

INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

November 21, 2014

Third Party Communication: None
Date of Communication: Not Applicable

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CASE-MIS No.: TAM-108896-14

Industry Director, Financial Services
Large Business & International

Taxpayer's Name:
Taxpayer's Address:

Taxpayer's Identification No
Year(s) Involved:
Date of Conference:

No Conference Held

LEGEND:

Taxpayer =
Subsidiary =
Bank A =
State A =
Statutory Trust Year 3 =
Rating Agency =
Clearing Agency =
RMB Securities =
a =
b =
c =
d =
e =
f =
g =
h =

<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>	=
Year <u>1</u>	=
Year <u>2</u>	=
Year <u>3</u>	=
Year <u>4</u>	=
Year <u>5</u>	=
Month <u>1</u>	=
Month <u>2</u>	=
Month <u>3</u>	=
Month <u>4</u>	=
Date <u>1</u>	=
Date <u>2</u>	=
Date <u>3</u>	=
<u>M</u>	=
<u>N</u>	=
<u>P</u>	=
<u>Q</u>	=

ISSUE(S):

1. Whether Subsidiary may take a capital loss from the sale or exchange of REMIC regular interests?
2. Whether Subsidiary may take an ordinary loss on a retained REMIC residual interest under § 860F(b)(1)(D)(ii) of the Internal Revenue Code and § 1.860F-2(b)(4)(iv) of the Treasury Regulations?

CONCLUSION(S):

1. Subsidiary may take a capital loss from the sale or exchange of REMIC regular interests.
2. Subsidiary may take an ordinary loss on a REMIC residual interest under § 860F(b)(1)(D)(ii) and § 1.860F-2(b)(4)(iv).

FACTS:

Taxpayer is the parent (“Parent”) of a life-nonlife consolidated group (hereinafter, “the group”). Subsidiary is a subsidiary of Taxpayer and is a life insurance company both for statutory accounting purposes and as defined under § 816.

Background

At the time of the transaction described below, Subsidiary owned a portfolio of a residential mortgage backed securities (RMB Securities), consisting of regular interests in real estate mortgage investment conduits (REMICs). The RMB Securities were purchased by Taxpayer between Year 1 and Year 2. The RMB Securities were backed primarily by “subprime” mortgages. By Year 3, many of the RMB Securities were reported by Subsidiary as “other than temporarily impaired” for statutory accounting purposes and as partially worthless under § 166. At the time of the transaction, the RMB Securities had a face value of approximately \$b, an adjusted tax basis of \$c, a statutory accounting statement value of approximately \$d, and a “fair value” of approximately \$e. According to one of Taxpayer’s internal projections, the cash flows to be received from the RMB Securities were approximately \$f between Month 2 Year 3 and Month 3 Year 4, \$g between Month 4 Year 4 and Month 3 Year 5, and the balance, or \$g, in the following h years. All of the RMB Securities were held outside of the closed block of assets dedicated to Taxpayer’s demutualized policyholders.

The Transaction

In Month 1 Year 3, Subsidiary formed a statutory trust, Statutory Trust Year 3 (Trust), under the laws of State A. The Trust elected to be treated as a REMIC with the calendar year as its taxable year. Under the terms of the Trust Agreement, Subsidiary, as Depositor, sold all of its right, title, and interest in the RMB Securities in exchange for REMIC regular and residual interests. Subsidiary retained the right to pursue certain claims with respect to the RMB Securities. Assignment of the RMB Securities was intended to be a sale of the RMB Securities by the Subsidiary to the Trust. The Trust also received a perfected first priority secured interest in the RMB Securities. To perfect the assignment of the RMB Securities to the Trust and the subsequent grant of security to the Indenture Trustee for the benefit of the Noteholders, Subsidiary caused the RMB Securities to be registered in the name of, or endorsed to, the Indenture Trustee, an

independent third party. Pursuant to the Indenture, the RMB Securities were deposited in a securities account in the name of the Indenture Trustee with the Clearing Agency. No legal opinion was obtained regarding whether the transfer of the RMB Securities to the Trust constituted a true sale in part because of the Parent Guaranty, discussed below.

The Trust issued two classes of securities: the Notes and a Certificate. The Notes represent REMIC regular interests and state that the Noteholders have the benefit of the Parent Guaranty and the Make-Whole Guaranty. The Notes are secured by the RMB Securities. The Notes were initially issued to Subsidiary, which immediately sold them to capital market investors (Noteholders) for their market and face value of \$i. The Certificate represents a REMIC residual interest. The Certificate was retained by Subsidiary and is subject to transfer restrictions to prevent transfers to disqualified persons. Subsidiary, as holder of the Certificate, is the beneficiary of the Trust, but Subsidiary's rights to the Trust estate are subject to the Trust's obligations to the Noteholders under the Indenture and to the security interest over the Trust assets granted to the Indenture Trustee for the benefit of the Noteholders.

Each Note bears an issue date of Date 1, provides for semi-annual payments beginning Date 2, and has a maturity date of Date 3. On each semi-annual payment date prior to the maturity date of the Notes, interest on the Notes is payable at j percent, as well as a principal payment in the amount of k percent of the initial principal balance of the Notes (i.e., \$l).

Payments of principal and interest from the RMB Securities are based on the cash flows of the underlying securitized mortgages. On each semi-annual payment date prior to the maturity date of the Notes, distributions from the Trust to pay the Noteholders are made in accordance with the cash flow waterfall specified in the Indenture. Payments of principal and interest to the Noteholders are not, however, directly linked to the payments of principal and interest from the RMB Securities. The cash flow from the RMB Securities for each semi-annual period prior to the maturity date of the Notes was projected to exceed significantly the amount of principal and interest payable on the Notes and the Parent Guaranty Fees for such period, and this has in fact been the case. The Certificate holder is entitled to receive any cash collected on the RMB Securities remaining for distribution after principal and interest on the Notes and the Parent Guaranty Fee (discussed below) are paid, up to a limit of m percent of the initial amount of the Notes. In Month 3 Year 4, a balloon payment of n percent of the initial principal balance, or \$o, is due to the Noteholders, together with interest then due and payable. After repayment of the Notes, the Certificate holder is entitled to any remaining net assets in the Trust.

Taxpayer provided two forms of guaranties to the Noteholders. Pursuant to the "Parent Guaranty," Taxpayer unconditionally guarantees the prompt and complete payment of principal and interest on the Notes when due. In return for the Parent Guaranty,

Taxpayer receives a fee (Parent Guaranty Fee) at the rate of p percent per year of the principal balance of the Notes prior to each payment date.

Taxpayer also provided a "Make-Whole Guaranty," designed to protect the Noteholders against a reduction in the cash flow of the Trust available to make payments on the Notes due to extraordinary prepayments on the RMB Securities. In that event, Taxpayer agreed to pay a "make-whole premium" designed to compensate Noteholders for interest that would be foregone as a result of any such prepayment of principal on the Notes.

On an ongoing basis, the underlying RMB Securities had to generate approximately \$q (which amount decreased slightly for each subsequent semi-annual period as principal on the Notes was amortized) in cash flow semi-annually to cover interest, principal and Parent Guaranty Fees. The cash flow from the RMB Securities for each semi-annual period was projected to exceed this amount significantly, but was not projected to cover the entire cost of the balloon payment of principal on the Notes due in Month 3 Year 4.

Under the terms of the Indenture, on the maturity date of the Notes or the payment date following an acceleration event, an auction will be held for the sale of the RMB Securities pursuant to a plan of liquidation of the Trust. Bids for the RMB Securities will be solicited from a list of nationally recognized broker dealers. Subsidiary, the Initial Purchasers and their affiliates are allowed to bid in the auction. Prior to accepting the highest auction price, the auction advisor must first notify Subsidiary of the highest auction price and Subsidiary will be given two days to respond with a counteroffer. The auction advisor may accept a third-party bid only if no higher counteroffer is received from Subsidiary or its affiliates. If the auction bids received are insufficient to cover the remaining principal balance and any unpaid interest on the Notes, any unpaid make-whole premium, and unpaid trust expenses, the Trustee will not settle with any bidder until Taxpayer pays the amount of any deficiency under the Parent Guaranty.

The Noteholders were advised that the secondary mortgage market was experiencing disruptions that might continue to adversely affect the value of the RMB Securities. The Noteholders were also advised that Subsidiary was conducting an investigation into the accuracy of the offering materials provided to the original investors in the RMB Securities and that Subsidiary was considering bringing misrepresentation and related claims based on alleged inaccuracies in such materials to compensate it for losses suffered from investing in the RMB Securities in reliance on such misrepresentations. Because these losses had already been suffered by Subsidiary as of the time ownership of the RMB Securities was transferred to the Trust (and because the related claims were not assets that are permitted be held by a REMIC), the rights to any recoveries in such actions were not transferred to the Trust and remained with Subsidiary. The Indenture included an acknowledgement from investors that certain personnel of the Initial Purchasers not involved with the offering of the Notes may have material non-public information about the RMB Securities that will not be disclosed to

investors. Subsidiary understands that such personnel of an Initial Purchaser may have obtained non-public information if, e.g., such Initial Purchaser itself owned interests in the RMB Securities of the same class as the RMB Securities or participated in the original offering of those RMB Securities.

A condition of the issuance of the Notes was that they receive an M rating from Rating Agency. The rating of the Notes was based on the rating of Taxpayer in light of its full and unconditional guaranty with respect to payment of interest and principal on the Notes and any make-whole premium. Under the Indenture, if the Indenture Trustee is requested to take any action or give any consent, approval or waiver (including an amendment or default related to any of the RMB Securities), it must act as directed by Taxpayer, as guarantor under the Parent Guaranty or, if Taxpayer's rating from Rating Agency has declined below N as directed by Taxpayer and a specified percentage of the Noteholders. Investors were advised that the Rating Agency did not assess the RMB Securities or the structure of the Notes in determining the rating of the Notes, and that the rating did not derive or relate in any way to the quality of the RMB Securities or the mortgage loans securitized by the RMB Securities. At the time of the transaction, approximately r percent of the RMB Securities had a P rating or lower, and s percent were rated Q or lower. However, the fair value of the RMB Securities was approximately \$e, or approximately \$t greater than the original principal amount of the Notes, which provided a substantial amount of cushion to the Noteholders.

Pricing of the Notes was based on the price of U.S. Treasuries with comparable maturities plus u. At the time of issuance of the Notes, a standard v senior unsecured corporate bond issue of Taxpayer would typically be priced at w Treasuries plus x, or about y less than the Notes.

Accounting Treatment

Statement of Statutory Accounting Principles (SSAP) 91R dictates that a transfer of financial assets will be accounted for as a sale if three criteria are met. The first criteria is that the transferred assets have been "isolated from the transferor," that is, put presumptively beyond the reach of the transferor and its creditors, even in bankruptcy or receivership. A trust arrangement such as the arrangement at issue in this case would satisfy sale criteria if other facts and circumstances demonstrated that the transferred financial assets had been put beyond the reach of the transferor and its creditors.

Accountants for Subsidiary concluded that sale accounting was not appropriate for SSAP 91R purposes due to the failure to satisfy the first criteria. They noted that counsel was unable to provide a legal "true sale" opinion "as proof that the risk and rewards of ownership have transferred," and that the inability to obtain a legal true sale opinion was a strong indicator the assets were not isolated in the event of receivership. Because all three criteria must be met to account for the transaction as a sale, Taxpayer did not further evaluate the accounting for the transaction for SSAP 91R purposes. In

its accounting treatment, Taxpayer and Subsidiary accounted for the transaction as a secured financing.

Taxpayer's Tax Treatment

Beginning in Year 3, the Trust elected to be a REMIC that has issued one class of regular interests (represented by the Notes) and one class of residual interest (represented by the Certificate).

Subsidiary intends to claim a capital loss in Year 3 under § 165 on the sale of the Notes to the third party investors, measured by the difference between the "issue price" of the Notes and their allocated tax basis. Subsidiary also intends to amortize an ordinary loss over the expected life of the REMIC, based on the difference between the "issue price" of the Certificate and Subsidiary's allocated tax basis in the Certificate pursuant to § 860F(b)(1)(D)(ii).

Section 860F(b)(1)(B) provides that the adjusted bases of the regular and residual REMIC interests received in exchange for a transfer of property shall be equal to the aggregate adjusted bases of the property transferred. The adjusted basis shall be allocated among the regular and residual interests received in proportion to the respective fair market values of the interests.

Section 1.860G-1(d)(1) provides that if the interest is in a class that is retained by the sponsor, the issue price is its fair market value on the pricing date (as defined in § 1.860F-2(b)(3)(iii)), if any, or, if none, the startup day, regardless of whether the property exchanged therefor is publicly traded.

Subsidiary's basis allocation and estimated tax losses are summarized below.

Aggregate Tax Basis	FMV	Allocated Tax Basis	Issue Price	Amount Realized	Tax Loss
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Notes

Certificate

Taxpayer took the position that Subsidiary's sale of the REMIC regular interests resulted in a capital loss under § 165 equal to the difference between the Subsidiary's allocated tax basis in the REMIC regular interests and their issue price. Taxpayer also

took the position that Subsidiary would apply the rules of § 860F(b)(1)(D)(ii) and § 1.860F-2(b)(4)(iv) and deduct the excess of its basis in the REMIC residual interest over the issue price of the REMIC residual interest over the anticipated weighted average life of the REMIC, \underline{v} years.

Service Position

The Service questioned whether Subsidiary's transaction resulted in the formation of a REMIC for federal tax purposes. Specifically, the Service asked whether, considering the facts and circumstances (i.e., the Parent and Make-Whole Guaranties, the Subsidiary's right of last bid under the auction procedures, the Subsidiary's retention of the Certificate, and the Subsidiary's nontax treatment of the transaction as a secured financing), the Subsidiary did not transfer the benefits and burdens of ownership of the securities to the Trust and the RMB Securities should not be treated as transferred to the Trust for tax purposes.

If the Subsidiary did not transfer the RMB Securities to the Trust in exchange for REMIC regular and residual interests, then the Service suggested that the transaction should be recast as a secured loan in the form of the Notes issued by Taxpayer and Subsidiary that are collateralized by the RMB Securities. If so, Taxpayer would not be entitled to recognize a capital loss on the sale of the Notes under § 165, and also would not be entitled to an ordinary loss on a retained REMIC residual interest under § 860F(b)(1)(D)(ii) and § 1.860F-2(b)(4)(iv) because a REMIC was not validly formed.

LAW AND ANALYSIS

We have been asked to determine whether Subsidiary is allowed a capital loss from the sale or exchange of the REMIC regular interests and whether Subsidiary is allowed a loss on the REMIC residual interest under § 860F(b)(1)(D)(ii) and § 1.860F-2(b)(4)(iv). Taxpayer states that it complied with the REMIC statute and regulations and it is therefore entitled to a capital loss upon the sale of the REMIC regular interest as well as a loss on the retained residual interest.

The REMIC statute and regulations clearly evidence a Congressional intent that these rules be the exclusive means for determining REMIC characterization. The REMIC statute and regulations provide rules regarding the treatment of mortgage securitizations if certain requirements have been met. The legislative history of §§ 860A through 860G of the Code further emphasizes that the tax consequences of REMIC transactions are governed exclusively by the REMIC rules.

The Senate Report on the Tax Reform Act of 1986, which added §§ 860A through 860G to the Code, states that Congress enacted the REMIC rules to clarify the considerable uncertainty concerning the federal income tax treatment of real estate mortgages traded on secondary markets and multiple class arrangements used in the "packaging" of such

mortgages. See S. Rep. No. 99-313, 99th Cong., 2d Sess., at 791 et. seq. The Senate Report states that Congress believed the best method to clarify this uncertainty was “to provide a new type of vehicle for the issuance of such multiple class securities, and to provide rules that are as comprehensive as possible for the taxation of all transactions relating to the use of such vehicles.” *Id.* at 791. The Conference Report on the Tax Reform Act of 1986 states: “The conferees intend that where the requirements for REMIC status are met, that the exclusive set of rules for the treatment of all transactions relating to the REMIC and to holders of interests therein are to be those set forth in the provisions of the conference agreement.” H.R. Rep. No. 99-841, 99th Cong., 2d Sess., at II-230. Application of these rules is thus elective and the tax consequences of a REMIC transaction follow from such election.

Section 860D(a) and regulations thereunder set forth a list of requirements that must be met for an entity to qualify for REMIC treatment. As noted above, the Service asked whether Taxpayer failed to form a REMIC for tax purposes and whether the transaction should therefore be recast as a secured lending transaction. Here, Taxpayer and Subsidiary have satisfied the requirements of § 860D, and all statutory and regulatory REMIC requirements have been met. The Trust made an election to be treated as a REMIC, all of the interests in which consist of one class of REMIC regular interests described as Notes and one residual interest described as the Certificate held by Subsidiary. Title to the RMB Securities was transferred to the Trust and Indenture Trustee.

In addition, the REMIC rules specifically envision that a REMIC sponsor has a choice of either retaining its interests in the REMIC or transferring them. This electivity is evident in the rules governing the timing of a sponsor’s recognition of gain or loss with respect to those interests. Under § 860F(b)(1)(A), a sponsor does not recognize gain or loss upon transfer of any property to a REMIC in exchange for regular or residual interests in the REMIC. A sponsor receives a basis in the regular and the residual interests received equal to the aggregate basis of the property transferred to the REMIC and such basis is allocated among those interests in proportion to their respective fair market values. § 860F(b)(1)(B). If and when a sponsor sells any such REMIC interest to a third party, the sponsor may then recognize gain or loss equal to the difference between its adjusted tax basis in the interest sold and the amount received. § 1.860F-2(b)(2).

A sponsor may also retain either a REMIC regular or residual interest. If the issue price of a retained interest is more or less than the sponsor’s basis in that interest, then the sponsor has unrecognized gain or loss in the interest, and the sponsor recognizes gain or loss with respect to the retained regular or residual interest in accordance with the applicable rules. See § 860F(b)(1)(C) and (D); § 1.860F-2(b)(4)(i) through (iv). Here, the sponsor sold the REMIC regular interest and retained the residual interest, a result permitted by the statute and regulations.

Because Subsidiary met the requirements under the statute and regulations for REMIC characterization, Subsidiary is entitled to a capital loss upon the sale of its regular interests, and is also permitted to recognize loss on its residual interest ratably over the anticipated life of the Trust under § 860F(b)(1)(D)(ii).

CAVEAT(S):

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