Year 5   0.50

If pays as expected:

End AIP	Payments	Beg. AIP	OID
4.73	5.00	8.97	.76
2.63	2.50	4.73	.40
1.35	1.50	2.63	.22
0.46	1.00	1.35	.11
0	0.50	0.46	.04
			1.53

          Actual Yield 8.455%

If pays faster than expected:

End AIP	Payments	Beg. AIP	OID
1.89	5.00	8.97	(1.11)
1.05	1.00	2.86	(0.35)
0.54	0.60	1.50	(0.19)
0.18	0.40	0.72	(0.09)
0	0.20	0.23	(0.03)
			(1.77)

          Actual Yield -12.397%

Holder's OID Income under Current Rules (w/ Negative OID prohibition):

Year 1   0
Year 2   0
Year 3   0
Year 4   0
Year 5   0
1.77 loss at maturity

Holder's OID income under Proposal allowing Negative OID:

Year 1   (2.08)loss
Year 2   0.16
Year 3   0.09
Year 4   0.05
Year 5   0.02
Overall income (1.77)

ALTERNATIVE METHOD EXAMPLE

Examples:

Investment/Issue Price $8.97   Expected Yield 8.455%

Total expected return: $10.50

Example 1
Expected Cash Flows:
Year 0   (8.97)
Year 1   5.00
Year 2   2.50
Year 3   1.50
Year 4   1.00
Year 5   0.50

(Offset amounts in bold.)
Year 1
payments for year/total expected payments =
5/10.5 = .47
ratio multiplied by investment =
.47(8.97) = **4.27**
Year 2
2.5/10.5 = .23
.23(8.97) = **2.14**
Year 3
1.5/10.5 = .143
.143(8.97) = **1.28**
Year 4
1/10.5 = .095
.095(8.97) = **.85**
Year 5
.5/10.5 = .047
.047(8.97) = **.43**

[4.27 + 2.14 + 1.28 + .85 + .43 = 8.97]

Example 2
If the expected return is not updated, the holder won't recover
its investment.

Actual Cash Flows:
Year 0   (8.97)
Year 1   5.00
Year 2   1.00
Year 3   0.60
Year 4   0.40
Year 5   0.20

Year 1
5/10.5 = .48
.48(8.97) = **4.27**
Year 2
1/10.5 = .095
.095(8.97) = **.85**
Year 3
.6/10.5 = .06
.06(8.97) = **.51**
Year 4
.4/10.5 = .04
.04(8.97) = **.34**
Year 5
.2/10.5 = .02
.02(8.97) = **.17**
[4.27 + .85 + .51 + .34 + .17 = 6.14]

Example 3

If you update the expected return after year 1:

Actual Cash Flows:
Year 0   (8.97)
Year 1   5.00
Year 2   1.00
Year 3   0.60
Year 4   0.40
Year 5   0.20

Year 1
5/10.5 = .48
.48(8.97) = **4.27**
After year 1, total expected return is 7.20 (5+1+.6+.4+.2):

Year 2
1/7.2 = .14
.14(8.97) = **1.25**
Year 3
.6/7.2 = .08
.08(8.97) = **.75**
Year 4
.4/7.2 = .06
.06(8.97) = **.50**
Year 5
.2/7.2 = .03
.03(8.97) = **.25**
[4.27 + 1.25 + .75 + .50 + .25 = 7.02]

If the holder recalculates Year 1, using the new total expected

return ((5/7.2)(8.97)) = 6.23), and takes into account the

difference between that amount (6.23) and the amount calculated

using the original expected return (4.27), which equals 1.96,

the holder will recover its total investment.