mortgage and fails to do so within a designated time, then the entity is treated as not having anticipated receiving payments on the mortgage.

Section 301.7701(i)-1(d)(3)(ii)— Obligations Secured by Other Obligations Treated as Principally Secured by Real Property

Under the proposed regulations, an obligation is treated as a real estate mortgage if it is principally secured by an interest in real property. Whether an obligation is principally secured by an interest in real property ordinarily depends on the value of the real property relative to the amount of the obligation. The proposed regulations also provide that an obligation secured by real estate mortgages is treated as an obligation secured by an interest in real property. That obligation, therefore, may itself qualify as a real estate mortgage.

The final regulations retain these rules and clarify how they are applied if an obligation is secured by both real estate mortgages and other property. Under the final regulations, such an obligation is treated as secured by real property, but only to the extent of the combined value of the real estate mortgages and any real property that secures the obligation.

Section 301.7701(i)-1(f)(3)—Certain Liquidating Entities Not Treated as Taxable Mortgage Pools

The proposed regulations provide that an entity formed to liquidate real estate mortgages is not treated as a taxable mortgage pool if the entity meets four conditions. One condition is that the entity must liquidate within three years of acquiring its first asset. If the entity fails to liquidate within that time, then the payments the entity receives on its assets must be paid through to the holders of the entity's liabilities in proportion to the adjusted issue prices of the liabilities.

One commentator has asked that this condition be modified. The commentator suggested that either the three- year liquidation period should be extended to four years or an entity should have to liquidate only a certain percentage of its assets within the three-year period. The commentator alternatively suggested that an entity should be treated as meeting the condition if it satisfies fifty percent of the issue price of each of its liabilities using liquidation proceeds.

The final regulations retain the threeyear liquidation rule. The IRS and Treasury believe that performing mortgages that conform to current underwriting standards may easily be disposed of within that time. Further, the market has developed to the point where three years is also ample time to dispose of non-performing mortgages. Mortgages that require more than three years for disposal are more likely to be seriously impaired, and a taxpayer who holds a sufficient quantity can avoid taxable mortgage pool classification by other means. The final regulations, therefore, do not change the basic rules in the proposed regulations.

Section 301.7701–1(g)—Anti-Avoidance Rules

An anti-avoidance rule in the proposed regulations authorizes the Commissioner to disregard or make other adjustments to any transaction if the transaction is entered into with a view to achieving the same economic effect as that of an arrangement subject to section 7701(i) while avoiding the application of that section. This authority is flexible, and among other things, includes the ability to override any safe harbor otherwise available under the regulations. The final regulations retain the anti-avoidance rule and provide two additional examples illustrating its exercise.

Section 301.7701(i)-4—Certain Governmental Entities Not Treated as Taxable Mortgage Pools

The proposed regulations provide that an entity is not classified as a taxable mortgage pool if: (1) The entity issuing the debt obligations is a State, the District of Columbia, or a political subdivision within the meaning of § 1.103–1(b), or is empowered to issue obligations on behalf of one of the foregoing; (2) the entity issues the debt obligations in the performance of a governmental purpose; and (3) the entity holds the remaining interest in any asset that supports the outstanding debt obligations until those obligations are satisfied.

Two commentators have asked that the third requirement be dropped because it prevents a governmental entity from reselling a package of mortgages. The IRS and Treasury believe, however, that dropping the requirement is inappropriate. Typically, when a mortgage pool is used to create multiple class debt, tax gains in excess of economic gains are generated during the early part of the pool's life and tax losses in excess of economic losses are generated during the latter part of the pool's life. Without the third requirement, a governmental entity can hold an interest in the pool during the early period and then convey that interest to a taxable entity during the latter period. Moreover, requiring a governmental entity to maintain an

interest in pool assets is consistent with the second requirement that debt obligations supported by the pool are issued in performance of a governmental purpose.

### **Special Analyses**

It has been determined that this Treasury decision is not a significant regulatory action as defined in EO 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) and the Regulatory Flexibility Act (5 U.S.C. chapter 6) do not apply to these regulations, and, therefore, a Regulatory Flexibility Analysis is not required. Pursuant to section 7805(f) of the Internal Revenue Code, the notice of proposed rulemaking preceding these regulations was submitted to the Small Business Administration for comment on its impact on small business.

#### **Drafting Information**

The principal authors of these regulations are Marshall D. Feiring and Arnold P. Golub, Office of Assistant Chief Counsel (Financial Institutions and Products), and Carol E. Schultze, formerly of that office. However, other personnel from the IRS and Treasury Department participated in their development.

The Office of Assistant Chief Counsel (Financial Institutions and Products) notes with sadness the passing of Susan E. Overlander, who contributed significantly to this project.

#### List of Subjects in 26 CFR Part 301

Employment taxes, Estate taxes, Excise taxes, Gift taxes, Income taxes, Penalties, Reporting and recordkeeping requirements.

# Adoption of Amendments to the Regulations

Accordingly, 26 CFR part 301 is amended as follows:

## PART 301—PROCEDURE AND ADMINISTRATION

**Paragraph 1.** The authority citation for part 301 is amended by adding the following citations in numerical order to read as follows:

**Authority:** 26 U.S.C. 7805 \* \* \* Section 301.7701(i)–1(g)(1) also issued under 26 U.S.C. 7701(i)(2)(D).
Section 301.7701(i)–4(b) also issued under 26 U.S.C. 7701(i)(3). \* \* \*

**Par. 2.** Sections 301.7701(i)-0 through 301.7701(i)-4 are added to read as follows: