OFFICE OF
CHIEF COUNSEL

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224
April 20, 2001

Number: **200130009**
Release Date: 7/27/2001
CC:FIP:Br.3
TL-N-5924-00
UILC: 61.03-00
1001.02-00
1286.00-00

INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR DAVID R. SMITH
ASSOCIATE AREA COUNSEL (MIAMI) CC:LM:RFP:MIA

FROM: Lon Smith
Acting Associate Chief Counsel (Financial Institutions and Products) CC:FIP

SUBJECT:

This Chief Counsel Advice responds to your memorandum dated December 15, 2000. In accordance with I.R.C. §6110(k)(3), this Chief Counsel Advice should not be cited as precedent.

LEGEND

Bank =

Calendar year 1 =

Class A instruments =

Class B Instrument =

Class 1 Notes =

Class 2 Notes =

Class 3 Notes =

Class 4 Notes =

Co-owner Trustee =

Date 1 =

Date 2 =

Date 3 =

Date 4 =

Distribution Date =

Holding =

Owner Trustee =

Page a =

Page b =

Page c =

Page d =

Rating Agency =

Section a =

Section b =

Section c =

Section d =

State A =

Trust =

$a =

b% =

$c =

$d =

<u>e</u>% =

$<u>f</u> =

$<u>g</u> =

$<u>h</u> =

$<u>i</u> =

$<u>j</u> =

$<u>k</u> =

<u>l</u>% =

<u>m</u>% =

<u>n</u>% =

<u>o</u>% =

<u>p</u>% =

<u>q</u> =

$<u>r</u> =

$<u>s</u> =

$<u>t</u> =

<u>u</u>% =

<u>v</u> =

<u>w</u> =

<u>x</u> =

<u>y</u> =

<u>ISSUES</u>

(1) Did Bank's transfer to Trust of a pool of subordinated mortgage loans and the Trust's subsequent issuance of the Class 1 Notes, the Class 2 Notes, the Class 3 Notes, the Class 4 Notes, the Class A Instruments, and the Class B Instrument (the transactions) constitute (a) Bank's sale of all or a part of its interest in the pool of subordinated mortgage loans, or (b) a pledge of the mortgage loans as security for a loan to Bank[1]?

(2) Assuming the transactions constituted a sale of the mortgage loans, did Bank's retention of certain servicing rights in the mortgage loans transferred to Trust constitute Bank's retention of an ownership interest in the mortgage loans? If so, how would section 1286 apply in analyzing the consequences of the retention of such ownership interest?

CONCLUSIONS

(1) The transactions constituted a sale of part of Bank's interest in the pool of subordinated mortgage loans.

(2) The issue of whether Bank's retention of servicing rights constituted retention of an ownership interest in the mortgage loans is partly a factual issue. The facts presented are insufficient to determine whether Bank's retention of servicing rights was also a retention of an ownership interest.

FACTS

Bank is a commercial bank chartered under the laws of State A and uses the overall accrual method of accounting. Bank is a member of a consolidated group of which Holding is the parent.

During Calendar year 1, Bank originated or purchased certain loans secured by second mortgages on residential real estate. As a general matter, the value of the mortgagors' equity in the real estate, after giving effect to the senior mortgage, was relatively small but the mortgagors had good credit histories. These loans were not guaranteed or insured by a government agency. By Date 1, Bank had accumulated a pool of these subordinated mortgage loans with an outstanding principal balance of $a. The weighted average interest rate for these loans was approximately b%.

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[1] This memorandum will not address the issue of whether Trust would be a "taxable mortgage pool" for the purposes of section 7701(i). However, we note that in section a of the Servicing Agreement (as such term is defined below), Bank represented that a significant proportion of the subordinated mortgage loans did not constitute "real estate mortgages" for the purposes of section 301.7701(i)-1. Therefore, this memorandum assumes, without holding, that Trust is not a taxable mortgage pool.

Trust was formed pursuant to a trust agreement, dated as of Date 2, among Bank, Owner Trustee, and Co-Owner Trustee. The Trust Agreement provides, among other things, for the issuance of two types of financial instruments: Class A Instruments and the Class B Instrument. The Class A instruments could be issued as multiple certificates with a minimum denomination of $c and in integral multiples of $d in excess thereof. The Class A instruments bear interest at a rate of e% per annum and had an aggregate stated principal amount at issuance of $f. Only a single Class B instrument was issued and it has neither a principal amount nor an interest rate. The Class B instrument represents the right to trust assets after satisfaction of the Trust's obligations under the Class A instruments and the Class 1, Class 2, Class 3, and Class 4 Notes, further described below.

Also as of Date 2, Bank and Co-Owner Trustee entered into a trust indenture agreement (the Indenture) and, with the Trust as an additional party, a sales and servicing agreement (the Servicing Agreement). The Servicing Agreement contemplates the transfer of a pool of subordinated mortgage loans to Trust and the delivery of various mortgage loan documents (including the original mortgage loans and an Assignment of Mortgage endorsed in blank by Bank) to a custodial agent of Co-owner Trustee. If a mortgage loan fails to conform to certain representations and warranties of Bank in a manner that materially affects the mortgage loan's value (a non-conforming mortgage loan), Bank must repurchase the non-conforming mortgage loan by paying its outstanding principal balance (plus any accrued but unpaid interest) or by providing a replacement mortgage loan with comparable terms that conforms to the applicable representations and warranties.

The Servicing Agreement and Indenture also contemplate Trust's issuance of four classes of promissory notes: Class 1 Notes, Class 2 Notes, Class 3 Notes, and Class 4 Notes (the Notes). The aggregate stated principal amount at issuance of the four classes of Notes was $g (Class1), $h (Class 2), $i (Class 3), and $j (Class 4). Thus, the aggregate stated principal amount of all classes of Notes and the Class A Instruments at issuance was $k. Stated annual interest rates on the four classes of notes are l%, m%, n%, and o%, respectively. The Servicing Agreement also provides that Bank will service the pool of subordinated mortgage loans held by Trust in return for a monthly servicing fee equal to p% of the outstanding aggregate outstanding principal balance of the loans divided by 12.

On or about Date 3, Bank transferred to Trust a pool of q subordinated mortgage loans with an outstanding principal balance of $a (the Initial Loans). In addition, Trust had the right to acquire additional subordinated mortgage loans from Bank (the Additional Loans) with an aggregate outstanding principal balance of up to $r by Date 4 using the proceeds of the sale of the Notes in excess of the amount needed to reimburse Bank for the transfer of the Initial Loans. In the event that the total amount of the excess was not used to purchase the Additional Loans, the amount remaining would be distributed as a principal payment to either holders of the Class 1 Notes or, in certain circumstances, pro rata, to all holders of all classes of Notes. Thus, the outstanding principal balance of all subordinated mortgage loans to be held by the trust, plus any excess cash not used to purchase the Additional Loans, ($a + $r = $s) would exceed the principal balance of the Notes and the Class A Instruments ($k) by $t. Therefore, the Notes and Class A Instruments were overcollateralized. In addition, the stated interest on the subordinated mortgage loans typically exceeded the stated interest on the Notes and the Class A Instruments. Thus, assuming no defaults, the subordinated mortgage loans held by Trust would create cash flow in excess of the amounts needed to pay principal and interest on the Notes and the Class A Instruments.

The Notes and the Class A Instruments paid interest and, in the circumstances further described below, principal on the Distribution Date of each calendar month. The total amount available for distribution on the Notes and Instruments would be the amount collected on the mortgage loans during the previous calendar month plus any interest earned on the collection account in which the collections on the mortgage notes were held.

The portion of this amount used to make principal distributions depended on whether overcollateralization equaled or exceeded a set percentage of the aggregate outstanding principal balance of the Notes and the Class A Instruments (the percentage varying over time and dependent on the occurrence of various events). In all events, the amount distributable as principal payments on each Distribution Date would at least equal the amount of principal collected on the subordinated mortgage loans (including collections from foreclosure) during the previous calendar month. However, since the stated interest on the mortgage loans exceeded the stated interest on the Notes and the Class A Instruments and the Notes and Class A Instruments were overcollateralized, the total amount available for distribution would typically exceed the stated interest on the Notes and Class A Instruments plus the amount of principal collected on the mortgage loans. If the overcollateralization target were met, such excess cash would be paid to the holder of the Class B instrument on the Distribution Date. If the overcollateralization target was not met, such excess cash would instead be distributed as a payment of principal on the Distribution Date in the order listed below. Thus, the aggregate outstanding principal balance of the Notes and the Class A Instruments would be reduced until the overcollateralization target was met.

As a general matter, collections on the pool of subordinated mortgage loans would be used first to pay trust fees and expenses (including the servicing fee due to Bank in its role as servicer), then interest due (including interest previously due and not yet paid) from the most senior to the most junior tranche; that is the Class 1 Notes and the Class 2 Notes, then the Class 3 Notes, the Class 4 Notes, and the Class A instruments, in that order. Additional collections would then be used to pay down the principal balance of the Class1 Notes, then the Class 2 Notes, the Class

3 Notes, the Class 4 Notes and the Class A instruments, in that order. No principal payments would be made on a tranche until the principal balance of the more senior tranches had been first reduced to zero. For example, principal payments would not be made on the Class 2 Notes until the Class 1 Notes had been paid off in their entirety. The holder of the Class B instrument has the option of repurchasing all remaining mortgage loans on a "clean-up call", that is when the aggregate outstanding principal balance of the Notes and the Class A Instruments have declined to u% or less of the original aggregate balance.

Thus, the risk of there being insufficient cash flow to service the various obligations of the Trust are shared sequentially from the most junior to the most senior tranche. The holder of the Class B Instrument is the first to suffer from inadequate cash flow, followed by the holders of the Class A Instruments, the Class 4 Notes, the Class 3 Notes, the Class 2 Notes, and the Class1 Notes. This is reflected in the ratings assigned to these securities. Prior to sale, the Notes and the Class A Instruments had each been rated by Rating Agency. Specifically, the Class 1 and Class 2 Notes had been rated as "v", the Class 3 Notes had been rated as "w", the Class 4 Notes had been rated as "x", and the Class A Instruments had been rated as "y." The Class B instrument is unrated.

On or about Date 3, the Bank distributed to certain institutional investors a private placement memorandum that offered for sale both the Notes and the Class A Instruments. However, although the Notes and the Class A Instruments were distributed to underwriters, only the Class 1, Class 2, and Class 3 Notes were sold to institutional investors. The Class 4 Notes and the Class A Instruments were sold to the Bank. During the relevant period, the Bank was also the owner of the Class B Instrument.

Holding initially reported the transactions as a sale of the pool of subordinated mortgage loans for tax purposes on the consolidated federal income tax return filed for Calendar Year 1. However, Holding subsequently filed an amended return reclassifying the transactions as a financing.

Trust did not elect to be treated as a Real Estate Mortgage Investment Conduit (REMIC) pursuant to section 860D(b).

LAW AND ANALYSIS

1. Did the transactions constitute a sale or a pledge of the pool of subordinated mortgage loans?

In general, federal income tax consequences are governed by the substance of a transaction determined by the intentions of the parties to the transaction, the underlying economics, and all other relevant facts and circumstances. Gregory v.

Helvering, 293 U.S. 465, 470 (1935), XIV-1 C.B. 193. The label the parties affix to a transaction does not determine its character. Helvering v. Lazarus & Co., 308 U.S. 252, 255 (1939), 1939-2 C.B. 208; Mapco Inc. v. United States, 556 F.2d 1107, 1110 (Ct. Cl. 1977).

The term "sale" is given its ordinary meaning and is generally defined as a transfer of the ownership of property for money or for a promise to pay money. Commissioner v. Brown, 380 U.S. 563, 570-71 (1965), 1965-2 C.B. 282. Whether a transaction is a sale or a financing arrangement is a question of fact, which must be ascertained from the intent of the parties as evidenced by the written agreements read in light of the surrounding facts and circumstances. Haggard v. Commissioner, 24 T.C. 1124, 1129 (1955), aff'd, 241 F.2d 288 (9th Cir. 1956). But see Farley Realty Co. v. Commissioner, 279 F.2d 701, 705 (2d Cir. 1960) ("[T]he parties' bona fide intentions may be ignored if the relationship the parties have created does not coincide with their intentions.").

A transaction is a sale if the benefits and burdens of ownership have passed to the purported purchaser. Highland Farms, Inc. v. Commissioner, 106 T.C. 237, 253 (1996); Grodt & McKay Realty, Inc. v. Commissioner, 77 T.C. 1221, 1237 (1981). In cases involving transfers of debt instruments such as mortgage loans, the courts have considered the following factors to be relevant in determining whether the benefits and burdens of ownership passed: (1) whether the transaction was treated as a sale, see United Surgical Steel Co., Inc. v. Commissioner, 54 T.C. 1215, 1229-30, 1231 (1970), acq., 1971-2 C.B. 3; (2) whether the obligors on the debt instruments were notified of the transfer of the debt instruments, id.; (3) which party serviced the debt instruments, id.; Town & Country Food Co., Inc. v. Commissioner, 51 T.C. 1049, 1057 (1969), acq., 1969-2 C.B. xxv; (4) whether payments to the transferee corresponded to collections on the debt instruments, United Surgical Steel Co., 54 T.C. at 1229-30, 1231; Town & Country Food Co., 51 T.C. at 1057; (5) whether the transferee imposed restrictions on the operations of the transferor that are consistent with a lender-borrower relationship, United Surgical Steel Co., 54 T.C. at 1230; Yancey Bros. Co. v. United States, 319 F. Supp. 441, 446 (N.D. Ga. 1970); (6) which party had the power of disposition, American Nat'l Bank of Austin v. United States, 421 F.2d 442, 452 (5th Cir. 1970), cert. denied, 400 U.S. 819 (1970); Rev. Rul. 82-144, 1982-2 C.B. 34; (7) which party bore the risk, Union Planters Nat'l Bank of Memphis v. United States, 426 F.2d 115, 118 (6th Cir. 1970), cert. denied, 400 U.S. 827 (1970); Elmer v. Commissioner, 65 F.2d 568, 569 (2d Cir. 1933) aff'g 22 B.T.A. 224 (1931); Rev. Rul. 82-144; and (8) which party had the potential for gain, United Surgical Steel Co., 54 T.C. at 1229; Town & Country Food Co., 51 T.C. at 1057; Rev. Rul. 82-144. No one factor is dispositive of the issue of whether a sale has taken place. The facts and circumstances determine the importance of each factor. Thus, a factor-by-factor analysis is necessary to determine whether Bank sold the mortgage loans.

(1) Were the transactions treated as sales?

The form of the transactions was a sale of the subordinated mortgage loans to the Trust. Section b of the Servicing Agreement states that Bank "does hereby sell, transfer, assign, set over and otherwise convey to the Trust, without recourse, but subject to the other terms and provisions of this Agreement, all of its right, title and interest in and to the [pool of subordinated mortgage loans]" (emphasis added). Section c specifically states that "it is the intention of the parties hereto that the transfers and assignments contemplated by this Agreement shall constitute a sale of [the pool of subordinated mortgage loans]." Page a of the private placement memorandum states: "on [Date 3], the Trust will purchase from the [Bank] a pool ... of home loans ... ." (Emphasis added). Page b of the private placement memorandum similarly describes the mortgage loans as having been "conveyed to the Trust." Holding also treated the transaction as a sale of the pool of subordinated mortgage loans when the consolidated federal income tax return for Calendar Year 1 was first filed.

Notwithstanding the foregoing, the documents may evince an intent that the transactions be financings for tax purposes even though they are sales for state law purposes. Page c of the private placement memorandum advises that the Notes are debt and that holders of the Notes must agree to treat the Notes as such for federal income tax purposes. Section d of the Indenture also provides that the Notes be treated as indebtedness. Page d of the private placement memorandum advises that the Class A Instruments are partnership interests and that holders of the Class A Instruments must agree to treat the instruments as such for federal income tax puposes[2]. Since the Class A and B Instruments are retained by the Bank, this implies that the Trust is a partnership with a single partner. The private placement memorandum, therefore, may imply an intention that the Trust should be disregarded and the Notes treated as the Bank's indebtedness for tax purposes. See §301.7701-3(a), -4(b) (a business entity with a single owner that is not classified as a corporation can elect to be classified as a corporation or be disregarded as an entity separate from its owner). If so, the parties may also have intended that the mortgage loans not be considered sold for tax purposes (since they continue to be owned by the Bank through the Trust) but rather as pledged as collateral for the Notes. However, as noted previously, Holding did treat the transactions as sales in the tax return initially filed for Calendar Year 1.

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[2]The private placement memorandum does not discuss the Class B Instrument since it was not offered for sale. However, the Class B Instrument is more equity-like than the Class A Instruments since it is merely the right to the assets of the Trust when all other obligations of the Trust have been satisfied. If the Class A Instruments are partnership instruments then, a fortiori, the Class B Instrument must be a partnership interest.

(2) Were Bank's customers notified of the transactions?

The facts provided do not state of whether the mortgagors were made aware of the transfer of the mortgage loans to Trust.

(3) Which party handled collections and serviced the subordinated mortgage loans?

As discussed in the FACTS section, the Servicing Agreement provides that the Bank will continue to service the subordinated mortgage loans in return for the payment of a monthly fee.

(4) Did payments to the holders of the Notes, the Class A Instruments, and the Class B Instrument (the Holders) correspond to collections on the pool of subordinated mortgage loans ?

The Holders received payments generally only from amounts collected on the subordinated mortgage loans. The Bank had no obligation to make payments to the Holders. The Holders received payments only if and when Bank, as servicer, collected amounts on the customer notes. Compare United Surgical Steel Co., 54 T.C. at 1230, and Town & Country Food Co., 51 T.C. at 1057 (lenders looked to taxpayers rather than payments on pledged installment notes for repayment) with Branham v. Commissioner, 51 T.C. 175, 180 (1968) (taxpayer's payments to purported lender were exactly the same in amount and timing as payments on underlying installment notes). In addition, assuming that the overcollateralization target was met, the Holders would receive payments of principal only as principal payments were collected on the subordinated mortgage loans.

Additional amounts could be earned from reinvestment of collections during the period between receipt and payments being made to the Holders. However, the amount that could be earned by reinvestment was relatively small since collections on the mortgage loans in any calendar month were paid to the Holders on the Distribution Date in the next calendar month.

The Holders (other than the Bank) did not receive all the amounts received on the subordinated mortgage loans. As discussed in the FACTS section, the Bank was the holder of the Class 4 Notes, the Class A Instruments and the Class B Instrument. Therefore, a significant part of the collections on the subordinated mortgage loans would be paid to the Bank in its capacity of holder of such financial instruments. In addition, fees were paid from the collections on the pool of subordinated mortgage loans to various parties, including the Bank in its role as servicer.

(5) Were there restrictions on the operations of the Bank that are consistent with a lender-borrower relationship?

The relationship between Bank and Trust or the Holders lacked the restrictive covenants often imposed by lenders on borrowers. No restrictions were imposed on the operations of Bank as a result of entering into the transactions. For example, Bank was not required to maintain a specified ratio of assets to liabilities or current assets to current liabilities. Neither Trust nor the Holders received the right to review Bank's books and records. Since no restrictions were imposed on Bank's operations, Bank is less like a borrower and more like a seller of the pool of subordinated mortgage loans. See, e.g., United Surgical Steel Co., 54 T.C. at 1230 (bank's imposition of restrictions on operations of putative borrower was a factor showing lender-borrower relationship). This conclusion is further supported by the fact that Bank was not required to post any additional collateral in the event that high losses on the pool resulted in Trust failing to have sufficient assets to make required payments on the Notes or the Class A Instruments. See, e.g., Union Planters Nat'l Bank of Memphis, 426 F.2d at 118, (purported seller required to make margin account payments); Yancey Bros. Co., 319 F. Supp. at 446 (taxpayer obligated to maintain ratio of collateral to debt of not less than 105 percent).

(6) Which party had the power of disposition?

Bank no longer had title to the mortgage loans, and so could not transfer the mortgage loans. In particular, the original mortgage loan documents were transferred to a custodial agent of the Co-owner Trustee. A mortgage loan would not be returned to Bank except in those cases in which Bank was required to repurchase or replace a non-conforming mortgage loan. Only Trust could dispose of mortgage loans. However, the applicable documents contemplate that the mortgage loans would generally be held by Trust until maturity, subject to the duty of Bank to repurchase or replace non-conforming mortgage loans and the ability of the holder of the Class B Instrument to repurchase the remaining mortgage loans on a clean-up call.

(7) Which party bore the risk on the mortgage notes?

By transferring the pool of subordinated mortgage loans to Trust, Bank seemingly eliminated its exposure to credit risk on the pool. However, Bank also became the owner of the Class 4 Notes, the Class A Instruments, and the Class B Instrument. As developed previously, the risks of there being inadequate cash flow on the mortgage loans is shared sequentially with the holder of the Class B Instrument being the first to suffer from inadequate cash flow, followed by the holders of the Class A Instruments, the Class 4 Notes, the Class 3 Notes, the Class 2 Notes, and the Class1 Notes. This is reflected in the ratings given the various tranches by Rating Agency. Therefore, Bank as holder of the three most “junior” tranches has retained most of the credit risk associated with the mortgage loans.

However, mortgage loans carry not only credit risk but also prepayment risk. That is, prepayments on mortgage loans typically vary directly with declines in interest rates. When interest rates go down, mortgagors are likely to refinance, thus depriving the mortgage holder of the benefit of holding a mortgage loan with greater than market interest. Similarly, when interest rates go up, mortgagors are less likely to refinance forcing the mortgage holder to hold an obligation with a below-market yield. Lore and Cowan, MORTGAGE-BACKED SECURITIES, DEVELOPMENTS AND TRENDS IN THE SECONDARY MORTGAGE MARKET, pp. 1-5,1-6. (2000 Ed.). Because principal amounts received on the pool of subordinated mortgage loans are passed through, as received, to sequentially pay off the various tranches of Notes and instruments, the prepayment risk associated with the mortgage loans is also passed through to the holders of those tranches. Although Bank retains the three most junior tranches and so, the prepayment risk associated with those tranches, other investors hold the three most senior tranches and the prepayment risk associated with those tranches. Therefore, Bank has transferred a large part of the prepayment risk associated with the mortgage loans.

(8) The potential for gain on the mortgage loans.

In this particular instance, the opportunity for gain is largely the obverse of the risk carried. As developed previously, much of the credit risk is associated with the junior tranches retained by Bank. Similarly, a lower than expected default rate on the mortgage loans will significantly increase the cash flow on the junior tranches including, particularly, the Class B Instrument, which is the first tranche that must absorb the costs of any default. Thus, Bank will benefit significantly from a lower default rate.

However, as also developed previously, Bank has passed through a significant part of the prepayment risk to the holders of the three most senior tranches. Thus, these holders will benefit to the extent that prepayments are less than would be expected in a falling-interest-rate environment or higher than expected in an increasing-interest-rate environment. Bank’s right, as the holder of the Class B Instrument, to initiate a clean-up call, does create an opportunity for Bank to keep some of the gains in the value of the mortgages in a falling interest rate environment. However, since Bank may only call the bonds when the aggregate outstanding principal balance of the Notes and the Class A Instruments have declined to u% or less of the original aggregate balance, the portion of the gains that the Bank can sequester by calling the bonds at a time of falling interest rates is very limited.

The above analysis establishes that the transactions constitute a sale of interests in the Mortgage Loans.

Certain factors do suggest that the transactions should be characterized as a financing rather than a sale. Bank did retain the servicing rights on the mortgage loans and much of the credit risk associated with the mortgage loans. Further, there is some ambiguous evidence in the documents indicating that Bank believed that the mortgage loans should be considered to have been pledged as collateral rather than sold for tax purposes (although this belief was not reflected in the consolidated tax return for Tax Year 1 initially filed by Holding).

However, other factors strongly suggest that the transactions constitute a sale of the mortgage loans. The transactions were, on their face, sales and treated as such in the initial consolidated tax return filed for Tax Year 1. Restrictions that would normally be associated with a borrowing were not placed on Bank. Payments to the Holders closely corresponded to collections on the pool of subordinated mortgage loans. Holders also bore much of the prepayment risk associated with the mortgage loans and stood to benefit if prepayments were less than expected at a time of falling interest rates or greater than expected at a time of rising interest rates.

Thus, in this particular transaction, it is clear that the Holders other than the Bank (i.e,.the holders of the Class 1, Class 2, and Class 3 Notes) have obtained many of the economic benefits and burdens of ownership of the pool of the subordinate mortgage loans. The transfer of a substantial portion of the benefits and burdens of ownership of property is not characteristic of a financing. Thus, the transactions constitute the sale of a part of the Bank's interest in the mortgage loans. Cf §301.7701-4(c)(2), Example (1) (state law "trust" that holds mortgage loans and issues senior and subordinated tranche is an "association" or partnership rather than grantor trust for tax purposes; thus, tranches represent equity interest in entity).

(2) Did the Bank's retention of servicing rights in the mortgage loans constitute the Bank's retention of an ownership interest in the mortgage loans?

Section 1286 provides rules to deal with a taxpayer that sells a portion of the future payments on a debt instrument (a stripped bond) while retaining the right to other payments. A taxpayer that simultaneously sells mortgages and enters into a contract to service the mortgages in return for amounts received from interest payments on the mortgages may be treated as having retained a portion of the future interest payments. The taxpayer's rights to receive amounts under the contract are "stripped coupons" under section 1286 to the extent they are rights to receive mortgage interest other than as reasonable compensation for the services to be performed. Rev. Rul. 91-46, 1991-2 C.B. 358.

Rev. Proc. 91-50, 1991-2 C.B. 78, provides an elective safe harbor that determines the extent to which fees for servicing residential mortgages represent reasonable compensation for the services provided. In the instant case, Bank's servicing fee of p% of the outstanding principal balances of the mortgage loans exceeded the safe harbor rates of Rev. Proc. 91-50. However, the facts presented are not sufficient to determine if Bank's servicing fee exceeds reasonable compensation for the services it performs.

Assuming, arguendo, that the Bank's servicing fee is in excess of reasonable compensation, then the portion of the fees that constitutes reasonable compensation should be treated as received by Bank as compensation for services. The excess is treated as received by Bank directly from the mortgagors. Bank's ownership of the right to this excess is treated as the ownership of a stripped coupon rather than as the ownership of an interest in the Trust. Rev. Rul. 91-46. Bank's basis in the stripped coupons is calculated by multiplying the Bank's aggregate basis in all the assets transferred to the Trust on or about Date 1 by a fraction that is equal to the fraction of the fair market value of these assets that was represented by the stripped coupons. Section 1286(b)(4).

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

1. Treating the transactions as a sale of the pool of subordinated mortgage loans?

The information provided is sufficient to establish that the transactions constituted a sale rather than a pledge of the mortgage loans. [redacted]

[redacted] The only authority we have found that deals with a factually similar transaction is example (1) in §301.7701-4(c)(2). This example involved the transfer of a portfolio of mortgage loans to a trust that issues two tranches of certificates. As in the instant case, the principle amount of the senior tranche must be paid before payments are made on the junior tranche. The example concludes that, since a large part of the prepayment risk on the mortgage loans has been passed through to the senior tranche, neither the senior tranche nor the junior tranche represent merely a direct ownership interests in the mortgage loans. The "trust," therefore, cannot be a grantor trust for tax law purposes but must be characterized as either an "association" (i.e., a corporation) or as a partnership. The implication of the example is that the transferror of the mortgages had transferred an ownership interest in the mortgages to the holders of the two tranches. Applied in this context, this example suggests that the transactions constitute a “carving up” of the ownership interests in the subordinated mortgage loans. Ownership in the subordinated mortgage loans has been divided in a complex manner between the holders of the Notes and Instruments, i.e. the Bank and the other investors.

Another implication of the example is that, in order to represent properly the complex ownership structure, the putative “trust” should be treated as a partnership or corporation for tax purposes. Although you have not asked, we believe a similar analysis may apply here. Furthermore under current law, Trust may elect to be treated as a partnership rather than a corporation for tax purposes and will probably do so in order to avoid the corporate income tax. Section 301.7701-3.

[redacted]

(2) <u>The Bank’s retention of servicing rights in the mortgage loans</u>.

Bank’s servicing fee significantly exceeds the “safe harbor” rates of Rev. Proc. 91-50. This alone suggests that the servicing fees are not limited to reasonable compensation but instead include an equity interest in the mortgage loans. In addition, the amount Bank is considered to receive for servicing the mortgage loans is not limited to amounts that are explicitly identified as servicing fees. Certain other amounts that Bank may receive as a result of acting as servicer (e.g. fees for late payments), may also be considered as received for servicing and further increase the amount by which the Bank’s receipts are in excess of the safe harbor rates. Rev. Proc. 91-50, 1991-2 C.B. 778, §§ 2.04, 4.01.

[redacted]

[redacted]

[redacted]

[redacted]

This writing may contain privileged information. Any unauthorized disclosure of this writing may have an adverse affect on privileges, such as the attorney client privilege. If disclosure becomes necessary, please contact this office for our views.

Please call if you have any further questions.

Lon Smith
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