

NEW YORK STATE BAR ASSOCIATION
TAX SECTION

REPORT ON PROPOSALS
REGARDING TRANSFERS OF
REMIC AND FASIT RESIDUAL INTERESTS

I. Introduction.

This report¹ comments on a proposal in the Administration's Fiscal Year 2001 Budget to impose secondary liability on real estate mortgage investment conduits ("REMICs") and financial asset securitization investment trusts ("FASITs") for tax owed by holders of residual interests. This report also comments on the proposed amendment to regulations section 1.860E-1(c)(4) denying that provision's safe harbor to transferors of noneconomic REMIC and FASIT residual interests unless the consideration paid for the transfer and the residual's expected cash flows together exceed the holder's net expected tax liabilities (all determined on a present value basis and assuming the highest marginal corporate rate).²

We share the Treasury Department's concern that taxpayers may be attempting to avoid tax on income allocable to holders of residual interests, and we agree that current rules should be tightened to prevent potential abuse. However, we do not believe that secondary liability for the residual holder's tax should be imposed on a REMIC.³ Because

¹ David S. Miller was the principal drafter of this report. Helpful comments were received from Charles M. Adelman, John T. Lutz, David C. Miller, David Z. Nirenberg, Michael L. Schler, and Paul R. Wysocki.

² All references to section numbers are to the Internal Revenue Code of 1986, as amended, and the Treasury regulations proposed and promulgated thereunder.

³ This report generally refers to REMICs only, although its recommendations apply equally to the analogous provisions of the FASIT rules.

tax owed by a REMIC would be paid out of assets required to pay interest and principal due regular interest holders, the burden of any tax imposed under the proposal would fall on regular interest holders. Thus, the practical effect of the proposal is to make holders of regular interests secondarily liable for tax on income allocable to residual interest holders.

We object to burdening regular interest holders with tax that residual holders fail to pay for the following reasons. First, a contingent liability on regular interests would introduce uncertainty into their pricing and adversely affect their liquidity. It would thereby tend to frustrate the primary purpose of the REMIC rules, which was to increase efficiency of capital markets. Second, because regular interest holders do not have contact with residual interest holders, effectively imposing contingent liability on regular interest holders is an inefficient means of ensuring that residual interest holders pay tax. In this report, we propose alternative changes to the rules governing transfers of residual interests that would be more effective and efficient means of preventing tax evasion.

Rules facilitating transfers of residual interests increase the economic efficiency of the REMIC vehicle and thus advance Congress's objective in enacting the REMIC provisions. We recognize, of course, that the goal of economic efficiency must be balanced against the need to prevent abusive transfers of residual interests that may permit tax evasion. Proposed regulations section 1.860E-1(c)(4) would, however, deny the safe harbor to certain nonabusive transfers of residuals and thus would unnecessarily reduce the economic efficiency of the REMIC vehicle and of the mortgage market. To prevent abusive transfers of residuals without unnecessarily reducing market liquidity, this report suggests that the current safe harbor be converted into a substantive rule; thus, a transferor that does not satisfy its requirements would be secondarily liable for tax on income allocable to the transferred

interest. We also suggest additional safeguards to help assure that the residual interest holder pays tax it owes.

In short, we recommend as follows:

1. American Indian tribes and tribal corporations should be added to the list of disqualified organizations.

2. The transfer of an interest in a partnership or other pass through entity that holds a residual interest should be treated as a “transfer” of the residual by the transferor, and the issuance of an interest in such an entity should be treated as a transfer of the residual interest by the pass through entity (*i.e.*, an “aggregate approach” would be applied to the residual). Accordingly, the putative transfer would be disregarded with respect to the residual interest under existing rules if it was abusive.

3. Neither a REMIC nor its regular interest holders should be liable for the tax liability of the residual holder.

4. The safe harbor in proposed regulations section 1.860E-1(c)(4) should be converted into a substantive rule that imposes secondary liability for the residual tax liability on a transferor that does not comply with it. We also suggest some possible additional restrictions.

II. Background.

A. In General.

Congress enacted the REMIC provisions in 1986 to permit mortgages to be pooled and interests in them sold without imposition of a corporate-level tax, and to eliminate uncertainty regarding the tax treatment of those interests. Thus, under the REMIC rules, the REMIC entity is not generally subject to tax, and regular interests issued by the REMIC are treated as indebtedness for federal income tax purposes and are subject to a stable and widely-understood tax regime. The REMIC provisions have largely succeeded in advancing Congress’s goal of increasing the liquidity of mortgage loans and the efficiency of the mortgage markets. The FASIT provisions were enacted in 1997 to achieve similar objectives for a broader class of assets.

In the REMIC provisions, Congress also sought to assure that tax would be paid on a specified amount of the “phantom income” of a REMIC that arises when, in a “normal” interest rate environment (i.e., long-term interest rates exceed short-term rates), long-term mortgages are financed by issuance of different tranches of debt with varying maturities (as is generally the case with REMICs). Accordingly, under section 860C, the residual interest holder is subject to tax on the net income of the REMIC and, in all events, is subject to tax on the REMIC’s “excess inclusion income,” which is intended to be a proxy for the REMIC’s phantom income.⁴ The REMIC provisions impose three separate mechanisms to ensure that tax on excess inclusion income may not be avoided by transfers to persons that will not pay the tax. Each of these three mechanisms is discussed below.

B. Penalty Tax on Transfers to Disqualified Organizations.

First, to qualify as a REMIC, an entity must have in place “reasonable arrangements” to prevent ownership of residual interests by certain persons – “disqualified organizations” – that are not subject to U.S. federal income tax.⁵ Moreover, the transfer of a residual interest to a disqualified organization subjects the transferor to a penalty tax equal to the highest marginal corporate rate times the present value of anticipated excess inclusions for periods after the transfer.⁶ A tax at the highest marginal corporate rate is also imposed on the

⁴ See section 860E. More specifically, an excess inclusion is defined, with respect to each residual interest holder, as the excess of the holder’s share of the taxable income of the REMIC for the calendar quarter over the sum of the “daily accruals” for such residual interest (generally, a measure of the economic return on the issue price of the residual interest) based on the number of days during that quarter that the interest was held by the holder. Section 860E(c)(1).

⁵ Section 860D(a)(6).

⁶ Section 860E(e)(2).

excess inclusion income of any “pass through entity” to the extent allocable to its disqualified organization interest holders.⁷

Disqualified organizations include (i) the United States, its states and political subdivisions, (ii) foreign governments and international organizations (and their agencies and instrumentalities), (iii) tax-exempt organizations not subject to the tax on “unrelated business taxable income,” and (iv) cooperatives described in section 1381(a)(2)(C).⁸ However, American Indian tribes and tribal corporations are not included in this list.

Under section 860E(e)(4) and its regulations, the transferor of a residual interest is not subject to the section 860E(e) penalty tax if the transferee furnishes to the transferor an affidavit containing the transferee’s social security number and a statement, signed under penalties of perjury, that the transferee is not a disqualified organization.⁹

c. Restrictions on Transfers of “Noneconomic Residuals” to Domestic Entities.

Second, under regulations, if a “noneconomic residual interest”¹⁰ is transferred to a domestic entity and a “significant purpose” of the transfer is to impede the assessment or collection of tax, the transfer is disregarded and the transferor remains liable for the tax on the

⁷ Section 860E(e)(6); Treasury regulations section 1.860E-2(b). A “pass through entity” is a RIC, REIT, partnership, trust, estate, or subchapter T cooperative. Section 860E(e)(6)(B). The tax paid by the entity is deductible. Section 860E(e)(6)(C).

⁸ Section 860(e)(5).

⁹ See Treasury regulations section 1.860E-2(a)(7). Similarly, a pass through entity can avoid the penalty tax if it receives an affidavit from its record holders. Treasury regulations section 1.860E-2(b)(2).

¹⁰ A noneconomic residual is, in general, a residual that (i) at the time of the transfer the present value of expected future distributions is less than the product of the anticipated excess inclusions times the highest marginal corporate income tax rate for the year of the transfer or (ii) with respect to which the transferor does not expect that the transferee will timely receive distributions from the REMIC sufficient to satisfy anticipated taxes on the excess inclusion income. Treasury regulations section 1.860E-1(c)(1).

residual.¹¹ A significant purpose to impede the assessment or collection of tax is deemed to exist if the transferor knows or should have known (i.e., the transferor has “improper knowledge”) that the transferee would be unwilling or unable to pay the taxes due on its share of the REMIC’s taxable income.¹² On the other hand, under a safe harbor, the regulations presume that the transferor does not have improper knowledge if it (i) conducts a reasonable investigation of the financial condition of the transferee and, as a result of the investigation, finds that the transferee has historically paid its debts as they came due and there exists no significant evidence to indicate that the transferee will not continue to pay its debts as they come due in the future, and (ii) receives a representation that the transferee understands that, as a holder of a noneconomic residual interest, it may incur tax liabilities in excess of cash flows generated by the interest and that the transferee intends to pay the taxes as they come due.¹³

D. Restrictions on Transfers of Certain Residuals to Foreign Persons.

Finally, under rules that are analogous to the rules for noneconomic residual transfers to domestic transferees, the regulations provide that the transfer of a residual interest with “tax avoidance potential” to a foreign person that does not report the residual interest income as effectively connected with its U.S. trade or business also is disregarded and the transferor remains liable for the tax on the residual.¹⁴ In general, a residual interest has tax

¹¹ Treasury regulations section 1.860E-1(c)(1). This provision applies equally to transfers to foreign persons of residuals the income from which is effectively connected to the foreigner’s U.S. trade or business.

¹² Treasury regulations section 1.860E-1(c)(2).

¹³ Treasury regulations section 1.860E-1(c)(4)(ii).

¹⁴ Treasury regulations section 1.860G-3. This report sometimes refers to residuals that are both noneconomic and have tax avoidance potential as “negative value residuals.”

avoidance potential if the cash flows of the residual interest are insufficient to satisfy a 30% withholding tax on excess inclusion income.¹⁵ Under a safe harbor, a residual interest is not treated as having tax avoidance potential (and thus the transfer is not disregarded) if, based on each prepayment speed between 50% and 200% of the REMIC's assumed prepayment speed, the REMIC would distribute enough cash to satisfy the 30% tax.¹⁶ For a residual that is treated as not having tax avoidance potential, no representation from the transferee is needed to ensure that the transfer is not disregarded.

III. Potential Abuses Involving Transfers of Residual Interests, and the Administration's Proposals

A. Potential Abuses

As indicated above, one of Congress's objectives in enacting the REMIC provisions was to ensure that, in all events, tax is paid on a REMIC's excess inclusion income. The Treasury Department, the Joint Committee on Taxation and commentators have identified at least three potential methods by which taxpayers may nevertheless attempt to avoid this liability.

First, American Indian tribes and tribal corporations organized under federal law are not subject to U.S. federal income tax,¹⁷ but Congress neglected to include them in the list of disqualified organizations. One commentator has speculated that REMIC residuals

¹⁵ More precisely, a residual interest has tax avoidance potential unless the transfer expects that for each excess inclusion, the REMIC will distribute to the transferee residual interest holder an amount that will equal at least 30% of the excess inclusion at or after the time at which the excess inclusion accrues and not later than the close of the calendar year following the year of accrual. Treasury regulations section 1.860G-3(a)(2).

¹⁶ Treasury regulations section 1.860G-3(a)(2)(ii).

¹⁷ Revenue Ruling 94-16, 1994-1 C.B. 19 (an unincorporated Indian tribe or tribal corporation organized pursuant to section 17 of the Indian Reorganization Act of 1934 is not subject to federal income tax on the income earned in the conduct of commercial business).

are held by American Indian tribes, and that the associated excess inclusion income escapes tax.¹⁸

Second, the restrictions on transfers of noneconomic interests and residual interests with tax avoidance potential arguably do not apply to transfers of interests in partnerships or other pass through entities that own residuals, or to issuances of interests in these entities. Thus, a U.S. taxpayer that owns a negative value residual in a domestic partnership could cause the partnership to issue interests to foreign persons, and claim that the issuance is not a “transfer” of the residual interest. In fact, the Internal Revenue Service (“IRS”) is currently litigating such a case in Tax Court.¹⁹

Finally, a bankruptcy proceeding may excuse a residual holder from tax liability on the excess inclusion income. Thus, conceivably, a noneconomic residual interest could be purchased by a corporation that subsequently declares bankruptcy, and the tax liability would be discharged. Unless the transferor “knew or should have known” that the corporate transferee would be unwilling or unable to pay tax on income from the residual, liability could not be imposed on the transferor.

B. The Administration’s Proposals

The Treasury Department and the IRS have become concerned that taxpayers may be evading tax on income from residual interests. To address potential abuses, in February 2000, the Treasury Department proposed regulatory and statutory amendments to prevent abusive residual interest transfers.

¹⁸ See Calvin H. Johnson, “H.R. ___, The Anti-Skunk Works Corporate Tax Shelter Act of 1999,” 84 Tax Notes 443 (July 19, 1999).

¹⁹ See Cebem Mortgage Investors, 1 L.P. v. Commissioner (Tax Court petition) (December 22, 1999).

First, as part of the FASIT proposed regulations package issued on February 4, 2000, Treasury and the IRS proposed an additional condition for the safe harbor under regulations section 1.860E-1(c)(4) for transfers of noneconomic REMIC residuals (and FASIT ownership interests). Under the proposed regulation, the safe harbor would be available only if the present value of the anticipated tax liabilities associated with holding the residual interest (computed based on the highest marginal corporate tax rate) does not exceed the sum of (i) the present value of any consideration paid to the transferee to acquire the interest, (ii) the present value of the expected future distributions on the interest, and (iii) the present value of the anticipated tax savings associated with holding the interest as the REMIC generates losses.²⁰ The change is proposed to be effective for transfers on and after February 4, 2000.

Second, as part of the Administration's Fiscal Year 2001 Budget Revenue Proposals, the Treasury Department proposed to make REMICs and FASITs secondarily liable for tax owed by holders of residual interests. Because tax owed by a REMIC or FASIT would be paid from assets otherwise used to make payments due regular interest holders, the proposal would effectively impose secondary liability on holders of regular interests to the extent of their value. The provision is proposed to be effective for REMICs created after the date of enactment.

²⁰ Present values are computed using a discount rate equal to the applicable federal rate or a lower discount rate 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. Proposed Treasury regulations section 1.860E-1(c)(5)(ii). The same rules are proposed to apply to transfers of FASIT ownership interests. See Proposed Treasury regulations section 1.860H-6(g)(2).

IV. Comments on the Proposals.

A. In General.

We share the concern of the Treasury Department and the IRS that certain taxpayers may be attempting to avoid residual interest tax. However, we believe that the proposal to impose secondary liability for the residual tax on REMICs and FASITs (and, in practical effect, on their regular interest holders) would significantly impair the effectiveness of these vehicles and thus frustrate Congress's purpose in creating them. We also believe that it is not the best means of insuring that the tax is in fact paid.

Effective securitization of assets requires that the securitization vehicle not be subject to the claims of third-party creditors. The proposal to impose secondary liability on a REMIC or FASIT for tax owed by its residual interest holder (or owner) would violate this requirement. We understand that, if this proposal were enacted, the contingent tax liability on the REMIC or FASIT would adversely affect the credit rating of regular interests issued by "private label REMICs,"²¹ and would preclude a "AAA" rating for any class of regular interests without additional reserves to cover the contingent liability. Requiring REMICs to hold additional reserves would defeat the purpose of providing an economically efficient vehicle for securitizing mortgage loans.²²

²¹ "Private label REMICs" are REMICs that are not sponsored by an "agency" (i.e., the Government National Mortgage Association ("GNMA"), the Federal Home Loan Mortgage Corporation ("FHLMC"), or the Federal National Mortgage Association ("FNMA")).

²² The regular interests of agency-sponsored REMICs likely would retain their AAA ratings based on the agency's guarantee. However, FHLMC and FNMA may be compelled to retain the residual in order to manage their risks. In many circumstances, FHLMC's and FNMA's retention of the residual would not be an attractive investment. It is unclear how GNMA, which is a disqualified organization and may not hold a residual, would manage its risk.

Second, we do not believe that the proposal would help ensure that residual holders in fact pay their tax liability. Although regular interest holders would bear the economic burden of tax not paid by the residual interest holder, because regular interest holders rarely (and in public transactions never) have privity with the residual holder, they would be unable to ensure that the residual holder actually pays its tax. We believe that it is possible to address the problem of abusive transfers of residuals without affecting the liquidity of regular interests; therefore we oppose imposition of secondary liability for the residual interest tax on the REMIC (and, by extension, on its regular interest holders).

Proposed regulations section 1.860E-1(c)(4) presents more difficult issues. Residual interest liquidity generally improves the economic efficiency of the REMIC vehicle (and, consequently, the mortgage market). The goal of increasing efficiency of the mortgage market must, of course, be balanced against the need to prevent tax evasion. We suggest a number of alternatives to balance these competing policies.

B. Addition of American Indian Tribes and Tribal Corporations to the List of Disqualified Organizations.

We are not aware of American Indian tribes or tribal corporations holding residual interests. Nevertheless, we recommend that section 860E(e)(5) be amended to add American Indian tribes and tribal corporations organized under federal law to the list of disqualified organizations. The Treasury Department should also be granted regulatory authority to add additional entities that are not subject to federal income tax.

C. Transfer or Issuance of a Partnership Interest Treated as a Transfer of Any Residual Held By the Partnership.

To prevent taxpayers from using partnerships, trusts and other flow-through vehicles to avoid tax on negative value residuals, we recommend that the certification requirements of regulations sections 1.860E-1(c) and 1.860G-3 be amended to provide that

the transfer of a beneficial interest in a partnership, trust, estate, or other “pass through” entity (as defined in section 860E(e)(6)(B)) that holds a residual interest is treated as a “transfer” of the residual by the transferor, and to provide that the issuance of an interest in such an entity is treated as a “transfer” of the residual interest by the pass through entity. Accordingly, the putative transfer (with respect to the residual only, and not the entity’s other assets) would be disregarded under existing rules if abusive.

The existing certification safe harbors would apply to transfers of interests in flow-through entities. Moreover, a certification from the transferee of an interest in a pass through entity would not be necessary if a representative of the pass through entity certifies (under penalties of perjury) in the year of the transfer that the entity’s cash flows to the transferee from the residual and its other assets (less applicable withholding) are expected to be sufficient to pay the transferor’s tax liability with respect to the residual in each year based on prepayment speeds between 50% and 200% of the REMIC’s assumed prepayment speed.²³

The amendment would not affect the ability of the IRS under current law to attack the use of a partnership or other entity to avoid residual tax liability under the existing anti-abuse rules and other common law doctrines.

D. Alternatives to Proposed Regulations Section 1.860E-1(c)(4).

For a variety of reasons, in certain cases it is either impossible, unfeasible, or otherwise economically inefficient for a REMIC sponsor to retain a noneconomic residual interest. For example, because GNMA is a disqualified organization, it is not permitted to hold the residuals from the REMICs it sponsors. In addition, mortgage origination (and not

²³ The entity certification would be analogous to the certification provided by a transferee under regulations sections 1.860E-1(c)(4)(ii) and 1.860G-3(a)(2).

cash flow management) is the core business of many REMIC sponsors, and they generally do not have the professional personnel to manage the liability represented by a REMIC residual and to efficiently invest the cash reserves necessary to fund the liability. Accordingly, as a matter of efficient balance sheet management, these sponsors prefer to transfer the residual (and the liability it represents) to a party that is better able to manage it.

Rules that require REMIC sponsors to increase the amounts they pay to transfer residuals (or, worse, that preclude them from transferring residuals), increase their cost of doing business. All or a portion of this increased cost, in turn, is passed along through the market as an additional cost of mortgage lending and ultimately increases mortgage interest rates. In contrast, rules that minimize consideration REMIC sponsors must pay to transfer noneconomic residuals generally minimize their cost of doing business, which improves the efficiency of the mortgage market. We believe that enhancing efficiency of the mortgage market is an important policy goal and was a major purpose of the REMIC regime.

The proposed regulation would require that the consideration for the transfer plus the residual interest's future cash flow exceed the tax liability associated with the residual, based on the highest marginal corporate income tax rate and the present value of expected future distributions, discounted at the applicable federal rate (or lower rate only if the transferee can demonstrate a lower borrowing rate). This proposed formula may overstate the consideration that a transferee would demand if the transferee is able to invest the payment at a rate that exceeds the applicable federal rate. Moreover, market changes after the REMIC is organized may cause the expected prepayment rate to be higher at the time of the transfer of the residual than the REMIC's prepayment assumption, thereby also justifying the payment of less consideration, and the proposed regulation is unclear as to whether the transferee may take into account these market changes in determining the

present value of the net tax liabilities associated with the residual. AMT taxpayers may be subject to a marginal rate of 20%, rather than 35%, on their excess inclusion income during some or all periods. Finally, taxpayers are permitted to offset tax on excess inclusions by certain credits, such as low-income housing tax credits, also resulting in an effective tax rate that is less than the highest marginal rate. Therefore, the proposed regulation is overbroad and denies safe harbor treatment for many nonabusive transfers. Moreover, to the extent the proposed regulation does not increase the likelihood that the residual tax will be paid, it is unsuited to the task of preventing abuse.

Although the proposed regulation would affect only a “safe harbor,” in practice, because the stakes are so high for the transferor of a noneconomic residual interest (i.e., the transferor pays the transferee to accept the residual and, if the transfer is disregarded, the transferor is out the payment and is subject to tax), the safe harbor has effectively become the substantive rule for major REMIC transactions and is regularly incorporated into transaction documents. As a practical matter, therefore, the proposed regulation would effectively preclude or impede nonabusive transfers of residuals, and thus would make mortgage securitizations using REMICs less efficient.

Nevertheless, we recognize that the policy goal of economic efficiency must be balanced against the policy goal of preventing tax evasion through abusive residual transfers. To minimize opportunities for evasion, without unnecessarily impeding transfers of residuals, we recommend that the safe harbor of regulations section 1.860E-1(c)(4) be converted into a substantive rule, so that any transferor not complying would be secondarily liable for tax on income from the transferred residual. In other words, if a transferor does not comply with the regulation’s requirements to conduct an investigation of the financial condition of the transferee and receive a representation from the transferee as to its intent to

pay the tax, and the transferee does not in fact pay the residual tax liability, the transferor would remain liable for the tax and would not be permitted to escape liability by demonstrating that it did not know and should not have known that the transferee would fail to pay the tax. (However, if the tax is in fact paid by the transferee, the transfer would be respected even if the transferor does not comply with the safe harbor.) We believe this change will help prevent abusive residual transfers without adversely affecting residual liquidity. If this change is not sufficient to prevent residual abuse, we suggest below a number of alternatives to proposed regulations section 1.860E-1(c)(4) that attempt to balance the goals of maximizing liquidity for noneconomic residuals and preventing abuse.

1. Penalties of Perjury Statement by CFO (or Equivalent Officer) of the Transferee. First, regulations sections 1.860E-1(c)(4) could be amended to impose the additional requirement that the transferor receive a certification from the chief financial officer (or equivalent officer) of the transferee, signed under penalties of perjury, that the CFO has personal knowledge of the financial condition of the transferee and, to the best of the CFO's knowledge, all tax liability with respect to the residual will in fact be paid (even if it exceeds the transferee's projections). In the case of any transferee that is a pass through entity, the certification would be received from the CFO (or equivalent officer) of each beneficial owner.²⁴ The safe harbor would not be available if the transferor knew or had

²⁴ In lieu of receiving a certification from the chief financial officer of a beneficial owner of an interest in the pass through entity, the transferor could receive a certification from an equivalent representative of the pass through entity to the effect that the distributable cash flows of that owner from the residual and the entity's other assets are expected to be sufficient to pay the owner's tax liability with respect to the residual in each year based on all prepayment speeds between 50% and 200% of the REMIC's assumed prepayment speed.

reason to know that the certification was false. In addition, transfers of residuals would be reported to the IRS along with the penalties of perjury statement.

Requiring certification under penalties of perjury by an individual senior officer of the transferee would (i) place responsibility where it belongs – on an individual responsible for the transferee’s activities, (ii) permit maximum flexibility for nonabusive residual interest transfers,²⁵ and (iii) ensure residual liquidity and therefore maximize economic efficiency. Of course, a penalties-of-perjury statement would not absolutely ensure payment of the residual tax. Even assuming the statement is made in good faith, abuses could occur after the signatory resigns as an officer of the transferee. It is also possible, although less likely, that a transferee would hire a CFO solely to sign the statement.

2 Modified Proposed Regulation. Under a second approach, a modified version of the proposed regulation would be adopted permitting transfers for less consideration than generally required if the transferor could justify the lesser amount by considerations such as (i) a reasonable belief that its own actual return on investment and/or cost of funds will differ from the applicable federal rate (which belief is supported by evidence and a certification), or (iii) the expectation that it will be an AMT taxpayer or will use credits to offset tax from the residual (supported by documentation and a certification). In addition to certification, the penalties of perjury statement suggested in Part IV.D.1. could be required. This modification to the proposed regulation would make it less likely that transferors would be required to pay an amount of consideration that exceeds the present

²⁵ We recognize that taxpayers regularly sign their tax returns under penalties of perjury and this statement is not effective in eliminating abuse. However, we believe the penalties of perjury statement we are suggesting would be more effective because, in contrast to determination of income tax liability, the tax liability associated with holding the residual is almost entirely a factual determination and does not depend on interpretation of law.

value of the tax the transferee will actually be required to pay. This approach would not, however, foreclose opportunities for abuse, and implementation may be difficult. For example, it may be difficult to evaluate the transferee's assertions regarding its expected return on investment.

3 Limit Safe Harbor Transfers to Well-Capitalized Transferees.

Under a third approach, the safe harbor would be limited to transfers to well-capitalized transferees that are unlikely to declare bankruptcy or otherwise experience financial distress that would cause them to default on their obligations. One natural class of transferees would be C corporations that are also "qualified institutional buyers" ("QIBs"), which generally have gross assets of at least \$100 million. In addition, this approach might require that the transferee have a minimum level of pre-transfer net assets (such as the greater of \$10 million or 100 times the present value of the expected tax liability associated with the residual interest). This restriction might help prevent transfers of noneconomic residuals to transferees that later declare bankruptcy, but it would exclude a large market for residual interests consisting of substantial partnerships and less well-capitalized (but bona fide) purchasers.

4 Mandate Secondary Liability for Transferors In All Instances.

Finally, it is possible that no approach will adequately prevent abusive transfers. If that is the case, the safe harbor arguably should be repealed so that transferors would always be secondarily liable for tax on transferred residual interests. We have serious reservations about this approach because it would either require REMIC sponsors to retain the contingent liability on their books, effectively restrict transfers to transferees with AAA credit ratings, or force transferors to seek insurance against the contingent liability, and in any case impose transaction costs and reduce REMIC efficiency. Although this approach may eventually

prove necessary, we do not recommend it, at least until the alternatives we propose have been tried and found ineffective.

We do recommend that, whatever approach is adopted, the effective date be no earlier than the date of enactment (if by statute) or issuance in final form (if by regulation). Accordingly, we recommend that the effective date of proposed regulations section 1.860E-1(c)(4) be postponed until the regulation (or its replacement) is finalized.