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From:
Sent: Monday, July 09, 2012 5:00:51 PM
To:
Cc:
Subject: : REMIC Suspended Loss Carryforwards

Dear

Thank you for your recent request for electronic chief counsel advice relative to the treatment of suspended loss carryforwards by a holder of Real Estate Mortgage Investment Conduit ("REMIC") residual interests.

Background

The Compliance team with which you are working is examining a taxpayer that holds numerous REMIC non-economic residual interests ("NERIs"). Taxpayer has been prohibited from taking net losses into account in particular calendar quarters with respect to certain of the NERIs by virtue of the basis limitation rules of section 860C(e)(2)(A). In any calendar quarter for any individual NERI with respect to which taxpayer is prohibited from taking net losses into account, taxpayer credits what is called a suspended loss account for the net loss amount it is prohibited from taking into account. For many of these NERIs, the REMIC to which the NERI relates had taxable income in quarters subsequent to the crediting of the suspended loss account.

The Compliance team has posited the following simplified example relative to one NERI. Coming into the first calendar quarter of the year in the example, taxpayer has basis in the NERI of $100. In the first quarter, the REMIC to which the NERI relates has $20 of taxable income. In the second quarter, the REMIC has $50 of taxable income. In the third quarter, the REMIC has $200 of net loss. In the fourth quarter, the REMIC has $25 of taxable income. Finally, in the first quarter of the subsequent calendar year (which is the fifth calendar quarter since the start of the example), the REMIC has $30 of taxable income. At the end of the first quarter of the subsequent year, taxpayer transfers the NERI.

The example therefore posits that taxpayer's basis in its NERI is $170 coming into the third quarter, at which time the REMIC has $200 of net loss. Under the example, the NERI holder is precluded from using $30 of the REMIC net loss and the NERI holder therefore credits that $30 to the suspended loss account at the end of the third quarter. The Compliance team's principal question is how do the suspended loss carryforward rules of section 860C(e)(2)(B) operate to determine the NERI holder's tax obligations in the fourth quarter and the first quarter of the subsequent calendar year of the example (the fifth calendar quarter since the start of the example), quarters where the REMIC has taxable income and the NERI holder has a positive balance in its suspended loss account.

By way of additional background, it is understood that the Compliance team has generally ascertained that: (1) taxpayer is not summing REMIC taxable income and net loss across all the NERIs that it holds and reporting one net number; (2) taxpayer is making quarterly determinations of REMIC taxable income allocable to the NERI holder and is reporting as income the sum of the quarterly positive income amounts (i.e., the taxpayer is not netting intra-year); and (3) the REMICs to which the NERIs held by the taxpayer relate generally follow the typical profile of having taxable income in the early part of their existence and net loss later in their existence. The following discussion assumes that the original issue price of the NERI was zero.

Analysis

First Quarter of the Example. Section 860E(c)(2)(A) provides that the daily accrual with respect to any residual interest shall be determined by allocating to each day its ratable portion of the product of the adjusted issue price of the residual interest at the beginning of the quarter and 120-percent of the long-term Federal rate. Section 860E(c)(2)(B) provides that the adjusted issue price of a residual interest at the beginning of any calendar quarter is the issue price of the residual interest increased by the amount of daily accruals for prior quarters and decreased by any distribution made with respect to such interest before the quarter. Since the issue price for the NERI in the example was zero, the applicable REMIC's taxable income generally will be characterized as excess inclusion income ("EII") that is properly allocable to the NERI holder.

Therefore, the $20 of REMIC taxable income is characterized as EII and is allocable to the NERI holder. Additionally, the NERI holder now has an adjusted basis in the NERI of $120. See § 860C(d)(1); § 1.860C-1(b)(1)(i).

Second Quarter of the Example. For the reasons set out above with respect to the first quarter, the $50 of REMIC taxable income is characterized as EII and is allocable to the NERI holder. Additionally, the NERI holder now has an adjusted basis in the NERI of $170. See § 860C(d)(1); § 1.860C-1(b)(1)(i).

Third Quarter of the Example. As noted, the REMIC to which the NERI relates has $200 of net loss in the third quarter. Section 860C(e)(2)(A) provides that the amount of the net loss of any REMIC taken into account by a residual interest holder with respect to any calendar quarter shall not exceed the adjusted basis of such holder's residual interest as of the close of that calendar quarter (determined without regard to the adjustment under section 860C(d)(2)(B) for such calendar quarter). Therefore, the NERI holder in this example may take into account $170 of REMIC net loss, but is precluded from taking into account the remaining $30 of REMIC net loss.

Section 860C(d)(2)(B) provides that the basis of any person's residual interest shall be reduced by the sum of the net loss of a REMIC taken into account by the NERI holder. See also § 1.860C-1(b)(2). The NERI holder's adjusted basis in the NERI at the end of the third quarter is therefore zero.

Section 860C(e)(2)(B) provides that any loss disallowed by virtue of the loss limitation provisions of section 860C(e)(2)(A) shall be treated as incurred by the REMIC in the succeeding calendar quarter with respect to such holder. The NERI holder therefore credits what it calls a suspended loss account with the $30 it was precluded from using in the third quarter.

Fourth Quarter of the Example. As noted, section 860C(e)(2)(B) provides that any loss disallowed by virtue of the loss limitation provisions of section 860C(e)(2)(A) shall be treated as incurred by the REMIC in the succeeding calendar quarter with respect to such holder. Therefore, the $30 of REMIC net loss not taken into account by virtue of the loss limitation provisions and credited to the suspended loss account at the end of the third quarter is treated as incurred by the REMIC in the fourth quarter with respect to the NERI. The result is that REMIC taxable income relative to the NERI holder is zero in the fourth quarter. Because the REMIC's taxable income in the fourth quarter was $25, the balance of the suspended loss account to be applied in the next succeeding calendar quarter is $5. Because REMIC taxable income is also characterized as EII, for reasons discussed above, and there is no REMIC taxable income with respect to the NERI holder in the fourth quarter, there is also no REMIC taxable income characterized as EII allocable to the NERI holder. The NERI holder's adjusted basis in the NERI at the end of the fourth quarter is zero. The positive balance in the suspended loss account is $5.

Additionally, the NERI holder reports a total of $70 of REMIC taxable income characterized as EII for the calendar year.

First Quarter of Subsequent Calendar Year (Fifth Calendar Quarter Since the Start of the Example). As noted with respect to the fourth quarter, any loss disallowed by virtue of the loss limitation provisions is treated under the indefinite carryforward provisions as incurred by the REMIC in the succeeding calendar quarter with respect to such holder. In your hypothetical, REMIC taxable income in the first quarter of the subsequent calendar year is $30. Therefore, the $5 of REMIC net loss not taken into account in the fourth quarter is treated as incurred by the REMIC in the first quarter of the year subsequent to the start of the example with respect to the NERI. The result is that REMIC taxable income that is characterized as EII and that is allocable to the NERI holder is $25 in this quarter, the balance of the suspended loss account is zero, and the NERI holder's adjusted basis in the NERI is $25.

<u>Transfer of the NERI</u>. The Compliance team also asks whether, if the basis limitation provisions did not operate as set out above to reduce the REMIC taxable income allocable to the NERI holder (because, it is argued, section 860C(a) operates independently of the other REMIC provisions), the REMIC NERI holder could recognize the REMIC net loss represented by the positive amount in the suspended loss account via a basis adjustment upon transfer of the NERI to another holder.

Inasmuch as the basis limitation provisions do operate as set out above, addressing this alternative hypothetical will not be undertaken here. That said, the question does highlight the issue posed in the event the NERI holder were to transfer the NERI at the end of the fourth quarter under the facts set out above, when the NERI holder has a positive $5 in the suspended loss account and zero adjusted basis in the NERI.

Section 1.860C-1(b)(3) provides that if any person disposes of a residual interest, the adjustments to basis prescribed in paragraphs (b)(1)(increases in basis) and (2)(decreases in basis) are deemed to occur immediately before disposition. At the end of the fourth quarter, the NERI holder would not have sufficient basis in the NERI to make any adjustment, with the result that the $5 in the NERI holder's suspended loss account would expire unutilized upon the transfer. Absent taxpayer having sufficient basis in the NERI, the statute and regulations do not permit taxpayer to avail itself of the $5 in the suspended loss account, even upon transfer of the NERI.

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I hope the foregoing answers your questions. Please feel free to contact me if you have any other questions.