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April 12, 2013

Legend:

Taxpayer =

Sub 1 =

Sub 2 =

State =

Dear \_\_\_\_\_ :

This is in response to a letter dated October 5, 2012, requesting a ruling that beneficial ownership of a certain excess servicing spread constitutes a real estate asset, and that income received from such excess servicing spread 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, a State corporation, is publicly traded and 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 as its taxable year.

Originators of mortgage loans often bundle and sell the mortgages they originate. Owners of mortgages employ companies to service the mortgages which collect payments from the mortgage borrowers on behalf of the owners in exchange for

compensation known as mortgage servicing rights (MSRs). MSRs generally represent a right to a portion of the interest payments on the serviced mortgages expressed as a percentage of the outstanding principal amounts of the serviced mortgages. A mortgage servicer may be paid a servicing fee that is greater than the “normal” servicing fee charged for servicing mortgages. Thus, MSRs may include both the normal servicing fee received as compensation for servicing mortgages and an additional amount known as excess servicing (ES). See, e.g., section 4.02 of Rev. Proc. 91-50, 1991-2 C.B. 778. To the extent that ES exceeds reasonable compensation for servicing the mortgages, the ES may be treated as stripped coupons under section 1286 of the Code. See, Rev. Rul. 91-46, 1991-2 C.B. 358.

Taxpayer proposes to acquire MSRs that include excess servicing described in Rev. Rul. 91-46, supra., in a transaction involving two wholly-owned subsidiaries. Sub 1, a taxable REIT subsidiary, will acquire MSRs related to a portfolio of mortgage loans and will engage an unrelated third-party subservicer to service the mortgage loans in the portfolio. Sub 1 will retain the normal servicing spread and from that spread will pay the subservicer its fee for servicing the mortgages loans. Sub 1 will sell the ES to Sub 2, a qualified REIT subsidiary, on an arm’s length fair market value basis. Sub 2 may purchase ES from Sub 1 and/or other unrelated third parties (sellers).

Sub 2 will acquire all or a pro rata portion of the ES through an ES purchasing agreement with the sellers. Following the acquisition of all or a portion the ES, Sub 2 will not have any obligation or duty with respect to servicing the underlying mortgages. Additionally, Sub 2 will have no right to control the manner in which the selling servicer services the underlying mortgage loans with respect to which Sub 2 owns the ES. As owner of the ES, Sub 2 will receive payments directly from the servicer from the interest on the mortgage payments made by the mortgage borrowers.

The right of Sub 2 to receive the ES may be senior to, subordinate to or *pari passu* with the servicer’s right to receive all or a portion of the normal servicing spread. Accordingly, the amount of ES received by Sub 2 will vary depending on the amount of interest collected on the mortgage loans and the priority scheme adopted with respect to those mortgages.

If the servicer of an arrangement for MSR that has been bifurcated between normal servicing and ES is terminated other than for cause, the proceeds of either the sale of the MSR or a termination payment, as the case may be, will be disbursed to each of servicer and Sub 2 in accordance with their respective interests. If the servicer of such an arrangement is terminated for cause, neither the servicer nor Sub 2 will be entitled to any further payments in respect of their interests.

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 856(f)(1) provides that the term "interest" does not include any amount received or accrued, directly or indirectly, if the determination of such amount depends in whole or in part on the income or profits of any person except that--

(A) any amount so received or accrued shall not be excluded from the term "interest" solely by reason of being based on a fixed percentage or percentages of receipts or sales, ... .

Section 1.856-5(b) of the Income Tax Regulations directs taxpayers to the principles set out in section 1.856-4 in determining whether an amount that depends in whole or in part on the income or profits of any person is includable as interest for purposes of sections 856(c)(2)(B) and (c)(3)(B) of the Code. Section 1.856-4(b)(3) provides, in part, as follows:

An amount received or accrued as rent for the taxable year which consists, in whole or in part, of one or more percentages of the lessee's receipts or sales in excess of determinable dollar amounts may qualify as "rents from real property", but only if two conditions exist. First, the determinable amounts must not depend in whole or in part on the income or profits of the lessee. Second, the percentages and, ... the determinable amounts, must be fixed at the time the lease is entered into and a change in percentages and determinable amounts is not renegotiated during the term of the lease (including any renewal periods of the lease) in a manner which has the effect of basing rent on income or profits. In any event, an amount will not qualify as "rents from real property" if, considering the lease and all the surrounding circumstances, the arrangement does not conform with normal business practice but is in reality used as a means of basing the rent on income or profits.

Section 856(i)(2) defines a qualified REIT subsidiary as any corporation in which 100 percent of the stock is owned by a REIT, with an exception for a taxable REIT subsidiary. Section 856(1)(1) provides that a qualified REIT subsidiary shall not be treated as a separate corporation, and that all assets, liabilities, and items of income, deduction and credit of such corporation shall be treated as assets, liabilities and such items, as the case may be, of the REIT.

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, the taxpayer was a mortgage company in the business of originating and servicing mortgages. After 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 portion of interest payments that taxpayer was entitled to receive that was greater than the amount allowable for normal servicing was referred to as excess servicing. 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 specifically proposes acquiring, through its qualified REIT subsidiary, MSRs representing ES. To the extent that the ES acquired from the servicer exceeded the servicer’s reasonable compensation, under Rev. Rul. 91-46, the ES rights are treated as coupons under section 1286(e)(5). The amounts Taxpayer will receive from ES 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 the ES 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 the ES if the servicer is terminated for cause, such a remote contingency does not adversely impact the characterization of the ES right as an interest in mortgages on real property or the interest income as interest on obligations secured by mortgages on real property.

Neither section 856(c) nor Rev. Rul. 91-46 distinguishes between junior and senior interests 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 the ES 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 ES as an ownership interest in the underlying mortgage loans for purposes of section 856.

Accordingly, assuming that the ES rights acquired by Taxpayer through Sub 2 are properly treated as stripped coupons under section 1286, we rule that the ES rights constitute interests in mortgages on real property and thus are real estate assets for purposes of section 856(c)(5)(B), and further that interest income received by Taxpayer through Sub 2 from the ES 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 amounts acquired by Sub 2 were acquired in an arm's length transaction at fair market value, exceed reasonable compensation for services and are properly characterized as excess servicing (and therefore are 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. Taxpayer should attach a copy of this ruling to each tax return to which it applies. Section 6110(k)(3) of the Code provides that this ruling may not be used or cited as precedent.

Sincerely,

David B. Silber  
Chief, Branch 2  
Office of Associate Chief Counsel  
(Financial Institutions & Products)