OFFICE OF
CHIEF COUNSEL

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

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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR

FROM: Deborah A. Butler
Assistant Chief Counsel CC:DOM:FS

SUBJECT: Unpaid losses attributable to mortgage guaranty insurance

This Field Service Advice responds to your memorandum dated April 23, 1999. 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:

Taxpayer =
B =
Year 1 =
Year 2 =

ISSUE:

Whether Taxpayer, a mortgage guaranty insurer, may increase its unpaid loss reserve upon notification by the insured lender that the loan is in default, or whether it is precluded from increasing its reserves until foreclosure proceedings have been completed.

CONCLUSION:

Taxpayer may increase its unpaid loss reserve at the time the insured lender notifies it of the borrower's default.

FACTS:

Taxpayer, a subsidiary of B, issued mortgage guaranty insurance during taxable Years 1 and 2 and filed its Federal income tax returns as a non-life insurance company. Pursuant to these policies, Taxpayer insured lenders against the risk of a borrower's default in payments on its loan. For purposes of the deduction for losses incurred provided in I.R.C. § 832(b), Taxpayer increased its unpaid losses with respect to each mortgage guaranty insurance policy when it was notified that the borrower had defaulted on its obligation to the insured lender. In contrast, the agent argues that Taxpayer is not entitled to increase its unpaid loss reserve until its liability under the policy has been fixed by the conveyance of title to either the insured or Taxpayer. The sample policy submitted with your request for advice provides, "A Loss shall be deemed to have occurred when a Default on a Loan payment occurs, notwithstanding that the amount of the Loss is not then either presently ascertainable or due and payable." Accordingly, the borrower's default triggered Taxpayer's liability to provide coverage for a particular loss event.

LAW AND ANALYSIS:

This issue has been addressed by the United States Court of Appeals for the Seventh Circuit in Sears, Roebuck and Co. v. Commissioner, 972 F.2d 858 (7th Cir. 1992) and by the United States Court of Federal Claims in American Int'l Group, Inc. v. United States, 38 Fed.Cl. 274 (1997) ("AIG"). In both cases, the courts held that property mortgage insurers were entitled to calculate unpaid loss reserves with reference to the date on which they were notified by the lender that the borrower had defaulted. Both courts reasoned that the method employed by the insurers was appropriate because their liability under the policies was triggered by a borrower's default. Sears, 972 F.2d at 867-68; AIG, 38 Fed.Cl. at 280. In similar fashion to the mortgage guaranty insurers in Sears and AIG, Taxpayer in the present case calculated unpaid losses by reference to the default of the borrower and not by reference to conveyance of title of the underlying property to either Taxpayer or the lender pursuant to or in lieu of disclosure.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS:

There are substantial hazards in litigating this issue. The terms of the policy reflect that Taxpayer was liable for coverage when a borrower defaulted on its obligation to pay the insured lender. Were this issue litigated, Taxpayer would likely prevail on the basis of Sears and AIG. In this regard, Taxpayer may seek to litigate this issue in the Court of Federal Claims, the same venue which issued the opinion in AIG. Accordingly, we would not oppose your recommendation to concede this issue.

Please call if you have any further questions.

Deborah A. Butler
Assistant Chief Counsel

By: _____

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