OFFICE OF
CHIEF COUNSEL

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR ASSISTANT REGIONAL COUNSEL
MIDSTATES REGION CC:MSR

FROM: ASSISTANT CHIEF COUNSEL (FIELD SERVICE)
CC:DOM:FS

SUBJECT: Noneconomic REMIC Residual Interests

This Field Service Advice responds to your memorandum dated January 6, 2000. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be cited as precedent.

LEGEND

A	=
B	=
C	=
D	=
E	=
F	=
G	=
H	=
I	=
Year 1	=
Year 3	=
Year 4	=
$a	= $
$b	= $
s	=
t	=

ISSUE

Whether B and C are liable for taxes associated with a noneconomic REMIC residual interest.

CONCLUSION

Whether B and C are liable for the taxes associated with a noneconomic REMIC residual interest will depend on the facts and circumstances associated with the transfer of the interest.

FACTS

A is a domestic corporation. B is a domestic corporation, wholly owned by A. In Year 1, C, a domestic corporation, was incorporated. In Year 3, C was acquired by A.

On September 24, Year 3, B and C formed D, a domestic partnership, for the purpose of acquiring REMIC residual interests.

On September 27, Year 3, D acquired five noneconomic REMIC residual interests from E. D received inducement fees in the amount of $a for the purchase of the five interests. The amount of the inducement fees were insufficient to compensate D's partners for the cost of taxes on the excess inclusion income.

Typically, each REMIC transfer included a letter stating that D is not a "disqualified organization," that it is aware of the income tax incidents or ownership of a residual interest, that it expects the purchase will be economically profitable to it overall, that it holds and will continue to hold a portfolio of investments that will generate economic income and cash flow, and that it has historically paid its debts and filed all required tax returns. The letter also states that D agrees that any subsequent transfers of the residual interests will be made only to a U.S. person who is not a "disqualified organization."

On September 30, Year 3, F, a foreign corporation which conducts no business in the United States, and G, a foreign person, formed H, a domestic partnership. H's business address is the same address as the business address of C and A. During the years at issue, H had no business activities other than its activities as a partner in D and had no independent place of business. As part of a package engagement, H's tax returns were prepared by the same accounting firm that prepared D's tax returns.

On October 7, Year 3, H was admitted as a partner in D. H contributed $b in exchange for a s percent limited partnership interest.

C, B, and H agreed that, as an inducement for H to join D, H was to receive an "acquisition fee" in an amount equal to t percent of C and B's share of the inducement fee distributed to them from D for residual interests acquired prior to H's admission. In addition, H would pay to C and B a "finder's fee" equal to t percent of any inducement fees D distributed to it for REMIC acquisitions made after H became a partner in D.

D was represented by an attorney in all of the REMIC transactions. He was the primary contact for D's partnership business in connection with bidding criteria, trade decisions, and documentation. The inducement fees were paid to a trust fund held by the firm for which the attorney worked. The law firm retained one-third of the inducement fees for services rendered. The remaining two-thirds was distributed out of the trust fund to C, B, and H in accordance with their agreement.

Between October 14, Year 3, and July 28, Year 4, C and B formed nine more limited partnerships. For a period of time, the parties followed the pattern of forming the partnership, acquiring the REMIC interest, and admitting H as a partner. The REMIC acquisition was generally made within one to 30 days before H was admitted as a partner. Subsequently, the partnership was formed and H was admitted as a partner before the REMIC interest was acquired. When I took over E, the REMIC interests were acquired by D from I. With respect to all REMIC acquisitions, the amount of the inducement fees were insufficient to compensate D's partners for the cost of taxes on the excess inclusion income.

The Internal Revenue Service issued Notices of Final Partnership Administrative Adjustment (FPAA) to D and the other nine limited partnerships stating that D's allocation of REMIC excess inclusion income from noneconomic REMIC residual interests violated Treas. Reg. § 1.860G-3(a). The FPAA also stated that the transfers of partnership interests were preconceived shams with no economic substance and that the partners acted in concert and may be treated as controlled by the same interests under section 482.

LAW AND ANALYSIS

A noneconomic REMIC residual interest is a special type of residual equity interest that is not allocated any actual cash in the transaction. It ordinarily generates tax income in the early years followed by tax losses in the later years. The tax income generated in the earlier years is referred to as "excess inclusion income" and is intended to be taxed in all cases. The tax losses generated in later years are deductible against other income, resulting in a tax benefit.

The holder of a residual interest bears the tax burden of the timing difference between the production of the tax income and the production of the tax losses. Generally, in the early years, a holder of a noneconomic residual interest will borrow the funds needed to pay the tax on the excess inclusion income. The funds will be repaid in later years through the tax savings generated by the deductible tax losses. Thus, from the perspective of the holder, the tax burden from the transaction is similar to undertaking a loan. A holder will, at a minimum, want to be compensated for the cost of carrying the loan (representing the taxes paid on the excess inclusion income) until it is repaid through tax savings generated by the losses. This compensation is provided through an inducement fee, which should reflect the holder's cost of carrying the loan and the effective tax rate on the excess inclusion income.

To avoid the tax due on the excess inclusion income, the holder of a residual interest may transfer the interest to another person. With the exception of tax exempt entities, the REMIC provisions allow the transfer of residual interests to any person. The REMIC regulations, however, anticipate that taxpayers may try to avoid the tax on excess inclusion income by transferring a residual interest to a foreign person or to a person unwilling or unable to pay the tax. In response, the REMIC regulations, under certain circumstances, ignore such transfers. Specifically, the transfer of a residual interest to a foreign person is disregarded "for all federal tax purposes" if the residual interest has tax avoidance potential. Treas. Reg. § 1.860G-3(a)(1). A residual interest has tax avoidance potential unless, at the time of transfer, the transferor reasonably expects that, for each excess inclusion, the REMIC will distribute to the foreign person an amount that will equal at least 30 percent of the excess inclusion, and that each such amount will be distributed at or after the time at which the excess inclusion accrues and not later than the close of the calendar year following the calendar year of accrual. Treas. Reg. § 1.860G-3(a)(2)(i).

The transfer of a noneconomic residual interest to a domestic person is disregarded "for all Federal tax purposes" if a significant purpose of the transfer was to enable the transferor to impede the assessment or collection of tax. Treas. Reg. § 1.860E-1(c)(1). A significant purpose to impede the assessment or collection of tax exists if the transferor, at the time of the transfer, either knew or should have known that the transferee would be unwilling or unable to pay taxes due on its share of the taxable income of the REMIC. Treas. Reg. § 1.860E-1(c)(1). A transferor is presumed not to have improper knowledge if the transferor conducted, at the time of the transfer, a reasonable investigation of the financial condition of the transferee and, as a result of the investigation, the transferor found that the transferee had historically paid its debts as they came due and found no significant evidence to indicate that the transferee will not continue to pay its debts as they come due in the future and the transferee represents to the transferor that it understands that, as the holder of the noneconomic residual interest, the transferee may incur tax liabilities in excess of any cash flow generated by the interest and that the transferee intends to pay taxes associated with holding the residual interest as they become due. Treas. Reg. § 1.860E-1(c)(4).

<u>CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS:</u>

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1 [redacted]

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Please call if you have any further questions.

By: WILLIAM C. SABIN, JR.
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