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INTERNAL REVENUE SERVICE
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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR DONALD WILLIAMSON, JR.
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FROM: LON B. SMITH
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SUBJECT: Yield Guaranty

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LEGEND

Corporation X	=
Security	=
Mortgage	=
Yield Guaranty	=
Sales Proceeds	=
Year 1	=
Year 2	=
a	=
b	=
c	=
d	=
e	=
f	=
g	=
h	=
i	=
j	=
k	=
l	=
m	=
n	=
o	=
p	=
q	=
r	=
s	=
t	=
u	=
v	=
w	=

ISSUE

Are the sale proceeds allocable to a yield guaranty contract, which is sold together with a REMIC regular interest, includible in the seller's income in the year of sale, or over the life of the yield guaranty contract?

CONCLUSION

Under I.R.C. § 451, the sale proceeds allocable to the yield guaranty contract are includible in income in the year of sale because the seller's right to keep the sale proceeds became fixed at the time of sale.

FACTS

In Years 1 and 2, Corporation X, an accrual method taxpayer, purchased $a of Mortgages. The sellers continued to be responsible for servicing the Mortgages and were entitled to keep certain amounts from the borrowers' interest payments.

The Mortgages had original terms to maturity of b, c, d, or e years. They paid fixed rates of interest, and provided for level monthly payments of principal and interest based on amortization periods of up to f years. In addition, each of the Mortgages imposed a penalty on any partial or full prepayment of principal.

Corporation X pooled the Mortgages and allocated $g of its basis in the total pool ($a) to its rights in the prepayment penalties. It allocated $h of basis to the Sales Proceeds and $i of basis to rights in principal and interest (P&I Rights). The P&I Rights were contributed by Corporation X to real estate mortgage investment trusts (REMICs) in exchange for regular interests and residual interests. The REMICs received neither the rights to the prepayment penalties nor the rights to the Sales Proceeds. Corporation X sold the regular REMIC interests to the public and retained the residual interests.

According to the circular (Circular) used to offer the regular interests, each REMIC regular interest holder was entitled to receive from the REMIC a stated principal amount and interest at a stated rate. In addition, each regular interest holder was to enjoy the benefit of the Payment Guaranty and the Yield Guaranty, which were described in the Circular, in bold capital letters, as the "**OBLIGATIONS OF CORPORATION X ONLY**" (and not the REMIC). An investor could neither purchase nor sell the Payment Guaranty and the Yield Guaranty separate and apart from the associated REMIC interest.

Under the Payment Guaranty, Corporation X guaranteed both the timely payment of interest on a REMIC regular interest and the ultimate collection of principal on the Mortgages to the extent of the regular interest holder's share.

Principal payments on the Mortgages, including unscheduled principal payments, were generally passed through to the holders of the REMIC regular interests. The Yield Guaranty obligated Corporation X to pay the regular interest holders amounts based on these unscheduled (or prepaid) principal amounts. In general, this obligation was calculated according to a formula designed to reflect the present value of the excess, if any, of (i) the annual yield on a specified b-year Treasury obligation on the original pricing date of a REMIC regular interest over (ii) the annual yield on the same Treasury obligation on the j business day of the month in which an unscheduled principal amount was passed through to the regular interest holder.

The prepayment penalty rights that Corporation X kept resembled the Yield Guaranty that Corporation X sold to the REMIC regular interest holders. The Circular described the features of the prepayment penalty as follows. During the yield maintenance period (Mortgage Yield Maintenance Period), which lasted the first b years of a Mortgage, the penalty was determined under a specified formula intended to measure the present value of the cost to the lender resulting from any decrease in market interest rates between the mortgage origination date and the prepayment date, calculated for each month remaining in the Mortgage Yield Maintenance Period. Also, during the Mortgage Yield Maintenance Period, the minimum penalty (regardless of whether market interest rates decreased) was k percent of the amount of principal being prepaid. After the end of the Mortgage Yield Maintenance Period, the entire penalty was k percent of principal prepaid; however, no penalty was assessed during the last l months of the term for mortgages with c-year, d-year, and e-year terms.

The Circular explained that Corporation X instructed servicers to collect the mortgage prepayment penalty in all circumstances where the borrower voluntarily prepaid the mortgage and where state law allowed enforcement of the penalty. In circumstances where the penalty was unenforceable under applicable state law or where the collection was uncertain, Corporation X would determine whether to pursue enforcement and collection of the prepayment penalty, taking into account the cost and difficulty of enforcement and collection.

The Circular also compared the Yield Guaranty and the Mortgage prepayment penalties. According to the Circular, the Yield Guaranty payments were calculated similarly to the mortgage prepayment penalties except as follows. First, the Yield Guaranty lasted for the first m years of a REMIC, whereas the Mortgage Yield Maintenance Period lasted for the first b years of a Mortgage. Second, although both the prepayment penalty formula and the Yield Guaranty formula compared an earlier Treasury yield with a later Treasury yield, the times for selecting the yields were different. The Yield Guaranty compared the Treasury yield on the original pricing date of a REMIC regular interest with the Treasury yield on the j business day of the month in which an unscheduled principal amount was passed through to the regular interest holder. The prepayment penalty compared the Treasury yield on the date a Mortgage was originated with the Treasury yield on the date b business days before the Mortgage was prepaid. Third, unlike the prepayment penalty, the Yield Guaranty did not provide for a minimum k percent penalty either during the Yield Guaranty period (m years) or at any time afterwards.

The Yield Guaranty payments were payable by Corporation X to the REMIC regular interest holders n to o months after the penalty amounts were payable by the mortgagors. According to Corporation X, it financed the Yield Guaranty payments by charging the penalty amounts.

When Corporation X sold the REMIC interests to investors, it received $p, which it allocated between (1) the REMIC regular interests ($q), and (2) the Yield Guaranty ($r). Corporation X included the sale proceeds allocated to the regular interests ($q) in income at the time of the sale, recognizing $s ($q - $i) as gain. Although no portion of the sale proceeds was refundable, Corporation X treated the portion allocated to the Yield Guaranty ($r) as an amount paid under a notional principal contract, excluding it from income at the time of sale and including it in income over the life of the Yield Guaranty (pro rata with principal paid). Corporation X also amortized its basis in the prepayment penalty right over the life of the Yield Guaranty (pro rata with principal paid). It included prepayment penalty amounts in income when received, and it deducted Yield Guaranty payments when made.

For book purposes, Corporation X did not account separately for the Yield Guaranty. Rather, it accounted for the entire amount realized on the sale of the REMIC interests as sale proceeds. No portion of the sale proceeds was designated on Corporation X's books as a sale of a Yield Guaranty.

On audit, Exam concluded that the entire amount of the sale proceeds ($p) should be included in income at the time of sale and that no portion of this amount should be deferred.

LAW AND ANALYSIS

Section 451 of the Internal Revenue Code gives rules for determining the taxable year of inclusion for items of gross income. The provision states that any item of gross income shall be included in gross income for the taxable year in which received, unless, under the taxpayer's method of accounting used in computing taxable income, the item is to be properly accounted for as of a different period.

Section 1.451-1(a) of the Income Tax Regulations provides that under an accrual method of accounting, income is includible in gross income when all the events have occurred that fix the right to receive such income and the amount thereof can be determined with reasonable accuracy (the all events test). Generally, all the events that fix the right to receive income have occurred when it is: (1) actually or constructively received; (2) due; or (3) earned by performance, whichever comes first. Schlude v. Commissioner, 372 U.S. 128 (1963); Union Mut. Life Ins. Co. v. United States, 570 F.2d 382, 385 (1st Cir. 1978); Automobile Club of

New York, Inc. v. Commissioner, 32 T.C. 906, 911-913 (1959), affd. 304 F.2d 781 (2d Cir. 1962).

For purposes of this field service advice, we assume arguendo that Corporation X sold two separate products, (1) a REMIC regular interest and (2) a Yield Guaranty. Nevertheless, we conclude the all events test was satisfied at the time of sale with respect to the entire amount of sale proceeds Corporation X received.

A guaranty of an instrument is a secondary and collateral promise to pay the amounts due under the instrument in the event the primary obligor (ordinarily the issuer) defaults. Zappo v. Commissioner, 81 T.C. 77, 87-88 (1983); Perry v. Commissioner, 47 T.C. 159, 163 (1966). The consideration for a contract such as a guaranty is currently included in income notwithstanding the taxpayer may incur, or create a reserve for, future expenses. See, Bell Electric Co. v. Commissioner, 45 T.C. 158 (1965), acq., 1966-2 C.B. 4.

Corporation X did not, under the Yield Guaranty, make a "guaranty" in the regular sense of the word. Specifically, Corporation X did not promise to pay amounts due under a REMIC interest in the case of default. Instead, Corporation X promised to make payments to REMIC interest holders in case unscheduled prepayments of principal reduced the yield on their specific REMIC interests. A REMIC that passed through prepayments of principal was legally entitled to do so and not in default. This distinction, however makes no difference. It only means that the Yield Guaranty more closely resembled a warranty. As in the case of a guaranty, the payment for a warranty is currently included in income notwithstanding the taxpayer may incur, or create a reserve for, future expenses.

The Yield Guaranty here resembles the warranty contracts at issue in Standard Television Tube Corp. v. Commissioner, 64 T.C. 238 (1975). Standard Television Tube concerned the tax treatment of proceeds received from the sale of television picture tube warranty contracts for periods extending beyond the taxable year of sale. Petitioner warranted that it would replace a television picture tube if the tube failed after the expiration of the original manufacturer's warranty. In concluding that the sale proceeds did not qualify for deferral under Treas. Reg. § 1.451–5, the court reasoned that the amounts received under the warranty contracts were more in the nature of insurance, and thus distinguishable from amounts paid for services or the sale of goods. Standard Television Tube, 64 T.C. at 243-44. The court concluded that the accrual method of accounting does not permit deferred recognition of prepayments received pursuant to warranty contracts. Standard Television Tube, 64 T.C. at 244.

Just as the taxpayer in Standard Television Tube warranted the performance of certain picture tubes beyond the manufacturer's warranty, Corporation X warranted the performance of specific REMIC interests beyond the performance level required of the issuer (the REMIC). Thus, just as in the case of Standard Television Tube, the amounts received by Corporation X from the sale of the Yield Guaranty are includible in gross income in the year received. See also, Bell Electric, 45 T.C. at 166. (The Supreme Court has held that income is taxable in the year it is received. American Automobile Association v. United States, 367 U.S. 687 (1961). Although American Automobile Association involves amounts received for a service contract, the Tax Court's reasoning in Standard Television Tube indicates that the holding in American Automobile Association is not limited to amounts paid either for goods or services. Standard Television Tube, 64 T.C. at 242.)

There are some exceptions to the general rule requiring income recognition in the year of receipt. For example, Notice 89-21, 1989-1 C.B. 651, allows for deferral for payments made on notional principal contracts. Also, Rev. Proc. 71-21, 1971-2 C.B. 549, allows taxpayers to defer recognition of payments received in one year where all of the services under such agreement are required to be performed before the end of the next year. Neither Notice 89-21 nor Rev. Proc. 71-21 apply to guaranty or warranty contracts. Notice 89-21 is restricted to notional principal contracts, and Rev. Proc. 71-21 specifically states that it does not apply to guaranty or warranty contracts.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

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[redacted]

Please call if you have any further questions.

By: MARSHALL FEIRING
Senior Technician Reviewer
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