Example 1

Expected Cash Flows:

Year 0	(8.97)
Year 1	5.00
Year 2	2.50
Year 3	1.50
Year 4	1.00
Year 5	0.50

(Offset amounts in bold.)

Year 1

payments for year/total expected payments = 5/10.5 = .47

ratio multiplied by investment = .47(8.97) = **4.27**

Year 2

2.5/10.5 = .23
.23(8.97) = **2.14**

Year 3

1.5/10.5 = .143
.143(8.97) = **1.28**

Year 4

1/10.5 = .095
.095(8.97) = **.85**

Year 5

.5/10.5 = .047
.047(8.97) = **.43**

[4.27 + 2.14 + 1.28 + .85 + .43 = 8.97]

Example 2

If the expected return is not updated, the holder won't recover its investment.

Actual Cash Flows:

Year 0	(8.97)
Year 1	5.00
Year 2	1.00
Year 3	0.60
Year 4	0.40
Year 5	0.20

Year 1

5/10.5 = .48
.48(8.97) = **4.27**

Year 2

1/10.5 = .095
.095(8.97) = **.85**

Year 3

.6/10.5 = .06
.06(8.97) = **.51**

Year 4

.4/10.5 = .04
.04(8.97) = **.34**

Year 5

.2/10.5 = .02
.02(8.97) = **.17**

[4.27 + .85 + .51 + .34 + .17 = 6.14]

Example 3

If you update the expected return after year 1:

Actual Cash Flows:

Year 0	(8.97)
Year 1	5.00
Year 2	1.00
Year 3	0.60
Year 4	0.40
Year 5	0.20

Year 1

5/10.5 = .48
.48(8.97) = **4.27**

After year 1, total expected return is 7.20 (5 + 1 + .6+ .4 + .2):

Year 2

1/7.2 = .14
.14(8.97) = **1.25**

Year 3

.6/7.2 = .08
.08(8.97) = **.75**

Year 4

.4/7.2 = .06
.06(8.97) = **.50**

Year 5

.2/7.2 = .03
.03(8.97) = **.25**

[4.27 + 1.25 + .75 + .50 + .25 = 7.02]

If the holder recalculates Year 1, using the new total expected return ((5/7.2)(8.97)) = 6.23), and takes into account the difference between that amount (6.23) and the amount calculated using the original expected return (4.27), which equals 1.96, the holder will recover its total investment.

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DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[REG–108637–03]

RIN 1545–BB94

Accrual for Certain REMIC Regular Interests

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking and notice of public hearing.

SUMMARY: This document contains proposed regulations relating to the accrual of original issue discount (OID) on certain real estate mortgage investment conduit (REMIC) regular interests. The proposed regulations are necessary to provide guidance to REMICs, REMIC regular interest holders and information reporters regarding the accrual of OID. This document also provides notice of a public hearing on the proposed regulations.

DATES: Written or electronic comments must be received by November 23, 2004. Outlines of topics to be discussed at the public hearing scheduled for November 17, 2004, must be received by October 27, 2004.

ADDRESSES: Send submissions to: CC:PA:LPD:PR (REG–108637–03), room 5203, Internal Revenue Service, PO Box 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand-delivered Monday through Friday between the hours of 8 a.m. and 4 p.m. to CC:PA:LPD:PR (REG–108637–03), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW., Washington, DC, or sent electronically, via the IRS Internet site at *http://www.irs.gov/regs* or via the Federal eRulemaking Portal at *http://www.regulations.gov* (IRS—REG–108637–03). The public hearing will be held in the Auditorium, Internal Revenue Building, 1111 Constitution Avenue, NW., Washington, DC.

FOR FURTHER INFORMATION CONTACT: Concerning the regulations, contact Rebecca Asta at (202) 622–3930. To be placed on the building access list for the hearing, contact Sonya Cruse at (202) 622–7180.

SUPPLEMENTARY INFORMATION:

Background and Explanation of Provisions

1. General Background

A debt instrument may provide for qualified stated interest (QSI) (that is, certain periodic payments of stated interest), OID, or both. Sections 163(e) and 1271 through 1275 provide rules for the treatment of OID on debt instruments. In general, the holder of a debt instrument includes OID in income as it accrues, even if the holder generally uses a cash method of accounting. A holder of a REMIC regular interest includes QSI in income under an accrual method of accounting because section 860B(b) requires that amounts includible in gross income with respect to a REMIC regular interest be determined under an accrual method.

For many debt instruments, only one or two days separate the date on which the holder becomes entitled to a payment (the record date) from the date on which the holder receives payment (the payment date). For REMIC regular interests, however, the record date may precede the payment date by 15 to 30 days.

2. Current REMIC Accrual Practice

Under the governing contract provisions, REMIC regular interests generally accrue interest from the issue date to the final record date, and holders become entitled to receive interest payments based on month-end record dates. The IRS and the Treasury Department understand, however, that, in general, REMIC servicers have interpreted the OID rules to require or permit holders' OID to accrue for tax purposes over the period from payment date to payment date and have treated QSI as accruing over the same periods. To compensate for accruing QSI and OID beyond the final record date to the final payment date, the servicers have treated QSI and OID on REMIC regular interests as not accruing from the date of issue for a period equal to the number of days between the record date and payment date. In effect, for tax purposes, the tax accrual of QSI and OID lags the legal accrual of interest by the delayed payment period.

For tax purposes, as of the date a REMIC regular interest is purchased in the secondary market, the purchaser begins to accrue QSI and OID, and the seller ceases to accrue QSI and OID. A purchaser that holds the instrument until the final payment date or redemption accrues QSI and OID past the final record date as long as it holds the instrument. A purchaser that begins to accrue QSI and OID on the purchase date gives up the benefit of the lag in the beginning of the accrual period. As a result, the delayed accrual system causes the last secondary market purchaser of a REMIC regular interest to accrue for tax purposes an additional number of days of QSI and OID equal to the number of days between the record and payment dates, and too much QSI and OID is allocated to the last secondary purchaser of the REMIC regular interest. Moreover, because of principal payments, the holder will earn interest on a declining principal balance, while the lagging tax accruals will be based on a higher principal amount between record dates and payment dates in many instances. Consequently, a secondary market purchaser that is not the last secondary market purchaser will experience tax accruals in excess of legal entitlements if the regular interest has significant stated principal and bears interest at a stated rate.

3. Overview of the Proposed Regulations

The proposed rules address the misallocation of QSI and OID by creating a special rule for accruing OID on REMIC regular interests that provide for a delay between record and payment dates. Under the proposed regulations, the period over which OID accrues generally coincides with the period over which the holder's right to interest payments accrues under the governing contract provisions.

Generally, under the proposed regulations, if the terms of a REMIC regular interest provide for a delay between the record and payment dates, the initial accrual period begins on the date of issuance of the regular interest, and the final accrual period ends on the final record date of that REMIC regular interest. By shifting the entire tax accrual schedule, this special rule allocates all QSI and OID to the period between the issue date and the final record date of the instrument and none to the period between the final record date and final payment date. For purposes of calculating OID in the final accrual period with the methodology described in section 1272(a)(6), but for no other purpose, payments on the REMIC regular interest after the end of that accrual period that are included in the stated redemption price at maturity of the instrument (such as the payment on the final payment date) are treated as being made during the final accrual period.

The IRS and Treasury Department recognize that, although the proposed regulations result in a more accurate allocation of QSI and OID among REMIC regular interest holders, some economic accuracy may be sacrificed by ending the accrual of OID before final payments are made on the regular interests. Therefore, the proposed regulations are limited to REMIC regular interests with delayed payment periods of fewer than 32 days. The regulation regarding REMIC regular interests with delayed payment periods of more than 31 days is reserved. The IRS and Treasury Department request comments on whether additional guidance is needed for these REMIC regular interests.

4. Accrual of Qualified Stated Interest

Section 1.1272–1(a) requires a holder to include QSI in income under the holder's regular method of accounting. Section 1.446–2(b) requires a holder, as well as the issuer, to accrue QSI ratably over the accrual period to which it is attributable. In addition, section 860B(b) requires a holder of a regular interest to accrue amounts into gross income regardless of the holder's overall method of accounting. The amounts that must be so accrued include QSI. The Treasury Department and the IRS understand that many REMIC servicers have accrued QSI over the same period as OID. It is intended that, with respect to the accrual periods referenced in § 1.446–2(b), the initial accrual period for QSI will begin on the date of issuance and the final accrual period for QSI will end on the final record date. As a result, the QSI accrues over the same period as the OID.

Proposed Effective Date

These regulations are proposed to apply to any REMIC regular interest issued after the date the final regulations are published in the **Federal Register**. The proposed regulations provide automatic consent for the holder of a REMIC regular interest to change its method of accounting for OID under the final regulations. The change is proposed to be made on a cut-off basis and, thus, does not affect REMIC regular interests issued before the date the final regulations are published in the **Federal Register**.

The Treasury Department and the IRS are concerned regarding the extent to which holders of REMIC regular interests will be aware that changes in accounting methods for QSI may be necessary to comply with the special rule in the proposed regulations. If a holder of REMIC regular interests relies on data provided on behalf of the REMIC rather than performing its own computations, the holder may be unaware that these rules will have required newly issued REMICs to alter the accrual periods over which interest reported to holders is computed. The Treasury Department and the IRS request comments on the way in which a change in accounting method for QSI should be effected.

The Treasury Department and the IRS request comments concerning the extent to which any other debt instruments provide for a significant delay between record and payment dates and, if some do, whether rules like those in the proposed regulations should be extended to them. Any comments received will be considered in connection with the publication of final regulations in the **Federal Register**.

Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory flexibility assessment is not required. It has also been determined that section 553(b) of the Administrative Procedures Act (5 U.S.C. chapter 5) does not apply to these regulations, and because the regulation does 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 Internal Revenue Code, this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small businesses.

Comments and Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written comments (a signed original and eight (8) copies) or electronic comments that are submitted timely to the IRS. The Treasury Department and IRS specifically request comments on the clarity of the proposed rules and how they may be made easier to understand. All comments will be available for public inspection and copying.

A public hearing has been scheduled for November 17, 2004, beginning at 10 a.m. in the Auditorium of the Internal Revenue Building, 1111 Constitution Avenue, NW., Washington, DC. Due to building security procedures, visitors must enter at the Constitution Avenue entrance. All visitors must present photo identification to enter the building. Because of access restrictions, visitors will not be admitted beyond the immediate entrance area more than 30 minutes before the hearing starts. For information about having your name placed on the building access list to attend the hearing, see the **FOR FURTHER INFORMATION CONTACT** section of this preamble.

The rules of 26 CFR 601.601(a)(3) apply to the hearing. Persons who wish to present oral comments at the hearing must submit written or electronic comments by November 23, 2004 and an outline of the topics to be discussed and the time to be devoted to each topic (signed original and eight (8) copies) by October 27, 2004. A period of 10 minutes will be allotted to each person for making comments. An agenda showing the schedule of speakers will be prepared after the deadline for receiving outlines has passed. Copies of the agenda will be available free of charge at the hearing.

Drafting Information

The principal author of these proposed regulations is Rebecca Asta of the Office of Associate Chief Counsel (Financial Institutions and Products). However, other personnel from the IRS and Treasury Department participated in their development.

List of Subjects in 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

Proposed Amendments to the Regulations

Accordingly, 26 CFR part 1 is proposed to be amended as follows:

PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 continues to read in part as follows:

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

Par. 2. Section 1.1271–0 is amended by adding entries for § 1.1275–2(l) and (m) to read as follows:

§ 1.1271–0 Original issue discount; effective date; table of contents.

* * * * *

§ 1.1275–2 Special rules relating to debt instruments.

* * * * *

(l) [Reserved].

(m) Special rule for certain REMIC regular interests.

(1) Scope.

(2) General rules.

(3) Special rule for calculation of OID in final accrual period.

(4) Definition of record date.

(5) Accrual of qualified stated interest.

(6) Example.

(7) Treatment of REMIC regular interests if the record dates and the payment dates are separated by more than thirty-one days.

(8) Effective date.

* * * * *

Par. 3. Section 1.1275–2 is amended by adding new paragraphs (l) and (m) to read as follows:

§ 1.1275–2 Special rules relating to debt instruments.

* * * * *

(l) [Reserved].

(m) *Special rules for certain REMIC regular interests*—(1) *Scope.* If the terms of a REMIC regular interest (as defined in section 860G(a)(1)) provide for a delay between its record dates and the associated payment dates, the initial accrual period and final accrual period for that regular interest are determined under this paragraph (m). Except as provided in paragraph (m)(7) of this section, this paragraph (m) does not apply to a REMIC regular interest if the record dates and the payment dates are separated by more than thirty-one days.

(2) *General rules*—(i) *Initial accrual period.* The initial accrual period for a REMIC regular interest subject to this paragraph (m) begins on issuance of the REMIC regular interest.

(ii) *Final accrual period.* The final accrual period for a REMIC regular interest subject to this paragraph (m) ends on the final record date of the REMIC regular interest.

(3) *Special rule for calculation of OID in final accrual period.* In applying section 1272(a)(6)(A) to calculate OID in the final accrual period for a REMIC regular interest subject to this paragraph (m), payments after the end of the final accrual period of amounts included in the stated redemption price at maturity are treated as payments during the final accrual period.

(4) *Definition of record date.* For purposes of this paragraph (m), a *record date* of a REMIC regular interest is a date, provided by the terms of the REMIC regular interest, on which the holder becomes entitled to a payment (of interest or principal) that is to be made on a subsequent payment date.

(5) *Accrual of qualified stated interest.* See § 1.446–2 for the accrual of qualified stated interest.

(6) *Example.* The following example illustrates the application of this paragraph (m).

Example. REMIC X issues regular interests on January 1, 2009. The terms of the regular interests provide for payments of interest and principal to the persons who hold the regular interests on the last day of the calendar month (the record date). Each such payment is to be made on the fifteenth day of the succeeding calendar month (the payment date). The last payment with respect to the regular interests issued by REMIC X is to be made on January 15, 2014, to persons who hold the regular interests on December 31, 2013. Under this paragraph (m), the initial accrual period begins on the date of issuance, January 1, 2009, and the last accrual period ends on the last record date, December 31, 2013.

(7) *Treatment of REMIC regular interests if the record dates and the payment dates are separated by more than thirty-one days.* [Reserved]

(8) *Effective date*—(i) *In general.* This paragraph (m) applies to REMIC regular interests issued after the date the final regulations are published in the **Federal Register**.

(ii) *Automatic consent to change method of accounting.* Taxpayers are hereby granted the Commissioner's consent under section 446(e) to change their method of accounting for REMIC regular interests to which this paragraph (m) applies if—

(A) The change involves changing accrual periods to accrual periods allowed by this paragraph (m);

(B) The change is made for the first taxable year of the taxpayer during which the taxpayer holds a REMIC regular interest to which the rules of this paragraph (m) apply; and

(C) The change in method of accounting is effected on a cut-off basis.

Deborah M. Nolan,

Acting Deputy Commissioner for Services and Enforcement.

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