

interests from the REMIC on the start-up day in a transaction described in § 1.860F-2(a).

[T.D. 8458, 57 FR 61306, Dec. 24, 1992; 58 FR 8098, Feb. 11, 1993; 58 FR 15089, Mar. 19, 1993; T.D. 8614, 60 FR 42787, Aug. 17, 1995]

§ 1.860G-2 Other rules.

(a) *Obligations principally secured by an interest in real property*—(1) *Tests for determining whether an obligation is principally secured.* For purposes of section 860G(a)(3)(A), an obligation is principally secured by an interest in real property only if it satisfies either the test set out in paragraph (a)(1)(i) or the test set out in paragraph (a)(1)(ii) of this section.

(i) *The 80-percent test.* An obligation is principally secured by an interest in real property if the fair market value of the interest in real property securing the obligation—

(A) Was at least equal to 80 percent of the adjusted issue price of the obligation at the time the obligation was originated (see paragraph (b)(1) of this section concerning the origination date for obligations that have been significantly modified); or

(B) Is at least equal to 80 percent of the adjusted issue price of the obligation at the time the sponsor contributes the obligation to the REMIC.

(ii) *Alternative test.* For purposes of section 860G(a)(3)(A), an obligation is principally secured by an interest in real property if substantially all of the proceeds of the obligation were used to acquire or to improve or protect an interest in real property that, at the origination date, is the only security for the obligation. For purposes of this test, loan guarantees made by the United States or any state (or any political subdivision, agency, or instrumentality of the United States or of any state), or other third party credit enhancement are not viewed as additional security for a loan. An obligation is not considered to be secured by property other than real property solely because the obligor is personally liable on the obligation.

(2) *Treatment of liens.* For purposes of paragraph (a)(1)(i) of this section, the fair market value of the real property interest must be first reduced by the amount of any lien on the real prop-

erty interest that is senior to the obligation being tested, and must be further reduced by a proportionate amount of any lien that is in parity with the obligation being tested.

(3) *Safe harbor*—(i) *Reasonable belief that an obligation is principally secured.* If, at the time the sponsor contributes an obligation to a REMIC, the sponsor reasonably believes that the obligation is principally secured by an interest in real property within the meaning of paragraph (a)(1) of this section, then the obligation is deemed to be so secured for purposes of section 860G(a)(3). A sponsor cannot avail itself of this safe harbor with respect to an obligation if the sponsor actually knows or has reason to know that the obligation fails both of the tests set out in paragraph (a)(1) of this section.

(ii) *Basis for reasonable belief.* For purposes of paragraph (a)(3)(i) of this section, a sponsor may base a reasonable belief concerning any obligation—

(A) Representations and warranties made by the originator of the obligation; or

(B) Evidence indicating that the originator of the obligation typically made mortgage loans in accordance with an established set of parameters, and that any mortgage loan originated in accordance with those parameters would satisfy at least one of the tests set out in paragraph (a)(1) of this section.

(iii) *Later discovery that an obligation is not principally secured.* If, despite the sponsor's reasonable belief concerning an obligation at the time it contributed the obligation to the REMIC, the REMIC later discovers that the obligation is not principally secured by an interest in real property, the obligation is a defective obligation and loses its status as a qualified mortgage 90 days after the date of discovery. See paragraph (f) of this section, relating to defective obligations.

(4) *Interests in real property; real property.* The definition of "interests in real property" set out in § 1.856-3(c), and the definition of "real property" set out in § 1.856-3(d), apply to define those terms for purposes of section 860G(a)(3) and paragraph (a) of this section.

(5) *Obligations secured by an interest in real property.* Obligations secured by interests in real property include the following: mortgages, deeds of trust, and installment land contracts; mortgage pass-thru certificates guaranteed by GNMA, FNMA, FHLMC, or CMHC (Canada Mortgage and Housing Corporation); other investment trust interests that represent undivided beneficial ownership in a pool of obligations principally secured by interests in real property and related assets that would be considered to be permitted investments if the investment trust were a REMIC, and provided the investment trust is classified as a trust under §301.7701-4(c) of this chapter; and obligations secured by manufactured housing treated as single family residences under section 25(e)(10) (without regard to the treatment of the obligations or the properties under state law).

(6) *Obligations secured by other obligations; residual interests.* Obligations (other than regular interests in a REMIC) that are secured by other obligations that are not principally secured by interests in real property even if the underlying obligations are secured by interests in real property. Thus, for example, a collateralized mortgage obligation issued by an issuer that is not a REMIC is not an obligation principally secured by an interest in real property. A residual interest (as defined in section 860G(a)(2)) is not an obligation principally secured by an interest in real property.

(7) *Certain instruments that call for contingent payments are obligations.* For purposes of section 860G(a)(3) and (4), the term “obligation” includes any instrument that provides for total non-contingent principal payments that at least equal the instrument’s issue price even if that instrument also provides for contingent payments. Thus, for example, an instrument that was issued for \$100x and that provides for non-contingent principal payments of \$100x, interest payments at a fixed rate, and contingent payments based on a percentage of the mortgagor’s gross receipts, is an obligation.

(8) *Defeasance.* If a REMIC releases its lien on real property that secures a qualified mortgage, that mortgage

ceases to be a qualified mortgage on the date the lien is released unless—

(i) The mortgagor pledges substitute collateral that consists solely of government securities (as defined in section 2(a)(16) of the Investment Company Act of 1940 as amended (15 U.S.C. 80a-1));

(ii) The mortgage documents allow such a substitution;

(iii) The lien is released to facilitate the disposition of the property or any other customary commercial transaction, and not as part of an arrangement to collateralize a REMIC offering with obligations that are not real estate mortgages; and

(iv) The release is not within 2 years of the startup day.

(9) *Stripped bonds and coupons.* The term “qualified mortgage” includes stripped bonds and stripped coupons (as defined in section 1286(e) (2) and (3)) if the bonds (as defined in section 1286(e)(1)) from which such stripped bonds or stripped coupons arose would have been qualified mortgages.

(b) *Assumptions and modifications—(1) Significant modifications are treated as exchanges of obligations.* If an obligation is significantly modified in a manner or under circumstances other than those described in paragraph (b)(3) of this section, then the modified obligation is treated as one that was newly issued in exchange for the unmodified obligation that it replaced. Consequently—

(i) If such a significant modification occurs after the obligation has been contributed to the REMIC and the modified obligation is not a qualified replacement mortgage, the modified obligation will not be a qualified mortgage and the deemed disposition of the unmodified obligation will be a prohibited transaction under section 860F(a)(2); and

(ii) If such a significant modification occurs before the obligation is contributed to the REMIC, the modified obligation will be viewed as having been originated on the date the modification occurs for purposes of the tests set out in paragraph (a)(1) of this section.

(2) *Significant modification defined.* For purposes of paragraph (b)(1) of this section, a “significant modification” is

any change in the terms of an obligation that would be treated as an exchange of obligations under section 1001 and the related regulations.

(3) *Exceptions.* For purposes of paragraph (b)(1) of this section, the following changes in the terms of an obligation are not significant modifications regardless of whether they would be significant modifications under paragraph (b)(2) of this section—

- (i) Changes in the terms of the obligation occasioned by default or a reasonably foreseeable default;
- (ii) Assumption of the obligation;
- (iii) Waiver of a due-on-sale clause or a due on encumbrance clause; and
- (iv) Conversion of an interest rate by a mortgagor pursuant to the terms of a convertible mortgage.

(4) *Modifications that are not significant modifications.* If an obligation is modified and the modification is not a significant modification for purposes of paragraph (b)(1) of this section, then the modified obligation is not treated as one that was newly originated on the date of modification.

(5) *Assumption defined.* For purposes of paragraph (b)(3) of this section, a mortgage has been assumed if—

- (i) The buyer of the mortgaged property acquires the property subject to the mortgage, without assuming any personal liability;
- (ii) The buyer becomes liable for the debt but the seller also remains liable; or
- (iii) The buyer becomes liable for the debt and the seller is released by the lender.

(6) *Pass-thru certificates.* If a REMIC holds as a qualified mortgage a pass-thru certificate or other investment trust interest of the type described in paragraph (a)(5) of this section, the modification of a mortgage loan that backs the pass-thru certificate or other interest is not a modification of the pass-thru certificate or other interest unless the investment trust structure was created to avoid the prohibited transaction rules of section 860F(a).

(c) *Treatment of certain credit enhancement contracts—(1) In general.* A credit enhancement contract (as defined in paragraph (c) (2) and (3) of this section) is not treated as a separate asset of the REMIC for purposes of the asset test

set out in section 860D(a)(4) and §1.860D-1(b)(3), but instead is treated as part of the mortgage or pool of mortgages to which it relates. Furthermore, any collateral supporting a credit enhancement contract is not treated as an asset of the REMIC solely because it supports the guarantee represented by that contract. See paragraph (g)(1)(ii) of this section for the treatment of payments made pursuant to credit enhancement contracts as payments received under a qualified mortgage.

(2) *Credit enhancement contracts.* For purposes of this section, a credit enhancement contract is any arrangement whereby a person agrees to guarantee full or partial payment of the principal or interest payable on a qualified mortgage or on a pool of such mortgages, or full or partial payment on one or more classes of regular interests or on the class of residual interests, in the event of defaults or delinquencies on qualified mortgages, unanticipated losses or expenses incurred by the REMIC, or lower than expected returns on cash flow investments. Types of credit enhancement contracts may include, but are not limited to, pool insurance contracts, certificate guarantee insurance contracts, letters of credit, guarantees, or agreements whereby the REMIC sponsor, a mortgage servicer, or other third party agrees to make advances described in paragraph (c)(3) of this section.

(3) *Arrangements to make certain advances.* The arrangements described in this paragraph (c)(3) are credit enhancement contracts regardless of whether, under the terms of the arrangement, the payor is obligated, or merely permitted, to advance funds to the REMIC.

(i) *Advances of delinquent principal and interest.* An arrangement by a REMIC sponsor, mortgage servicer, or other third party to advance to the REMIC out of its own funds an amount to make up for delinquent payments on qualified mortgages is a credit enhancement contract.

(ii) *Advances of taxes, insurance payments, and expenses.* An arrangement by a REMIC sponsor, mortgage servicer, or other third party to pay taxes and hazard insurance premiums on, or other expenses incurred to protect the

REMIC's security interest in, property securing a qualified mortgage in the event that the mortgagor fails to pay such taxes, insurance premiums, or other expenses is a credit enhancement contract.

(iii) *Advances to ease REMIC administration.* An agreement by a REMIC sponsor, mortgage servicer, or other third party to advance temporarily to a REMIC amounts payable on qualified mortgages before such amounts are actually due to level out the stream of cash flows to the REMIC or to provide for orderly administration of the REMIC is a credit enhancement contract. For example, if two mortgages in a pool have payment due dates on the twentieth of the month, and all the other mortgages have payment due dates on the first of each month, an agreement by the mortgage servicer to advance to the REMIC on the fifteenth of each month the payments not yet received on the two mortgages together with the amounts received on the other mortgages is a credit enhancement contract.

(4) *Deferred payment under a guarantee arrangement.* A guarantee arrangement does not fail to qualify as a credit enhancement contract solely because the guarantor, in the event of a default on a qualified mortgage, has the option of immediately paying to the REMIC the full amount of mortgage principal due on acceleration of the defaulted mortgage, or paying principal and interest to the REMIC according to the original payment schedule for the defaulted mortgage, or according to some other deferred payment schedule. Any deferred payments are payments pursuant to a credit enhancement contract even if the mortgage is foreclosed upon and the guarantor, pursuant to subrogation rights set out in the guarantee arrangement, is entitled to receive immediately the proceeds of foreclosure.

(d) *Treatment of certain purchase agreements with respect to convertible mortgages—(1) In general.* For purposes of sections 860D(a)(4) and 860G(a)(3), a purchase agreement (as described in paragraph (d)(3) of this section) with respect to a convertible mortgage (as described in paragraph (d)(5) of this section) is treated as incidental to the

convertible mortgage to which it relates. Consequently, the purchase agreement is part of the mortgage or pool of mortgages and is not a separate asset of the REMIC.

(2) *Treatment of amounts received under purchase agreements.* For purposes of sections 860A through 860G and for purposes of determining the accrual of original issue discount and market discount under sections 1272(a)(6) and 1276, respectively, a payment under a purchase agreement described in paragraph (d)(3) of this section is treated as a prepayment in full of the mortgage to which it relates. Thus, for example, a payment under a purchase agreement with respect to a qualified mortgage is considered a payment received under a qualified mortgage within the meaning of section 860G(a)(6) and the transfer of the mortgage is not a disposition of the mortgage within the meaning of section 860F(a)(2)(A).

(3) *Purchase agreement.* A purchase agreement is a contract between the holder of a convertible mortgage and a third party under which the holder agrees to sell and the third party agrees to buy the mortgage for an amount equal to its current principal balance plus accrued but unpaid interest if and when the mortgagor elects to convert the terms of the mortgage.

(4) *Default by the person obligated to purchase a convertible mortgage.* If the person required to purchase a convertible mortgage defaults on its obligation to purchase the mortgage upon conversion, the REMIC may sell the mortgage in a market transaction and the proceeds of the sale will be treated as amounts paid pursuant to a purchase agreement.

(5) *Convertible mortgage.* A convertible mortgage is a mortgage that gives the obligor the right at one or more times during the term of the mortgage to elect to convert from one interest rate to another. The new rate of interest must be determined pursuant to the terms of the instrument and must be intended to approximate a market rate of interest for newly originated mortgages at the time of the conversion.

(e) *Prepayment interest shortfalls.* An agreement by a mortgage servicer or other third party to make payments to

the REMIC to make up prepayment interest shortfalls is not treated as a separate asset of the REMIC and payments made pursuant to such an agreement are treated as payments on the qualified mortgages. With respect to any mortgage that prepays, the prepayment interest shortfall for the accrual period in which the mortgage prepays is an amount equal to the excess of the interest that would have accrued on the mortgage during that accrual period had it not prepaid, over the interest that accrued from the beginning of that accrual period up to the date of the prepayment.

(f) *Defective obligations*—(1) *Defective obligation defined.* For purposes of sections 860G(a)(4)(B)(i) and 860F(a)(2), a defective obligation is a mortgage subject to any of the following defects.

(i) The mortgage is in default, or a default with respect to the mortgage is reasonably foreseeable.

(ii) The mortgage was fraudulently procured by the mortgagor.

(iii) The mortgage was not in fact principally secured by an interest in real property within the meaning of paragraph (a)(1) of this section.

(iv) The mortgage does not conform to a customary representation or warranty given by the sponsor or prior owner of the mortgage regarding the characteristics of the mortgage, or the characteristics of the pool of mortgages of which the mortgage is a part. A representation that payments on a qualified mortgage will be received at a rate no less than a specified minimum or no greater than a specified maximum is not customary for this purpose.

(2) *Effect of discovery of defect.* If a REMIC discovers that an obligation is a defective obligation, and if the defect is one that, had it been discovered before the startup day, would have prevented the obligation from being a qualified mortgage, then, unless the REMIC either causes the defect to be cured or disposes of the defective obligation within 90 days of discovering the defect, the obligation ceases to be a qualified mortgage at the end of that 90 day period. Even if the defect is not cured, the defective obligation is, nevertheless, a qualified mortgage from the startup day through the end of the

90 day period. Moreover, even if the REMIC holds the defective obligation beyond the 90 day period, the REMIC may, nevertheless, exchange the defective obligation for a qualified replacement mortgage so long as the requirements of section 860G(a)(4)(B) are satisfied. If the defect is one that does not affect the status of an obligation as a qualified mortgage, then the obligation is always a qualified mortgage regardless of whether the defect is or can be cured. For example, if a sponsor represented that all mortgages transferred to a REMIC had a 10 percent interest rate, but it was later discovered that one mortgage had a 9 percent interest rate, the 9 percent mortgage is defective, but the defect does not affect the status of that obligation as a qualified mortgage.

(g) *Permitted investments*—(1) *Cash flow investment*—(i) *In general.* For purposes of section 860G(a)(6) and this section, a cash flow investment is an investment of payments received on qualified mortgages for a temporary period between receipt of those payments and the regularly scheduled date for distribution of those payments to REMIC interest holders. Cash flow investments must be passive investments earning a return in the nature of interest.

(ii) *Payments received on qualified mortgages.* For purposes of paragraph (g)(1) of this section, the term “payments received on qualified mortgages” includes—

(A) Payments of interest and principal on qualified mortgages, including prepayments of principal and payments under credit enhancement contracts described in paragraph (c)(2) of this section;

(B) Proceeds from the disposition of qualified mortgages;

(C) Cash flows from foreclosure property and proceeds from the disposition of such property;

(D) A payment by a sponsor or prior owner in lieu of the sponsor’s or prior owner’s repurchase of a defective obligation, as defined in paragraph (f) of this section, that was transferred to the REMIC in breach of a customary warranty; and

(E) Prepayment penalties required to be paid under the terms of a qualified

mortgage when the mortgagor prepays the obligation.

(iii) *Temporary period.* For purposes of section 860G(a)(6) and this paragraph (g)(1), a temporary period generally is that period from the time a REMIC receives payments on qualified mortgages and permitted investments to the time the REMIC distributes the payments to interest holders. A temporary period may not exceed 13 months. Thus, an investment held by a REMIC for more than 13 months is not a cash flow investment. In determining the length of time that a REMIC has held an investment that is part of a commingled fund or account, the REMIC may employ any reasonable method of accounting. For example, if a REMIC holds mortgage cash flows in a commingled account pending distribution, the first-in, first-out method of accounting is a reasonable method for determining whether all or part of the account satisfies the 13 month limitation.

(2) *Qualified reserve funds.* The term qualified reserve fund means any reasonably required reserve to provide for full payment of expenses of the REMIC or amounts due on regular or residual interests in the event of defaults on qualified mortgages, prepayment interest shortfalls (as defined in paragraph (e) of this section), lower than expected returns on cash flow investments, or any other contingency that could be provided for under a credit enhancement contract (as defined in paragraph (c) (2) and (3) of this section).

(3) *Qualified reserve asset*—(i) *In general.* The term “qualified reserve asset” means any intangible property (other than a REMIC residual interest) that is held both for investment and as part of a qualified reserve fund. An asset need not generate any income to be a qualified reserve asset.

(ii) *Reasonably required reserve*—(A) *In general.* In determining whether the amount of a reserve is reasonable, it is appropriate to consider the credit quality of the qualified mortgages, the extent and nature of any guarantees relating to either the qualified mortgages or the regular and residual interests, the expected amount of expenses of the REMIC, and the expected availability of proceeds from qualified mort-

gages to pay the expenses. To the extent that a reserve exceeds a reasonably required amount, the amount of the reserve must be promptly and appropriately reduced. If at any time, however, the amount of the reserve fund is less than is reasonably required, the amount of the reserve fund may be increased by the addition of payments received on qualified mortgages or by contributions from holders of residual interests.

(B) *Presumption that a reserve is reasonably required.* The amount of a reserve fund is presumed to be reasonable (and an excessive reserve is presumed to have been promptly and appropriately reduced) if it does not exceed—

(1) The amount required by a nationally recognized independent rating agency as a condition of providing the rating for REMIC interests desired by the sponsor; or

(2) The amount required by a third party insurer or guarantor, who does not own directly or indirectly (within the meaning of section 267(c)) an interest in the REMIC (as defined in § 1.860D-1(b)(1)), as a condition of providing credit enhancement.

(C) *Presumption may be rebutted.* The presumption in paragraph (g)(3)(ii)(B) of this section may be rebutted if the amounts required by the rating agency or by the third party insurer are not commercially reasonable considering the factors described in paragraph (g)(3)(ii)(A) of this section.

(h) *Outside reserve funds.* A reserve fund that is maintained to pay expenses of the REMIC, or to make payments to REMIC interest holders is an outside reserve fund and not an asset of the REMIC only if the REMIC’s organizational documents clearly and expressly—

(1) Provide that the reserve fund is an outside reserve fund and not an asset of the REMIC;

(2) Identify the owner(s) of the reserve fund, either by name, or by description of the class (e.g., subordinated regular interest holders) whose membership comprises the owners of the fund; and

(3) Provide that, for all Federal tax purposes, amounts transferred by the REMIC to the fund are treated as amounts distributed by the REMIC to

the designated owner(s) or transferees of the designated owner(s).

(i) *Contractual rights coupled with regular interests in tiered arrangements*—(1) *In general.* If a REMIC issues a regular interest to a trustee of an investment trust for the benefit of the trust certificate holders and the trustee also holds for the benefit of those certificate holders certain other contractual rights, those other rights are not treated as assets of the REMIC even if the investment trust and the REMIC were created contemporaneously pursuant to a single set of organizational documents. The organizational documents must, however, require that the trustee account for the contractual rights as property that the trustee holds separate and apart from the regular interest.

(2) *Example.* The following example, which describes a tiered arrangement involving a pass-thru trust that is intended to qualify as a REMIC and a pass-thru trust that is intended to be classified as a trust under § 301.7701-4(c) of this chapter, illustrates the provisions of paragraph (i)(1) of this section.

Example. (i) A sponsor transferred a pool of mortgages to a trustee in exchange for two classes of certificates. The pool of mortgages has an aggregate principal balance of \$100x. Each mortgage in the pool provides for interest payments based on the eleventh district cost of funds index (hereinafter COFI) plus a margin. The trust (hereinafter REMIC trust) issued a Class N bond, which the sponsor designates as a regular interest, that has a principal amount of \$100x and that provides for interest payments at a rate equal to One-Year LIBOR plus 100 basis points, subject to a cap equal to the weighted average pool rate. The Class R interest, which the sponsor designated as the residual interest, entitles its holder to all funds left in the trust after the Class N bond has been retired. The Class R interest holder is not entitled to current distributions.

(ii) On the same day, and under the same set of documents, the sponsor also created an investment trust. The sponsor contributed to the investment trust the Class N bond together with an interest rate cap contract. Under the interest rate cap contract, the issuer of the cap contract agrees to pay to the trustee for the benefit of the investment trust certificate holders the excess of One-Year LIBOR plus 100 basis points over the weighted average pool rate (COFI plus a margin) times the outstanding principal balance of the Class N bond in the event One-Year

LIBOR plus 100 basis points ever exceeds the weighted average pool rate. The trustee (the same institution that serves as REMIC trust trustee), in exchange for the contributed assets, gave the sponsor certificates representing undivided beneficial ownership interests in the Class N bond and the interest rate cap contract. The organizational documents require the trustee to account for the regular interest and the cap contract as discrete property rights.

(iii) The separate existence of the REMIC trust and the investment trust are respected for all Federal income tax purposes. Thus, the interest rate cap contract is an asset beneficially owned by the several certificate holders and is not an asset of the REMIC trust. Consequently, each certificate holder must allocate its purchase price for the certificate between its undivided interest in the Class N bond and its undivided interest in the interest rate cap contract in accordance with the relative fair market values of those two property rights.

(j) *Clean-up call*—(1) *In general.* For purposes of section 860F(a)(5)(B), a clean-up call is the redemption of a class of regular interests when, by reason of prior payments with respect to those interests, the administrative costs associated with servicing that class outweigh the benefits of maintaining the class. Factors to consider in making this determination include—

(i) The number of holders of that class of regular interests;

(ii) The frequency of payments to holders of that class;

(iii) The effect the redemption will have on the yield of that class of regular interests;

(iv) The outstanding principal balance of that class; and

(v) The percentage of the original principal balance of that class still outstanding.

(2) *Interest rate changes.* The redemption of a class of regular interests undertaken to profit from a change in interest rates is not a clean-up call.

(3) *Safe harbor.* Although the outstanding principal balance is only one factor to consider, the redemption of a class of regular interests with an outstanding principal balance of no more than 10 percent of its original principal balance is always a clean-up call.

(k) *Startup day.* The term “startup day” means the day on which the REMIC issues all of its regular and residual interests. A sponsor may, however, contribute property to a REMIC

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in exchange for regular and residual interests over any period of 10 consecutive days and the REMIC may designate any one of those 10 days as its startup day. The day so designated is then the startup day, and all interests are treated as issued on that day.

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§ 1.860G-3 Treatment of foreign persons.

(a) *Transfer of a residual interest with tax avoidance potential*—(1) *In general.* A transfer of a residual interest that has tax avoidance potential is disregarded for all Federal tax purposes if the transferee is a foreign person. Thus, if a residual interest with tax avoidance potential is transferred to a foreign holder at formation of the REMIC, the sponsor is liable for the tax on any excess inclusion that accrues with respect to that residual interest.

(2) *Tax avoidance potential*—(i) *Defined.* A residual interest has tax avoidance potential for purposes of this section unless, at the time of the transfer, the transferor reasonably expects that, for each excess inclusion, the REMIC will distribute to the transferee residual interest holder an amount that will equal at least 30 percent of the excess inclusion, and that each such amount will be distributed at or after the time at which the excess inclusion accrues and not later than the close of the calendar year following the calendar year of accrual.

(ii) *Safe harbor.* For purposes of paragraph (a)(2)(i) of this section, a transferor has a reasonable expectation if the 30-percent test would be satisfied were the REMIC's qualified mortgages to prepay at each rate within a range of rates from 50 percent to 200 percent of the rate assumed under section 1272(a)(6) with respect to the qualified mortgages (or the rate that would have been assumed had the mortgages been issued with original issue discount).

(3) *Effectively connected income.* Paragraph (a)(1) of this section will not apply if the transferee's income from the residual interest is subject to tax under section 871(b) or section 882.

(4) *Transfer by a foreign holder.* If a foreign person transfers a residual interest to a United States person or a

foreign holder in whose hands the income from a residual interest would be effectively connected income, and if the transfer has the effect of allowing the transferor to avoid tax on accrued excess inclusions, then the transfer is disregarded and the transferor continues to be treated as the owner of the residual interest for purposes of section 871(a), 881, 1441, or 1442.

(b) [Reserved]

[T.D. 8458, 57 FR 61313, Dec. 24, 1992]

TAX BASED ON INCOME FROM SOURCES WITHIN OR WITHOUT THE UNITED STATES

DETERMINATION OF SOURCES OF INCOME

§ 1.861-1 Income from sources within the United States.

(a) *Categories of income.* Part I (section 861 and following), subchapter N, chapter 1 of the Code, and the regulations thereunder determine the sources of income for purposes of the income tax. These sections explicitly allocate certain important sources of income to the United States or to areas outside the United States, as the case may be; and, with respect to the remaining income (particularly that derived partly from sources within and partly from sources without the United States), authorize the Secretary or his delegate to determine the income derived from sources within the United States, either by rules of separate allocation or by processes or formulas of general apportionment. The statute provides for the following three categories of income:

(1) *Within the United States.* The gross income from sources within the United States, consisting of the items of gross income specified in section 861(a) plus the items of gross income allocated or apportioned to such sources in accordance with section 863(a). See §§ 1.861-2 to 1.861-7, inclusive, and § 1.863-1. The taxable income from sources within the United States, in the case of such income, shall be determined by deducting therefrom, in accordance with sections 861(b) and 863(a), the expenses, losses, and other deductions properly apportioned or allocated thereto and a ratable part of any other expenses, losses, or deductions which cannot definitely