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PLR 201234006, 2012 WL 3631201 (IRS PLR)

Internal Revenue Service (I.R.S.)
IRS PLR

Private Letter Ruling

Issue: August 24, 2012
May 24, 2012[Section 856](#) -- Definition of Real Estate Investment Trust 856.00-00 Definition of Real Estate Investment TrustCC:FIP:2
PLR-105442-12Legend
Taxpayer =

Subsidiary =

State =

Dear ***:

This is in response to a letter dated February 2, 2012, requesting a ruling on behalf of Taxpayer and Subsidiary (hereafter collectively "Taxpayer") that ownership of excess servicing spreads constitutes a real estate asset and income from the excess servicing spreads will be treated as interest on obligations secured by mortgages on real property for purposes of [section 856 of the Internal Revenue Code](#).

Facts:

Taxpayer is a State corporation that has elected to be treated as a real estate investment trust (REIT) pursuant to [sections 856](#) through [860](#) of the Code. Taxpayer uses the overall accrual method of accounting and the calendar year for its taxable year.

Subsidiary is currently a qualified REIT subsidiary of, and is disregarded as an entity from Taxpayer. After receipt of a favorable ruling, Taxpayer intends to take the necessary steps to establish Subsidiary as a freestanding publicly traded REIT pursuant to [sections 856](#) through [860](#) of the Code.

Originators of mortgage loans often bundle and sell the mortgages loans they originate. Buyers of mortgage loans will typically either service the mortgages loans themselves or enter into a servicing agreement with respect to the loans. The servicer under the servicing agreement may be the originator of the mortgages or a third-party servicer.

In consideration for performing mortgage servicing activities, a servicer will generally retain the right to receive a portion of the interest payments made by the borrowers with respect to the pool of mortgages being serviced. The amount of interest retained by the servicer (the Mortgage Servicing Spread), will be treated in part by the servicer as reasonable compensation for services performed. The portion of a Mortgage Servicing Spread that exceeds reasonable compensation for services performed (the Excess Servicing Spread) represents a continuing investment in the interest component of the underlying mortgage pool. See, e.g., section 4.02 of [Rev. Proc. 91-50, 1991-2 C.B. 778](#).

A servicer may desire to sell all or a portion of its Excess Servicing Spread to a passive investor such as Taxpayer. Taxpayer proposes to purchase Excess Servicing Spreads. In any purchase of an Excess Servicing Spread by Taxpayer, the portion of the Mortgage Servicing Spread retained by the servicer, together with ancillary income retained by the servicer, will equal or exceed the reasonable compensation of the selling servicer. Thus, Taxpayer will acquire only the Excess Servicing Spread of a Mortgage Servicing Spread.

Taxpayer intends to acquire Excess Servicing Spreads pursuant to two types of acquisition agreements. Under the first type Taxpayer would acquire Excess Servicing Spreads that exist at the time the acquisition agreement is entered into (Current Spread Agreements). Under the second type of acquisition agreement, Taxpayer would have the right or obligation to acquire, and the relevant selling servicer would have the right or obligation to sell, Excess Servicing Spreads that will be created in connection with loan origination and securitization transactions that take place in the future (Future Spread Agreements).

Future Spread Agreements may relate either to refinancings of existing mortgages that underlie Excess Servicing Spreads owned by Taxpayer or to entirely new mortgages with new borrowers. A Future Spread Agreement may require Taxpayer to pay all or a portion of the purchase price for the Excess Servicing Spread at the time the Future Spread Agreement is entered into. Alternatively, a Future Spread Agreement may require Taxpayer to pay for the Excess Servicing Spread at the time it is acquired by Taxpayer, based on a price that either is determined at that time or is fixed at the time the Future Spread Agreement is entered into. In situations where the amount paid or to be paid by Taxpayer for the Excess Servicing Spread is fixed at the time a Future Spread Agreement is entered into, the price will reflect the parties' expectations regarding interest rates, the level of future loan origination and refinancing activity, and other economic factors, including the health of the economy in general and the real estate market in particular.

Taxpayer's right to receive payments in respect of the Excess Servicing Spreads may be senior to, subordinate to, or *pari passu* with the Servicer's right to receive the portion of the Mortgage Servicing Spread owned by the servicer. Accordingly, if the borrowers on the underlying mortgage loans do not pay the full amount of interest due on those loans, the amount received by Taxpayer will vary depending on the amount of interest paid by the borrowers and the priority scheme adopted with respect to the particular Excess Servicing Spread to which those mortgage loans relate.

Certain Excess Servicing Spread arrangements may require the relevant Servicer to make advances of principal and interest to investors, including Taxpayer, either in the pool or in individual mortgages in the pool in respect of its Excess Servicing Spread. Such servicer advances are customary features of certain types of mortgage pools. Servicer advances are designed to ensure that payments received by investors with respect to a pool of mortgages are level from month to month, not taking into account prepayments or foreclosures. Thus, if a handful of borrowers in a mortgage pool fail to make their monthly mortgage payments on time, servicer advances may prevent those late payments from causing undue variations in the investors' payment streams. Servicer advances are made with the expectation that they will be repaid in full, and a servicer's right to repayment of a servicer advance ranks senior to the right of investors to receive other payments on the underlying mortgages, including amounts received upon foreclosure or liquidation.

Each Excess Servicing Spread agreement entered into by Taxpayer will require the selling servicer to perform all mortgage servicing activities with respect to the underlying mortgage loans. Taxpayer will not, and will not be required or permitted to perform any services in order to acquire or maintain its interest in an Excess Servicing

Spread. Additionally, Taxpayer will have no right to control the manner in which the selling servicer services the underlying mortgage loans with respect to which Taxpayer owns an Excess Servicing Spread.

Termination of the selling servicer for cause as the servicer of the mortgage loans underlying an Excess Servicing Spread will terminate Taxpayer's rights in respect of the Excess Servicing Spread. If the selling servicer is terminated other than for cause, the proceeds of either the sale of the bundled Mortgage Servicing Rights or a termination payment from the relevant buyer or investor will be disbursed to each of selling servicer and Taxpayer in accordance with their respective interests. Ownership of an Excess Servicing Spread does not provide Taxpayer with any rights with respect to any income earned by any servicer or any of its affiliates from any other source.

Law and Analysis:

[Section 856\(c\)\(2\)](#) provides that at least 95 percent of a REIT's gross income must be derived from sources that include interest, and [section 856\(c\)\(3\)](#) provides that at least 75 percent of a REIT's gross income be derived from sources including interest on obligations secured by mortgages on real property or on interests in real property. Moreover, [section 856\(c\)\(4\)](#) provides that at least 75 percent of the value of a REIT's assets must be represented by real estate assets, cash or cash items and Government securities. Pursuant to [section 856\(c\)\(5\)\(B\)](#) the term real estate assets includes interests in mortgages on real property.

[Section 1286\(e\)\(1\)](#) defines the term "bond" as a bond, debenture, note, or certificate or other evidence of indebtedness. [Section 1286\(e\)\(5\)](#) defines the term "coupon" as any right to receive interest on a bond whether or not evidenced by a coupon.

In [Rev. Rul. 91-46, 1991-2 C.B. 358](#), the taxpayer was a mortgage company in the business of originating and servicing mortgages. When transferring a pool of mortgages, the taxpayer entered into a contract to service the mortgages under which taxpayer was obligated to collect monthly mortgage payments from the borrowers and remit those payments to the owner of the mortgages; accumulate escrows for the payment of insurance and taxes and disburse those funds as the payments came due; maintain records relating to the mortgages, and handle delinquency problems. The mortgage servicing contract provided that the taxpayer was entitled to receive amounts from interest payments collected on the mortgages in an amount that was greater than the minimum annual amount allowable for normal servicing of mortgages of the type sold by the taxpayer. The ruling states:

... To some extent, [taxpayer's] rights to receive amounts under the mortgage servicing contract are rights to receive reasonable compensation for the services that the contract requires [taxpayer] to perform. Because of the nature of these services, it is traditional in the mortgage servicing industry to compensate services with amounts of interest collected on the mortgages serviced. Therefore, to the extent that [taxpayer's] rights to receive amounts under the mortgage servicing contract represent rights to receive reasonable compensation for services to be performed under the contract, they will be treated as rights to receive compensation from [the purchaser]. However, to the extent that the contract entitles [taxpayer] to receive amounts in excess of reasonable compensation for services, [taxpayer's] rights to receive amounts from interest payments collected on the mortgages will be treated as "coupons" under [section 1286\(e\)\(5\)](#).

[Rev. Rul. 91-46](#) holds that to the extent that amounts received are treated as payments with respect to stripped coupons, they are treated as received directly by the holder from the mortgagors.

In the instant case, Taxpayer represents that it will acquire only Excess Servicing Spreads. Pursuant to [Rev. Rul. 91-46](#), the Excess Servicing Spread is treated as a coupon under [section 1286\(e\)\(5\)](#) giving rise to the right to receive interest income. The amounts Taxpayer will receive from an Excess Servicing Spread are based on a fixed percentage of the outstanding principal amounts of the serviced mortgages, and will not be renegotiated during the term of the service contract. Therefore, the amounts Taxpayer will receive from Excess Servicing Spread do not depend in whole or in part on the income or profits of the servicer. Although Taxpayer would not receive any interest income from Excess Servicing Spread if the servicer is terminated for cause, such a remote contingency does not adversely impact the characterization of either the Excess Servicing Spread as an interest in mortgages on real property, or the

interest income received as interest on obligations secured by mortgages on real property.

Acquisition of an Excess Servicing Spread through a Future Spread Agreement does not alter the character of the Excess Servicing Spread. For tax purposes, the classification of an asset is not affected by the manner in which that asset was acquired, and specifically is not affected by the fact that it was acquired pursuant to a prior agreement. For example, a parcel of real property that is a real estate asset within the meaning of [section 856\(c\)](#) does not cease to be a real estate asset because the purchaser agreed to acquire the property before closing on the acquisition. Thus, the fact that Taxpayer may acquire certain of its Excess Servicing Spreads pursuant to one or more Future Spread Agreements does not change the characterization of the Excess Servicing Spreads for purposes of the asset and income tests in [section 856](#).

Neither [section 856\(c\)](#) nor [Rev. Rul. 91-46](#) distinguishes between junior and senior interest in mortgages. Contingency of priority in receiving income is not relevant to the analysis of the characterization of the income to be received. Thus, the fact that Taxpayer's rights to receive payments in respect of an Excess Servicing Spread may be subordinate to, senior to, or *pari passu* with the servicer's rights to receive a portion of the Mortgage Servicing Spread does not alter the tax classification of the Excess Servicing Spread as an ownership interest in the underlying mortgage loans for purposes of [section 856](#).

Servicer advances are customary features of certain types of mortgage pools, are designed to ensure that payments received by investors are level from month to month without regard to prepayments or foreclosures, and are issued with the expectation that they will be repaid in full. Taxpayer, as an investor in the underlying mortgage pool through its ownership of an Excess Servicing Spread, will be treated as any other investor in the mortgage pool that receives a servicer advance, *i.e.*, the leveling, to the extent possible, of its receipt of monthly income from the underlying mortgages. In this regard, the servicer advance is a form of credit enhancement with respect to the mortgage pool to which it relates. At all events, the character of the interest income received by Taxpayer and other investors in the mortgage pool will not be altered by the existence of a servicer advance.

Accordingly, we rule that the an Excess Servicing Spread acquired by Taxpayer is an interest in mortgages on real property and thus a real estate asset for purposes of [section 856\(c\)\(5\)\(B\)](#), and further that interest income received by Taxpayer from an Excess Servicing Spread will be considered as derived from interest on obligations secured by mortgages on real property for purposes of [section 856\(c\)\(3\)\(B\)](#).

Except as specifically ruled upon, no opinion is expressed concerning any federal income tax consequences relating to the facts herein under any other provision of the Code. Specifically, we do not rule whether Taxpayer otherwise qualifies as a REIT under part II of subchapter M of Chapter 1 of the Code. Additionally, no opinion is expressed regarding whether the servicer properly characterized the amounts acquired by Taxpayer as excess servicing (and therefore treated as stripped coupons), or whether either [section 1286](#) or [Rev. Rul. 91-46](#) was properly applied to such amounts.

This ruling is directed only to the taxpayer requesting it. [Section 6110\(k\)\(3\)](#) of the Code provides that it may not be used or cited as precedent.

Sincerely,
Jonathan Silver
Acting Chief, Branch 2
Office of Associate Chief Counsel (Financial Institutions & Products)

[Section 6110\(j\)\(3\) of the Internal Revenue Code](#)This document may not be used or cited as precedent. .
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