

Part III

Administrative, Procedural, and Miscellaneous

26 CFR 601.105: Examination of returns and claims for refund, credit, or abatement; determination of correct tax liability. (Also Part I, §§ 860E, 860H; 1.860E-1.)

Rev. Proc. 2001-12

SECTION 1. PURPOSE

This revenue procedure sets forth a safe harbor for establishing the lack of improper knowledge under § 1.860E-1(c) of the Income Tax Regulations for transfers of noneconomic residual interests in real estate mortgage investment conduits (REMICs) and ownership interests in Financial Asset Securitization Investment Trusts (FASITs).

SECTION 2. BACKGROUND

The current regulations governing REMICs contain rules governing the transfer of noneconomic residual interests in REMICs. In general, a transfer of a noneconomic residual interest is disregarded for all tax purposes if a significant purpose of the transfer is to enable the transferor to impede the assessment or collection of tax. This purpose 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 REMIC's taxable income.

The current regulations also contain a safe harbor for establishing the lack of a purpose to impede the assessment or collection of tax. Under the safe harbor, a transferor of a noneconomic residual interest in a REMIC is presumed to lack this

purpose if two requirements are satisfied. First, the transferor must conduct a reasonable investigation of the transferee's financial condition. Second, the transferor must secure a representation from the transferee stating that the transferee understands the tax obligations associated with holding a residual interest and intends to pay those taxes.

The Internal Revenue Service and Treasury have been concerned that some transferors of residual interests have claimed they satisfy the safe harbor even though the economics of a transfer clearly indicate the transferees are unwilling or unable to pay the tax associated with holding the interest. For this reason, on February 7, 2000, the Service published in the Federal Register a notice of proposed rulemaking (65 Fed. Reg. 5807) designed to clarify the safe harbor. The proposed regulation explains that the safe harbor is unavailable unless the present value of the anticipated tax liabilities associated with holding the residual interest does not exceed the sum of: (1) the present value of any consideration given to the transferee to acquire the interest; (2) the present value of the expected future distributions on the interest; and (3) the present value of the anticipated tax savings associated with holding the interest as the REMIC generates losses. This clarification is proposed to be effective on February 4, 2000.

The notice of proposed rulemaking published on February 7, 2000 also contained proposed rules for FASITs. Proposed § 1.860H-6(g) provides requirements for transfers of FASIT ownership interests and adopts a safe harbor for establishing lack of improper knowledge by reference to the safe harbor provisions of the REMIC regulations.

Some commentators have stated that, although current regulations are inadequate, the proposed regulations are inappropriately restrictive. This revenue procedure sets forth an alternate safe harbor that may be used while the Service and Treasury consider the comments on the proposed regulations.

SECTION 3. SCOPE

This revenue procedure applies to all transfers of noneconomic residual interests in REMICs. The principles set forth in this revenue procedure, appropriately adjusted with respect to terminology and other technical differences between the REMIC and FASIT provisions, also apply to transfers of ownership interests in FASITs. See section 8 for applicability.

SECTION 4. PROCEDURE

A transferor of a residual interest in a REMIC is presumed not to have improper knowledge under § 1.860E-1(c) of the regulations if—

.01 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;

.02 The transferee represents to the transferor that it understands that, as the holder of the residual interest, the transferee may incur tax liabilities in excess of any cash flows generated by the interest and that the transferee intends to pay taxes associated with holding the residual interest as they become due; and

.03 Either section 5 or section 6 is satisfied.

SECTION 5. FORMULA TEST

.01 The present value of the anticipated tax liabilities associated with holding the residual interest does not exceed the sum of—

- (1) The present value of any consideration given to the transferee to acquire the interest;
- (2) The present value of the expected future distributions on the interest; and
- (3) The present value of the anticipated tax savings associated with holding the interest as the REMIC generates losses.

.02 For purposes of section 5.01 of this revenue procedure, both of the following rules apply:

- (1) The transferee is assumed to pay tax at a rate equal to the highest rate of tax specified in § 11(b)(1) of the Internal Revenue Code; and
- (2) Present values are computed using a discount rate equal to the applicable Federal rate prescribed by § 1274(d) compounded semiannually. (A lower discount rate may be used if the transferee can demonstrate that it regularly borrows, in the course of its trade or business, substantial funds at such lower rate from unrelated third parties.)

SECTION 6. ASSET TEST

.01 The following three requirements must be satisfied—

- (1) At the time of the transfer, and at the close of each of the transferee's two fiscal years preceding the year of transfer, the transferee's gross assets for financial reporting purposes exceed \$100 million and its net assets for financial reporting purposes exceed \$10 million;

(2) The transferee is an eligible corporation (as defined in § 860L(a)(2)) that makes a written agreement that any subsequent transfer of the interest will be to another eligible corporation in a transaction that satisfies section 4; and

(3) The facts and circumstances known to the transferor on or before the date of the transfer must not reasonably indicate that the taxes associated with the residual interest will not be paid. The consideration given to the transferee to acquire the noneconomic residual interest in the REMIC is only one factor to be considered. However, if the amount of consideration is so low that under any set of reasonable assumptions a reasonable person would conclude that the taxes associated with holding the residual interest will not be paid, then the transferor is deemed to know that the transferee cannot or will not pay. In determining whether the amount is too low, the specific terms of the formula test in section 5 of this revenue procedure need not be used.

.02 For purposes of section 6.01 of this revenue procedure, all of the following rules apply:

(1) The gross assets and net assets of a transferee do not include any obligation of any person related to the transferee (as defined in § 860L(g)) or any other asset if a principal purpose for holding or acquiring that asset is to permit the transferee to satisfy section 6 of this revenue procedure;

(2) A transfer fails to meet the requirements of section 6 of this revenue procedure if the transferor knows, or has reason to know, that the transferee will not honor the restrictions on subsequent transfers of the residual interest; and

(3) Section 6.01(2) fails to be satisfied in the case of any transfer or assignment of the interest to a foreign branch of an eligible corporation or any other arrangement by

which the interest is at any time subject to net tax by a foreign country or possession of the United States.

SECTION 7. EXAMPLES

.01 Example 1. Transfer to partnership. X transfers a noneconomic residual interest in a REMIC to Partnership P. Y and Z are the partners of P. The transfer does not satisfy the formula test of section 5. Even if Y and Z are eligible corporations that satisfy section 6.01(1) and that make the written agreement in section 6.01(2), the transfer fails to qualify under section 4 because P is a partnership rather than an eligible corporation.

.02 Example 2. Transfer to corporation without capacity to carry additional residual interests. During the first ten months of a year, Bank transfers five residual interests to Corporation U under circumstances meeting the requirements of section 6. Bank is the major creditor of U and for that reason has access to U's financial records. During the last month of the year, Bank transfers three additional residual interests to U. At the time of transfer, U's financial records indicate it has retained the previously transferred residual interests. Bank has knowledge of U's financial circumstances, including the aggregate tax liabilities it has assumed with respect to REMIC residual interests, that would reasonably cause Bank to conclude that U will be unable to meet its tax liabilities when due. The transfers in the last month of the year fail to satisfy section 4 and 6.01(3) because Bank has reason to know that U will not be able to pay the tax due on those interests.

SECTION 8. EFFECTIVE DATE

This revenue procedure applies to all transfers of noneconomic residual interests in REMICs and all transfers of FASIT ownership interests occurring on or after February 4, 2000, until the date specified in future published guidance.

DRAFTING INFORMATION

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