



DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

OFFICE OF
CHIEF COUNSEL

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MEMORANDUM FOR ASSISTANT REGIONAL COUNSEL (LARGE CASE)

ATTN:

FROM: WILLIAM C. SABIN, JR.
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SUBJECT:

This Field Service Advice responds to your memorandum dated
Field Service Advice is not binding on Examination or Appeals and is not a
final case determination. This document is not to be cited as precedent.

LEGEND:

X =
Year 1 =
Year 2 =
Year 3 =
Year 5 =
Date 1 =
Date 2 =

ISSUES:

(1) May a taxpayer's request under Rev. Proc. 91-51, 1991-2 C.B. 779, to change its method of accounting for mortgage sales authorize a change in the taxpayer's method of amortizing mortgage servicing rights that are stripped coupons under Internal Revenue Code section 1286 (I.R.C.) (stripped mortgage servicing rights)?

(2) If a taxpayer properly requests under Rev. Proc. 91-51 to change its method of accounting for mortgage sales, may the taxpayer use the sum of the years-digits method to amortize its stripped mortgage servicing rights before 1997?

CONCLUSIONS:

(1) Yes. If a taxpayer properly requests under Rev. Proc. 91-51 to change its method of accounting for mortgage sales, the taxpayer has requested, in part, to change its method of amortizing stripped mortgage servicing rights.

(2) Since stripped mortgage servicing rights must be treated as instruments having original issue discount (OID), a taxpayer's basis in these rights must be recovered in accordance with the OID rules. In the present case, the sum of the years-digits method is acceptable for stripped mortgage servicing rights if the taxpayer's use of this method (together with the taxpayer's accrual of income on the stripped mortgage servicing rights) produce a net inclusion of income approximating that which would result under section 1272(a).

FACTS:

Like many banks and mortgage lenders, X, after originating a mortgage, sold the mortgage to another party but retained the right to service the mortgage by entering into a mortgage servicing contract. Under the contract, X is paid a fee for performing certain services. The normal fee is large enough to cover the servicer's costs plus a reasonable amount of profit. Typically, a mortgage servicer like X also receives something extra called an "excess mortgage servicing fee," which is computed by subtracting the interest rate paid to the purchaser of the mortgage from the interest rate collected from the homeowner.

For tax years before Year 2, X (a calendar year taxpayer) amortized its "excess" mortgage servicing rights under the straight line method. Pursuant to Rev. Proc. 91-51, X filed a Form 3115 with its Year 2 federal income tax return to comply with section 1286 and Rev. Rul. 91-46, 1991-2 C.B. 358, beginning in Year 2. In Year 2 X also began to amortize its excess mortgage servicing rights under the sum of the years-digits method over an 8-year life.

On audit for Year 3 through Year 5, Exam contended that X's Year 2 change in amortization method was unauthorized, on the theory that X had not requested the change. Examination also contended X had not established that the sum of the years-digits method was an allowable method clearly reflecting income. (Examination accepted the 8-year life as reasonable.) Examination adjusted X's amortization deductions for Years 3-5 to put the taxpayer on the straight line method. According to page 4 of the request for Field Service Advice, the mortgage servicing rights involved in this case may have been placed in service before Year 2. However, the chart on page 3 of the request indicates that all (or most) of the

adjustments were made only for mortgage servicing rights that X capitalized beginning in Year 2 and later years. X sold its mortgage servicing business in Year 5.

LAW:

ISSUE 1: CHANGE IN METHOD OF ACCOUNTING

Section 1286 provides rules on the treatment of stripped bonds and stripped coupons. Rev. Rul. 91-46 provides guidance on applying section 1286 to certain sales of mortgages when servicing rights are retained. In particular, Rev. Rul. 91-46 provides guidance on treating certain mortgage servicing rights as stripped coupons.

Rev. Proc. 91-51 provides an exclusive, automatic procedure for taxpayers to use in changing their method of accounting for sales of mortgages from a method that is inconsistent with the holding of Rev. Rul. 91-46 to a method consistent with that holding. The earliest year for which a change can be made under Rev. Proc. 91-51 is the taxpayer's first tax year ending on or after Date 2 (the Year 2 tax year). If a change under Rev. Proc. 91-51 is made for the Year 2 tax year, the Form 3115 must be attached to the taxpayer's timely filed federal income tax return for that year; Rev. Proc. 91-51 explicitly waives the 180-day rule then in effect under Treas. Reg. § 1.446-1(e)(3)(i). Changes under Rev. Proc. 91-51 are made on a cut-off basis; that is, the change covers only mortgage sales that occur on or after the first day of the year of change and does not affect the method of accounting for mortgage sales occurring before that first day. Thus, for a calendar year taxpayer, a change under Rev. Proc. 91-51 cannot affect the taxpayer's method of accounting for any mortgage servicing rights that the taxpayer began to capitalize before Year 2.

ISSUE 2: SWITCH TO THE SUM OF THE YEARS-DIGITS AMORTIZATION METHOD

The Tax Court concluded that for property placed into service prior to Date 1, section 167(c) rendered the accelerated amortization methods provided in section 167(b) inapplicable to intangible assets, leaving only the straight line method. Spencer v. Commissioner, 110 T.C. 62, 87 n.31 (1998). This office believes that while "reasonable allowances" does not, by Code, include methods described in paragraphs 2, 3, and 4 of section 167(b), a taxpayer is not precluded from a factual showing that a particular method may be appropriate.

If the taxpayer does not use a regular method of accounting, or if the method used by the taxpayer does not clearly reflect income, taxable income will be computed in accordance with a method that, in the opinion of the Secretary, does clearly reflect income.

I.R.C. § 446(b).

The taxpayer may take a depreciation deduction as a reasonable allowance for the exhaustion, wear and tear, and obsolescence of property used in the trade or business or held for the production of income. I.R.C. §167(a). Depreciation is allowable for certain intangible assets. Treas. Reg. § 1.167(a)-3.

The straight line method may be used in determining a reasonable allowance for depreciation for any property that is subject to depreciation under section 167 and it shall be used in all cases where the taxpayer has not adopted a different acceptable method with respect to such property. Treas. Reg. § 1.167(b)-1(a).

With respect to the present case, the assets at issue are excess mortgage servicing rights. These rights are intangible assets and as such are depreciable under section 167. Treas. Reg. § 1.167(a)-3 provides that intangible assets with determinable useful lives are depreciable under section 167. The issue to be addressed here is whether X's sum of the years-digits accelerated method of depreciation beginning in Y is an acceptable method under section 167.

The critical factor in determining whether a particular depreciation method is an acceptable method under section 167 is whether the method clearly reflects the taxpayer's income. This clear reflection is the basic requirement of section 446(b). All depreciation methods are measured against this standard. The taxpayer carries the burden of showing that its method clearly reflects income.

Section 1286 requires that any stripped coupons, such as stripped mortgage servicing rights, be treated as OID instruments. Thus, OID is to be accrued on stripped mortgage servicing rights, and the basis of such rights is to be recovered in accordance with the OID rules. Under the OID rules, the basic method of accruing income is the "constant yield" method of section 1272(a). Section 1272(a)(6) provides special rules for applying this method to debt with principal subject to acceleration, such as mortgages; these rules take expected prepayments into account and update the prepayment assumption to reflect actual prepayments. Section 1272(a)(6) became generally applicable to stripped mortgage servicing rights with the enactment of section 1272(a)(6)(C)(iii) in 1997. A taxpayer's basis in an OID instrument is increased by the amount of OID included in income and decreased by the amount of any payment received from the borrower. Thus, net reductions in basis result from payments that exceed the corresponding OID accrual.

ANALYSIS:

ISSUE 1: PROPER CHANGE IN METHOD OF ACCOUNTING

As noted above, Rev. Proc. 91-51 provides an exclusive, automatic procedure for taxpayers changing their method of accounting for sales of mortgages to comply with section 1286 and Rev. Rul. 91-46. Compliance with section 1286 includes treating certain mortgage servicing rights as stripped coupons. Because stripped coupons must be accounted for by accruing income and recovering basis in accordance with the OID rules, a method change that is within the scope of Rev. Proc. 91-51 includes, in part, a change to amortize stripped mortgage servicing rights in accordance with the OID rules.

Taxpayer X filed a Form 3115 with its Year 2 return, as required by Rev. Proc. 91-51. Assuming that X was within the scope of Rev. Proc. 91-51 and otherwise complied with Rev. Proc. 91-51 (issues on which we express no opinion), we believe X should be considered to have requested a change in amortization method for stripped mortgage servicing rights that X began to capitalize after Year 1. Rev. Proc. 91-51 does not authorize a change in accounting method for any servicing rights that a taxpayer began to capitalize before Year 2; therefore, based on the facts presented, we conclude that X did not request a change in accounting method for any such rights.

ISSUE 2: SWITCH TO THE SUM OF THE YEARS-DIGITS AMORTIZATION METHOD

As noted above, section 1272(a)(6) did not become generally applicable to stripped mortgage servicing rights until 1997. As a result, there are no clear standards for applying the OID rules to these rights for prior years, such as the years involved in the present case. Although the sum of the years-digits method ordinarily is not acceptable under the OID rules, stripped mortgage servicing rights are a unique type of debt instrument. Income received from these rights tends to be heavily front-loaded. Mortgage prepayments cause income to decrease dramatically over the life of a servicing contract. Moreover, we have no specific information on X's accrual of mortgage servicing income or on the nature of the underlying mortgages in the present case or their expected or actual rate of prepayment. For these reasons, and in view of the lack of guidance in effect for the years at issue, we cannot conclude that the sum of the years-digits method is necessarily unacceptable in the present case. We believe the sum of the years-digits method may be acceptable for stripped mortgage servicing rights for which X properly requested the Year 2 change if X's use of this method (together with X's accrual of income on the stripped mortgage servicing rights) produces a net inclusion of income approximating that which would result under section 1272(a). Generally the net inclusion of income for a debt instrument under section 1272(a) is relatively

steady and is not back-loaded. X should be required to show that its sum of the years-digits method approximately reflects this result.

Even if the sum of the years-digits method is not acceptable in the present case because of the uncertainty of this issue, we believe that X should not be required to use the straight line method for stripped mortgage servicing rights where a more appropriate method is available and for which it properly requested the Year 2 change. Mortgage servicing income is not received on a straight line basis. Although section 1272(a)(6) did not generally apply to stripped mortgage servicing rights until 1997, it provides the most appropriate method of accruing income and recovering basis for stripped mortgage servicing rights under the OID rules. Therefore, if the sum of the years-digits method is not acceptable in the present case, X should be permitted to use the section 1272(a)(6) method of accruing income and recovering basis for stripped mortgage servicing rights for which X properly requested the Year 2 change.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS:

