

**MEMO# 2769**

May 20, 1991

## **SUPREME COURT DECISION IN COTTAGE SAVINGS ASSN. V. COMMISSIONER**

May 20, 1991 TO: TAX MEMBERS NO. 15-91 ACCOUNTING/TREASURERS MEMBERS NO. 11-91 RE: SUPREME COURT DECISION IN COTTAGE SAVINGS ASSN. V. COMMISSIONER

The Supreme Court recently ruled in *Cottage Savings Assn. v. Commissioner*, 59 U.S.L.W. 4314 (April 17, 1991) (attached) that the swap of two portfolios of mortgage interests between savings and loan associations was a transaction in which any deductible losses would be realized, despite the fact that the mortgage swap was a non-recognition event for savings and loan regulatory purposes. The regulations under Internal Revenue Code section 1001 provide that, for gain or loss to be taken into account, there must be a realization event in which there is a "material difference" between the properties exchanged. The Internal Revenue Service took the position in the *Cottage Savings* case that properties were not materially different if they were "economic substitutes" for each other. The Supreme Court held that the Service had no legal basis for its standard. Rather, the Court stated that a difference in the kind or extent of legal entitlements determined whether properties were materially different. Because the mortgage loans which were swapped had different obligors and were secured by different properties, the Supreme Court concluded that the properties were materially different, and that *Cottage Savings* must recognize the losses incurred upon the exchange of the portfolios. It has been suggested that this case may have implications for mutual funds which engage in reverse repurchase agreements secured by mortgage-backed securities such as Ginnie Maes, Fannie Maes and Freddie Macs if, upon unwinding the reverse repurchase agreement, the fund does not receive back the exact security which it pledged. We will keep you informed of developments. David J. Mangefrida, Jr. Assistant Counsel - Tax Attachment