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Legend

Taxpayer =

Agencies =

Dear _____ :

This is in reply to a letter dated April 1, 2010, and subsequent correspondence, requesting rulings that (1) the Exchange Certificates (described below) to be issued by the Exchange Trust (described below) will qualify as interests in “stripped coupons” or “stripped bonds” within the meaning of § 1286 of the Internal Revenue Code (assuming that all Exchange Certificates issued by an Exchange Trust are not held by one person), and (2) the Exchange Trust’s exchange mechanism, including the ability to exchange fixed rate REMIC Certificates for floating and inverse floating rate Exchange Certificates, will not cause the Exchange Trust to fail to be classified as a fixed investment trust under Treas. Reg. § 301.7701-4(c) (the “Regulations”).

Facts:

Taxpayer structures a variety of mortgage-backed securities offerings pursuant to multi-class mortgage-backed securities programs maintained by Agencies. In each case, qualified mortgages are conveyed to a trust (“REMIC Trust”) pursuant to the terms of a trust agreement in exchange for several classes of mortgage-backed pass-through certificates (each such certificate (other than the residual class) is referred to herein as a “REMIC Certificate”).

In certain Agency transactions, the owner of a REMIC Certificate has the right to deposit the REMIC Certificate in a supplemental trust (each such supplemental trust is an "Exchange Trust") in exchange for a proportionate interest in newly issued classes of pass-through certificates issued by the Exchange Trust (the "Exchange Certificates").

Taxpayer intends to contribute all or a portion of a single class of REMIC Certificates to an Exchange Trust in exchange for Exchange Certificates. The Exchange Trust only holds REMIC Certificates of the same class as the REMIC Certificates contributed by the Taxpayer. All distributions made with respect to REMIC Certificates held by the Exchange Trust are immediately distributed in respect of the Exchange Certificates; there will never be any reinvestment activity. Although an Exchange Trust can accept additional deposits of REMIC Certificates over time, the subsequent deposits of REMIC Certificates must be the same class of REMIC Certificates as is already held by the Exchange Trust.

The Exchange Certificates will represent collectively a 100 percent beneficial ownership interest in the Exchange Trust. They will be issued in multiple classes that will be separately assignable. Thus, Exchange Certificates may provide for principal and interest, principal only, or interest only. Moreover, the Exchange Certificates' interest distributions may be based on fixed rates, floating rates, or inverse floating rates.¹ For interest-only Exchange Certificates, there is no right to receive principal, but interest payments are based upon a notional principal amount. Each Exchange Certificate within a class will be entitled to a pro rata portion of payments allocated to the class. Additionally, the Exchange Certificates issued by the Exchange Trust will have the same maturity. Taxpayer represents that any Exchange Trust will not be an obligor of debt instruments with two or more maturities within the meaning of § 7701(i)(2)(A)(ii) and Treas. Reg. § 301.7701(i)-1(e).

Exchange Certificates can be deposited in the Exchange Trust in exchange for a proportionate interest in the original REMIC Certificates or for different classes of Exchange Certificates. Each exchange, including the initial contribution of the REMIC Certificate (or portion thereof) in exchange for the Exchange Certificates, will be for matching amounts, in that: (1) the actual principal amount of Exchange Certificates or REMIC Certificates deposited in the Exchange Trust will equal the actual principal amount of Exchange Certificates or REMIC Certificates received from the Exchange Trust; (2) the aggregate pass-through rate on Exchange Certificates or REMIC Certificates deposited in the Exchange Trust will equal the aggregate pass-through rate on Exchange Certificates or REMIC Certificates received from the Exchange Trust; and (3) Exchange Certificates or REMIC Certificates received from the Exchange Trust will

¹ Although the Exchange Trust is not a REMIC, Taxpayer represents that the floating and inverse floating rates paid on Exchange Certificates will be of the type described in Treas. Reg. § 1.860G-1(a)(2) and (a)(3), which permits REMICs to issue regular interests at floating and inverse floating rates. The formula used to compute interest on floating and inverse floating Exchange Certificates will not vary over the period that the Exchange Certificates are outstanding.

retain the same tax attributes as the Exchange Certificates or REMIC Certificates deposited in the Exchange Trust. A certificate owner is charged a fee for each exchange, generally based on a percentage of the principal amount of the certificates exchanged. Taxpayer represents that the exchanges will not cause exchanging Certificate holders or non-exchanging Certificate holders to be entitled to a differing stream of aggregate payments from differing obligors. The exchanges will have no effect on the rights to principal or interest of any Exchange Certificate holder not participating in the exchange.

Law and Analysis:

Ruling Request 1: The Exchange Certificates will qualify as interests in “stripped coupons” or “stripped bonds” within the meaning of § 1286 of the Internal Revenue Code.

Section 1286 provides rules governing the tax treatment of stripped bonds and stripped coupons. Section 1286(a) treats a stripped bond or stripped coupon in the hands of a purchaser as if it were a newly issued debt instrument issued at a price equal to the purchase price. Section 1286(b) provides rules governing the person stripping a bond, including rules for allocating basis between stripped bonds or coupons that are sold and disposed of.

Section 1286(e)(1) of the Code defines the term “bond” to include a bond, debenture, note, or certificate or other evidence of indebtedness. Section 860B(a) provides that 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. The REMIC Certificates are evidences of indebtedness and, therefore, are “bonds” within the meaning of section 1286(e)(1).

Section 1286(e)(5) of the Code defines the term “coupon” to include any right to receive interest on a bond (whether or not evidenced by a coupon). The Exchange Certificates that represent rights to receive interest on the REMIC Certificates are rights to receive interest on a bond and, therefore, are “coupons” within the meaning of § 1286(e)(5).

Section 1286(e)(2) of the Code defines the term “stripped bond” as a bond issued with interest coupons where there is a separation in ownership between the bond and any coupon that has not yet become payable. Section 1286(e)(3) defines a “stripped coupon” as any coupon relating to a stripped bond. Since Taxpayer’s request contemplates that fixed rate REMIC Certificates will be contributed into the Exchange Trust in exchange for Exchange Certificates, including Exchange Certificates that pay interest at floating and inverse floating rates, Taxpayer considers the term “separation of ownership” under section 1286(e)(2) to include the stripping of fixed rate REMIC interest payments into floating rate and inverse floating rate Exchange Certificates. Such stripping does not merely separate principal from the interest payments as stated in the

terms of the underlying loan, but rather, provides for future allocation of interest payments through an index or formula not found in the terms of the underlying loan. Taxpayer has represented that the index or formula for determining payments under floating and inverse floating rate Exchange Certificates will be a “specified portion” within the meaning of Treas. Reg. § 1.860G-1(a)(2) (with “startup day” being defined as the date of the exchange); thus, the referenced index or formula applicable to a floating-rate Exchange Certificate will not vary while the certificate is outstanding.

Section 1286 does not specifically address the stripping of fixed rate debt instruments into floating rate and inverse floating rate components. The rules governing REMICs, however, do allow for the stripping of fixed rate interest payments into floating and inverse floating rate interest payments. Section 860G(a)(1)(B) of the Code provides that a “regular interest” issued by a REMIC must pay interest, if at all, based on either a fixed rate or a “specified portion” of the interest payments on qualified mortgages if such portion does not vary while such interest is outstanding. Treas. Reg. § 1.860G-1(a)(2)(i)(C) provides that a specified portion means a portion of the interest, but only if it can be expressed as a fixed percentage of the interest that is payable at a fixed or variable rate, a fixed number of basis points of interest, or as interest payable at a fixed or variable rate in excess of a fixed number of basis points or a variable rate. Treas. Reg. § 1.860G-1(a)(2)(iv) provides that if a REMIC interest consists of a specified portion of the interest payments on the REMIC’s qualified mortgages, no minimum principal amount need be assigned to that interest. Thus, the definition of “specified portion” in § 860G(a)(1)(B)(ii) and the accompanying regulations allows for REMIC trusts to issue interests comprising rights to floating rate and inverse floating rate interest-only payments arising from qualified mortgages. Holders of floating rate and inverse floating rate interest-only REMIC regular interests are deemed to hold discrete debt instruments that they account for under the OID regime by applying the principles of § 1272(a)(6). See § 1272(a)(6) (setting forth rules for computing OID for instruments subject to prepayment); Glick v. United States, 96 F. Supp. 2d 850, 870-71 (S.D. Ind. 2000) (treating REMIC regular interest, primarily comprising interest payments from underlying mortgage pool, as OID instrument subject to § 1272(a)(6)).

Taxpayer has represented that the floating rate and inverse floating rate Exchange Certificates issued by the Exchange Trust will only comprise a “specified portion” of the interest payable from the REMIC Certificates held within the Exchange Trust, i.e., the Exchange Trust will only issue floating rate and inverse floating rate certificates that are otherwise allowable under § 860G. The Exchange Certificates represent partial ownership interests in REMIC Certificates that are considered debt instruments; REMICs may issue regular interests that provide for floating rates and inverse floating rates of interest without assigned principal; and the rules governing REMICs treat such interests as discrete debt instruments. Taxpayer’s request is that the Exchange Certificates, which are derived from REMIC Certificates, qualify as interests in stripped coupons under § 1286; this yields the same tax result as would occur had the Exchange Certificates themselves been REMIC Certificates. In particular, both REMIC regular

interests and stripped coupons are treated as debt, and application of § 1286 to the Exchange Certificates would treat Exchange Certificates as newly-issued debt instruments when ownership of interest payments arising from REMIC Certificates held within the Exchange Trust is separated from rights to principal. Accordingly, we conclude that § 1286 applies to the Exchange Certificates issued by the Exchange Trusts, including the floating rate and inverse floating rate certificates. Therefore, when the interest portion of a REMIC Certificate is separated into a floating rate portion and an inverse floating rate portion through multiple classes of the Exchange Trust, the basis between the two shall be allocated under § 1286 and each of the interests represented by the Exchange Certificates will qualify as interests in “stripped coupons” or “stripped bonds” within the meaning of § 1286.

Ruling Request 2: The Exchange Trust’s exchange mechanism, which includes the ability to exchange fixed rate interests for floating rate interests, will not cause the Exchange Trust to fail to be classified as a fixed investment trust under Treas. Reg. § 301.7701-4(c).

For federal income tax purposes, unincorporated entities such as Exchange Trust are classified as trusts, partnerships, or corporations. See Treas. Reg. § 301.7701-1(b). An entity formed as an investment trust, but having multiple classes of ownership, will ordinarily be classified as a partnership or corporation under Treas. Reg. § 301.7701-2. Nonetheless, investment trusts with multiple classes of ownership interests will still be considered trusts if: (i) neither the trustee nor any other party has the power to vary the investment of the holders of beneficial interests in the trust; and (ii) the trust is formed to facilitate direct investment in the assets of the trust and the existence of multiple classes of ownership interests is incidental to that purpose. Treas. Reg. § 301.7701-4(c)(1).

(i) Whether the Exchange Mechanism Creates a Power to Vary the Exchange Trust Certificate Holders’ Investment

Taxpayer represents that the Exchange Trust will accept deposits of REMIC Certificates in exchange for Exchange Certificates, and the trustee will immediately distribute to holders of Exchange Certificates any distributions that the Exchange Trust receives with respect to the REMIC Certificates that the Exchange Trust holds. Exchange Certificates may pay at a floating rate based upon a formula or index, but the trustee may not vary the referenced formula or index while the certificates are outstanding. The assets held in the Exchange Trust do not “vary” insofar as the trustee has no power to sell and reinvest assets contributed to the trust, nor may the trustee modify existing assets within the trust. Likewise, contributions of additional assets into the trust must be identical to and in the same proportion as those already held within the Exchange Trust such that the additional contributions will not affect the economic position of existing certificate holders. See Commissioner v. Chase Nat’l Bank, 122 F.2d 540, 543 (2d Cir. 1941) (holding that entity with power to accept additional deposits of securities identical to those it already holds is taxable as a trust). Lastly, REMIC Certificates deposited into

the Exchange Trust will be exchanged for Exchange Certificates having the same aggregate rights to principal and interest, and the Exchange Certificates will retain the same tax attributes as the REMIC Certificates; likewise, holders of Exchange Certificates may exchange their certificates for REMIC Certificates possessing identical rights to principal and interest and having the same tax attributes as the Exchange Certificates deposited in the Exchange Trust.² On the basis of Taxpayer's representations, we conclude that there is no power to vary the investment of the Exchange Trust's certificate holders.

(ii) Whether the Exchange Trust's Multiple Classes of Beneficial Ownership Facilitate Direct Ownership in Underlying Assets

Taxpayer represents that the Exchange Trust will issue multiple classes of Certificates, but maintains that those classes are incidental to the trust's purpose of facilitating direct investment in the trust's assets. As noted, Treas. Reg. § 301.7701-4(c)(1) provides that generally, an investment trust with multiple classes of ownership interests will not be taxable as a trust. The preamble to those Regulations, issued in 1986, addresses concerns regarding multiple class trusts as follows:

The existence of varied beneficial interests may indicate that the trust is not employed simply to hold investment assets, but serves a significant additional purpose of providing investors with economic and legal interests that could not be acquired through direct investment in the trust assets. Such use of an investment trust introduces the potential for complex allocations of trust income among investors, with correspondingly difficult issues of how such income is to be allocated for tax purposes. These issues are properly foreign to the taxation of trust income, where rules have not developed to accommodate the varied forms of commercial investment, and no comprehensive economic substance requirement governs the allocation of income for tax purposes.

T.D. 8080, 1986-1 C.B. 371, 372.

Treas. Reg. § 301.7701-4(c) sets forth four examples of multiple class trusts to illustrate the meaning of the "incidental" exception. Example 4 of the Regulations illustrates the treatment of a trust that is used to strip a portfolio of bonds:

Example 4. Corporation N purchases a portfolio of bonds and transfers the bonds to a bank under a trust agreement. At the same time, the trustee delivers

² Rev. Rul. 90-7, 1990-1 C.B. 153, provides that a certificate holder in an investment trust that has a single class of ownership interests and a fixed portfolio of stock does not recognize gain or loss when the certificates are exchanged for a proportionate share of the trust's assets. The reasoning of Rev. Rul. 90-7 does not extend to multiple class structures where the certificate holder's tax attributes in the trust certificates differ from the holder's tax attributes in the trust assets received in exchange therefor.

to N certificates evidencing interests in the bonds. These certificates are sold to public investors. Each certificate represents the right to receive a particular payment with respect to a specific bond. Under section 1286, stripped coupons and stripped bonds are treated as separate bonds for federal income tax purposes. Although the interest of each certificate holder is different from that of each other certificate holder, and the trust thus has multiple classes of ownership, the multiple classes simply provide each certificate holder with a direct interest in what is treated under section 1286 as a separate bond. Given the similarity of the interests acquired by the certificate holders to the interests that could be acquired by direct investment, the multiple classes of trust interests merely facilitate direct investment in the assets held by the trust. Accordingly, the trust is classified as a trust.

We have concluded, supra, that the Exchange Certificates, insofar as they represent rights to receive portions of principal and interest from the REMIC Certificates contributed to the Exchange Trust, qualify as interests in stripped bonds and stripped coupons for the purposes of § 1286 once the certificate holder creates a separation of ownership by selling a portion of its Exchange Certificates to a third party. With respect to Exchange Certificates that provide for floating and inverse floating rates of interest from a fixed rate REMIC Certificate held by the Exchange Trust, we note that: REMICs are permitted to issue such interests to investors directly; Taxpayer represents that the floating and inverse floating rates will comply with the “specified portion” requirement of Treas. Reg. § 1.860G-1(a)(2) and -1(a)(3),³ and there exists in place a mechanism for accounting for such interests as separate bonds. See § 1272(a)(6). Insofar as separation of Exchange Trust principal from income may result in complex allocations as described in the preamble to the regulations, such allocations are inherent in § 1286 transactions generally, and Example 4 expressly allows for fixed investment trusts to issue certificates that represent stripped coupons under § 1286. Thus, the complexity in allocating principal and income among stripped interests is not the type of complexity contemplated in the preamble. Accordingly, we conclude that the Exchange Trust, if operated in accordance with the above representations, will be taxable as a fixed investment trust for federal income tax purposes.

Holdings:

Ruling Request 1: The Exchange Certificates to be issued by the Exchange Trust will qualify as interests in “stripped coupons” or “stripped bonds” within the meaning of § 1286 of the Internal Revenue Code (assuming that all Exchange Certificates issued by an Exchange Trust are not held by one person).

³ Though Example 4 describes “certificate[s] represent[ing] the right to receive a particular payment with respect to a specific bond,” Taxpayer’s representation that the floating and inverse-floating rates will comply with the specified portion rules creates a clearly ascertainable allocation of the right to payments among the holders of Exchange Certificates such that the certificates can be accounted for under § 1286 within the meaning of Example 4.

Ruling Request 2: The Exchange Trust's exchange mechanism, including the ability to exchange fixed rate REMIC Certificates for floating and inverse floating rate Exchange Certificates, will not cause the Exchange Trust to fail to be classified as a fixed investment trust under Treas. Reg. § 301.7701-4(c).

The rulings contained in this letter are based upon information and representations submitted by the taxpayer and accompanied by a penalty of perjury statement executed by an appropriate party. While this office has not verified any of the material submitted in support of the request for rulings, it is subject to verification on examination.

Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter.

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.

In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to your authorized representative.

Sincerely,

Robert A. Martin
Robert A. Martin
Senior Technician Reviewer, Branch 1
(Financial Institutions & Products)