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# Final Regulations Issued for "Non-Economic" REMIC Residual Transfers

**By Terry Meyers and Bob Siegel**

This month, just shy of 2 ½ years following their initial volley[1], the IRS issued "final regulations"[2] that both limit and liberalize the scope of the safe-harbor rule applicable to the transfer of non-economic REMIC residual interests.

Generally speaking, a transfer of a non-economic residual interest will be disregarded if a significant purpose of the transfer was to enable the transferor to impede the assessment or collection of tax. If the transfer were disregarded, the transferor would remain liable for any taxes due from the income on the residual interest. According to the prior regulation, this condition exists when the transferor has *"improper knowledge*[3]*"* at the time of the transfer. The safe-harbor provided an opportunity for the transferor to establish that they did not have such knowledge.

While the final regulations modestly expand the rules for meeting the safe harbor[4], for the most part, they have adopted the earlier proposed regulations.

Nonetheless, in response to certain perceived abuses around transfers to foreign branches of U.S. corporations, two additions have been made.

1. The transferee must represent that it will not cause income from the noneconomic residual interest to be attributable to a foreign permanent establishment or fixed base (within the meaning of an applicable treaty) of the transferee or another U.S. taxpayer (i.e., a foreign branch)

[1] For further background, kindly refer to SOS Volume 5, Issue 2—February 2000 *Non-Economic REMIC Residual Transfers Hit as Part of Proposed FASIT Regulation Package* and SOS Volume 6, Issue 1—January 2001—*Non-Economic REMIC Residual Transfers Proposed Regulations Revisited.*

[2] Treasury Decision 9004, released July 19, 2002.

[3] The transferor knew or should have known that the transferee would be "unwilling or unable" to pay taxes due on its share of the taxable income from the REMIC.

[4] The prior regulations required the following two conditions be met to qualify for the safe harbor:

1. the transferor must conduct a reasonable investigation of the transferee's financial condition and,
2. the transferor must obtain a representation from the transferee that it understands it may incur a tax in excess of actual cash distributions from the REMIC and that the transferee intends to pay any such tax.

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2. Such transfers are no longer eligible for the safe-harbor under either the "asset test" or the "formula test".

Essentially, these measures were taken to prevent the use of excess foreign tax credits or tax treaties to shelter the tax on the income of the residual interest.

In addition, the "formula test", has been modified as follows:

- Calculating anticipated tax liabilities[5] and savings:
  - — The corporate alternative minimum tax (AMT)[6] rate may be used in lieu of the highest applicable corporate income tax rate[7], if:
    - ✓ the transferee has been subject to the AMT in the preceding 2 years, and
    - ✓ the transferee will compute its current year's tax using the AMT rate.
- Determining present values:
  - — The applicable federal short term rate for the month of the transfer, with the appropriate compounding period being that used in the computation
  - — The ability to use an alternative lower rate based upon the transferee's cost of borrowing has been eliminated.

## Effective Dates:

Except for the provisions relating to foreign branches, the regulations are effective for transfers occurring on or after, February 4, 2000, as originally proposed. The foreign branch provisions apply to transfers occurring on or after August 19, 2002.

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Please contact either Terry Meyers at (202) 378-5028 or Bob Siegel (713) 982-4060, with questions or to discuss how these regulations might apply to you.

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[5] It continues to be the case that no additional guidance has been offered with respect to the prepayment and related assumptions to be used for determining taxable income or loss.

[6] The rate provided in IRC section 55(b)(1)(B) - 20%

[7] IRC Section 11(b)(1) - 35%