State of California
Franchise Tax Board

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LEGAL RULING 2009-01

Subject: Application of the REMIC Excess Inclusion Rules in a Unitary Combined Reporting Group

ISSUE

How the excess inclusion (EI) is determined for a residual interest holder in a Real Estate Mortgage Investment Conduit (REMIC) that is a California taxpayer member of a unitary combined reporting group?

FACTS

Situation One:

Corporation A is a California taxpayer member of a unitary combined reporting group,[1] from which it is allocated California-sourced income or loss.[2] Corporation A is a residual interest holder in a REMIC. As such, for federal income tax purposes, Corporation A is required to report a minimal amount of taxable income. For California franchise tax purposes, the minimal amount for Corporation A has been determined on a post-apportioned basis.

Situation Two:

Assume that a net California-sourced loss has been allocated to Corporation A for the taxable year. For California franchise tax purposes, the minimal amount of taxable income was not considered for purposes of determining the amount of net operating loss (NOL) that Corporation A can carry forward to subsequent years.

LAW AND ANALYSIS

General REMIC Excess Inclusion Rules

Subchapter M of Chapter 1 of Subtitle A of the Internal Revenue Code (IRC) provides the federal rules relating to REMICs. (See IRC sections 860A through 860G.) California

[1] See California Code of Regulations, title 18 (CCR), § 25106.5, sub. (b)(3).

[2] See CCR § 25106.5, sub. (c)(7)(D).

Revenue and Taxation Code (CRTC) sections 17088 and 24870 provide that Subchapter M of Chapter 1 of Subtitle A of the IRC applies for California tax purposes.[3]

REMICs are investment vehicles through which mortgage-backed securities are issued. A sponsor[4] will transfer a pool of mortgages to an entity in exchange for interests in that entity.[5] The entity that received the mortgages will then elect REMIC status. (See IRC section 860D(a)(1).) Pursuant to IRC section 860F(b)(1), the sponsor will not recognize any taxable gain from the exchange of the mortgages for the interests. Rather, the sponsor will recognize taxable gain when the interests are sold.[6]

There are two types of REMIC interest holders: Regular and Residual. (See IRC section 860D(a)(2).) Regular interest holders are entitled to receive specified principal and interest payments. (See IRC section 860G(a)(1).) As mentioned in IRC section 860B(a), regular interest holders are, in essence, treated as bondholders. Accordingly, the regular interest holder is taxed on the interest it receives.[7]

Pursuant to IRC section 860G(a)(2), residual interest holders own the portion of the REMIC that is not owned by the regular interest holders. According to IRC section 860A(a), for tax purposes a REMIC is not treated as corporation or partnership and is not subject to tax. Instead, as required by IRC section 860C(a)(1), the REMIC's income, after deducting payments to the regular interest holders, is reported by the residual interest holder. A residual interest that does not receive distributions is referred to as a "Noneconomic residual interest" (NERI). (See Treas. Reg. section 1.860E-1(c)(2).) As a result, the NERI will receive insufficient distributions to cover the resulting tax liabilities relating to the reportable REMIC taxable income. Therefore, an inducement fee is generally paid to an entity or person to become the NERI holder. (See Treas. Reg. section 1.446-6(a).) Accordingly, there is no cost basis attributable to the interest in the NERI. The vast majority of residual interests are NERIs.[8]

The REMIC treats the interest received from the mortgages as income. The amount of interest that the REMIC pays to the regular interest holders is treated as an expense.[9] Depending on the way the REMIC is structured, there are a variety of regular interests that can be issued. In some instances, not all of the interest that a REMIC receives from the

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[3] The FTB has not issued its own regulations pertaining to REMICs. Therefore, pursuant to CRTC §§ 17024.5, subd. (d), and 23051.5, subd. (d), the applicable federal Treasury Regulations (Treas. Reg.) also govern California's treatment of REMICs.

[4] A sponsor of the REMIC is the former owner of the mortgages that were transferred to the REMIC. Peaslee & Nirenberg, Federal Income Taxation of Securitization Transactions (2001), at p. 1102 (Peaslee).

[5] Peaslee, at p. 342.

[6] Lore & Cowan, Mortgage-Backed Securities: Development and Trends in the Secondary Mortgage Market (2007 – 2008), § 6:48, at p. 320 (Lore).

[7] Lore, § 6.107, at p. 351.

[8] For the remainder of this ruling, it is presumed that the residual interest at issue is a NERI.

[9] Peaslee at p. 626.

mortgages during a particular period is necessarily paid to the regular interest holders. Therefore, during certain periods, the REMIC might receive more in interest income than it pays to the regular interest holders. This will result in income to the REMIC,[10] which must be taken into account by the NERI holder.[11]

The following example illustrates how a REMIC might have income remaining after paying interest to the regular interest holders. Assume the following variables:

1. The REMIC has a $400 mortgage pool. Interest is paid at 9% with $100 of principal returned each year.

2. There are four different types of regular interests, each of which was acquired for $100.

3. The first type of regular interest pays interest at 7% and the $100 of principal is returned at the end of the first year.

4. The second type of regular interest pays interest at 8% and the $100 of principal is returned at the end of the second year.

5. The third type of regular interest pays interest at 9% and the $100 of principal is returned at the end of the third year.

6. The fourth type of regular interest pays interest at 10% and the $100 of principal is returned at the end of the fourth year.

7. Based on Items 3 – 6, the cumulative amount of outstanding principal for all of the different types of regular interests is $400 for the first year, $300 for the second year, $200 for the third year and $100 for the fourth year.

The following table provides the calculation of the REMIC's interest income for each year.

Year	Principal	Interest Rate	Interest Income
Year One	$400	9%	$36
Year Two	$300	9%	$27
Year Three	$200	9%	$18
Year Four	$100	9%	$9
Total			$90

[10] Peaslee at p. 648.

[11] Peaslee at p. 654.

The following table provides the calculation of the REMIC's interest expense for each year.

Year	Type	Principal	Interest Rate	Interest Expense
Year One	First	$100	7%	$7
	Second	$100	8%	$8
	Third	$100	9%	$9
	Fourth	$100	10%	$10
Total Year One				$34
Year Two	Second	$100	8%	$8
	Third	$100	9%	$9
	Fourth	$100	10%	$10
Total Year Two				$27
Year Three	Third	$100	9%	$9
	Fourth	$100	10%	$10
Total Year Three				$19
Year Four	Fourth	$100		$10
Total Year Four				$10

The following table provides the calculation of the REMIC's income or loss for each year.

Year	Interest Earned	Interest Paid	Income/(Loss)
Year One	$36	$34	$2
Year Two	$27	$27	-0-
Year Three	$18	$19	($1)
Year Four	$9	$10	($1)
Total Income/(Loss)			-0-

As these tables indicate, cumulatively over the four years, the amount of interest income the REMIC received equaled the amount of interest expense the REMIC paid to the various regular interest holders. Nonetheless, the REMIC has income for the first year, which must be taken into account by the NERI holder. Essentially, the REMIC tax rules require that for any year in which there is income, in no event can the NERI holder report less than a minimal amount of taxable income (minimal amount). The minimal amount is the EI for that taxable year.

The rules for calculating EI are at IRC section 860E(c).[12] The first factor considered is the REMIC's taxable income for each calendar quarter that would be taken into account by the NERI holder. If there is a loss in a calendar quarter and the NERI holder has insufficient

[12] EI is not a separate type of income, such as capital gains, but is rather a method of characterizing REMIC income. Therefore, the term "Excess Inclusion Income" is a misnomer.

basis in the NERI, then such loss can be treated as occurring in the succeeding quarter.[13] The next factor considered is the sum of the "daily accruals" for each calendar quarter. Multiplying the basis in the NERI by 120% of the federal long-term rate[14] derives the daily accrual.[15] However, because there is no cost basis associated with a NERI, the daily accrual will always be zero. Essentially, the EI for each calendar quarter is the REMIC's taxable income for that calendar quarter. (See IRC sections 860E(c)(1) and 860E(a)(1).) The minimal amount equals the sum of the EI for all of the calendar quarters.

The following example illustrates how EI is calculated. Assume the following variables:

1. The NERI holder only possesses its interest for three calendar quarters.

2. The REMIC's taxable income (loss) for the first calendar quarter is $100.

3. The REMIC's taxable income (loss) for the second calendar quarter is ($300).

4. The REMIC's taxable income (loss) for the third calendar quarter is $150.

Based on these variables, the EI for the first calendar quarter is the REMIC's taxable income for that calendar quarter, which is $100. (Accordingly, the NERI holder's basis in the NERI becomes $100.) For the second calendar quarter, because there is a loss, there is no taxable income and, therefore, no EI. The excess of the loss over the NERI holder's basis in the NERI (($300) + $100 = ($200)) can be treated as if it occurred in the third calendar quarter. Therefore, there is no EI for the third calendar quarter because there is a remaining net loss of $50 ($150 - $200 = ($50).[16] For the entire three calendar quarters there is EI of $100, which is the minimal amount that the NERI must report.

In ordinary circumstances, the cumulative $50 loss from the three calendar quarters qualifies as a net operating loss (NOL) carryforward. However, pursuant to Treas. Reg. section 1.860E-1(a)(1), the minimal amount is not included in gross income or taxable income for purposes of calculating the NERI holder's NOL carryforward[17] for that taxable year.

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[13] IRC §860C(e)(2)(B) provides that the suspended loss can be applied to eliminate or reduce the next calendar quarter's taxable income Additionally, under IRC § 860C(d)(1), the basis in the NERI will be increased by the amount of REMIC income taken into account by the NERI holder. Thereafter, pursuant to IRC § 860C(e)(2), any subsequent loss, even it is attributable to the previous calendar quarter, will be limited by the NERI holder's basis in the NERI.

[14] The "federal long term rate" is defined at IRC § 1274(d). Pursuant to IRC § 1274(d)(1)(B), the Secretary of the Treasury determines the "federal long term rate" for each calendar year quarter.

[15] Daily accruals are a proxy for the return on the residual interest during the quarter if it had earned income at all times at a constant, compounded rate. (See Peaslee at p. 657.)

[16] Because the NERI holder only possesses its interest for three calendar quarters, the remaining $50 loss cannot be applied to a successive calendar quarter.

[17] See IRC § 172(b)(2).

Application of REMIC Excess Inclusion Rules in a Combined Report Context

California-sourced income subject to tax is determined by following apportionment principles based on a combined report methodology.[18] CCR sections 25106.5, subsection (b)(18), and 25106.5, subsection (c)(1), require that each unitary combined reporting group member restate its income to comply with the CRTC on a separate company basis. After appropriate modifications, the various unitary combined reporting group members' income is aggregated, forming the unitary combined reporting group's apportionable business income base.[19] The apportionable business income base is multiplied by each California taxpayer member's[20] California apportionment percentage[21] to derive that member's California sourced income. For California franchise tax purposes, with respect to an apportioning taxpayer, the amount of its income subject to tax is its California-sourced income.[22]

Because the NERI holder's taxable income represents the REMIC's taxable income, the NERI's minimal amount for federal purposes represents the REMIC's activities in multiple jurisdictions. If the NERI holder's entire minimal amount determined for federal purposes was taken into account for California purposes, it would reflect the REMIC's activities in other jurisdictions. To avoid taxing income that is not attributable to other jurisdictions, the minimal amount that the NERI holder must take into account for California purposes based on the EI rules should be determined by reference to its California apportionment factor percentage. Stated another way, the minimal amount that the NERI holder must report for California purposes based on the EI rules is determined on a post-apportioned basis. For example, if for federal purposes, through application of the EI rules, a NERI holder is required to report a minimal amount of $100 and its California apportionment factor percentage is 10 percent, then based on the EI rules, for California purposes, the minimal amount that the NERI holder must report is $10.

Finally, as mentioned above, Treas. Reg. section 1.860E-1(a)(1) requires that the minimal amount is not included in gross income or taxable income for purposes of calculating the NERI holder's NOL carryforward for the taxable year. CRTC section 25108 conforms to the federal NOL rules for apportioning corporations, which are found at IRC section 172. Therefore, the minimal amount will not be included in

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[18] If a taxpayer engages in activities within California and outside California, CRTC § 25101 requires that its net income be apportioned. CRTC § 25106.5 provides that a combined report methodology is used to determine the proper amount of income apportioned to California. The Franchise Tax Board has adopted regulations that provide guidance as to how the combined report methodology is employed. (See CCR §§ 25106.5-0, et seq.)

[19] See CCR § 25106.5, sub. (c)(6).

[20] See CCR § 25106.5, sub. (b)(11).

[21] See CCR § 25106.5 sub. (c)(7)(C).

[22] See CCR § 25106.5, sub. (d)(1). Also, for purposes of this discussion, it is presumed that the taxpayer does not have any other California-sourced income. (See CCR §§ 25106.5, subs. (d)(1)(B), (d)(1)(C), and (d)(2)(C).)

gross income or taxable income for purposes of calculating the NERI's NOL carryforward for California purposes.

HOLDINGS

Situation One:

The minimal amount that Corporation A must report for California purposes was appropriately determined on a post-apportioned basis.

Situation Two:

The calculation of the Corporation A NOL carryforward for California purposes was appropriately determined by not including the minimal amount in the calculation.

DRAFTING INFORMATION

The principal author of this ruling is Craig Swieso of the Franchise Tax Board, Legal Division. For further information regarding this ruling, contact Mr. Swieso at the Franchise Tax Board, Legal Division, P.O. Box 1720, Rancho Cordova, CA 95741-1720.