

INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

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Taxpayer's Name:
Taxpayer's Address:
Taxpayer's Identification No:
Years Involved:
Date of Conference:

LEGEND:

Issuer =
Year 1 =
State =
Bonds =
Date 1 =

ISSUE:

Whether the portion of the interest payments on mortgage loans (financed with the proceeds of mortgage revenue bonds under § 143 of the Internal Revenue Code of 1986 (the "1986 Code")) used to pay the Government National Mortgage Association ("GNMA") to guarantee the payment on the mortgage loans must be taken into account in determining the effective rate of interest on the mortgage loans for purposes of § 143(g).

CONCLUSION:

The portion of the mortgagors' interest payments used to pay the guarantee fees to GNMA must be taken into account when determining the effective rate of interest on the mortgage loans for purposes of § 143(g).

FACTS:

The Issuer was created in Year 1 pursuant to State law to provide financing for various types of housing for low and moderate income persons. In furtherance of these purposes, the Issuer issued the Bonds on Date 1 as mortgage revenue bonds under § 143. As more fully described below, the proceeds of the Bonds were used to make mortgage loans ("Mortgages") to finance the acquisition of owner-occupied residences by eligible borrowers and the payments on the Mortgages were guaranteed by GNMA.

The Mortgages were made in the following manner. The Issuer entered into an agreement with the trustee for the Bonds (the "Trustee") and a group of mortgage lending institutions (each, a "Lender") under which the Lenders agreed to originate the Mortgages and, with respect to certain Lenders, service the Mortgages (in such capacity, a "Servicer"). The Lenders originated the Mortgages with their own funds. Each Lender that is not a Servicer assigned the Mortgages it originated to a Servicer. At such time as a Servicer originated (or received by assignment) Mortgages in a minimum aggregate principal amount (specified by GNMA), the Servicer issued a "fully modified pass-through security" (each, a "GNMA Security") backed by such Mortgages and sold it to the Trustee for an amount of Bond proceeds equal to the unamortized principal amount of the GNMA Security and the accrued interest thereon. Under the terms of a GNMA Security, the Servicer is required to pass through to the Trustee the regular monthly payments on the Mortgages (less certain servicing and guarantee fees discussed below), whether or not received by the Servicer, plus any prepayments and liquidation proceeds in the event of a foreclosure or other disposition of any Mortgages. At the time of issuance of a GNMA Security, GNMA guarantees the timely payment of principal and interest on the GNMA Security. GNMA will only guarantee a GNMA Security to the extent that the underlying Mortgages are insured by certain federal agencies or instrumentalities, including the Federal Housing Administration and the Veterans' Administration.

Each mortgagor makes its Mortgage payments to a Servicer. From these payments, the Servicer retains a servicing fee equal to 0.44 percent of the unamortized principal amount of the Mortgages, pays a guarantee fee to GNMA equal to 0.06 percent of the unamortized principal amount of the Mortgages, and pays the remaining amount to the Trustee. For purposes of calculating the effective rate of interest on the Mortgages under § 143(g), the Issuer did not take into account the amount of interest paid by the mortgagors which was to be used to pay the GNMA guarantee fees. Not taking the GNMA guarantee fees into account results in the effective rate of interest on the Mortgages being lower than if they were taken into account. Taking the GNMA guarantee fees into account would result in the yield on the Mortgages exceeding the yield on the Bonds by more than 1.125 percentage points.

LAW:

Generally, under § 103(a), gross income does not include interest on any state or local bond. Section 103(b)(1) provides that § 103(a) shall not apply to any private activity bond which is not a qualified bond (within the meaning of § 141).

Section 141(e)(1)(B) provides that the term "qualified bond" includes any private activity bond that is a qualified mortgage bond. Section 143(a) defines qualified mortgage bond as a bond that is issued as part of a qualified mortgage issue. Section 143(a)(2)(A)(ii) provides that a qualified mortgage issue must satisfy the requirements of § 143(g).

Section 143(g)(1) provides that one of the requirements of § 143(g) is that the issue meets the requirements of § 143(g)(2). Section 143(g)(2)(A) provides that an issue will meet the requirements of paragraph (g) only if the excess of (i) the effective rate of interest on the mortgages provided under the issue, over (ii) the yield on the issue, is not greater than 1.125 percentage points.

Section 143(g)(2)(B) defines the effective rate of mortgage interest. Section 143(g)(2)(B)(i) provides that in determining the effective rate of interest on any mortgage for purposes of § 143(g)(2), there shall be taken into account all fees, charges, and other amounts borne by the mortgagor which are attributable to the mortgage or to the bond issue.

Section 143(g)(2)(B)(ii) provides that, for purposes of determining the effective rate of mortgage interest, the following items (among others) shall be treated as borne by the mortgagor:

(I) all points or similar charges paid by the seller of the property, and

(II) the excess of the amounts received from any person other than the mortgagor by any person in connection with the acquisition of the mortgagor's interest in the property over the usual and reasonable acquisition costs of a person acquiring like property where owner-financing is not provided through the use of qualified mortgage bonds or qualified veterans' mortgage bonds.

Section 143(g)(2)(B)(iii) provides that, for purposes of determining the effective interest rate of mortgage interest, the following items shall not be taken into account:

(I) any expected rebate of arbitrage profits, and

(II) any application fee, survey fee, credit report fee, insurance charge, or similar amount to the extent such amount does not exceed amounts charged in such area in cases where owner-financing is not provided through the use of qualified mortgage bonds or qualified veterans' mortgage bonds.

Regulations have not been issued under § 143. Section 6a.103A-2(h)(2)(ii) of the Temporary Regulations describes how to calculate the effective rate of interest for purposes of § 103A(i) of the Internal Revenue Code of 1954 (the "1954 Code"), the predecessor to § 143(g) of the 1986 Code. The Tax Reform Act of 1986, 1986-3 (Vol. 1) C.B. 519-575 (the "1986 Act") reorganized §§ 103 and 103A of the 1954 Code into §§ 103 and 141 through 150 of the 1986 Code. Congress intended that to the extent not amended by the 1986 Act, all principles of pre-1986 Act law would continue to apply to the reorganized provisions. H.R. Conf. Rep. No. 99-84, at 11-686 (1986), 1986-3 (Vol. 4) C.B. 686. The pertinent language of § 143(g) of the 1986 Code remains unchanged from that of § 103A(i) of the 1954 Code.

Section 6a.103A-2(h)(2)(ii)(A) provides that in determining the effective rate of interest on any mortgage, there shall be taken into account all fees, charges, and other amounts borne by the mortgagor which are attributable to the mortgage or to the bond issue. Such amounts include points, commitment fees, origination fees, servicing fees, and prepayment penalties paid by the mortgagor.

Section 6a.103A-2(h)(2)(ii)(B) provides that the following shall be treated as borne by the mortgagor and shall be taken into account in calculating the effective rate of interest:

(1) All points, commitment fees, origination fees, or similar charges borne by the seller of the property;

(2) The excess of any amounts received from any person other than the mortgagor by any person in connection with the acquisition of the mortgagor's interest in the property over the usual and reasonable costs incurred by a person acquiring like property where owner financing is not provided through the use of qualified mortgage bonds.

Section 6a.103A-2(h)(2)(ii)(C) provides that the following shall not be treated as borne by the mortgagor and shall not be taken into account in calculating the effective rate of interest:

(1) Any expected rebate of arbitrage profit (as required by § 6a.103A-2(i)(4));

(2) Any application fee, survey fee, credit report fee, insurance fee or similar settlement or financing cost to the extent such amount does not exceed amounts charged in such area in cases where owner financing is not provided through the use of qualified mortgage bonds. For example, amounts paid for FHA, VA, or similar private mortgage insurance on an individual's mortgage need not be taken into account so long as such amounts do not exceed the amounts charged in the area with respect to a similar mortgage that is not financed with qualified mortgage bonds. Premiums charged for pool mortgage insurance will be considered amounts in excess of the usual and reasonable amounts charged for insurance in cases where owner financing is not provided through the use of qualified mortgage bonds.

The Congressional Record contains the following colloquy from the floor of the House of Representatives with respect to the Mortgage Subsidy Bond Tax Act of 1980, 1980-2 C.B. 509(the "Ullman Act"), which created § 103A(i):

Mr. ULLMAN. FHA and VA mortgage insurance premiums and premiums for similar private mortgage insurance are not taken into account under the bill in determining the effective interest rate of mortgages so long as such amounts do not exceed the amounts charged in the area for a similar mortgage is not financed by mortgage subsidy bondsHowever charges on the mortgagor for mortgage pool insurance which typically is obtained by the issuer to cover risks not covered by other insurance would be taken into account.

126 Cong. Rec. 31872-73 (1980). The Congressional Record contains a colloquy from the floor of the Senate that is virtually identical to the colloquy quoted above. Id. at 31713. The Congressional Record also contains a letter from the then Assistant Secretary of the Treasury(Tax Policy) confirming that the colloquy conforms with his understanding and interpretation of the legislation. Id.

ANALYSIS:

Section 143(g)(2)(B)(iii) of the 1986 Code provides that for purposes of determining the effective interest rate on any mortgage, any insurance charge is not taken into account to the extent such amount does not exceed amounts charged in such area in cases where owner-financing is not provided through the use of qualified mortgage bonds or qualified

veterans' mortgage bonds. Interpreting § 103A(i)(2)(B)(iii) of the 1954 Code, which is identical in pertinent part to § 143(g)(2)(B)(iii) of the 1986 Code, § 6a.103A-2(h)(2)(ii)(C) differentiates between amounts paid for FHA, VA or similar private mortgage insurance on an individual mortgage and premiums for pool mortgage insurance. The regulations provide that amounts paid for FHA, VA, or similar private mortgage insurance on an individual's mortgage need not be taken into account so long as such amounts do not exceed the amounts charged in the area with respect to a similar mortgage that is not financed with qualified mortgage bonds. However, premiums charged for pool mortgage insurance will be considered amounts in excess of the usual and reasonable amounts charged for insurance in cases where owner financing is not provided through the use of qualified mortgage bonds, regardless of the amount of such premiums. Accordingly, if the fees paid to GNMA to guarantee the GNMA Security are premiums for pool mortgage insurance, such fees must be taken into account in computing the effective rate of interest on the Mortgages.

The Issuer argues that the guarantee fee paid to GNMA is not for pool mortgage insurance as the term is used in the regulations. The Issuer argues that the term pool mortgage insurance is a term of art that described a particular insurance product in use at the time the regulations were written. This product typically did not cover 100% of the principal and interest payments on the mortgage loans, reduced payments by the amount of any loss paid by FHA, VA or other private mortgage insurance, and did not make payments immediately following a payment default. By contrast, the GNMA guarantee, which covers 100% of the principal and interest payments on mortgage loans, pays the full amount due on mortgage loans if not paid when due, and then seeks reimbursement from FHA, VA or other private mortgage insurer. The Issuer also argues that the GNMA guarantee should not be treated as pool mortgage insurance because GNMA guarantees were not widely used at the time the regulations were drafted. The Issuer suggests that the reference to pool mortgage insurance in the regulations is explained by the fact that at the time the regulations were drafted, pool mortgage insurance was not widely used in taxable securitizations of mortgage loans, and therefore, could never meet the standard that the amounts charged do not exceed the amounts charged in the area with respect to a similar mortgage that is not financed with qualified mortgage bonds. By contrast, they indicate that the use of GNMA guarantees in taxable and tax-exempt securitizations was very common at the time the Bonds were issued.

The regulations contain no definition of the term pool mortgage insurance. Notwithstanding, the function of the GNMA guarantee is the same as the product described by the Issuer. The GNMA guarantee is insurance acquired by an issuer to guarantee the payments on its pool of mortgage loans. It is acquired in addition to the FHA, VA, or other private mortgage insurance on an individual's mortgage loan, and like the product described by the Issuer, represents a cost of securitizing mortgage loans. While the GNMA guarantee and the product described by the Issuer operate in a different manner, this does not change the fact that they perform the same function. Moreover, the fact that GNMA guarantees were not commonly used in tax-exempt or taxable securitizations at the time the regulations were drafted does not alter this conclusion. Under the facts and circumstances, the GNMA guarantee is properly treated as pool mortgage insurance as such term is used in § 6a.103A-2(h)(2)(ii)(C).

The Issuer argues that even if the fee paid to GNMA is for pool mortgage insurance, the reference to such insurance in the regulations is just illustrative. Thus, the Issuer argues that if the fees paid to GNMA are not in excess of the usual and reasonable amounts charged for insurance in cases where owner financing is not provided through the use of qualified mortgage bonds, then it is an insurance charge as described in § 143(g)(2)(B)(iii). We acknowledge that the use of GNMA guarantees in taxable and tax-exempt securitizations was common at the time the Bonds were issued. However, even if we were to agree that the reference to pool mortgage insurance is illustrative, we do not believe that the GNMA guarantee fee is an insurance charge as described in § 143(g)(2)(B)(iii). The other items listed in § 143(g)(2)(B)(iii) suggest a different kind of charge was intended to be covered by the provision. The types of costs other than an insurance charge that are specifically referred to in the provision are application fees, survey fees and credit report fees. These costs are all amounts typically charged to a mortgagor that relate to his or her individual mortgage. They do not relate to the pool of mortgage loans financed with the proceeds of an issue of bonds. The fact that a fee is not in excess of the usual and reasonable amounts charged for insurance in cases where owner financing is not provided through the use of qualified mortgage bonds is insufficient; rather, to come within § 143(g)(2)(B)(iii), it must be a cost that relates to an individual's mortgage.

Our interpretation of the statute and regulations is consistent with the colloquies contained in the Congressional Record at the time of passage of the Ullman Act. The colloquies, which were confirmed by the Assistant Secretary of the Treasury (Tax Policy) at the time, differentiate between insurance on an individual's mortgage and pool mortgage insurance obtained by the issuer to cover risks not covered by other insurance. That distinction is equally applicable to the GNMA guarantee as it was to any other form of pool mortgage insurance that may have been in use at the time of passage of the Ullman Act.

CAVEAT(S):

A copy of this technical advice memorandum is to be given to the taxpayer(s). Section 6110(k)(3) of the 1986 Code provides that it may not be used or cited as precedent.