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DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

TD 9128

RIN 1545-BB73

Real Estate Mortgage Investment Conduits; Application of
Section 446 With Respect to Inducement Fees

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulation.

SUMMARY: This document contains final regulations relating to the proper timing and source of income from fees received to induce taxpayers to become the holders of noneconomic residual interests in Real Estate Mortgage Investment Conduits (REMICs).

DATES: Effective Date: These regulations are effective May 11, 2004.

Applicability Dates: For dates of applicability of the final regulations, see §§1.446-6(g) and 1.863-1(f).

FOR FURTHER INFORMATION CONTACT: For information concerning accounting for inducement fees relating to noneconomic REMIC residual interests, contact John W. Rogers III at (202) 622-3950 (not a toll-free number). For information concerning the

source of REMIC inducement fee income, contact Bethany Ingwalson at (202) 622-3850 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background

This document contains amendments to the Income Tax Regulations (26 CFR part 1) under sections 446(b)(relating to general rules for methods of accounting), 860C (relating to other definitions and special rules applicable to REMICs), and 863(a)(relating to special rules for determining source) of the Internal Revenue Code of 1986 (Code). On July 21, 2003, the IRS and Treasury Department published a notice of proposed rulemaking (REG-162625-02) in the Federal Register [68 FR 43055].

In the notice of proposed rulemaking the IRS and Treasury Department requested comments on the proper method of accounting to be used by taxpayers for inducement fee income. No written or electronic comments were received from the public in response to the notice of proposed rulemaking. No requests to speak at the public hearing were received, and, accordingly, the hearing was canceled. Therefore, these final regulations adopt without substantive changes the proposed regulations set out in the notice of proposed rulemaking.

Explanation of Provisions

Final regulations governing REMICs, issued in 1992, contain rules governing the transfer of noneconomic residual interests. Those regulations do not, however, contain rules that address the transferee's treatment of the fee received to induce the transferee to become the holder of a noneconomic residual interest. Following release of the final REMIC regulations, the IRS and the Treasury Department received requests for guidance on the proper method of accounting to be used by taxpayers for inducement fee income. These regulations provide rules relating to the proper timing and source of income from an inducement fee received in connection with becoming the holder of a noneconomic residual interest in a REMIC.

The notice of proposed rulemaking published on July 21, 2003, stated that, to clearly reflect income, an inducement fee must be included in income over a period that is reasonably related to the period during which the applicable REMIC is expected to generate taxable income or net loss allocable to the holder of the noneconomic residual interest. The notice of proposed rulemaking further stated that an inducement fee generally may not be taken into account in a single tax year. The notice of proposed rulemaking also set forth two safe harbor methods of accounting for inducement

fees and contained a rule clarifying that an inducement fee is income from sources within the United States. The final regulations adopt these provisions without substantive change. For further information on the rationale for the rules set out in these final regulations, see the preamble for the proposed regulations in the notice of proposed rulemaking.

The effective date provision of §1.446-6(g) contained in the notice of proposed rulemaking stated that these regulations would become effective upon publication of the final regulations in the Federal Register. The notice of proposed rulemaking specifically requested comments on whether the applicability of these regulations should be limited to transactions arising on or after their effective date and whether some delay in the effective date of these regulations is warranted. No comments were received from the public in response to this request. In finalizing these regulations, the IRS and Treasury Department have determined not to limit the applicability of these regulations to transactions arising on or after the effective date of the final regulations or to delay the effective date. The effective date provision in §1.446-6(g), therefore, is also adopted without substantive change.

Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It has also been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations, and because these regulations do not impose a collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Pursuant to section 7805(f) of the Code, the notice of proposed rulemaking preceding these regulations was submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Drafting Information

The principal author of these regulations is John W. Rogers III, Office of Associate Chief Counsel (Financial Institutions & Products). However, other personnel from the IRS and the Treasury Department participated in their development.

List of Subjects in 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

Adoption of Amendments to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

PART 1--INCOME TAXES

Paragraph 1. The authority citation for part 1 is amended by adding an entry in numerical order to read, in part, as follows:

Authority: 26 U.S.C. 7805 * * *

Section 1.446-6 also issued under 26 U.S.C. 446 and 26 U.S.C. 860G; * * *

Par. 2. Section 1.446-6 is added to read as follows:

§1.446-6 REMIC inducement fees.

(a) Purpose. This section provides specific timing rules for the clear reflection of income from an inducement fee received in connection with becoming the holder of a noneconomic REMIC residual interest. An inducement fee must be included in income over a period reasonably related to the period during which the applicable REMIC is expected to generate taxable income or net loss allocable to the holder of the noneconomic residual interest.

(b) Definitions. For purposes of this section:

(1) Applicable REMIC. The applicable REMIC is the REMIC that issued the noneconomic residual interest with respect to which the inducement fee is paid.

(2) Inducement fee. An inducement fee is the amount paid to induce a person to become the holder of a noneconomic residual interest in an applicable REMIC.

(3) Noneconomic residual interest. A REMIC residual interest is a noneconomic residual interest if it is a noneconomic residual interest within the meaning of §1.860E-1(c)(2).

(4) Remaining anticipated weighted average life. The remaining anticipated weighted average life is the anticipated weighted average life determined using the methodology set forth in §1.860E-1(a)(3)(iv) applied as of the date of acquisition of the noneconomic residual interest.

(5) REMIC. The term REMIC has the same meaning in this section as given in §1.860D-1.

(c) General rule. All taxpayers, regardless of their overall method of accounting, must recognize an inducement fee over the remaining expected life of the applicable REMIC in a manner that reasonably reflects, without regard to this paragraph, the after-tax costs and benefits of holding that noneconomic residual interest.

(d) Special rule on disposition of a residual interest. If any portion of an inducement fee received with respect to becoming the holder of a noneconomic residual interest in an applicable REMIC has not been recognized in full by the holder as of the time the holder transfers, or otherwise ceases to be the holder for Federal tax purposes of, that residual interest

in the applicable REMIC, then the holder must include the unrecognized portion of the inducement fee in income at that time. This rule does not apply to a transaction to which section 381(c)(4) applies.

(e) Safe harbors. If inducement fees are recognized in accordance with a method described in this paragraph (e), that method complies with the requirements of paragraph (c) of this section.

(1) The book method. Under the book method, an inducement fee is recognized in accordance with the method of accounting, and over the same period, used by the taxpayer for financial reporting purposes (including consolidated financial statements to shareholders, partners, beneficiaries, and other proprietors and for credit purposes), provided that the inducement fee is included in income for financial reporting purposes over a period that is not shorter than the period during which the applicable REMIC is expected to generate taxable income.

(2) The modified REMIC regulatory method. Under the modified REMIC regulatory method, the inducement fee is recognized ratably over the remaining anticipated weighted average life of the applicable REMIC as if the inducement fee

were unrecognized gain being included in gross income under §1.860F-2(b)(4)(iii).

(3) Additional safe harbor methods. The Commissioner, by revenue ruling or revenue procedure (see §601.601(d)(2) of this chapter), may provide additional safe harbor methods for recognizing inducement fees relating to noneconomic REMIC residual interests.

(f) Method of accounting. The treatment of inducement fees is a method of accounting to which the provisions of sections 446 and 481 and the regulations thereunder apply. A taxpayer is generally permitted to adopt a method of accounting for inducement fees that satisfies the requirements of paragraph (c) of this section. Once a taxpayer adopts a method of accounting for inducement fees, that method must be applied consistently to all inducement fees received in connection with noneconomic REMIC residual interests and may be changed only with the consent of the Commissioner, as provided by section 446(e) and the regulations and procedures thereunder.

(g) Effective date. This section is applicable for taxable years ending on or after May 11, 2004.

Par. 3. Section 1.860A-0 is amended by adding an entry in the outline for §1.860C-1(d) to read as follows:

§1.860A-0 Outline of REMIC provisions.

* * * * *

§1.860C-1 Taxation of holders of residual interests.

* * * * *

(d) Treatment of REMIC inducement fees.

* * * * *

Par. 4. Section 1.860C-1 is amended by adding paragraph (d) to read as follows:

§1.860C-1 Taxation of holders of residual interests.

* * * * *

(d) For rules on the proper accounting for income from inducement fees, see §1.446-6.

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Par. 5. Section 1.863-0 is amended by:

1. Revising the entry for the section heading for §1.863-1.
2. Adding an entry for §1.863-1(d).
3. Redesignating the entry for §1.863-1(e) as §1.863-1(f).
4. Adding a new entry for §1.863-1(e).

The additions and revisions read as follows:

§1.863-0 Table of contents.

* * * * *

§1.863-1 Allocation of gross income under section 863(a).

* * * * *

(d) Scholarships, fellowship grants, grants, prizes and awards.

(e) REMIC inducement fees.

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Par. 6. Section 1.863-1 is amended as follows:

1. Paragraph (e) is revised.

2. Paragraph (f) is added.

The revision and addition read as follows:

§1.863-1 Allocation of gross income under section 863(a).

* * * * *

(e) REMIC inducement fees. An inducement fee (as defined in §1.446-6(b)(2)) shall be treated as income from sources within the United States.

(f) Effective dates. The rules of paragraphs (a), (b), and (c) of this section apply to taxable years beginning after December 30, 1996. However, taxpayers may apply the rules of paragraphs (a), (b), and (c) of this section for taxable years beginning after July 11, 1995, and on or before December 30, 1996. For years beginning before December 30, 1996, see §1.863-1 (as contained in 26 CFR part 1 revised as of April 1, 1996). See paragraph (d)(4) of this section for rules regarding the applicability date of paragraph (d) of this section. Paragraph (e) of this section is applicable for taxable years ending on or

after May 11, 2004.

Mark E. Matthews,
Deputy Commissioner for Services and
Enforcement

Approved: May 4, 2004

Gregory Jenner,
Acting Assistant Secretary of the
Treasury