

585. Reserves for losses on loans of banks

(a) Reserve for bad debts. --

(1) In general. -- Except as provided in subsection (c), a bank shall be allowed a deduction for a reasonable addition to a reserve for bad debts. Such deduction shall be in lieu of any deduction under section 166(a).

(2) Bank. -- For purposes of this section --

(A) In general. -- The term "bank" means any bank (as defined in section 581) other than an organization to which section 593 applies.

(B) Banking business of United States branch of foreign corporation. -- The term "bank" also includes any corporation to which subparagraph (A) would apply except for the fact that it is a foreign corporation. In the case of any such foreign corporation, this section shall apply only with respect to loans outstanding the interest on which is effectively connected with the conduct of a banking business within the United States.

(b) Addition to reserves for bad debts. --

(1) General rule. -- For purposes of subsection (a), the reasonable additions to the reserve for bad debts of any financial institution to which this section applies shall be an amount determined by the taxpayer which shall not exceed the greater of --

(A) for taxable years beginning before 1988 the addition to the reserve for losses on loans determined under the percentage method as provided in paragraph (2), or

(B) the addition to the reserve for losses on loans determined under the experience method as provided in paragraph (3).

(2) Percentage method. -- The amount determined under this paragraph for a taxable year shall be the amount necessary to increase the balance of the reserve for losses on loans (at the close of the taxable year) to the allowable percentage of eligible loans outstanding at such time, except that --

(A) If the reserve for losses on loans at the close of the base year is less than the allowable percentage of eligible loans outstanding at such time, the amount determined under this paragraph with respect to the difference shall not exceed one-fifth of such difference.

(B) If the reserve for losses on loans at the close of the base year is not less than the allowable percentage of eligible loans outstanding at such time, the amount determined under this paragraph shall be the amount necessary to increase the balance of the reserve at the close of the taxable year to (i) the allowable percentage of eligible loans outstanding at such time, or (ii) the balance of the reserve at the close of the base year, whichever is greater, but if the amount of eligible

loans outstanding at the close of the taxable year is less than the amount of such loans outstanding at the close of the base year, the amount determined under clause (ii) shall be the amount necessary to increase the balance of the reserve at the close of the taxable year to the amount which bears the same ratio to eligible loans outstanding at the close of the taxable year as the balance of the reserve at the close of the base year bears to the amount of eligible loans outstanding at the close of the base year.

For purposes of this paragraph, the term "allowable percentage" means 1.8 percent for taxable years beginning before 1976; 1.2 percent for taxable years beginning after 1975 but before 1982; 1.0 percent for taxable years beginning in 1982; and 0.6 percent for taxable years beginning after 1982. The amount determined under this paragraph shall not exceed 0.6 percent of eligible loans outstanding at the close of the taxable year or an amount sufficient to increase the reserve for losses on loans to 0.6 percent of eligible loans outstanding at the close of the taxable year, whichever is greater. For purposes of this paragraph, the term "base year" means " for taxable years beginning before 1976, the last taxable year beginning on or before July 11, 1969, for taxable years beginning after 1975 but before 1983, the last taxable year beginning before 1976, and for taxable years beginning after 1982, the last taxable year beginning before 1983; except that for purposes of subparagraph (A) such term means the last taxable year before the most recent adoption of the percentage method, if later.

(3) Experience method. -- The amount determined under this paragraph for a taxable year shall be the amount necessary to increase the balance of the reserve for losses on loans (at the close of the taxable year) to the greater of --

(A) the amount which bears the same ratio to loans outstanding at the close of the taxable year as (i) the total bad debts sustained during the taxable year and the 5 preceding taxable years (or, with the approval of the Secretary, a shorter period, bears to (ii) the sum of the loans outstanding at the close of such 6 or fewer taxable years, or

(B) the lower of --

(i) the balance of the reserve at the close of the base year, or

(ii) if the amount of loans outstanding at the close of the taxable year is less than the amount of loans outstanding at the close of the base year, the amount which bears the same ratio to loans outstanding at the close of the taxable year as the balance of the reserve at the close of the base year bears to the amount of loans outstanding at the close of the base year. For purposes of this paragraph, the base year shall be the last taxable year before the most recent adoption of the experience

method, except that for taxable years beginning after 1987 the base year shall be the last taxable year beginning before 1988.

(4) Refutations; definition of eligible loan, etc. -- The Secretary shall define the terms "loan" and "eligible loan" and prescribe such regulations as may be necessary to carry out the purposes of this section; except that the term "eligible loan" shall not include --

(A) a loan to a bank (as defined in section 581),

(B) a loan to a domestic branch of a foreign corporation to which subsection (a)(2) applies,

(C) a loan secured by a deposit (i) in the lending bank, or (ii) in an institution described in subparagraph (A) or (B) if the lending bank has control over withdrawal of such deposit,

(D) a loan to or guaranteed by the United States, a possession or instrumentality thereof, or a State or a political subdivision thereof,

(E) a loan evidenced by a security as defined in section 165(g)(2)(C),

(F) a loan of Federal funds, and

(G) commercial paper, including short-term promissory notes which may be purchased on the open market.

(c) Section not to apply to large banks. --

(1) In general. -- In the case of a large bank, this section shall not apply (and no deduction shall be allowed under any other provision of this subtitle for any addition to a reserve for bad debts).

(2) Large banks. -- For purposes of this subsection, a bank is a large bank if, for the taxable year (or for any preceding taxable year beginning after December 31, 1986) --

(A) the average adjusted bases of all assets of such bank exceeded \$500,000,000, or

(B) such bank was a member of a parent-subsidiary controlled group and the average adjusted bases of all assets of such group exceeded \$500,000,000.

(3) 4-year spread of adjustments. --

(A) In general. -- Except as provided in paragraph (4), in the case of any bank which for its last taxable year before the disqualification year maintained a reserve for bad debts --

(i) the provisions of this subsection shall be treated as a change in the method of accounting of such bank for the disqualification year,

(ii) such change shall be treated as having been made with the consent of the Secretary, and

(iii) the net amount of adjustments required by section 481(a) to be taken into account by the taxpayer shall be taken into account in each of the 4 taxable years beginning with the disqualification year with --

(I) the amount taken into account for the 1st of such

taxable years being the greater of 10 percent of such net amount or such greater amount as the taxpayer may designate, and

(II) the amount taken into account in each of the 3 succeeding taxable years being equal to the applicable fraction (determined in accordance with the following table for the taxable year involved) of the portion of such net amount not taken into account under subclause (I).

If the case of the --	The applicable fraction is --
1st succeeding year	2/9
2nd succeeding year	1/3
3rd succeeding year	4/9.

(B) Suspension of recapture for taxable year for which bank is financially troubled. --

(i) In general. -- In the case of a bank which is a financially troubled bank for any taxable year --

(I) no adjustment shall be taken into account under subparagraph (A) for such taxable year, and

(II) such taxable year shall be disregarded in determining whether any other taxable year is a taxable year for which an adjustment is required to be taken into account under subparagraph (A) or the amount of such adjustment.

(ii) Exception for elective recapture for 1st year. -- Clause (i) shall not apply to the 1st taxable year referred to in subparagraph (A)(iii)(I) if the taxpayer designates an amount in accordance with such subparagraph.

(iii) Financially troubled bank. -- For purposes of clause (i), the term "financially troubled bank" means any bank if, for the taxable year, the nonperforming loan percentage of such bank exceeds 75 percent.

(iv) Nonperforming loan percentage. -- For purposes of clause (iii), the term "nonperforming loan percentage" means the percentage determined by dividing --

(I) the sum of the outstanding balances of non-performing loans of the bank as of the close of each quarter of the taxable year, by

(II) the sum of the amounts of equity of the bank as of the close of each such quarter.

In the case of a bank which is a member of a parent-subsidiary controlled group for the taxable year, the preceding sentence shall be applied with respect to such group.

(v) Other definitions. -- For purposes of this subparagraph --

(I) Nonperforming loans. -- The term "nonperforming loan" means any loan which is considered to be nonperforming by the primary Federal regulatory agency with respect to the bank.

(II) Equity. -- The term "equity" means the equity of the

bank as determined for Federal regulatory purposes.

(C) Coordination with estimated tax payments. -- For purposes of applying section 6655(e)(2)(A)(i) with respect to any installment, the determination under subparagraph (B) of whether an adjustment is required to be taken into account under subparagraph (A) shall be made as of the last day prescribed for payment of such installment.

(4) Elective cut-off method. -- If a bank makes an election under this paragraph for the disqualification year --

(A) the provisions of this subsection shall not be treated as a change in the method of accounting of the taxpayer for purposes of section 481,

(B) the taxpayer shall continue to maintain its reserve for loans held by the bank as of the 1st day of the disqualification year and charge against such reserve any losses resulting from loans held by the bank as of such 1st day, and

(C) no deduction shall be allowed under this section (or any other provision of this subtitle) for any addition to such reserve for the disqualification year or any subsequent taxable year.

(5) Definitions. -- For purposes of this subsection --

(A) Parent-subsidiary controlled group. -- The term "parent-subsidiary controlled group" means any controlled group of corporations described in section 1563(a)(1). In determining the average adjusted bases of assets held by such a group, interests held by one member of such group in another member of such group shall be disregarded.

(B) Disqualification year. -- The term "disqualification year" means, with respect to any bank, the 1st taxable year beginning after December 31, 1986, for which such bank was a large bank if such bank maintained a reserve for bad debts for the preceding taxable year.

586. Repealed.

591. Deduction for dividends paid on deposits

(a) In general. -- In the case of mutual savings banks, cooperative banks, domestic building and loan associations, and other savings institutions chartered and supervised as savings and loan or similar associations under Federal or State law, there shall be allowed as deductions in computing taxable income amounts paid to, or credited to the accounts of, depositors or holders of accounts as dividends or interest on their deposits or withdrawable accounts, if such amounts paid or credited are withdrawable on demand subject only to customary notice of intention to withdraw.

(b) Mutual savings bank to include certain banks with capital stock. -- For purposes of this part, the term "mutual

savings bank" includes any bank --

- (1) which has capital stock represented by shares, and
- (2) which is subject to, and operates under, Federal or State laws relating to mutual savings bank.

592. Repealed.

593. Reserves for losses on loans

(a) Reserve for bad debts. --

(1) In general. -- Except as provided in paragraph (2), in the case of --

(A) any domestic building and loan association,

(B) any mutual savings bank, or

(C) any cooperative bank without capital stock organized and operated for mutual purposes and without profit, there shall be allowed a deduction for a reasonable additions to a reserve for bad debts. Such deduction shall be in lieu of any deduction under section 166(a).

(2) Organization must meet 60-percent asset test of section 7701(a)(19). -- This section shall apply to an association or bank referred to in paragraph (1) only if it meets the requirements of section 7701(a)(19)(C).

(b) Addition to reserves for bad debts. --

(1) In general. -- For purposes of subsection (a), the reasonable addition for the taxable year to the reserve for bad debts of any taxpayer described in subsection (a) shall be an amount equal to the sum of --

(A) the amount determined to be a reasonable addition to the reserve for losses on nonqualifying loans, computed in the same manner as is provided with respect to additions to the reserves for losses on loans of banks under section 585(b)(2), plus

(B) the amount determined by the taxpayer to be a reasonable addition to the reserve for losses on qualifying real property loans, but such amount shall not exceed the amount determined under paragraph (2) or (3), whichever is the larger, but the amount determined under this subparagraph shall in no case be greater than the larger of --

(i) the amount determined under paragraph (3), or

(ii) the amount which, when added to the amount determined under subparagraph (A), equals the amount by which 12 percent of the total deposits or withdrawable accounts of depositors of the taxpayer at the close of such year exceeds the sum of its surplus, undivided profits, and reserves at the beginning of such year (taking into account any portion thereof attributable to the period before the first taxable year beginning after December 31, 1951).

(2) Percentage of taxable income method. --

(A) In general. -- Subject to subparagraphs (B) and (C), the amount determined under this paragraph for the taxable year shall be an amount equal to 8 percent of the income for such year.

(B) Reduction for amounts referred to in paragraph (1) (A). -- The amount determined under subparagraph (A) shall be reduced (but not below 0) by the amount determined under paragraph (1) (A).

(C) Overall limitation on paragraph. -- the amount determined under this paragraph shall not exceed the amount necessary to increase the balance at the close of the taxable year of the reserve for losses on qualifying real property loans to 6 percent of such loans outstanding at such time.

(D) Computation of taxable income. -- For purposes of this paragraph, taxable income shall be computed --

(i) by excluding from gross income any amount included therein by reason of subsection (e),

(ii) without regard to any deduction allowable for any addition to the reserve for bad debts,

(iii) by excluding from gross income an amount equal to the net gain for the taxable year arising from the sale or exchange of stock of a corporation or of obligations the interest on which is excludable from gross income under section 103,

(iv) by excluding from gross income dividends with respect to which a deduction is allowable by part VIII of subchapter B, reduced by an amount equal to 8 percent of the dividends received deduction (determined without regard to section 596) for the taxable year, and

(v) if there is a capital gain rate differential (as defined in section 904(b) (3) (D)) for the taxable year, by excluding from gross income the rate differential portion (within the meaning of section 904(b) (3) (E)) of the lesser of --

(I) the net long-term capital gain for the taxable year, or

(II) the net long-term capital gain for the taxable year from the sale or exchange of property other than property described in clause (iii).

(3) Experience method. -- The amount determined under this paragraph for the taxable year shall be computed in the same manner as is provided with respect to additions to the reserves for losses on loans of banks under section 585(b) (3).

(c) Treatmentj of reserves for bad debts. --

(1) Establishment of reserves. -- Each taxpayer described in subsection (a) which uses the reserve method of accounting for bad debts shall establish and maintain a reserve for losses on qualifying real property loans, a reserve for losses on nonqualifying loans, and a supplemental reserve for losses on loans. For purposes of this title, such reserves shall be treated as reserves for bad debts, but no deduction shall be

allowed for any addition to the supplemental reserve for losses on loans.

(2) Certain pre1963 reserves. -- Notwithstanding the second sentence of paragraph (1), any amount allocated pursuant to paragraph (5) (as in effect immediately before the enactment of the Tax Reform Act of 1976) during a taxable year beginning before January 1, 1977, to the reserve for losses on qualifying real property loans out of the surplus, undivided profits, and bad debt reserves (determined as of December 31, 1951, shall not be treated as a reserve for bad debts for any purpose other than determining the amount referred to in subsection (b)(1)(B), and for such purpose such amount shall be treated as remaining in such reserve.

(3) Charging of bad debts to reserves. -- Any debt becoming worthless or partially worthless in respect of a qualifying real property loan shall be charged to the reserve for losses on such loans, and any debt becoming worthless or partially worthless in respect of a nonqualifying loan shall be charged to the reserve for losses on nonqualifying loans; except that any such debt may, at the election of the taxpayer, be charged in whole or in part in the supplemental reserve for losses on loans.

(d) Loans defined. -- For purposes of this section --

(1) Qualifying real property loans. -- The term "qualifying real property loan" means any loan secured by an interest in improved real property or secured by an interest in real property which is to be improved out of the proceeds of the loan, but such term does not include --

(A) any loan evidenced by a security (as defined in section 165(g)(2)(C));

(B) any loan, whether or not evidenced by a security

858. Dividends paid by real estate investment trust after close of taxable year

(a) General rule. -- For purposes of this part, if a real estate investment trust -

(1) declares a dividend before the time prescribed by law for the filing of its return for a taxable year (including the period of any extension of time granted for filing such return), and

(2) distributes the amount of such dividend to shareholders or holders of beneficial interests in the 12-month period following the close of such taxable year and not later than the date of the first regular dividend payment made after such declaration, the amount so declared and distributed shall, to the extent the trust elects in such return (and specifies in dollar amounts) in accordance with regulations prescribed by the Secretary, be considered as having been paid only during such taxable year, except as provided in subsections (b) and (c).

(b) Receipt by shareholder. -- Except as provided in section 857(b)(8), amounts to which subsection (a) applies shall be treated as received by the shareholder or holder of a beneficial interest in the taxable year in which the distribution is made.

(c) Notice to shareholders. -- In the case of amounts to which subsection (a) applies, any notice to shareholders or holders of beneficial interests required under this part with respect to such amounts shall be made not later than 30 days after the close of the taxable year in which the distribution is made (or mailed to its shareholders or holders of beneficial interests with its annual report for the taxable year).

859. Adoption of annual accounting period

(a) General rule. -- For purposes of this subtitle --

(1) a real estate investment trust shall not change to any accounting period other than the calendar year, and

(2) a corporation, trust, or association may not elect to be a real estate investment trust for any taxable year beginning after October 45, 1976, unless its accounting period is the calendar year.

Paragraph (2) shall not apply to a corporation, trust, or association which was considered to be a real estate investment trust for any taxable year beginning on or before October 4, 1976.

(b) Change of accounting period without approval. -- Notwithstanding section 442, an entity which has not engaged in any active trade or business may change its accounting period to a calendar year without the approval of the Secretary if such change is in connection with an election under section 856(c)

860. Deduction for deficiency dividends

(a) General rule. -- If a determination with respect to any qualified investment entity results in any adjustment for any taxable year, a deduction shall be allowed to such entity for the amount of deficiency dividends for purposes of determining the deduction for dividends paid (for purposes of section 852 or 857, whichever applies) for such year.

(b) Qualified investment entity defined. -- For purposes of this section, the term "qualified investment entity" means --

(1) a regulated investment company, and

(2) a real estate investment trust.

(c) Rules for application of section. --

(1) Interest and additions to tax determined with respect to the amount of deficiency dividend deduction allowed. -- For purposes of determining interest, additions to tax, and additional amounts --

(A) the tax imposed by this chapter (after taking into

account the deduction allowed by subsection (a)) on the qualified investment entity for the taxable year with respect to which the determination is made shall be deemed to be increased by an amount equal to the deduction allowed by subsection (a) with respect to such taxable year,

(B) the last date prescribed for payment of such increase in tax shall be deemed to have been the last date prescribed for the payment of tax (determined in the manner provided by section 6601(b) for the taxable year with respect to which the determination is made, and (C) such increase in tax shall be deemed to be paid as of the date the claim for the deficiency dividend deduction is filed.

(2) Credit or refund. -- If the allowance of a deficiency dividend deduction results in an overpayment of tax for any taxable year, credit or refund with respect to such overpayment shall be made as if on the date of the determination 2 years remained before the expiration of the period of limitation on the filing of claim for refund for the taxable year to which the overpayment relates.

(d) Adjustment. -- For purposes of this section --

(1) Adjustment in the case of regulated investment company. -- In the case of any regulated investment company, the term "adjustment" means --

(A) any increase in the investment company taxable income of the regulated investment company (determined without regard to the deduction for dividends paid (as defined in section 561)),

(B) any increase in the amount of the excess described in section 852(b)(3)(A) (relating to the excess of the net capital gain over the deduction for capital gain dividends paid), and

(C) any decrease in the deduction for dividends paid (as defined in section 561) determined without regard to capital gains dividends.

(2) Adjustments in the case of real estate investment trust. -- In the case of any real estate investment trust, the term "adjustment" means --

(A) any increase in the sum of --

(i) the real estate investment trust taxable income of the real estate investment trust (determined without regard to the deduction for dividends paid (as defined in section 561) and by excluding any net capital gain), and

(ii) the excess of the net income from foreclosure property (as defined in section 857(b)(4)(B)) over the tax on such income imposed by section 857(b)(4)(A),

(B) any increase in the amount of the excess described in section 857(b)(3)(A)(ii) (relating to the excess of the net capital gain over the deduction for capital gains dividends paid), and

(C) any decrease in the deduction for dividends paid (as defined in section 561) determined without regard to capital gains dividends.

(d) Determination. -- For purposes of this section, the term "determination" means --

(1) a decision by the Tax Court, or a judgment, decree, or other order by any court of competent jurisdiction, which has become final;

(2) a closing agreement made under section 7121; or

(3) under regulations prescribed by the Secretary, an agreement signed by the Secretary and by, or on behalf of, the qualified investment entity relating to the liability of such entity for tax.

(f) Deficiency dividends. --

(1) Definition. -- For purposes of this section, the term "deficiency dividends" means a distribution of property made by the qualified investment entity on or after the date of the determination and before filing claim under subsection (g), which would have been includible in the computation of the deduction for dividends paid under section 561 for the taxable year with respect to which the liability for tax resulting from the determination exists if distributed during such taxable year. No distribution of property shall be considered as deficiency dividends for purposes of subsection (a) unless distributed within 90 days after the determination, and unless a claim for a deficiency dividend deduction with respect to such distribution is filed pursuant to subsection (g).

(2) Limitations. --

(A) Ordinary dividends. -- The amount of deficiency dividends (other than deficiency dividends qualifying as capital gain dividends) paid by a qualified investment entity for the taxable year with respect to which the liability for tax resulting from the determination exists shall not exceed the sum of --

(i) the excess of the amount of increase referred to in subparagraph (A) of paragraph (1) or (2) of subsection (d) (whichever applies) over the amount of any increase in the deduction for dividends paid (computed without regard to capital gain dividends) for such taxable year which results from such determination, and

(ii) the amount of decrease referred to in subparagraph (C) of paragraph (1) or (2) of subsection (d) (whichever applies).

(B) Capital gain dividends. -- The amount of deficiency dividends qualifying as capital gain dividends paid by a qualified investment entity for the taxable year with respect to which the liability for tax resulting from the determination exists shall not exceed the amount by which (i) the increase referred to in subparagraph (B) of paragraph (1) or (2) of

subsection (d) (whichever applies), exceeds (ii) the amount of any dividends paid during such taxable year which are designated as capital gain dividends after such determination.

(3) Effect on dividends paid deduction. --

(A) For taxable year in which paid. -- Deficiency dividends paid in any taxable year shall not be included in the amount of dividends paid for such year for purposes of computing the dividends paid deduction for such year.

(B) For prior taxable year. -- Deficiency dividends paid in any taxable year shall not be allowed for purposes of section 855(a) or 858(a) in the computation of the dividends paid deduction for the taxable year preceding the taxable year in which paid.

(g) Claim required. -- No deficiency dividend deduction shall be allowed under subsection (a) unless (under regulations prescribed by the Secretary) claim therefore is filed within 120 days after the date of the determination.

(h) Suspension of statute of limitations and stay of collection. --

(1) Suspension of running of statute. -- If the qualified investment entity files a claim as provided in subsection (g), the running of the statute of limitations provided in section 6501 on the making of assessments, and the bringing of distraint or a proceeding in court for collection, in respect of the deficiency established by a determination under this section, and all interest, additions to tax, additional amounts, or assessable penalties in respect thereof, shall be suspended for a period of 2 years after the date of the determination.

(2) Stay of collection. -- In the case of any deficiency established by a determination under this section --

(A) the collection of the deficiency, and all interest, additions to tax, additional amounts, and assessable penalties in respect thereof, shall, except in cases of jeopardy, be stayed until the expiration of 120 days after the date of the determination, and

(B) if claim for a deficiency dividend deduction is filed under subsection (g), the collection of such part of the deficiency as is not reduced by the deduction for deficiency dividends provided in subsection (a) shall be stayed until the date the claim is disallowed (in whole or in part), and if disallowed in part collection shall be made only with respect to the part disallowed.

No distraint or proceeding in court shall be begun for the collection of an amount the collection of which is stayed under subparagraph (A) or (B) during the period for which the collection of such amount is stayed.

(i) Deduction denied in case of fraud. -- No deficiency dividend deduction shall be allowed under subsection (a) if the

determination contains a finding that any part of any deficiency attributable to an adjustment with respect to the taxable year is due to fraud with intent to evade tax or to willful failure to file an income tax return within the time prescribed by law or prescribed by the Secretary in pursuance of law.

(j) Penalty. --

For assessable penalty with respect to liability for tax of a regulated investment company which is allowed a deduction under subsection (a), see section 6697.

860A. Taxation of REMIC's

(a) General rule. -- Except as otherwise provided in this part, a REMIC shall not be subject to taxation under this subtitle (and shall not be treated as a corporation, partnership, or trust for purposes of this subtitle).

(b) Income taxable to holders. -- The income of any REMIC shall be taxable to the holders of interests in such REMIC as provided in this part.

860B. Taxation of holders of regular interests

(a) General rule. -- In determining the tax under this chapter of any holder of a regular interest in a REMIC, such interest (if not otherwise a debt instrument) shall be treated as a debt instrument.

(b) Holders must use accrual method. -- The amounts includible in gross income with respect to any regular interest in a REMIC shall be determined under the accrual method of accounting.

(c) Portion of gain treated as ordinary income. -- Gain on the disposition of a regular interest shall be treated as ordinary income to the extent such gain does not exceed the excess (if any) of --

(1) the amount which would have been includible in the gross income of the taxpayer with respect to such interest if the yield on such interest were 110 percent of the applicable Federal rate (as defined in section 1274(d) without regard to paragraph (2) thereof) as of the beginning of the taxpayer's holding period, over

(2) the amount actually includible in gross income with respect to such interest by the taxpayer.

(d) Cross reference. --

For special rules in determining inclusion of original issue discount on regular interests, see section 1272(a)(6).

860C. Taxation of residual interests

(a) Pass-thru of income or loss. --

(1) In general. -- In determining the tax under this chapter of any holder of a residual interest in a REMIC, such

holder shall take into account his daily portion of the taxable income or net loss of such REMIC for each day during the taxable year on which such holder held such interest.

(2) Daily portion. -- The daily portion referred to in paragraph (1) shall be determined --

(A) by allocating to each day in any calendar quarter its retable portion of the taxable income (or net loss) for such quarter, and

(B) by allocating the amount so allocated to any day among the holders (on such day) of residual interests in proportion to their respective holdings on such day.

(b) Determination of taxable income or net loss. -- For purposes of this section --

(1) Taxable income. -- The taxable income of a REMIC shall be determined under an accrual method of accounting and, except as provided in regulations, in the same manner as in the case of an individual, except that --

(A) regular interests in such REMIC (if not otherwise debt instruments) shall be treated as indebtedness of such REMIC,

(B) market discount on any market discount bond shall be included in gross income for the taxable years to which it is attributable as determined under the rules of section 1276(b)(2) (and sections 1276(a) and 1277 shall not apply),

(C) there shall not be taken into account any item of income, gain, loss, or deduction allocable to a prohibited transaction,

(D) the deductions referred to in section 703(a)(2) (other than any deduction under section 212) shall not be allowed, and

(E) the amount of the net income from foreclosure property (if any) shall be reduced by the amount of the tax imposed by section 860G(c).

(2) Net loss. -- The net loss of any REMIC is the excess of --

(A) the deductions allowable in computing the taxable income of such REMIC, over

(B) its gross income.

Such amount shall be determined with the modifications set forth in paragraph (1). (c) Distributions. -- Any distribution by a REMIC

(1) shall not be included in gross income to the extent it does not exceed the adjusted basis of the interest, and

(2) to the extent it exceeds the adjusted basis of the interest, shall be treated as gain from the sale or exchange of such interest.

(d) Basis rules. --

(1) Increase in basis. -- The basis of any person's residual interest in a REMIC shall be increased by the amount of the taxable income of such REMIC taken into account under

subsection (a) by such person with respect to such interest.

(2) Decreases in basis. -- The basis of any person's residual interest in a REMIC shall be decreased (but not below zero) by the sum of the following amounts:

(A) any distributions to such person with respect to such interest, and

(B) any net loss of such REMIC taken into account under subsection (a) by such person with respect to such interest.

(e) Special rules. --

(1) Amounts treated as ordinary. -- Any amount taken into account under subsection (a) by any holder of a residual interest in a REMIC shall be treated as ordinary income or ordinary loss, as the case may be.

(2) Limitation on losses. --

(A) In general. -- The amount of the net loss of any REMIC taken into account by a holder under subsection (a) with respect to any calendar quarter shall not exceed the adjusted basis of such holder's residual interest in such REMIC as of the close of such calendar quarter (determined without regard to the adjustment under subsection (d)(2)(B) for such calendar quarter).

(B) Indefinite carryforward. -- Any loss disallowed by reason of subparagraph (A) shall be treated as incurred by the REMIC in the succeeding calendar quarter with respect to such holder.

(3) Cross reference. --

For special treatment of income in excess of daily accruals, see section 860E.