INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

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Chief, Exam Division

Taxpayer's Name:

Taxpayer's Address:

Taxpayer's Identification No.:
Year Involved:
Date of Conference:

LEGEND:

Mortgage Company =

Escrow Company =

Holding Company =

Bank =

Mortgage Services Company =

Date 1 =

Year 1 =

$x =

$y =

$z =

ISSUE:

If a bank holds rights to service mortgage loans (mortgages) that are owned by others, may the bank include the mortgages in its loans outstanding for purposes of determining the balance of its reserve for bad debts under § 585 of the Internal Revenue Code?

CONCLUSION:

A bank that holds rights to service mortgages owned by others may not include the mortgages in its loans outstanding for purposes of determining the balance of its bad debt reserve under § 585.

FACTS:

Before Date 1, Mortgage Company originated, warehoused, sold, and serviced residential and non-residential mortgages. When Mortgage Company sold mortgages, it retained the rights to service those mortgages. Mortgage Company also purchased mortgage servicing rights. Mortgage Company's wholly-owned subsidiary, Escrow Company, provided loan closing and escrow services to Mortgage Company and other lenders.

On Date 1, Mortgage Company reorganized its business into five affiliated corporations, including a newly formed holding company (Holding Company), a newly chartered state savings bank (Bank), and another newly formed corporation (Mortgage Services Company). The stated purpose of the reorganization was to "provide an additional, stable source of funding to generate growth in [the] mortgage lending business." After the reorganization, Holding Company was the parent of the affiliated group and had two direct, wholly-owned subsidiaries – Bank and Mortgage Services Company. Mortgage Company (the former parent of the group) and Escrow Company were wholly-owned subsidiaries of Bank after the reorganization.

According to the Reorganization Plan and Agreement (the Plan), Bank was expected to provide funds for residential mortgage lending; Mortgage Services Company was expected to conduct the non-residential mortgage business previously conducted by Mortgage Company; Mortgage Company was expected to originate residential mortgages for Bank; and Escrow Company was expected to provide loan closing and escrow services. The Plan provided that, in the reorganization, all of Mortgage Company's rights to service residential mortgages securitized by the Federal National Mortgage Association (Fannie Mae) would be transferred to Bank. The Plan also provided that all of Mortgage Company's rights to service residential mortgages securitized by entities other than Fannie Mae, and all of Mortgage Company's non-residential lending assets (including its rights to service non-residential loans), would be transferred to Mortgage Services Company in the reorganization.

Bank, which is a bank as defined in § 581, sells residential mortgages, retaining the rights to service those mortgages. Bank also will purchase mortgage servicing rights. At the end of the affiliated group's first taxable year ending after the reorganization (Year 1), the Fannie Mae mortgage servicing rights transferred to Bank in the reorganization comprised the bulk of Bank's mortgage servicing rights. Bank claims that it also held smaller amounts of rights to service residential mortgages securitized by others. The mortgage servicing rights held by Bank were rights to receive reasonable compensation for servicing the mortgages.

In the Consolidated Report of Condition (FFIEC 034, Schedules RC and RC-L) that Bank filed with its federal regulators for the close of Year 1, the mortgages serviced under Bank's mortgage servicing rights were not included in Bank's assets and were treated as having been sold without recourse. Likewise, the mortgages serviced under Bank's mortgage servicing rights were not included in Bank's assets on its year-end balance sheet for Year 1 for financial accounting (book) purposes. Bank had no tax basis in those mortgages.

Holding Company filed a consolidated federal income tax return with its four subsidiaries for Year 1. According to this return, as of the end of Year 1 the affiliated group had total assets of $<u>x</u>, including mortgages and real estate loans of $<u>y</u> and intangible assets (such as mortgage servicing rights) of $<u>z</u>. The return claimed a deduction under § 585 for an addition to a reserve for bad debts. Bank was eligible to maintain a bad debt reserve under § 585 because it was a bank as defined in § 581 and the average adjusted bases of the affiliated group's total assets did not exceed the $500 million asset limit of § 585(c)(2) for maintaining a § 585 reserve. All of the other members of the group were eligible to account for their bad debts under the specific charge-off method of § 166, but not the reserve method of § 585.

For purposes of determining the amount of Bank's deduction under § 585, a statement attached to the return for Year 1 computed Bank's bad debt reserve by including, in Bank's outstanding loans, all of the mortgages serviced under mortgage servicing rights held by any member of the affiliated group (*i.e.*, mortgages owned by investors outside the affiliated group and serviced by members of the group). Bank later agreed to exclude from its outstanding loans the mortgages serviced under rights held by other members of the group. Bank contends, however, that it is permitted to include in its outstanding loans the mortgages serviced under the mortgage servicing rights that it held (the Sold Mortgages). The total outstanding principal balance of the Sold Mortgages far exceeded that of all of the mortgages and real estate loans held by the affiliated group, far exceeded the amount of the group's total assets, and far exceeded the $500 million asset limit for maintaining a § 585 reserve.

Because Bank was a new bank, the rules of § 1.585-2(c)(2) of the Income Tax Regulations, relating to new financial institutions, applied for purposes of determining the balance of Bank's bad debt reserve. And because Bank's predecessor (Mortgage Company) was not a § 581 bank, § 1.585-2(c)(2) allowed Bank's bad debt reserve balance to be determined by multiplying the amount of Bank's outstanding loans (at the close of the taxable year) by a bad debt experience ratio based largely on the experience of a "comparable bank" as defined in § 1.585-2(e)(7). As a result, although Bank did not charge off any bad debts in Year 1 (and Mortgage Company had previously charged off only relatively small amounts of bad debts), the inclusion of the Sold Mortgages in Bank's outstanding loans resulted in a claimed § 585 deduction that produced a large net operating loss on the consolidated return, which the group carried back and carried forward.

When a mortgage lender sells mortgages to a guarantor agency such as Fannie Mae for securitization, the mortgage lender receives cash for the mortgages on the sale and generally retains rights to service them. The guarantor agency securitizes the mortgages and generally sells the resulting mortgage-backed securities to investors. The mortgage-backed securities may be mortgage pass-through securities or interests in Real Estate Mortgage Investment Conduits (REMICs). The investors that purchase the mortgage-backed securities (the security holders) generally are entitled to receive and retain the principal and most of the interest on the underlying mortgages. The guarantor agency guarantees the timely payment of mortgage principal and mortgage interest to the security holders and is entitled to receive a guarantee fee from interest collected on the mortgages (for Fannie Mae, typically an annual fee of up to 25 basis points, or 0.25 percent, of the outstanding principal balance of the mortgages). The mortgage seller/servicer is responsible for servicing the mortgages in accordance with the rules of the guarantor agency and is entitled to receive a servicing fee from interest collected on the mortgages (typically an annual fee of about 25 basis points for mortgages securitized by Fannie Mae).

Fannie Mae's rules for these transactions are contained in the Fannie Mae Selling Guide and the Fannie Mae Servicing Guide. Fannie Mae enters into a Mortgage Selling and Servicing Contract with each mortgage seller/servicer that incorporates by reference the terms of these guides. According to the Fannie Mae Selling and Servicing Guides, every mortgage sale transaction under the guides is expressly intended to be the lender's sale of the mortgages and not the lender's pledge to secure a debt. Section 201.03 of Part I of the guides states, "The lender and Fannie Mae intend for the conveyance of all mortgages and participation interests to be a true, absolute, and unconditional sale."

Fannie Mae requires a mortgage seller/servicer to obtain private mortgage insurance (at the borrower's expense) for each mortgage that has a loan-to-value ratio greater than 80 percent (*i.e.*, a mortgage on property in which the borrower has equity of less than 20 percent), unless the mortgage is insured by the Federal Housing Administration (FHA) or guaranteed by the Veterans Administration (VA). Private mortgage insurance, FHA insurance, and VA guaranty provide protection against loss from mortgagor default.

When a mortgage lender sells mortgages to Fannie Mae, the lender must make various warranties and representations regarding the nature and quality of the mortgages sold and their conformance to Fannie Mae's requirements. (Fannie Mae considers a transferee servicer such as Bank to have made the same selling warranties that the mortgage seller made.) For example, a seller/servicer must warrant that the mortgages are not in default at the time of sale (but does not warrant that they will not go into default in the future). If Fannie Mae finds, at any time during the life of a mortgage, that a warranty has been breached, Fannie Mae may require the servicer to repurchase the defective mortgage or substitute another mortgage in its place. If a servicer incurs a loss with respect to a mortgage that it reacquired due to the breach of a selling warranty, the servicer generally looks to the mortgage insurer for reimbursement. (However, private mortgage insurers, the FHA, and the VA also require a mortgage seller/servicer to make certain warranties that, according to Bank, can give the insurer a defense if it chooses to assert that Bank's underwriting process was flawed.) Of course, if a servicer such as Bank reacquires a mortgage and continues to own it at the close of a taxable year, the mortgage is included in the servicer's outstanding loans for that year for purposes of § 585.

In some cases, Fannie Mae requires a mortgage servicer to advance its own funds to cover principal and interest payments due for a delinquent mortgage (delinquency advances). The servicer is entitled to reimburse itself for these advances from subsequent collections from the borrower, and the servicer retains fees imposed on borrowers for late payment. In the event of foreclosure on a delinquent mortgage, the guarantor agency or the mortgage insurer generally can be expected to reimburse the servicer for its delinquency advances if there has been no breach of warranty. Fannie Mae also requires a mortgage servicer to advance "out of pocket" costs incurred in performing its servicing obligations – such as those related to the foreclosure process. The servicer generally looks to the guarantor agency or the mortgage insurer for reimbursement of these types of advances if there has been no breach of warranty. According to Bank, mortgages guaranteed by the VA "can take a slightly different path, because it is possible for the VA to pay a specified amount on a defaulted VA loan and completely terminate its financial responsibilities by so doing."

In short, Bank and the other members of its affiliated group have relied heavily on governmental agencies and private mortgage insurers to manage the group's default and underwriting risks. Nevertheless, members of the affiliated group claim to have experienced losses with respect to mortgages they have serviced.

LAW AND ANALYSIS:

Section 585(a) provides that a bank (as defined in § 581), other than a large bank (as defined in § 585(c)(2)), shall be allowed a deduction for a reasonable addition to a reserve for bad debts.

Section 585(b)(1) provides that a bank's reasonable addition to its reserve for bad debts shall not exceed the addition to the reserve for losses on loans determined under the experience method as provided in § 585(b)(2). Section 585(b)(2) provides, in relevant part, that the amount determined 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 amount that 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 five preceding taxable years, adjusted for recoveries of bad debts during such period, bears to (ii) the sum of the loans outstanding at the close of such six taxable years.

Section 585(b)(3) provides that the Secretary shall define the term "loan" and prescribe such regulations as may be necessary to carry out the purposes of this section. Section 1.585-2(e)(2)(i) provides that the term "loan," for purposes of § 585, means debt as the term "debt" is used in § 166 and the regulations thereunder. Section 1.166-1(a) provides that a deduction is allowed for bad debts "owed to the taxpayer." Section 1.166-1(c) defines a bona fide debt as a debt that arises from a debtor-creditor relationship based upon a valid and enforceable obligation to pay a fixed or determinable sum of money. Section 1.585-2(e)(2)(i)(C) provides that the term "loan" includes a "loan participation to the extent that the taxpayer bears a risk of loss."

Pursuant to § 860B(a), a regular interest in a REMIC is treated as a debt instrument for federal income tax purposes. Therefore, a regular interest in a REMIC is a loan within the meaning of § 1.585-2(e)(2).

A series of revenue rulings has considered the tax treatment of mortgage pass-through securities. Rev. Rul. 84-10, 1984-1 C.B. 155, addresses the treatment of mortgage pass-through securities created by Fannie Mae and sold to investors. The revenue ruling concludes that the securities represent ownership interests in the underlying mortgages. The revenue ruling also holds that the securities represent "loans secured by an interest in real property" under § 7701(a)(19)(C)(v) and "qualifying real property loans" under § 593(d) (relating to the reserve method of § 593, now repealed). See also Rev. Rul. 77-349, 1977-2 C.B. 20; Rev. Rul. 71-399, 1971-2 C.B. 433; Rev. Rul. 70-545, 1970-2 C.B. 7; and Rev. Rul. 70-544, 1970-2 C.B. 6. More recently, Rev. Rul. 91-46, 1991-2 C.B. 358, confirmed that rights to receive reasonable compensation for servicing mortgages do not give a mortgage seller/servicer an ownership interest in the mortgages.

In LTR 9423002 (Jan. 25, 1994), the Service relied on these authorities to conclude that the holder of mortgage-backed securities guaranteed by an agency such as Fannie Mae should include the securities in its outstanding loans for purposes of § 585(b)(2). Some of the mortgage-backed securities in LTR 9423002 were interests in REMICs, and some were mortgage pass-through securities.

In the present case, Bank does not hold the mortgage-backed securities related to the Sold Mortgages. Bank has no ownership interest or tax basis in those mortgage-backed securities or in the Sold Mortgages themselves. Bank has no right to receive principal on the Sold Mortgages. The mortgagors owe no debt to Bank. Bank did not treat the Sold Mortgages as its own assets for federal regulatory purposes or financial accounting purposes. Rather, Bank treated the mortgages as having been sold without recourse.

In contrast to the security holders, Bank holds mortgage servicing rights that are rights to receive reasonable compensation for servicing the Sold Mortgages. Bank (or a predecessor) sold those mortgages to Fannie Mae or another guarantor agency, receiving cash for the mortgages on the sale. The guarantor agency then securitized the mortgages and sold the mortgage-backed securities to investors. The investors that purchased the securities have the right to receive and retain the principal and most of the interest on the Sold Mortgages. Although a guarantor agency guarantees the timely payment of mortgage principal and interest, the security holders bear the prepayment risk associated with the mortgages. That is, the security holders bear the risk that mortgagors will prepay their mortgages earlier than expected, thereby shortening the duration of the security holders' interest payments.

Bank relies heavily on governmental agencies and private mortgage insurers to manage the default and underwriting risks associated with its mortgage servicing rights. Nevertheless, Bank claims that its contractual servicing obligations expose it to a risk of loss with respect to the Sold Mortgages. For this reason, Bank contends that the mortgages should be counted as its outstanding loans, rather than as those of the security holders. Bank relies on § 1.585-2(e)(2)(i)(C), which provides that the term "loan" includes a "loan participation to the extent that the taxpayer bears a risk of loss." In particular, Bank relies on comments on this provision that are contained in LTR 8928002 (March 22, 1989).

Like LTR 9423002 (mentioned above), however, LTR 8928002 concludes that the holder of mortgage-backed securities guaranteed by an agency such as Fannie Mae should include the securities in its outstanding loans for purposes of § 585(b)(2). Comments in LTR 8928002 should not be construed as contradicting that conclusion. In the present case, § 1.585-2(e)(2)(i)(C) does not allow Bank to treat the Sold Mortgages as its own loans, because Bank does not have a "loan participation" in those mortgages. Bank or its predecessor sold the mortgages, and they are now owned by others. Any exposure that Bank may have to a risk of loss with respect to its mortgage servicing rights does not give Bank a participating interest in the mortgages serviced. Bank generally must reacquire a mortgage only if it or its predecessor breached a selling warranty on the mortgage and, even then, Bank generally looks to the mortgage insurer for reimbursement of any loss. In the event of foreclosure on a delinquent mortgage where there has been no breach of warranty, Bank generally looks to the guarantor agency or the mortgage insurer for reimbursement of Bank's delinquency advances and foreclosure costs.

If Bank reacquires a mortgage and continues to own it at the close of a taxable year, Bank may include that mortgage in its outstanding loans for that year. However, Bank may not include in its outstanding loans any mortgages that it services but does not own. In sum, for the reasons outlined above, Bank may not include the Sold Mortgages in its outstanding loans for purposes of determining the balance of its bad debt reserve under § 585.

CAVEATS:

A copy of this technical advice memorandum is to be given to the taxpayer. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.