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 DONALD WILLIAMSON, JR.
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ATTN: Kim A. Palmerino

FROM: DEBORAH A. BUTLER
ASSISTANT CHIEF COUNSEL (FIELD SERVICE)
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SUBJECT: INQUIRY REGARDING WHETHER RECEIPT OF CERTAIN FEES REPRESENTS A RETURN OF BASIS

This Field Service Advice responds to your memorandum dated July 26, 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:
A:
B:
C:
D:
E:
F:
G:
Date 1:
Date 2:
Year 1:
Year 2:
Act:
X Security:
aa:
bb:
cc:

dd:
ee:
ff:
x:
y:
z:

ISSUE(S):

Whether dd, received by Taxpayer subsequent to Date 2, but attributable the sale of X Securities prior to Date 2 should be included in gross income or should be excluded as a return of basis.

CONCLUSION:

The dd should be included in gross income under the circumstances presented below.

FACTS:

We rely on the facts set forth in your memorandum and in a private letter ruling related to Taxpayer. In addition, we rely on facts we have obtained through communications with you.

Taxpayer is a corporation that was created by A on Date 1. Taxpayer's principal activity consists of obtaining a from various financial institutions and issuing bb in those aa in the form of securities. Taxpayer was exempt from all federal and state taxes until Date 2. Effective on Date 2, Taxpayer was made subject to federal income tax by the Act.

Taxpayer does not originate aa. Taxpayer purchases aa from the financial institutions that make the loans. The aa are then pooled and investors are sold securities that are identified with specific pools of aa.

One type of security that Taxpayer issues is the X Security. X Securities have a stated principal amount and a stated interest rate. By their terms, they convey to investors a beneficial ownership interest in the underlying pool of aa. The principal due on an X Security is equal to a fixed percentage of the outstanding principal amount of the underlying loans at the time the securities are issued. The fixed percentage is generally 100%. Principal payments are made on the X Securities as principal payments are received on the underlying loans.

Taxpayer has established policies concerning its securities programs, including eligibility requirements for the aa and for the financial institutions from which it purchases aa. Taxpayer has also developed accounting, reporting and financial requirements to monitor the compliance of financial institutions participating in the programs.

At the time the aa are transferred to Taxpayer, the selling institutions generally enter into contracts to provide primary services on the loans. Primary services include collection of periodic loan payments from the borrowers, remittance of the payments to Taxpayer, maintenance of escrow accounts for payments of insurance and taxes, maintenance of records relating to the loans and handling delinquent payment problems. In exchange for providing primary services on the loans, the financial institutions are entitled to receive part of the interest collected on the loans, income earned on the principal and interest payments between the time those payments are collected and the time they are remitted to Taxpayer, and other fees, including fees for late payments and maintenance of escrow accounts.

After Taxpayer sells the X Securities, Taxpayer remains entitled to receive certain interest payments on the loans. Taxpayer is also entitled to receive income earned on principal and interest payments between the time the payments are received from the institutions that service the loans and the time the payments are remitted to the holders of the securities.

Taxpayer accounts for the income from the issuance of X Securities as a sale of assets. Taxpayer excludes the specific pools of aa associated with the specific X Securities that are sold from its retained a portfolio. The purchase price of the aa is reported as the cost of sales and, to the extent the proceeds from the issuance of the X Securities exceed Taxpayer's basis in the aa, the income is reported as gain.

As indicated above, Taxpayer receives income from the aa in addition to the proceeds from the issuance of the X Securities. Taxpayer describes this income as interest margin. Interest margin is defined by Taxpayer as the difference between the stated interest on the face of the aa and the interest retained by the seller. In essence, the interest margin is the interest retained by Taxpayer after the X Securities are sold. Taxpayer divides the interest margin into two components: the cc and the dd. The basis for the allocation of the interest margin is unclear from the facts we have; however, according to information provided by Taxpayer, the allocation of part of the interest margin to the dd was based on its conclusion that, as an economic matter, part of the interest margin could represent payment for things other than the cost of providing bb and providing actual services to administer the pool. This conclusion was reached in connection with the preparation of Taxpayer's initial federal income tax return.

According to Taxpayer, the dd, also called the ff, is considered contingent primarily because of the possibility of a prepayments. In addition, Taxpayer argues the dd is contingent because it relies on Taxpayer’s continued rendition of adequate services.

For tax purposes, the cc component of the interest is recognized by Taxpayer as ordinary income when monthly a payments are received. If the proceeds received from the sales of X Securities exceed Taxpayer’s basis in the aa, the dd is also recognized as ordinary income each month as it is received. If the proceeds from the sales of X Securities do not exceed Taxpayer’s basis in the aa, Taxpayer compares the deficit with the present value of the dd. If the present value of the dd is greater than the deficit, the difference is treated as a deferred loss. If the present value of the dd is less than the deficit, the difference is claimed as a loss.

In the situations where Taxpayer treats the difference as a deferred loss, Taxpayer offsets the deferred loss by the dd portion of each monthly payment until the deferred loss is completely offset. After the deferred loss is completely offset, the dd are included in income. According to Taxpayer, for tax purposes it had deferred loss from the issuance of X Securities in prior years in the amount of x as of Date 2. For book purposes, Taxpayer includes the dd in income as it is received and amortizes any loss from the sales of X Securities on a straight-line basis over the life of the aa in the pool.

For Year 1 and Year 2, Examination made adjustments in the amounts of y and z, respectively, based on the determination that Taxpayer is required to report both the cc and the dd as income in the year received.

LAW AND ANALYSIS

B of the Act repealed Taxpayer’s exemption from federal income tax, effective Date 2.

C of the Act provides generally that the adjusted basis of any asset of Taxpayer held on Date 2, shall for purposes of determining any loss, be equal to the lesser of the adjusted basis of such asset or the fair market value of such asset as of such date. For purposes of determining any gain, C specifies that the adjusted basis of any asset of Taxpayer held on Date 2 shall be equal to the greater of the adjusted basis of such asset or the fair market value of such asset as of such date.

D of the Act provides generally that C shall not apply to any right to receive income with respect to any ee or other similar interest in any aa (not including any aa).

The legislative history relating to B indicates that for purposes of the basis rules, rights to income retained by Taxpayer under ee and similar interests in aa sold prior to Date 2 are not to be considered to have a built-in-income component on Date 2 which could be treated as an asset held by Taxpayer as of the date of taxability.

The comments relating to the conference agreement emphasize that Taxpayer is to be treated as having no basis in income rights with respect to ee or similar interests sold in aa under the provisions of B where the ee, related security, or similar interest was sold or issued by Taxpayer prior to Date 2. Id.,

In addition, Congress states its intent with respect to the treatment of the income attributable to ee or similar obligations sold or issued prior to Date 2 as follows:

> Thus, income received by [Taxpayer] which is attributable to [ee], , or similar obligations sold prior to [Date 2], is to be taxable in the year received, regardless of whether such income is attributable to services performed by [Taxpayer] prior to [Date 2], to guarantees provided by [Taxpayer], or to a built-in income or profit component which may be considered to exist as of [Date 2]. Additionally, [Taxpayer] is not to be entitled to a deduction for depreciation or amortization with respect to its income rights in these obligations and is to have no basis in such income rights, under the basis provisions of the conference agreement, for purposes of determining gain or loss on the sale or disposition of such income rights.

Id.

We believe that dd are income attributable to ee and not, as Taxpayer argues, part of the sale proceeds from its sale of X Securities. Thus, we believe D of the Act and the related legislative history control the treatment of the Taxpayer's dd and that Taxpayer should be treated as having no basis in such fees.

The dd should not be considered part of the sale proceeds from the sale of X Securities because the fees do not arise out of the sale of the X Securities. Rather, the fees arise out of Taxpayer's ownership interest in the underlying pool of aa, a portion of which is sold via the X Securities.

In E, it was determined that an arrangement whereby ee were sold constituted a trust. The ruling characterized the sale of the ee as a transfer of an ownership interest in each of the underlying aa. Subsequent revenue rulings have applied the same basic principles to securities issued under similar arrangements and have consistently concluded that the sale of ee constitutes a sale of an ownership interest in the underlying aa. See F; G.

Based on E and its progeny, Taxpayer argues that it sells its entire interest in the underlying aa when it sells X Securities. According to Taxpayer, because the holder of the security acquires all rights to any income derived from the aa by virtue of its purchase of the security, any amounts Taxpayer retains must be characterized either as payment for services or as payment for the security. We believe Taxpayer's logic is flawed because it is based on the assumption that

Taxpayer transfers its entire interest in the underlying aa when it sells X Securities. Nothing in the rulings compels this conclusion and we do not believe the facts of this case support it.

As a result of Taxpayer's purchase of the aa from the originating banks, it becomes entitled to payments of interest and principal. Such rights are independent and separable. Helvering v. Horst, 311 U.S. 112, 115 (1940). As owner of the aa, Taxpayer is entitled to sell some or all of its rights to the payments of interest and principal to which it is entitled. Taxpayer accomplishes this through the sale of X Securities. Although there is no dispute that the sale of the securities transfers an ownership interest in the aa to the purchaser of the security, the question of whether Taxpayer's entire interest in the aa is transferred depends on the terms of the agreement between the parties. Franklin v. Commissioner, 683 F.2d 125, 128 (5th Cir. 1982).

In the instant case, when Taxpayer sells X Securities, it retains a certain percentage of the interest due on the aa. The Service has recognized the industry's practice of compensating a bank for servicing aa by allowing a bank that sells aa to retain a percentage of the interest due on the aa. More specifically, the Service has recognized that Taxpayer retains a certain portion of interest from the aa as compensation for services when the interests in the aa are sold via the X Securities. These servicing fees are treated as having been paid by the recipient of the services despite the fact that, in actuality, they are interest payments emanating from the aa. Thus, Taxpayer properly treats the retained interest that represents reasonable compensation for services as income in the period it is received.

The issue here, however, arises out of Taxpayer's treatment of retained interest that it claims exceeds the reasonable compensation for providing services. In this regard we note that it is unclear to us how Taxpayer has reached the determination that a portion of the retained interest exceeds the reasonable compensation for providing services. We believe Taxpayer's position is inconsistent with its argument that receipt of the dd depends on its continued provision of adequate services. If it is determined that Taxpayer receives the dd as compensation for providing services, the fees should be included in gross income as earned under section 61(a)(1).

If it is determined that the dd exceed the reasonable compensation for services, it follows that Taxpayer does not receive these excess amounts on account of the services it provides. Further, because the amounts are not paid by the buyer of the securities, there is no basis for treating them as ff.

In addition to the above, we are concerned that Taxpayer's treatment of the dd fails to consider the impact of adjustments made to income when the original sale occurred. According to the facts we have been provided, Taxpayer accounted for the sale of X Securities as the sale of assets and excluded the aa from its retained aa portfolio. The purchase price of the aa was reported as cost of sales. If this is true, the negative impact from the sale of aa at a loss should have been reflected in Taxpayer's income for the period in which the sale was made.

Generally, a sale gives rise to a realization event for tax purposes requiring the immediate recognition of gain or loss. Cottage Sav. Ass'n v. Commissioner, 499 U.S. 554 (1991); United States v. Centennial Sav. Bank, 499 U.S. 573, 578 (1991); I.R.C. § 1001(c). Taxpayer's method, which purports to recover basis from sales that occurred prior to Date 2, inappropriately allows Taxpayer to move losses from sales in pretax years to later years where they can be offset by taxable income. We do not believe Taxpayer's arguments justify this treatment.

Taxpayer argues it is entitled to adjust basis under section 1016(a)(3)(B). Section 1016(a)(3)(B) provides for proper adjustments to basis in property in respect of any period during which such property was held by a person or by an organization not subject to income taxation. Section 1016(a)(3)(B) requires adjustments to basis in such cases for exhaustion, wear and tear, obsolescence, amortization and depletion to the extent actually sustained.

We have several problems with Taxpayer's arguments under section 1016. First, it is unclear to which assets Taxpayer's purported basis adjustments relate. We see the sale of the X Securities as closed transactions. Thus, to the extent the sale of the securities disposed of Taxpayer's interest in the underlying aa prior to Date 2, Taxpayer would no longer hold the aa the basis of which it seeks to adjust. Section 1016(a)(3)(B) neither requires, nor supports basis adjustments to assets no longer held by the taxpayer at the time it becomes subject to income taxation.

If the asset under consideration is Taxpayer's retained interest in the income flow from the aa that exceeds the reasonable compensation for services, then, in the absence of B of the Act, Taxpayer would be entitled to adjust the basis of that asset under section 1016(a)(3)(B) to the extent it was retained after Date 2, provided Taxpayer could establish both its basis in that asset and an appropriate amount as an adjustment. As we have indicated, however, we believe B of the Act and the related legislative history require that Taxpayer be treated as having no basis in such rights to fees as of Date 2.

Even assuming Taxpayer was entitled to adjust its basis in its retained interest in the excess income flow from the aa under section 1016(a)(3)(B), it is questionable whether Taxpayer's offset of losses from prior years constitutes a proper basis adjustment within the meaning of the section. Adjustments under section 1016(a)(3)(B) are intended to reflect the exhaustion, wear and tear, obsolescence, amortization or depletion of an asset held for a period during which the owner was not subject to income tax. Such adjustments decrease basis to increase the gain or reduce the loss a taxpayer recognizes when the property is disposed of in a taxable year.

In this case, Taxpayer is not disposing of its interest in the income stream and it is not reducing basis to reflect wear and tear. Taxpayer is seeking to recover losses incurred in pretax years by reducing current income. We do not view section 1016 as authorizing the recovery of losses from sales in pretax years. Accordingly, section 1016(a)(3)(B) does not support Taxpayer's treatment of the dd.

With respect to Taxpayer's arguments under section 453 and the regulations thereunder, we believe they are equally misplaced because, in our view, the sale of X Securities is not an installment sale within the meaning of section 453(b)(1). Section 453(b)(1) defines an installment sale as a disposition of property where at least one payment is to be received after the close of the taxable year in which the disposition occurs. The facts of the instant case do not suggest that the sales of X Securities constitute dispositions of property with payments to be received in subsequent years. Rather, as between Taxpayer and the buyers of the securities, the sales of the securities appear to be closed transactions as of the date of the sale. Thus, while the receipt of the dd may be attributable to the sale of securities in a general sense, there does not appear to be a direct relationship between the income flow generated by the underlying property and amounts received in consideration for the purchase of securities. Accordingly, in our view, the disposition of the X Securities does not generate payments to be received after the close of the taxable year of the sale and the sale cannot be characterized as an installment sale. Because there is no installment sale, Taxpayer is not entitled to installment method accounting.

Taxpayer has not articulated a basis for allowing it to offset current income with prior year losses; accordingly, we conclude that the general rules under section 61 apply to the dd and that they should be treated as taxable income in the year received.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS:

[redacted]

[redacted]

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