INVESTMENT COMPANY INSTITUTE

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REGULATIONS ON STRIPPED BONDS AND COUPONS RESULTING FROM EXCESS SERVICING FEES ON MORTGAGE-BACKED SECURITIES

MEMORANDUM CORRECTION August 15, 1991 TO: ACCOUNTING/TREASURERS MEMBERS NO. 22-91 TAX MEMBERS NO. 33-91 RE: REGULATIONS ON STRIPPED BONDS AND COUPONS RESULTING FROM EXCESS SERVICING FEES ON MORTGAGE-BACKED SECURITIES ____ The Internal Revenue Service has issued guidance on the treatment of certain mortgage loans and mortgage-backed securities with respect to which there exists "excess servicing" fees. The first document in the package is Revenue Ruling 91-46, which clarifies the circumstances under which a mortgage will become a stripped bond. The Service ruled that to the extent that the mortgage servicing company receives interest on the mortgages in excess of reasonable compensation for the services provided, the mortgages become "stripped bonds" under Internal Revenue Code ("Code") section 1286, and the mortgage company's excess servicing fees become "stripped coupons". As a result of the characterization of the mortgages and servicing as stripped bonds and coupons, the bonds and coupons will be treated as instruments issued with original issue discount ("OID") under Code section 1286(a). The Service also provides rules for valuing the stripped bonds and coupons in order to calculate the amount of OID earned on the bonds and coupons, and indicated that taxpayers currently reporting income in a manner inconsistent with Rev. Rul. 91-46 and Code section 1286 must change to a method of accounting consistent with those authorities. In Rev. Proc. 91-50, the Service provides safe harbors for determining reasonable compensation in the context of servicing of mortgages on one- to four-family residential properties. Revenue Procedure 91-51, issued concurrently with Rev. Proc. 91-50, provides a simplified method for automatically changing to the proper method of accounting as required under the Revenue Ruling. The year of change is considered to be the first tax year beginning after August 8, 1991. The package also contains temporary and proposed regulations on the treatment of certain stripped bonds and coupons. The regulation clarifies that the OID de minimis rule of Code section 1273(a)(3) applies to stripped bonds and stripped - 1 - coupons. Code section 1273(a)(3) provides that if the excess of the stated redemption price at maturity over the issue price is less than one-fourth of one percent of the stated redemption price at maturity times the number of years to maturity, then the OID is treated as zero. Thus, if the OID on a stripped bond, calculated under section 1286(a), is less than the amount calculated as de minimis under section 1273(a)(3), the stripped bond is treated as having been issued without OID. The new regulation further provides that the Service, by publication in the Internal Revenue Bulletin, may provide that certain mortgage loans that are stripped bonds are to be treated as market discount bonds under Code section 1278. Under that authority, the Service concurrently issued Rev. Proc. 91-49, which provides simplified treatment of market discount for purchasers of mortgages which are stripped bonds. The simplified procedure would apply to mortgages which are stripped bonds if the amount of OID is considered to be zero under the new proposed and temporary regulations, or if the annual stated rate of interest payable on the stripped bond is no more than 100 basis points lower than the annual stated rate of interest payable on the original bond from which it was stripped. This new guidance appears potentially to affect any regulated investment company which holds mortgage backed securities which had excess servicing retained by the sponsors when the security was issued. We will keep you informed of further developments. David J. Mangefrida, Jr. Assistant Counsel - Tax Attachments DJM:bmb

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