HUNTON& WILLIAMS

Client Alert

July 2013

IRS Rules a REIT May Acquire Excess Servicing Spreads on Mortgage Loans Serviced by the REIT's Taxable REIT Subsidiary

The IRS recently issued a second private letter ruling (the "New PLR") concluding that the excess servicing spread portion of a mortgage servicing right (an "Excess IO") is a qualifying asset for the REIT 75% asset test and produces qualifying income for the REIT 75% gross income test. In the New PLR, the REIT proposes to acquire the Excess IOs from a taxable REIT subsidiary (a "TRS"), which will acquire the related mortgage servicing rights and will, through a subservicer, service the mortgage loans. The New PLR follows closely the analysis in a similar private letter ruling on Excess IOs issued last year (the "Old PLR").

Unlike in the Old PLR, the REIT in the New PLR proposes to own the entire mortgage servicing right through a TRS and a qualified REIT subsidiary (a "QRS"), which is a disregarded entity for tax purposes. In the proposed transactions, the TRS will acquire the mortgage servicing rights on a portfolio of mortgage loans and will engage an unrelated third-party subservicer to service the mortgage loans. The TRS will retain the normal servicing spread and, from that spread, will pay the subservicer its fee for servicing the mortgages loans. The TRS will sell the Excess IO to the QRS at a fair market value price in an arm's-length transaction.

Consistent with prior IRS guidance, the New PLR affirms that the Excess IO is the portion of the total mortgage servicing fee in excess of reasonable compensation for the services performed and obligations undertaken by the servicer. The Excess IO is treated as an entitlement to a portion of the interest paid on the underlying mortgage loans, rather than as a fee or compensation income. Because the Excess IO represents ownership of a portion of the underlying interest coupon on the underlying mortgages, it is a qualifying asset and generates qualifying income for purposes of the REIT income and asset tests.

The New PLR confirms that the activities of the REIT's TRS will not cause the REIT to be treated as servicing the related mortgage loans. That conclusion is consistent with the general treatment of a TRS, which can typically engage in activities that are not REIT-compliant without affecting the tax status of its parent REIT.

We have broad experience representing both servicers and investors concerning Excess IOs, mortgage servicing fees and rights, and REITs. If you would like more information about the New PLR or its analysis or conclusions, please contact any of the attorneys listed on this alert.

Contacts

George C. Howell, III
ghowell@hunton.com

Cecelia Philipps Horner
chorner@hunton.com

Mark C. Van Deusen
mvandeusen@hunton.com

Kendal A. Sibley
ksibley@hunton.com

© 2013 Hunton & Williams LLP. Attorney advertising materials. These materials have been prepared for informational purposes only and are not legal advice. This information is not intended to create an attorney-client or similar relationship. Please do not send us confidential information. Past successes cannot be an assurance of future success. Whether you need legal services and which lawyer you select are important decisions that should not be based solely upon these materials.