NEW YORK STATE BAR ASSOCIATION

TAX SECTION

Report on REMIC IO Interests

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New York State Bar Association
Tax Section
Report on REMIC IO Interests[*]

I.   Introduction.

This report responds to Announcement 2004-75,[1] which requests comments on the proper timing and character of income, gain, loss, and deduction for holders and issuers of "interest only" interests subject to prepayment risk (whether issued by a "real estate mortgage investment conduit" (a "REMIC") or other entity).

A.   IO Interests.

Under the original REMIC legislation enacted in 1986, a REMIC regular interest was prohibited from paying interest that was disproportionately high compared to its principal amount.[2] In 1988, Congress permitted REMIC regular interests to pay high-coupon interest so long as the interest payments could be expressed as a nonvarying "specified portion" of the interest payments on the underlying mortgages. This change permitted "interest only" regular interests ("IOs"). An IO provides for no (or only a nominal amount of) stated principal, and pays the holder a specified portion of the interest on each mortgage held by the REMIC. Because

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[*]   This report was drafted by an ad hoc committee consisting of Charles M. Adelman, Micah Bloomfeld, Susan Cohen, Robert Davis, Steven Kopp, David S. Miller, Charles Morgan, David Z. Nirenberg, Deirdre O'Connor Quinn, James M. Peaslee, Andrew Walker, and Karen Walny. The principal draftsperson was David S. Miller with substantial assistance from Karen Walny and James M. Peaslee. The committee is grateful to Milton Miyashiro for his modeling assistance. Helpful comments were received from Micah Bloomfeld and Michael Schler.

[1]   Announcement 2004-75, 2004-40 I.R.B. 580. Announcement 2004-75 supercedes a similar notice issued on August 24, 2004.

[2]   See H.R. Rep. 99-841 99th Cong., 2d ("1986 Conference Report") at II-239.

most residential mortgages permit prepayment without penalty, an IO holder will purchase an IO for a price that reflects an estimate of the rate of defaults and prepayments on the underlying mortgages. The slower the rate of prepayments (and defaults), the higher the return for an IO holder. Conversely, the faster the rate of prepayments (and defaults), the lower the IO holder's return. Significantly, because an IO typically does not provide for stated principal, faster than expected prepayments may produce a negative return (i.e., the holder will suffer a loss).[3]

Under section 860B(a), REMIC regular interests are treated as debt instruments.[4] Therefore, IOs are unique: they are treated as debt instruments for federal income tax purposes even though they are not "principal protected."

B.   The PAC Method.

Holders of REMIC regular (and residual) interests account for their interests under the "prepayment assumption catch-up" ("PAC") method.[5] Under this method, the REMIC first applies a prepayment assumption to project the rate at which its mortgages will prepay. This assumption produces an estimate of cash flows on its regular interests. Then a yield to maturity is calculated for each regular interest based on the original purchase price and these projected cash flows. In each accrual period, each REMIC regular interest holder (including IO holders), and the REMIC residual holder, accrue OID equal to:

> 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

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[3]   To illustrate the extreme example, assume that a holder pays $100 for an IO with no stated principal amount and immediately after the purchase, all of the mortgages held by the REMIC are prepaid. In this case, the IO holder would not be entitled to any payments on the IO and would suffer an economic loss of $100.

[4]   All references to section numbers are to the Internal Revenue Code of 1986, as amended, or the Treasury regulations issued thereunder.

[5]   The PAC method appears in section 1272(a)(6).

the period, determined by applying the original estimated yield to maturity of the debt instrument (i.e., the end-of-period present value) and (2) the payments during the accrual period that are included in the "stated redemption price at maturity"[6] over the adjusted issue price of the debt instrument at the beginning of the period.

Under the PAC method, the present value calculation (in clause (1)) reflects both past experience (because, as mortgages prepay, fewer remaining interest payments may be made) and future anticipated prepayments. However, under the PAC method, the original prepayment assumption and the discount rate for present valuing the remaining payments each remain static, even though actual expectations regarding the rate of future prepayments (and the appropriate discount rate) may in fact change. This requirement that OID accruals reflect a static prepayment assumption and discount rate was imposed for administrative reasons: the computation of prepayment rates requires an analysis of the prepayment rate on the specific pool of mortgage loans held by the REMIC, and then an allocation of the cash flows resulting from that prepayment rate among the various regular interests issued by the REMIC. This analysis and allocation is expensive and time consuming.

If prepayments on a REMIC's mortgages are faster than expected, the present value of future payments plus the current period's payments may be less than the adjusted issue price of the IO. The PAC method described in section 1272(a)(6) is, however, expressed in terms of the "excess" of the present value of future payments and the current period's payments "over" the adjusted issue price of the regular interest and therefore produces only positive numbers. This formulation was deliberate.

In 1986, when the REMIC legislation was enacted, IOs were not permitted. Therefore, an initial REMIC regular interest holder that purchased its interest with OID could not

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[6] For an IO, all payments are generally included in the stated redemption price at maturity (i.e., no payments are generally qualified stated interest).

suffer economic losses by reason of faster-than-expected prepayments. However, a holder who purchased its regular interest with OID could experience "negative amounts" under the PAC method if prepayments were slower than expected. In this case, the holder would overaccrue income in early years that the holder would receive in later years. In this circumstance, Congress intended that the regular interest holder should not be permitted to claim a deduction for the "negative amounts" under the PAC method; instead, Congress intended that the holder would not report OID inclusions and the REMIC would not claim a deduction until the PAC method again produced a positive number:

> 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.[7]

C.   The Technical and Miscellaneous Revenue Act of 1988.

As mentioned above, in 1988, Congress amended section 860G(a)(i)(B) to permit a REMIC regular interest to provide for interest that consists of a non-varying specified portion of the interest payments on qualified mortgages, even if the interest rate is disproportionately high compared to the regular interest's principal amount. However, there is no evidence that Congress appreciated that with this change, REMIC regular interests could experience an irreversible economic loss if prepayment speeds are faster than expected. Accordingly, Congress did not modify the PAC method.

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[7]   1986 Conference Report at II-239.

D. Market Discount and Premium on REMIC Regular Interests.

The legislative history of the Tax Reform Act of 1986 provides that accruals of market discount and amortizations of bond premium on obligations that are eligible to use the PAC method may be accrued or amortized using the original prepayment assumption.[8] However, treating an IO that is purchased at a price that is less than its adjusted issue price as purchased with market discount and then simply applying the rules that would apply to a traditional bond purchased with market discount produces inappropriate results.

For example, the legislative history to the 1986 Tax Reform Act contemplates that, in the absence of regulations, if the principal amount of a debt instrument issued with OID may be paid in two or more installments, the discount that accrues during an accrual period is determined by multiplying the total remaining amount of market discount 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.[9] If this fraction were applied to an IO for any period in which the PAC method produces a negative number, the accrual would be zero and the secondary market holder would not accrue any OID or market discount. Thus, applying the traditional market discount rules to an IO would understate economic income.

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[8] See 1986 Conference Report at II-842 ("In the case of debt instruments that would be subject to the OID rules contained in new Code sec. 1272(a)(6) (without regard to whether the debt instrument has original issue discount), the same prepayment assumption that would be made in computing OID would be made in computing the accrual of market discount (whether or not the taxpayer elects to accrue market discount on the basis of a constant interest rate). In addition, the conferees intend that the same rules that apply to the accrual of market discount on debt instruments whose principal is paid in more than one installment, also [are] applied in amortizing amortizable bond premium (within the meaning of sec. 171).").

[9] 1986 Conference Report at II-842.

It is equally inappropriate as an economic matter to require a secondary market holder that purchases an IO at a discount that is attributable to faster-than-expected prepayments to accrue the "discount" because the secondary market holder is not guaranteed any amount of principal, and the holder does not expect the discount to be earned.[10] In this case, requiring accrual of market discount would overstate economic income.

Section 171(b)(2) provides that, for taxable bonds, amortizable bond premium is equal to the difference between the holder's basis in the bond and the "amount payable on maturity (or if it results in a smaller amortizable bond premium attributable to the period to earlier call date, with reference to the amount payable on earlier call date)." Since IOs have no stated principal amount, they provide for no amount to be payable on maturity or an earlier call date. Therefore, IOs appear to satisfy the statutory definition of a bond acquired with amortizable bond premium. However, the existing regulations under section 171 do not apply to bonds described in section 1272(a)(6).[11]

E.   The 1996 NYSBA Report.

In 1996, the Tax Section wrote a report recommending that the IRS consider issuing regulations that would coordinate section 171 and section 1272(a)(6). The 1996 report suggested three alternative methods for accounting for IOs: the "premium amortization method," the "PAC method," and the "contingent interest method." However, the 1996 report did not

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[10] In this sense, an IO purchased at a discount is roughly analogous to distressed debt purchased at a discount where there is substantial certainty that the debtor will not repay the full outstanding principal amount of the debt.

[11] Treasury regulations section 1.171-1(b)(2). These regulations define amortizable bond premium by reference to the stated redemption price at maturity of the bond.   Under this definition, IOs would not be issued with amortizable bond premium. However, as mentioned above, regulations section 1.171-1(b)(2) does not apply to section 1272(a)(6) debt instruments. This topic is discussed below in Part III.B.2.

express a view as to which method was appropriate (or even whether these three methods were the only appropriate methods to account for IOs).

The 1996 report did recommend that holders of non-REMIC stripped coupons or stripped bonds created in a single securitization transaction aggregate them and account for them as if they were a single debt instrument that is subject to the PAC method. The 1996 report also recommended that the IRS consider providing rules under regulations section 1.1221-2 or 1.1275-6 to avoid timing and character mismatches for taxpayers that hold IOs (whether issued by a REMIC or by a non-REMIC) and enter into financial instruments to hedge prepayment risk with respect to the IOs.

F.   The Glick Case.

In Glick v. United States,[12] the taxpayers paid $12.3 million in 1992 for an IO with a stated principal amount of $0.4 million. The prospectus for the IO indicated that, if the IO did in fact prepay in accordance with the prepayment assumption, the taxpayer's yield to maturity would be 7.92%. On this basis, the taxpayers apparently thought they were purchasing a "conservative investment." They were wrong. Prepayment speeds were much faster than expected and the taxpayers received only $3.4 million in 1992, $3.5 million in 1993, and $0.7 in 1994 (for a total of $7.6 million). Thus, the taxpayers lost $4.7 million, or close to 40%, of their investment.

The taxpayers claimed amortizable bond premium deductions under section 171 equal to the negative numbers produced under the PAC method. The IRS challenged these deductions, arguing that the taxpayers' loss should be deferred until 1994 (the year of retirement) and reported as a capital loss at that time.

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[12]   96 F.Supp. 2d 850 (S.D. Ind. 2000).

The court decided the case by first asking whether the IO was purchased at a premium or issued with OID, but resolved this question not by reference to the statutory and regulatory definitions but, instead, by "[e]xamining the economic reality of the transaction." Since the taxpayers (erroneously, as it turns out) thought they were purchasing a "conservative investment" and "didn't want to take a significant amount of risk," the court held that:

> the [IO] was intended [by the taxpayer] to be a debt instrument bearing 8% interest [on a purchase price of $12.3 million], not a debt instrument valued at $362,000 and bearing 1006% interest . . . Stated otherwise, we reject the Glick's contention that the [IO] was an instrument issued at an extremely high premium relative to the $362,000 "principal" and that §171 should be applied to determine the Glick's tax obligation on the [IO].[13]

Having determined that the IO was not issued at a premium, the court held that the IO was issued with OID, and applied the legislative history to section 1272(a)(6) to conclude that no deductions were permissible for negative amounts determined under the PAC method. Thus, the taxpayers were denied any deduction until maturity and, at that time, the loss was treated as a capital loss.

G.   Announcement 2004-75.

On October 4, 2004, the IRS issued Announcement 2004-75, which indicates that the IRS and the Treasury Department are considering a regulation that would permit IO holders to claim "negative OID deductions" (for negative amounts under the PAC method) and require the REMIC residual holders to accrue and recognize income from negative OID.

Second, Announcement 2004-75 requests comments as to whether section 166 bad debt deductions should be available for IOs that prepay more rapidly than expected. Third, Announcement 2004-75 suggests an "alternative" method to account for IOs issued by REMICs

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[13]   96 F.Supp. 2d at 868-69.

and other issuers based on the income forecast method of accounting. (This method is described below in Part III.D.5.) Fourth, Announcement 2004-75 requests comments on the proper treatment of secondary market purchasers of IOs. And, finally, Announcement 2004-75 requests comments on "negative yield instruments."[14]

II.   Summary of Recommendations.

1.   We recommend that the IRS issue regulations that permit holders of REMIC regular interests to deduct negative amounts under the PAC method and require holders of REMIC residual interests to include equal amounts of taxable income. We would treat the deductions by the holder as amortizable bond premium and the inclusions by the residual holders as bond issuance premium, and we would permit taxpayers to claim worthless debt deductions under section 166 only for losses that are attributable to defaults (and we would not permit section 166 losses in respect of faster-than-expected prepayments).

However, there are differing views within the Committee whether the deductions and inclusions should be limited or unlimited. Some members believe that a regular interest holder's deductions should be limited to the holder's prior inclusions; if the net negative amounts exceed the holder's prior inclusions, the holder should be permitted to carry forward the excess negative amounts to offset future inclusions, and any remaining negative amounts would reduce the holder's amount realized at maturity or an earlier sale. The residual holders' treatment would be symmetric: they would report ordinary income equal to the negative amounts under the PAC method with respect to a regular interest to the extent of prior deductions on the regular interest

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[14]   A negative yield instrument is an IO that, based on the prepayment assumption and the issue price, would produce a loss for the holder (i.e., the future cash flows are less than the purchase price). These instruments are discussed below in Part IV.

and, if the negative amounts exceed the residual holder's prior deductions, the residual holder would reduce future deductions on the regular interest by the excess.

Other members believe that the regular interest holders' deductions and residual holders' inclusions should not be so limited (at least until the holder's basis in, or the adjusted issue price of, any regular interest is equal to its outstanding principal balance). Under this method, REMIC regular interest holders would claim amortizable bond premium deductions equal to the negative amounts under the PAC method, even if these amounts exceed prior inclusions, and residual holders would report equal amounts as taxable income.

The division is a philosophical one. The Committee agrees that permitting unlimited deductions and requiring unlimited inclusions for negative amounts under the PAC method is a more accurate measure of economic loss and gain than limited deductions and inclusions, and full deductions and inclusions would be consistent with the timing regime that Congress established under section 1272(a)(6). However, those of us who believe that regular interest holders' losses should be limited are concerned that permitting holders unlimited ordinary deductions for negative amounts under the PAC method would be inconsistent with the treatment of most financial instruments where losses in excess of prior income inclusions are deferred until the holder sells or exchanges the instrument, and that unlimited deductions would permit holders whose regular interests experience slower-than-expected prepayments (and appreciate in value) to sell their regular interests at preferential capital gains rates, and holders whose regular interests experience faster-than-expected prepayments to retain their regular interests and claim ordinary losses.

In any event, the Committee agrees that the regulations should permit regular interest holders an additional loss in (and require the residual holders to include as additional

ordinary income) an amount equal to any difference between the regular interest holder's basis (or, in the case of the residual holders, the adjusted issue price) and all payments required to be made on the regular interest under the PAC method, based on a zero prepayment speed. There is, however, some disagreement within the Committee as to whether the regular interest holders' losses should be ordinary or capital.

2. We recommend that regulations provide that a secondary market holder of a REMIC regular interest whose issue price is more than 125% of its principal amount apply the PAC method with an adjustment that reflects the holder's purchase price. This adjustment could be accomplished by requiring the holder to apply the PAC method using the original prepayment assumption, but discounting future cash flows based on the yield calculated using the holder's actual purchase price, or requiring the holder to apply the PAC method based upon a new prepayment assumption that produces a yield equal to the original holder's yield. Alternatively, a secondary holder could be required to accrue market discount based on the fraction described in section 1276(b), except that the fraction would reflect the PAC method based upon a new prepayment assumption that produces a yield equal to the original holder's yield.

3. We recommend that regulations be issued that provide that if a regular interest would produce a yield under the PAC method that is less than the AFR, the REMIC should adjust the prepayment assumption or assumed interest rate with respect to that regular interest to produce a yield that is equal to the AFR. (The adjustment would apply only to that regular interest and would not affect the prepayment assumption or yield of the other regular interests.)

4.   We repeat our recommendation, last made in 1996, that regulations be issued that would permit taxpayers to integrate their section 1272(a)(6) securities with hedges of those securities under regulations section 1.1221-2, 1.446-4, and/or 1.1275-6. We also recommend that regulations permit taxpayers to treat their section 1272(a)(6) securities as hedges of other ordinary property or liabilities under regulations section 1.1221-2, 1.446-4, and/or 1.1275-6.

5.   Finally, we repeat our 1996 recommendation that bonds or coupons stripped from a portfolio of loans be subject to an "aggregation rule" and be treated as if they were a single debt instrument subject to the PAC method.

III.   The Taxation of IOs.

A.   Introduction.

There are many alternative methods that could be used to account for faster-than-expected prepayments on a REMIC regular interest that is issued for a price that is greater than its principal amount. These methods are described and discussed below. We believe that the first method, which we refer to as the "premium amortization method," is the most appropriate.

B.   The Premium Amortization Method.

1.   Overview. Under the "premium amortization method," all interest on a REMIC regular interest that does not literally satisfy the definition of qualified stated interest would be included in the regular interest's stated redemption price at maturity.[15] If the PAC

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[15]   The definition of qualified stated interest requires that the stated interest is unconditionally payable at least annually at a single fixed rate. Treasury regulations section 1.1273-1(c)(1)(i). It is questionable whether the "interest" on an IO with no (or nominal) stated

method produces a positive number in any year, an initial regular interest holder would report

OID income, and the REMIC would report OID expense. If the PAC method produces a

negative number in any year (i.e., the adjusted issue price of the regular interest exceeds the

present value of the remaining payments on the regular interest under the PAC method), an

initial regular interest holder would deduct amortizable bond premium,[16] and the REMIC

residual interest holders would include bond issuance premium.[17] However, in no case would a

regular holder be permitted to deduct an amount that would reduce the holder's tax basis below

the outstanding principal amount of the regular interest. Deductible amortizable bond premium

would reduce a regular interest holder's basis; bond issuance premium would reduce the regular

interest's adjusted issue price.

2. Regulatory Authority for the Premium Amortization Method.

The premium amortization method is similar to the "PAC Method Without Prohibition On

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principal constitutes interest at all and, in any event, the "interest" is not unconditionally payable.

The premium amortization method would have the greatest application to IOs, but would apply to all REMIC regular interests.

[16] Section 171(b) defines amortizable bond premium as the difference, if any, between the taxpayer's basis in a bond and "the amount payable at maturity (or if it results in a smaller amortizable bond premium attributable to the period to earlier call date, with reference to the amount payable on earlier call date)." The premium amortization method would be implemented by promulgating regulations that define "the amount payable on maturity (or if it results in a smaller amortizable bond premium attributable to the period of earlier call date, with reference to the amount payable on earlier call date)" with respect to a REMIC regular interest as the amount described in section 1272(a)(6)(A)(i).

Amortizable bond premium is deductible only if the taxpayer irrevocably elects to amortize the premium for all of the taxpayer's bonds. In the event that a taxpayer does not elect to amortize bond premium with respect to a regular interest, we would provide that the negative amount is not recognized until the sale or maturity of the regular interest, at which time the taxpayer would recognize a capital loss.

[17] See Treasury regulations section 1.163-13(d)(4).

Recognizing Negative OID" described in Announcement 2004-75.[18]   However, whereas Announcement 2004-75 would derive regulatory authority for this method from section 1275(d), which authorizes regulations to modify the tax treatment prescribed by sections 163(e) and 1271 through 1275, the premium amortization method derives its authority from section 171. We are concerned that if section 1275(d) is the sole basis for regulatory authority, REMIC residual interest holders that are required to report income when the PAC method produces a negative number would argue that, because section 1272(a)(6) produces only positive numbers,[19] the Treasury Department and the IRS do not have authority under section 1275(d) to require the REMIC residual interest holders to report income for "negative OID" under the PAC method.[20] We express no view as to whether this argument would succeed. However, for the following reasons, we believe that the Treasury Department and the IRS clearly have the authority to interpret "the amount payable at maturity" in section 171(b)(1) to mean "the amount described in section 1272(a)(6)(A)(i)," and to require a REMIC residual holder to include amounts under the PAC method in income under the authority of sections 61 and 163.[21]

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[18]   The premium amortization method is also similar to the "premium amortization method" described in the 1996 report. However, that method would have treated all interest on the IO as qualified stated interest and in certain circumstances would have produced a negative amount of premium amortization. We recommend the premium amortization method described in the text because interest on most IOs does not literally satisfy the definition of qualified stated interest in section 1273(a)(2). See footnote 15.

[19]   As mentioned above, section 1272(a)(6) provides that OID accrues in each year in an amount equal to "the excess (if any)" of the present value of the remaining payments based on the original prepayment assumption plus the current period's payments over the adjusted issue price. The word excess literally requires that the PAC method produce only positive amounts.

[20]   Section 1275(d) only authorizes regulations to carry out the purposes of the subpart. It is questionable whether regulations under section 1275(d) could provide for negative amounts under the PAC method when the statute mandates positive numbers.

[21]   See section 61(a) ("Except as otherwise provided in this subtitle, gross income means all income from whatever source derived, . . ."); Treasury regulations section 1.163-13(d)(4) ("If

First, the losses experienced by the holder of an IO (or other REMIC regular interest that is issued for a price that is greater than its principal amount) as a result of faster-than-expected prepayments are analogous to the losses experienced by the holder of a traditional premium bond that, contrary to expectations, receives a pro rata prepayment. In this case, regulations section 1.171-3(c)(5)(ii) permits the holder an immediate ordinary deduction reflecting the holder's economic loss.

Second, because IOs do not provide for principal, they are economically equivalent to other wasting assets that represent mere streams of income.[22] Permitting holders of these assets to claim ordinary amortization deductions would be consistent with the treatment of taxpayers that hold other wasting assets.[23]

Third, as a technical matter, IOs are issued with amortizable bond premium because IOs typically have zero or nominal stated principal, do not provide for amounts "payable at maturity" and, therefore, holders will typically have a basis in them in excess of all amounts payable at maturity.[24] We recognize that the regulations treat a traditional debt instrument as issued at a premium only if the purchase price exceeds the stated redemption price at maturity.[25]

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the bond issuance premium allocable to an accrual period exceeds the qualified stated interest allocable to the accrual period, the excess is treated as ordinary income by the issuer for the accrual period.").

[22] This statement is also true for other REMIC regular interests to the extent that the regular interest is issued for a price that is greater than its principal amount.

[23] See section 197 (holder of a section 197 intangible is generally entitled to amortize its cost over the remaining life of the instrument); Treasury regulations section 1.446-3(f)(2) (a taxpayer that makes an upfront payment under a swap may amortize that payment over the term of the swap).

[24] See section 171(b)(2).

[25] See Treasury regulations section 1.171-1(d)(1) ("A holder acquires a bond at a premium if the holder's basis in the bond immediately after its acquisition by the holder exceeds the sum of all amounts payable on the bond after the acquisition date (other than payments of

However, these regulations do not apply to section 1272(a)(6) debt instruments[26] and, because IOs do not guarantee interest or principal, denying holders their premium deductions on the theory that all payments are included in their stated redemption price at maturity would be inconsistent with the statutory language and the policy underlying section 171.[27]

Fourth, the legislative history to the 1986 Tax Reform Act provides that the amount of amortizable bond premium with respect to a REMIC regular interest should be determined using the same prepayment assumption that is used in computing original issue discount.[28] Although this legislative history was written before REMICs could issue IOs, we believe that it grants the Treasury Department and the IRS authority to apply section 1272(a)(6) concepts to section 171 with respect to regular interest holders and to require the residual holders to report an equal amount of income, and it would be consistent with this legislative history to treat any negative number under the PAC method as the amount of amortizable bond premium

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qualified stated interest)."); Treasury regulations section 1.1272-2(b)(2) ("A debt instrument is purchased at a premium if its adjusted basis immediately after its purchase by the holder (including a purchase at original issuance) exceeds the sum of all amounts payable on the instrument after the purchase date other than payments of qualified stated interest (as defined in §1.1273-1(c)."). The same reasoning applies to all regular interests whose stated redemption price at maturity exceeds their stated principal amount.

[26] See Treasury regulations section 1.171-1(b)(2)(i).

[27] The definition of stated redemption price at maturity in the OID rules was adopted so that the time value of the guaranteed payments under a debt instrument would be taxed as they accrue. In contrast, section 171 was intended to allow a holder who purchases a bond at a premium to deduct its economic loss in the event the bond is unexpectedly called, which describes the holder of an IO that experiences faster than expected prepayments.

[28] See 1986 Conference Report at II-842 ("In the case of debt instruments that would be subject to the OID rules contained in new Code sec. 1272(a)(6) (without regard to whether the debt instrument has original issue discount), the same prepayment assumption that would be made in computing OID would be made in computing the accrual of market discount (whether or not the taxpayer elects to accrue market discount on the basis of a constant interest rate). In addition, the conferees intend that the same rules that apply to the accrual of market discount on debt instruments whose principal is paid in more than one installment, also [are] applied in amortizing amortizable bond premium (within the meaning of sec. 171).").

(i.e., permit regular interest holders to deduct, and require residual interest holders to include, amounts based on the prepayment assumption, rather than assuming a zero prepayment assumption), even if the negative number arises after acquisition. Although the legislative history to the 1986 Tax Reform Act prohibits "negative amounts of OID," this prohibition is not violated by treating negative amounts under the PAC method as amortizable bond premium.

Finally, we do not believe that the Glick case presents any bar to the promulgation of regulations under sections 171, 61, and 163 that would treat negative amounts under the PAC method as amortizable bond premium and bond issuance premium. In Glick, the court accepted the IRS's assertion that an IO is issued either at a premium or with OID. In the absence of any regulations or other guidance, the court asked whether the taxpayers thought they were buying a risky investment (i.e., one that paid an interest rate of 1006% on a stated principal amount of $362,000 and was purchased at a premium) or a conservative one issued with OID that would yield 8.47% based on the original prepayment assumption. Having determined that the investors thought they were buying a conservative investment (even though they ultimately lost 40% of their investment), the court determined that the IO was issued with OID and then, in reliance on the legislative history to the 1986 Tax Reform Act, denied the taxpayers deductions in respect of the negative amounts. We believe that the result would have been different had regulations been promulgated treating negative amounts under the PAC method as amortizable bond premium.

We do note one oddity in applying the premium amortization method to IOs: In some periods (i.e., when the PAC method produces a positive number), the regular interest holder (and the REMIC residual holder) will accrue OID and in other periods (i.e., when the PAC method produces a negative number), the regular interest holder will accrue amortizable bond premium (and the REMIC residual holder will deduct bond issuance premium). Thus,

when the regular interest is acquired, no bond premium will exist but, as a result of prepayments, the bond premium may "spring" into existence. However, the statute does not bar "springing premium."

> **3. Reasons for Preferring the Premium Amortization Method.** There are several reasons to prefer the premium amortization method over the other methods described below. First, as mentioned above, we believe that there is clear regulatory authority for it. Second, it is consistent with the PAC method and would result in consistent treatment of all REMIC regular interests, regardless of whether they give rise to negative or positive numbers under the PAC method, and therefore this method does not require line drawing between an IO and a REMIC regular interest with a stated principal amount that is issued at a premium. As a result, the premium amortization method does not permit arbitrage or discontinuities between economically-similar interests. We recognize that the premium amortization method may permit holders to recognize losses that could be reversed in subsequent years, and we acknowledge that this treatment may be more favorable than for other securities. However, IOs (and other regular interests issued at a premium) are unique wasting assets and therefore comparisons with other securities may be inapposite. Second, "contingent payment debt instruments" – which might be viewed as a rough analogy – also permit deductions in some years that may be reversed in subsequent years.[29] Third, reversals of IO losses are rare; more likely, a negative number under

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[29] For example, assume that a CPDI is issued for $100, guarantees repayment of $100 in five years, and provides for contingent interest in each year equal to the increase, if any, in the value of the S&P 500 index. If, in the second year, the contingent payment is less than the scheduled payment, a holder would be entitled to a deduction up to the inclusion in year one, even though in later years the contingent payments may be greater than the scheduled amounts.

Also, sections 165(g) and 166 permit worthlessness deductions that may be reversed in subsequent periods.

the PAC method represents a real economic loss for the IO holder. In this case, because the original prepayment rate is fixed, if the faster prepayment rate represents a trend, the PAC method will not fully reflect the IO holder's loss. Fourth, this treatment mirrors the treatment for an IO holder that experiences slower-than-expected repayments (i.e., the holder may have greater-than-expected income in early years that is reversed by losses in subsequent years).And, finally, if the REMIC residual holder's treatment is symmetrical (see Parts III.C.4.a. and III.C.4.b., below), any deduction by the IO holder would be matched by income of the residual and PO holders.[30] In short, while the premium amortization method may not perfectly measure a holder's economic income or loss, because it is supported by clear regulatory authority, it reasonably reflects economic loss, it is administrable, and it is the regime most consistent with the regime that Congress prescribed for REMIC interests generally, we believe that it is the most appropriate regime to account for IOs.

4. **Variations on the Premium Amortization Method**. While we agree that the premium amortization method is the best method to account for REMIC regular interests, there are differing views within the Committee on the timing and character of the deductions that should be allowed to a REMIC regular interest holder that experiences greater than expected prepayments and the timing of the REMIC residual holder's corresponding inclusions.

a. **Regular Interest Holder's Ordinary Deductions Limited to Prior Inclusions; REMIC Residual Holder's Ordinary Inclusions Limited to**

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[30] In general and absent some market arbitrage, the economic loss recognized by an IO holder upon a faster than expected prepayment is matched by a gain to the PO holder. The residual holder stands in the middle: upon a faster-than-expected prepayment, the premium amortization method requires the residual holder to match its deduction in respect of the PO with income in respect of the IO.

Prior Deductions.   Under the first variation, a regular interest holder's ordinary deductions for amortizable bond premium on an IO or other regular interest would be limited to the holder's prior inclusions.[31]   Any amortizable bond premium in excess of a holder's prior inclusions would be carried forward indefinitely to offset future inclusions.[32]   Any unamortized bond premium upon a sale or maturity would give rise to a capital loss (or reduce capital gain).[33] A REMIC residual holder would report an amount of income equal to the deductions claimed by an initial regular interest holder (i.e., the REMIC residual holder would report income equal to the lesser of (x) the negative number under the PAC method and (y) the REMIC residual holder's prior deductions in respect of the regular interest).

This variation of the premium amortization method would generally conform the timing and character of the regular interest holder and the REMIC residual holder to the holder and issuer of a premium bond or a CPDI (including a coupon strip sold off of a single prepayable mortgage, if such a coupon is treated as a debt instrument and therefore as a CPDI).[34]

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[31]   Cf. Treasury regulations section 1.171-2(a)(4)(i)(A) ("...the amount treated as a bond premium deduction is limited to the amount by which the holder's total interest inclusions on the bond in prior accrual periods exceed the total amount treated by the holder as a bond premium deduction on the bond in prior accrual periods."); Treasury regulations section 1.1275-4(b)(6)(iii)(A) and (B).

[32]   Cf. Treasury regulations section 1.171-2(a)(4)(i)(B); Treasury regulations section 1.1275-4(b)(6)(iii)(C).

[33]   Cf. Treasury regulations section 1.171-2(a)(4)(i)(B); Treasury regulations section 1.1275-4(b)(6)(iii)(C).

[34]   Assume that a taxpayer purchases the right to receive all of the interest payments from a single mortgage that is prepayable without penalty. This taxpayer would not be subject to section 1272(a)(6) because the stripped coupon is not a regular interest in a REMIC, may not be accelerated by reason of prepayments of other obligations, and is not a pool of debt instruments. If this coupon is treated as a debt instrument for federal income tax purposes, see section 1286(a) (a stripped coupon is treated "as a bond"), then it would be treated as a CPDI. See Treasury regulations section 1.1275-4(a) (a CPDI is any debt instrument that is

First, in the case of the holder of a bond issued at a premium, the holder's bond premium deduction generally may be used to offset qualified stated interest for the current accrual period and then may be taken as an ordinary deduction only to the extent of the holder's total interest inclusion in prior accrual periods,[35] and the timing of the issuer's inclusions are symmetrical. Upon the sale or maturity of a premium bond, the holder generally reports solely capital gain or loss (even if there is unamortized bond premium), and upon the maturity of the premium bond, the issuer generally reports ordinary income to the extent of unincluded bond issuance premium.[36]

In the case of a CPDI, a holder's negative adjustment (i.e., the amount by which a contingent payment is less than the amount in the projected payment schedule) may be used to reduce interest for the current taxable year and then may be taken as an ordinary deduction only to the extent of the holder's prior net inclusions.[37] The issuer's treatment is symmetrical. Upon the sale or maturity of a CPDI, a holder's loss in excess of prior inclusions is treated as a capital loss; at maturity, the issuer's income is ordinary income.

Thus, for premium bonds and CPDIs, the holder is not generally entitled to a net deduction and the issuer is not required to report net inclusions on the instrument prior to maturity (or, in the case of the holder, a taxable sale or exchange). This variation of the premium amortization method would apply similar treatment to holders and issuers of regular interests.

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issued for money and provides for one or more contingent payments and is not specifically excepted).

[35]   Treasury regulations section 1.171-2(a)(4)(i).

[36]   See Treasury regulations section 1.163-13(d)(4)(ii) ("If a carryforward exists on the date the debt instrument is retired, the carryforward is treated as ordinary income on that date.").

[37]   Treasury regulations section 1.1275-4(b)(5)(iii).

In addition, this variation of the premium amortization method would conform the character treatment of a regular interest holder that retains its regular interest to the treatment of a regular interest holder that sells prior to maturity – in each case, all net gain or loss would be treated as capital gain or loss.

However, the timing and character of a regular interest holder under this approach would be less favorable than the treatment of the holder of a premium bond that provides for an alternative payment schedule and is redeemed sooner than expected. Under regulations section 1.171-3(c), if a holder purchases a bond at a premium and the bond provides for an alternative payment schedule that is significantly more likely than not to occur, the holder uses that payment schedule to determine and amortize its bond premium. However, if the issuer calls the bond or a pro rata portion of the bond prior to the expected maturity date, the holder is permitted to claim an ordinary deduction equal to the difference between the holder's basis in the portion of the bond and the greater of (A) the amount received on redemption and (B) the amount that would have been payable under the bond if no change in circumstances had occurred.[38]

Arguably, such a premium bond is directly analogous to an IO where the prepayment speed is faster than expected and a pro rata portion of the bond is called early. On the other hand, the regulations provide that this rule applies only where a particular schedule is significantly more likely to occur than any other. Although REMIC sponsors estimate the

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[38]   Treasury regulations 1.171-3(c)(5).

Thus, assume that a bond is issued for 130 and has a stated principal amount of 100. The bond provides that if the issuer experiences dramatically lower than expected earnings, the issuer may call the bond early at par. However, it is significantly more likely than not that the bond will remain outstanding until its maturity. Nevertheless, contrary to this expectation, the issuer calls the bond when the holder's basis is 125. Under regulations section 1.171-3(c), the holder is entitled to an ordinary deduction of 25.

prepayment speed for purposes of applying the PAC method, any particular prepayment estimate is not "significantly more likely than not to occur" than another and so the rule arguably is not relevant for IO interests. In addition, although regulations section 1.171-3(c)(5) permits a holder an ordinary deduction, it would appear more consistent with the treatment of debt instruments generally if the holder's loss on a premium bond in excess of prior inclusions were capital in nature, regardless of whether the holder sells prior to redemption or is redeemed early.[39]

We recommend that if this variation of the premium amortization method is adopted, it apply to all REMIC regular interests. We recognize that a deduction for negative amounts under the PAC method for these interests arguably conflicts with the legislative history to section 1272(a)(6). However, because any deduction would be limited to prior inclusions, holders of regular interests would not be claiming net losses, and because holders' deductions are limited to the amount that would reduce their basis to the outstanding principal of the regular interest, a holder could not claim a loss for an amount that is guaranteed to be received at maturity. Moreover, if REMICs did not apply this method to all REMIC regular interests, REMIC residual holders would defer their reversals of over-deductions. Finally, we believe that a seamless single accounting method is preferable than one regime for some regular interests and another for others.

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[39] Compare section 1271 ("Amounts received by the holder on retirement of any debt instrument shall be considered as amounts received in exchange therefore"); section 1234A (gain or loss attributable to the cancellation, lapse, expiration or other termination of a right or obligation with respect to a capital asset is treated as gain or loss from the sale of a capital asset); cf. Committee Report on the Economic Recovery Tax Act of 1981 (enacting section 1234A) ("The committee considers this ordinary loss treatment inappropriate if the transaction, such as settlement of a contract to deliver a capital asset, is economically equivalent to a sale or exchange of the contract... In order to insure that gains and losses from transactions equivalent to the sale or exchange of a capital asset obtain similar treatment, the bill adds a new section 1234A....").

We would permit a regular interest holder to claim a capital loss (and we would require the residual holders to report ordinary income) to the extent that the regular interest holder's basis (or, in the case of the REMIC residual holder, the adjusted issue price of the regular interest) exceeds all payments required to be made on the regular interest, based on a zero prepayment assumption, even if this loss (or, for the REMIC residual holder, income) exceeds prior inclusions (or deductions) on the regular interest.

We recognize that, under this approach, a holder would be permitted to claim a loss in the absence of a "sale or exchange."[40] However, we believe that a loss under these circumstances is appropriate because this amount of loss is a true economic loss that is determinable with reasonable certainty.[41] Although section 165(g) and regulations section 1.165-5(b) permits a deduction only for a "wholly worthless" security, section 165(g) does not apply to REMIC regular interests because REMIC regular interests are not issued by a corporation or a government.[42]

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[40] We also note that if the holder may claim a loss based on a zero prepayment assumption, the holder's treatment may be more favorable then the holder of a CPDI because the holder of a CPDI may never claim a loss in excess of prior inclusions before maturity or an earlier sale.

[41] Cf. Treasury regulations section 1.165-1(b) ("To be allowable as a deduction under section 165(a), a loss must be evidenced by closed and completed transactions, fixed by identifiable events and, . . . , actually sustained during the taxable year.").

We considered an alternative method under which a capital loss would be permitted in excess of prior inclusions only based on a zero prepayment assumption and a zero discount rate. This method would assure that the loss could not reverse in subsequent periods (and therefore would be consistent with the legislative history to section 1272(a)(6)). It would not accurately reflect the holder's economic loss and is inconsistent with the structure of the PAC method, which determines taxable income and loss on a present value basis.

[42] See section 165(g)(2)(C) ("a bond, debenture, note or certificate, or other evidence of indebtedness…issued…by a…corporation or by a government or political subdivision thereof"). REMICs are not corporations for tax purposes. See section 860A(a) ("Except as otherwise provided in this part, a REMIC shall not be treated as a corporation . . . ").

We considered whether a regular interest holder should be permitted to claim a loss under section 166 in the absence of a default by the REMIC or the issuers of the debt instruments underlying the regular interest, and whether section 166 should limit a regular interest holder's loss.[43] While a technical argument could be made that section 166 applies to regular interests,[44] we do not believe Congress intended that taxpayers should be permitted to claim losses under section 166 that are attributable to faster-than-expected prepayments, and we cannot articulate any tax policy that would permit a corporate taxpayer that holds the regular interest as an investment to claim an ordinary loss in respect of faster-than-expected prepayments.[45] Equally, we cannot articulate any sound tax policy to deny a noncorporate taxpayer that purchases a regular interest as an investment a deduction equal to its economic loss based on a zero prepayment assumption merely because the loss is only "partial." Therefore, we would limit section 166 to losses attributable to a default by the REMIC or the issuers of the debt instruments underlying the section 1272(a)(6) instrument.

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[43] Section 166 permits a corporation or a noncorporate taxpayer that acquires a debt instrument in the ordinary course of business to claim an ordinary worthless debt deduction if the instrument becomes wholly worthless, or a partial worthless debt deduction to the extent the instrument is written off on a corporate taxpayer's books. Noncorporate taxpayers are permitted only a short-term capital loss for their nonbusiness bad debts and only when the debt is wholly worthless; no partial bad debt deduction is permitted for a noncorporate taxpayer's nonbusiness bad debt deduction.

[44] As mentioned above, corporate taxpayers are permitted deductions for partially worthless debts under section 166. An IO is treated as debt for tax purposes, and if an IO prepays faster than expected, and the corporate holder does not expect to recover its basis, the taxpayer could take the position that the IO is partially worthless and the corporate holder is entitled to an ordinary loss under section 166(a).

[45] Cf. section 165(g)(1) (a taxpayer holding a security that is a capital asset is allowed a capital loss if the security becomes wholly worthless).

b. **Regular Interest Holder's Ordinary Deductions and REMIC Residual Holder's Ordinary Inclusions Not Limited to Prior Inclusions**. Under the second variation of the premium amortization method, a regular interest holder would be entitled to a full deduction for any negative amounts under the PAC method without limitation; REMIC residual holders would report an equal amount of income.[46] If this method is adopted, it would be reasonable to require secondary market holders to report any market discount currently if they wish to claim deductions for negative amounts under the PAC method.[47]

There are several reasons one might prefer this variation. First, REMIC residual holders should be required to include the entire negative amount under the PAC method and should not be permitted to defer inclusions of amounts in excess of prior deductions because it is unlikely that these "excess" negative amounts will reverse in subsequent years.

Second, if a REMIC residual holder is not required to include the full negative amount under the PAC method, REMICs will issue interests to minimize their inclusions and sell them as units with POs that are expected to be held together but can be separately assigned. These units will be sold to foreigners who would not be subject to U.S. taxation and therefore would not be affected by the limitations on deductibility of negative OID.

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[46] If this variation is adopted, we recommend that it apply to all regular interests that are issued at a premium to their stated principal amount, and not only IOs. Although a regular interest holder could claim a deduction for an amount that may be reversed in part due to slower-than-expected repayments, by limiting deductions to that amount that would reduce the holder's basis to the outstanding principal amount, holders will not be permitted to claim deductions for amounts that are certain to be reversed, which appears to have been the policy underlying the legislative history to the 1986 Tax Reform Act.

[47] If the first variation is adopted, no special rule would be required for secondary market holders.

Third, requiring full inclusion for the REMIC's residual holders and a full deduction for the regular interest holders equal to the negative amounts under the PAC method is consistent with the treatment of the issuer and holder of a premium bond that, contrary to expectations, receives a pro rata prepayment and would permit relatively consistent treatment between the two analogous types of debt instruments.[48]

Fourth, this treatment best measures the regular interest holder's and residual holder's economic income consistent with the PAC method. In most cases, prepayment rates in excess of the original prepayment assumption represent a real economic loss of future cash flow. Although it is possible for some reversal of a regular interest holder's loss to occur if subsequent prepayments are significantly less than the original prepayment assumption, shifts of this type are extremely unusual in practice and unlikely to result in any meaningful overdeduction. (And, as indicated below, any overdeduction by the regular interest holder is matched by an overinclusion by the REMIC residual holder.)

Fifth, the treatment of the regular interest holder would be analogous to the treatment of other wasting assets that represent streams of income. For example, the purchaser of a patent (representing a stream of royalty payments) or a section 197 intangible is generally entitled to amortize the cost over the remaining life of the asset, regardless of whether that cost exceeds the income generated by the amortizable asset. (Similarly, a taxpayer that makes an upfront payment under an interest rate swap is generally entitled to amortize the upfront payment over the term of the swap, even if the amortization exceeds the taxpayer's net inclusions.) Even

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[48] See Treasury regulations section 1.171-3(c)(5)(ii).

though regular interests are treated as debt instruments, if they are issued at a premium the absence of any principal protection makes them most analogous to a wasting asset.[49]

Sixth, the timing of the holder's deductions would be roughly analogous to the treatment under current law of a taxpayer who holds interest-only strips off of every mortgage in a pool of mortgages held by a grantor trust. As a mortgage prepays in its entirety, the holder would generally be entitled to an immediate loss or deduction under section 165 for the portion of its basis allocable to that mortgage.[50]

Seventh, a current ordinary loss for an IO holder (and a current ordinary inclusion for the REMIC residual holders) is consistent and symmetrical with the treatment when the prepayment speed is slower than expected. In each case, the IO holder reports immediate ordinary income and the residual holder claims an ordinary deduction (even though the prepayment speed may accelerate and reverse the income/deduction).

Finally, this method (full inclusion for the residual holder/full deduction for the REMIC residual holder) should, if anything, tend to increase revenues because it imposes symmetrical treatment on regular interest holders and residual holders and, while regular interests may be held by foreigners who cannot claim the full amount of the deduction for negative OID, REMIC residual holders are generally held by taxpayers (and, in any event, excess inclusion income is almost always taxable in all events).

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[49] We acknowledge that the amortization for patents and section 197 intangibles is ordinary because they are used in a trade or business. In contrast, regular interests are typically held as investments. However, section 166 permits corporations an ordinary deduction for bad debt deductions, and negative numbers under the PAC method are analogous.

[50] The loss would be capital. See section 1271(a) (amounts received in retirement of a debt instrument are treated as received in exchange for the debt instrument).

C.   **Secondary Market Holders.**

As mentioned above, it would be improper to apply the market discount rules to IOs and other regular interests that are issued for a price that is significantly greater than their principal amount. Instead, we believe that a different regime should apply to secondary market purchasers of a section 1272(a)(6) debt instrument whose issue price is more than 125% of its principal amount.[51] We recommend that regulations provide that secondary market holders of these REMIC regular interests apply the PAC method (including the premium amortization method) with an adjustment that reflects their purchase price.

Under one method, the secondary market holder's purchase price and the expected future cash flows based on the original prepayment assumption would be used to compute a purchase yield. The sponsor would provide the information to permit the holder to determine its purchase yield.[52] If this purchase yield is less than the applicable federal rate, the future anticipated cash flows would be adjusted upwards on a pro rata basis to produce the applicable federal rate.[53]

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[51] Cf. Treasury regulations section 1.860G-2(b)(5).

[52] For administrative convenience, the sponsor could be required to produce a table for sales occurring in the prior month that lists purchase prices at specified increments (say, 5% or 10% increments) of the adjusted issue price of the regular interest and the corresponding purchase yield. So, for example, the left hand side of the table would list a variety of purchase prices at increments of 5% of the adjusted issue price of the regular interest and the right hand side of the table would list purchase yields. The holder would find the purchase price on the table that is closest to (but not less than) the holder's purchase price and would record the holder's purchase yield.

[53] This adjustment corresponds to the adjustment we recommend for "negative yield" IOs. See Part IV.

Under this method, the difference between (x) any positive number computed under the "adjusted PAC method" (i.e., the PAC method that uses the secondary holder's purchase yield), and (y) any positive number under the "original PAC method" (i.e., the PAC method that uses the original yield), or zero if the original yield would produce a negative number, would be treated as market discount. The sponsor of the REMIC would provide these amounts to secondary market holders.[54]

Alternatively, the "adjusted PAC method" number could be determined by adjusting the prepayment assumption to produce the original yield based on the secondary holder's purchase price.[55] This variation would tend to produce more accurate numbers but is arguably less consistent with section 1272(a)(6) because it requires an adjustment to the original prepayment assumption.

The information required by either method should be relatively easy for a sponsor to calculate because it will not require a redetermination of the prepayment rates for the underlying mortgages or a reallocation of the cash flows among the REMIC regular interests; the

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[54] For instance, the sponsor could be required to produce a table that lists a variety of purchase yields at specified increments (at, say, 50 basis point increments) and the corresponding PAC number. So, for example, the left hand side of the table would list a variety of yields at increments of 50 basis points for any particular period and the right hand side of the table would list the PAC number for holders that apply that yield. The holder would find the yield that is closest to (but not less than) the holder's yield and use the corresponding PAC method number.

[55] In this case, the sponsor might produce a table that lists the purchase prices at specified increments (say, 5% or 10% increments) of the adjusted issue price of the regular interest and the prepayment assumption (as a multiple of the original prepayment assumption) that produces the original yield. Each period, the sponsor would produce a table that lists a variety of multiples of prepayment assumption and the corresponding PAC numbers for holders that apply the particular prepayment assumption.

calculations are purely mechanical. Therefore, the adjustments do not raise the administrative

concerns that led Congress to require a static prepayment assumption.

Secondary market holders that have not elected under section 1278(b) to report

accrued market discount currently would accrue market discount to the extent the positive

number under the adjusted PAC method exceeds the positive number under the original PAC

method. This accrued market discount would be reported as ordinary income to the extent

payments on the regular interest exceed the holder's inclusions (and not only to the extent of

repayments of stated principal). This treatment is appropriate because each payment in excess of

the holder's inclusions on a regular interest represents, in effect, a repayment of the holder's

investment.[56]

If the positive number computed under the "adjusted PAC method" is positive but

less than the positive number under the original PAC method, the secondary market holder

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[56] We considered a third method under which the secondary market holder would account for
OID under the PAC method as if it were the original holder, but could not deduct premium
until the aggregate amount of negative numbers under the PAC method exceeds the holder's
unaccrued market discount (i.e., the unaccrued portion of the excess of the IO's adjusted
issue price over the holder's basis). Although this method is simple to apply, we rejected it
because it would defer deductions of a secondary holder's economic loss until the entire
amount of the discount was recovered.

We also considered whether secondary market holders of IOs should accrue market discount
into income. However, IOs are generally purchased at a discount because the secondary
market purchaser expects to receive less cash flow on a present value basis than the initial
holder expected. In this respect IOs purchased at a discount are materially different than a
principal-protected bond that is purchased at a discount attributable to an increase in market
interest rates since issuance. While we recognize that the secondary market purchaser of a
distressed bond must accrue the market discount on the bond even if the discount is entirely
attributable to a decline in the credit quality of the issuer (and the holder does not expect to
receive the full amount of principal), we do not believe that this accrual reflects economic
income and do not recommend that this treatment be extended to secondary market IO
holders.

would report this amount as income. If the number computed under the "adjusted PAC method"

is negative, the secondary market holder would report this negative amount as amortizable bond

premium.

Under a different method, market discount could be accrued in a manner that is

similar to other bonds (based upon a fraction equal to current OID/interest over total

OID/interest) except that the market-discount fraction would be based upon the PAC method

approach, but with an adjusted prepayment speed.[57] More specifically, the secondary market

holder would report the OID or negative OID that the original holder reports plus market

discount equal to (i) the adjusted issue price of the regular interest when acquired less the

secondary holder's initial basis and less any previously accrued market discount, multiplied by

(ii) the market discount fraction based upon the adjusted-prepayment-assumption PAC method.

If this method is adopted, a secondary market holder should not be permitted to take deductions

for negative OID unless the holder agrees to report accrued market discount currently. If the IRS

decides to adopt one of these methods for secondary market holders, we suggest that proposed

regulations suggest a specific methodology and request comments from sponsors and servicers.

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[57] Thus, the sponsor would produce a table for sales occurring in the prior month that lists
    purchase prices at specified increments (say, 5% or 10% increments) of the adjusted issue
    price of the regular interest on the left hand side, and prepayment speeds (as a multiple of
    PSA) that produce the original yield, on the right. A secondary market holder would find the
    purchase price that is closest to (but not less than) the secondary holder's purchase price and
    would look up the secondary market holder's adjusted prepayment speed. Then, each month,
    the sponsor would produce a table that shows adjusted prepayment speeds on the left side of
    the table and the market discount fractions on the right side.

D.   **Other Methods.**

This section describes certain other methods of accounting for negative amounts under the PAC method and the reasons why we prefer the premium amortization method (regardless of which of the two variations suggested above in Part III.B.4 are adopted).

1.   **Regular Interest Holder's Ordinary Deductions Under the PAC Method Limited to Prior Deductions; REMIC Residual Holder's Ordinary Inclusions Under the PAC Method Unlimited**. Under a third alternative variation of the premium amortization method, regular interest holders' deductions for negative amounts under the PAC method would be limited to prior inclusions, but the REMIC residual holders' inclusions would be unlimited. This method would conform the treatment of regular interest holders to the treatment of holders of CPDIs and premium bonds, would best reflect the REMIC's economic income in the event prepayment speeds are faster than expected, and would prevent REMIC sponsors from underestimating prepayment speeds in order to defer the residual holder's taxable income. This method would tend to maximize revenue and minimize abuse. We do not recommend this approach because section 1272(a)(6) contemplates symmetric treatment between residual and regular interest holders, which this method would violate.

2.   **The Glick Method**. Under the Glick method, if the PAC method produces a negative number, an IO holder and the REMIC would treat the amount as zero. In other words, the IO holder would not be able to claim any deduction and the residual holder would not report any income in respect of negative amounts under the PAC method. Instead, at maturity, the holder would recognize a capital loss and the residual holder would report ordinary income.

We recognize that this method is consistent with the approach taken by the Glick court and the legislative history to section 1272(a)(6) (at least before REMICs were permitted to issue IOs). However, we believe that this method would unjustifiably understate the REMIC residual holders' income and overstate the IO holder's income.

More significantly, this method permits secondary holders to take the position that for any period that the PAC method produces a negative amount, no market discount is accrued.[58] We do not believe that this result is justifiable as a matter of sound tax policy.

We disagree on technical grounds with the Glick court's conclusion that IOs are not issued with amortizable bond premium.[59] In any event, we believe that a regulation that specifically treated IOs as issued with amortizable bond premium would change the result in Glick.

3.   The "Absolute Loss Limitation" Method. Under the "absolute loss limitation" method, a regular interest holder would be permitted to claim a loss (and a REMIC residual holder would be required to report income) only to the extent that the holder's

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[58]   The legislative history to the Tax Reform Act of 1986 provides 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 may accrue market discount 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. See 2 H.R. Conf. Rep. No. 841, 99th Cong., 2d Sess. II-842 (1986). If the PAC method produces a negative amount, the numerator of the fraction is treated as zero. We understand that in this case, the holder takes the position that no market discount should be accrued.

[59]   Section 171(b)(2) provides that, for taxable bonds, amortizable bond premium is equal to the difference between the holder's basis in the bond and the "amount payable on maturity or on an earlier call date." Since IOs have no stated principal amount, they provide for no amount to be payable on maturity or an earlier call date. Therefore, IOs appear to satisfy the statutory definition of a bond acquired with amortizable bond premium.

basis (or in the case of the REMIC residual holder, the adjusted issue price of the regular interest) exceeds all payments required to be made on the REMIC regular interest, based on a zero prepayment assumption.

This method would permit a regular interest holder to claim a loss (and require a residual holder to report income) for negative amounts under the PAC method only if the economic loss (and income) is realized. If Congress's intent, as reflected in the legislative history to the 1986 Tax Reform Act, was to prohibit a regular interest holder from claiming a loss for negative OID if the loss might eventually reverse, this method arguably best applies this intent to IOs following the 1988 amendments that permitted REMICs to issue IOs. However, this method would not clearly reflect a regular interest holder's (or a REMIC residual holder's) economic income, and we do not believe that it is compelled by the statute or the legislative history.

4. Financial Accounting Standard 91. Under Financial Accounting Standard Statement No. 91 ("FAS 91"),[60] an enterprise may account for a large number of loans (including a REMIC regular interest) for which prepayments are probable and the "timing and amount of prepayments can be reasonably estimated" by estimating prepayments, using the estimated prepayments to compute a constant yield, and reporting income based on that yield.[61] If an enterprise does estimate prepayments in order to report income, and the loans prepay at a rate that is different than expected, each year the enterprise must recalculate the effective yield to reflect actual payments to date and revised estimates of future payments. Therefore, FAS 91

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[60] Financial Accounting Standards Board, Statement of Financial Accounting Standards No. 91, Accounting For Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases ¶ 19 (1986).

[61] See FAS 91, paragraph 19.

effectively applies the PAC method with an annual adjustment to the prepayment assumption and an annual recomputation of the yield.[62]

Under the "FAS 91 approach," any holder that accounts for an IO under FAS 91 would report an equal amount of income or deduction for federal income tax purposes.[63] On the one hand, this approach might best economically reflect the IO holder's income or loss, and a taxpayer's incentive to maximize book income and minimize book loss would act as a check against the opposite desire to minimize tax liability.[64]

On the other hand, this method would be inconsistent with section 1272(a)(6), which raises regulatory authority issues. In addition, this method raises significant line-drawing issues. For example, does this method apply to a REMIC regular interest that provides for a principal amount but is issued at a premium? If this method is limited to REMIC regular interests whose issue price exceeds 125% of the specified principal amount,[65] then dramatically different tax treatment would apply to interests issued at 126% of the specified principal amount

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[62] A leading commentator reports that the IRS has not challenged taxpayers that use this method for federal income tax purposes. See David Garlock, Federal Income Taxation of Debt Instruments § 10.63[H] at 10.32 (2003 Supplement) ("it is well understood that the IRS has accepted this methodology without challenge, effectively allowing deviation from the literal requirements of section 1272(a)(6) in favor of the similar methodology used for book purposes.").

[63] Two alternative approaches could determine character:

First, all income and loss could be treated as ordinary. Cf. section 475. Second, all income could be treated as ordinary and loss would be treated as ordinary to the extent of prior inclusions of ordinary income, and otherwise as a capital loss. Cf. Treasury regulations section 1.1275-4.

[64] Cf. Announcement 2003-35, 2003-21 C.B. 956 (IRS is considering issuing regulations under section 475 permitting taxpayers to use the book values of securities for mark-to-market purposes).

[65] Cf. Treasury regulations section 1.860G-1(b)(5).

and 125% of the specified principal amount. Moreover, this method would apply only to taxpayers that report under FAS 91; and some taxpayers may still over-estimate prepayments in order to minimize taxes despite the hit to book earnings. And, finally, because this method does not affect residual holders, it permits deductions without the symmetrical income inclusions contemplated by section 1272(a)(6).

5. The "Income Forecast Method" (the "Alternative Method").

Under the "alternative method" described in Announcement 2004-75 (which we refer to as the "income forecast method"), a regular interest holder – regardless of whether the holder is a cash basis or an accrual basis taxpayer – would not report any income (or loss) on an IO until the holder receives a payment. At the time of any payment, the holder would treat as taxable income the entire amount less an "offset" equal to the product of (x) the taxpayer's investment and (y) the amount of the payment divided by the "total expected payments" over the life of the IO, based on a new prepayment assumption for each period and taking into account prior payments. This method effectively permits the regular interest holder to amortize its investment on a basis similar to the "income forecast method" for depreciation.[66]

Thus, assume that a regular interest holder paid $100 for an IO and in the first year receives a payment of $50. Assume also that, based on the prepayment assumption for the year of the payment, the IO holder expects to receive $120. In this case, the holder would report $50 minus an offset of $41.67 ($100 investment x $50/$120), or $8.33. In other words, since the $50 payment represents 41.67% (50/120) of the total expected payments on the IO, under this method, the holder would amortize 41.67% of its basis of $100.

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[66] Section 167(g).

Under a "look back rule" styled after section 167(g)(2), the taxpayer might compare the inclusions and deductions actually taken in each year with the inclusions or deductions that would have been allowable in each year based on actual payments on the IO. Then, the taxpayer would determine the underpayment or overpayment of tax in each year based on the difference and the taxpayer would pay or receive interest on the overpayment or underpayment of tax.

This method is simple to apply. However, there are six reasons why we do not recommend it. First, this method does not address the treatment of the REMIC residual holder. We would assume that the REMIC residual holder is treated symmetrically so that income reported by an initial holder is offset by deductions reported by the REMIC residual holder, and we assume that this treatment would continue even if the IO is sold (i.e., the residual holders' deductions would not be based on a secondary holder's inclusion). Significant arbitrage would exist if our assumption is incorrect.

Second, this method is inconsistent with the PAC method, which raises regulatory authority issues. For example, does this method apply to a REMIC regular interest that provides for a principal amount but is issued at a premium? If this method is limited to REMIC regular interests whose issue price exceeds 125% of the specified principal amount,[67] then dramatically different tax treatment would apply to interests issued at 126% of the specified principal amount and 125% of the specified principal amount.

Third, this method introduces the same line-drawing issues presented by the FAS 91 approach.

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[67] Cf. Treasury regulations section 1.860G-1(b)(5).

Fourth, this method requires annual re-estimates of the prepayment assumption for the REMIC, which is an expensive and time-consuming process. Fifth, as Announcement 2004-75 acknowledges, this method would delay inclusions of income until the first payment date and therefore will encourage REMIC sponsors to structure "delayed payment IO interests."

And finally, although this method seems intuitive and simple to apply, it can produce over- and-under- inclusions with complicated corrections. For instance, assume in the example above where the holder purchased its IO for $100 and included $8.33 in the first year that, in the second year, the holder receives a payment of $5 and expects to receive only $5 more (for a total of $60). In this case, the holder would have over-included income in the first year, and the method would produce a negative number in the second year of $3.33 (payment of $5 - $8.33 (100 x $5/$60)). Announcement 2004-75 contemplates that the overinclusion in year one could be corrected with a "look-back" rule. However, the "look-back" rule would add significant complexity. For these reasons, we do not recommend adoption of the income forecast method.

IV. "Negative Yield IOs"; Integration and Hedging Elections For Regular Interests.

The prepayment assumption (and/or interest rate assumption) used by some REMICs produces a negative yield for the IOs it issues.[68] (In other words, the REMIC projects that, as a result of prepayments (and based on current interest rates), the IO holder will receive less than the issue price of the IO.) We understand that investors view these IOs as if they were

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[68] Some IOs provide that payments are made only if a specified variable rate of interest (typically LIBOR) exceeds a specified amount. For these IOs, the yield is generally computed by assuming that the LIBOR rate on the issue date will remain constant.

"out-of-the-money options" and purchase them as hedges for POs or other interest-rate sensitive instruments they may hold.

REMICs and their regular interest holders typically use one of three methods to account for negative yield IOs. First, if payments on the IOs are dependent both on prepayment rates and interest rates, some REMICs will adjust their interest rate assumption only for the IO so that the IO produces a positive yield equal to the applicable federal rate for the weighted average life of the IO. These REMICs effectively keep a "separate set of books" for the IO based on the artificial interest rate assumption. [69]

Second, for fixed-rate IOs that are sensitive only to prepayment speeds, if the yield would be negative, some REMICs treat that yield as zero and otherwise apply the PAC method and, if the PAC method produces a negative number, the REMIC treats the number as zero. [70]

Third, for fixed-rate IOs that are sensitive only to prepayment speeds, if the yield would be negative, other REMICs do not apply the PAC method to the holder; instead, these REMICs treat all cash paid to the regular interest holder as a return of basis until the regular interest holder has recovered its basis and then additional cash payments are treated as ordinary income.

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[69] For example, if payments on an IO are dependent both on interest rates and prepayment speeds and, based on the prepayment assumption for the REMIC and current interest rate, the IO would produce a negative yield, the REMIC will adjust the interest rate assumption so that the IO produces a positive yield equal to the AFR and will use this interest rate assumption for purposes of applying the PAC method to the IO in all remaining periods.

[70] However, we understand that some conservative investors report income at a yield equal to the AFR even if the PAC method would produce a negative or zero yield.

We understand that in each of these cases, the REMIC uses the same method for reporting income and deduction for the residual holders. Thus, if the regular interest holders are not reporting income, the REMIC residual holders do not claim deductions.

We recommend that regulations be issued that require REMICs to adjust the prepayment assumption or interest rate assumption with respect to all regular interests so that they produce positive yields that correspond to the applicable federal rate for a debt instrument with a maturity equal to the weighted average life of the regular interest.[71] Both the IO and REMIC residual holders would account for the IO under the PAC method using the adjusted prepayment assumption and yield. In addition, as discussed above, under the premium amortization method, if a holder's purchase yield is less than the applicable federal rate, the future anticipated cash flows would be adjusted upwards on a pro rata basis to produce the applicable federal rates. Any premium resulting from this adjustment would be subject to the premium amortization method.

Although we recognize that an investor that purchases an IO as a hedge may indeed expect a "negative yield,"[72] we believe that section 1272(a)(6) requires that the PAC method apply to these instruments, that the PAC method can appropriately be applied only to IOs that produce a positive yield,[73] and that this method would produce a reasonable result for IOs purchased as an investment.

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[71] Announcement 2004-75 suggests that this positive yield be equal to an "economically reasonable discount rate." For ease of administrability, we suggest use of the applicable federal rate.

[72] For example, most insureds hope for and expect a "negative yield" on the property & casualty insurance they buy.

[73] As Announcement 2004-75 points out, because applying the PAC method to a negative yield instrument would require the holder to include amounts in income based on unrealistically

We do recognize that requiring taxpayers that purchase negative yield IOs as a hedge to accrue income under the PAC method based on a minimum yield may produce timing and character mismatches. In 1996, we recommended that the IRS consider amending regulations sections 1.1221-2/1.446-4 and/or 1.1275-6 to prevent character and timing mismatches for hedges of REMIC regular interests and stripped loans subject to prepayment.[74] We repeat this recommendation and also recommend that taxpayers be able to use REMIC regular interests and stripped loans as hedges.

V. Aggregation of Non-REMIC Stripped Bonds and Stripped Coupons.

Announcement 2004-75 indicates that any method to account for IOs might equally apply to non-REMIC IO strips from fixed investment mortgage trusts and high-yield REMIC regular interests and requests comments as to whether a single method should apply to these various instruments. In the 1996 report, we recommended that an "aggregation rule" apply to the holder of bonds or coupons stripped from a portfolio of loans to treat the bonds or coupons as if they were a single debt instrument subject to the PAC method. We continue to recommend this approach and believe that the premium amortization method should apply to this single debt instrument. This aggregation rule will help assure that the same tax treatment applies to economically identical financial instruments, regardless of their legal structure.

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high deemed present values, the holder would be required to include (and the REMIC residual holders would be permitted to deduct) uneconomically large amounts.

[74] Regulations section 1.1275-6 currently does not permit integration for instruments subject to section 1272(a)(6). See Treasury regulations section 1.1275-6(b)(1).

VI.   Section 166.

Announcement 2004-75 observes that section 166 was developed to address indebtedness that becomes wholly or partially worthless as a result of a decline in the issuer's credit quality and not by reason of contingencies inherent in the instrument (such as rapid prepayments or other obligations). Announcement 2004-75 requests comments as to whether section 166 should permit REMIC holders to claim losses.

As discussed above, we believe that section 166 should apply to REMIC regular interests (and other instruments described in section 1272(a)(6)) only to the extent losses are attributable to defaults (either by the issuer or by the debt instruments backing the instrument), and should not apply to losses attributable to prepayments. We believe that losses attributable to faster-than-expected prepayments are more appropriately claimed under the premium amortization method.