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VIA U.S. Mail and Electronic Mail

Internal Revenue Service
CC: PA; LPD: DR (REG-109367-06)
Room 5203
P. O. Box 7604
Ben Franklin Station
Washington, D.C. 20004

Comments on Prop. Reg. 6 1.1221-1(e)

Dear Sir or Madam:

The Mortgage Bankers Association[1] (MBA) appreciates the opportunity to comment on the above-referenced proposed regulation to Section 1221(a)(4) of the Internal Revenue Code ("Code") setting forth the capital asset exclusion for accounts and notes receivable. As proposed, the regulation would provide that if notes and accounts receivable are obtained in exchange for more than a "de minimis" amount of consideration other than property or services rendered they are not described in Section 1221(a)(4), which provides an exception from capital asset treatment. MBA is concerned that the proposed change could deny ordinary asset treatment for some loans acquired or originated by mortgage banking companies in the ordinary course of business. MBA is concerned that rather than providing clarity, the proposed change will foster inconsistent treatment by taxpayers and disagreements with the IRS about the appropriate tax treatment of mortgage loans, and possibly also retained excess servicing fees.

I. Background

According to the preamble to the proposed regulation (the "Preamble"), the Treasury Department and the IRS are seeking to narrow the scope of Section 1221(a)(4) to exclude notes originated or acquired by a creditor in a lending transaction in order to realign current interpretation of the law with what they believe was the intent of Congress in enacting it more than fifty years ago (in 1954). While the text of Prop. Reg. §1.1221-1(e) does not specifically

[1]The Mortgage Bankers Association (MBA) is the national association representing the real estate finance industry, an industry that employs more than 500,000 people in virtually every community in the country. Headquartered in Washington, D.C., the association works to ensure the continued strength of the nation's residential and commercial real estate markets; to expand homeownership and extend access to affordable housing to all Americans. MBA promotes fair and ethical lending practices and fosters professional excellence among real estate finance employees through a wide range of educational programs and a variety of publications. Its membership of over 3,000 companies includes all elements of real estate finance: mortgage companies, mortgage brokers, commercial banks, thrifts, Wall Street conduits, life insurance companies and others in the mortgage lending field. For additional information, visit MBA's Web site: www.mortgagebankers.org.

refer to mortgage notes, the Preamble makes it clear that mortgage notes are the principle focus of the regulation and that the intent is to reverse the holding of two cases specifically dealing with mortgage notes, Burbank Liquidating Corp. v. Commissioner, 39 T.C. 999 (1963), acq. subnom. United Associates, Inc., 1965-1 C.B. 3, aff'd in part and rev'd in part on other grounds 335 F. 2d 125 (9th Cir. 1964); and Federal National Mortgage Association v. Commissioner, 100 T.C. 541 (1993) ("Fannie Mae").

II. Summary of MBA Position

MBA believes neither the statutory language nor the legislative history of Section 1221(a)(4) indicates that Congress intended to treat loans originated and acquired for sale by mortgage bankers in the ordinary course of business as capital assets. MBA believes that tax policy considerations favor including mortgage loans within the group of ordinary assets described in Section 1221(a)(4). Such treatment would reduce or eliminate disputes relating to the characterization of some mortgage notes in the hands of a mortgage banker as capital assets and others as ordinary assets.

MBA's primary concern is that the proposed regulation could be construed as undermining the ordinary asset treatment of mortgage bankers' inventory of loans originated or acquired in the ordinary course of business unless those loans were promptly sold. MBA's secondary concern relates to the possibility that the proposed change could be construed also to change the tax character of "excess servicing fees" (under Section 1286 and Rev. Rul. 91-46[2]) which are generally regarded as ordinary assets consistent with the treatment of the debt instruments from which they are stripped. MBA's concerns are described below, along with MBA's recommendations for addressing them.

A. Mortgage Loans as Inventory

Many mortgage banking companies today characterize their mortgage loans as inventory created or acquired in the ordinary course of their businesses under Section 1221(a)(1). MBA believes this characterization is accurate given that mortgage banking companies' primary business activity consists of originating or acquiring loans for sale.[3] While some mortgage banking companies may retain some loans as portfolio investments, most mortgage banking companies sell the vast majority of their loans within a very short period (generally ninety days) after their acquisition or origination. As such, the vast majority of a typical mortgage company's loans are clearly inventory, as they are held pending sale to another party, rather than held for the benefits of ownership. The sales of the mortgage loans are typically made to regular customers such as Fannie Mae, Government National Mortgage Association or Federal Home Loan Mortgage Corporation with which the mortgage company will establish a substantial and long-term business relationship.

For this reason, MBA believes that mortgage banking companies will continue to characterize accurately their loans as inventory under Section 1221(a)(1), regardless of the outcome of the proposed regulation. Under Section 1236 of the Code, mortgage loans in the hands of any

[2] 1991-2 C.B. 358.

[3] Some mortgage companies are too small to efficiently sell their originated mortgage loans to a secondary market conduit such as Federal National Mortgage Association, Government National Mortgage Association, Federal Home Loan Mortgage Corporation, etc. Other larger mortgage banking companies act as intermediaries by accumulating sufficient mortgage loans through acquisitions and originations to efficiently sell to secondary market conduits.

mortgage banking company that is a dealer normally holding such loans as inventory for sale to customers in the ordinary course of business will be treated as ordinary assets unless the mortgage loan is both clearly identified on the day of origination or acquisition as a security held for investment and not thereafter held for sale to customers in the ordinary course of business. Nevertheless, MBA is concerned that an explicit exclusion of mortgage loans from Section 1221(a)(4) could raise doubts by some IRS Revenue Officers about their qualification as ordinary assets under Section 1221(a)(1). Absent more specific guidance from the Treasury, MBA believes the proposed regulation will create confusion that could escalate into unproductive disagreements over the relative scope of Sections 1221(a)(1) and (4).

B. Excess Servicing as Ordinary Assets

Many mortgage banking companies today also believe Section 1221 supports their position that their retained "excess servicing fees" are ordinary assets under the Code. Because excess servicing fees represent portions of the interest on loans sold to investors pursuant to Rev. Rul. 91-46, then to the extent the loans were characterized as inventory under Section 1221(a)(1), the excess servicing fees would be considered stripped from ordinary assets consistent with the treatment of stripped bond coupons under Section 1286. Through the operation of Section 1236, excess servicing fees would remain ordinary assets after being stripped from ordinary assets. Moreover, because excess servicing fees are received in cash only as certain loan administration functions are performed, they are like notes receivable under Section 1221(a)(4) that are received in exchanged for services rendered.

For these reasons, MBA believes many mortgage banking companies will continue to characterize accurately their excess servicing fees as ordinary assets regardless of the outcome of the proposed revision to the regulations under Section 1221(a)(4). Nevertheless, MBA is concerned that an explicit exclusion of mortgage loans from that section could raise questions regarding excess servicing fees. If the excess servicing fees are stripped from mortgage loans that could under some circumstances be regarded as capital assets, then the proper characterization of the excess servicing fees will also be unclear. In addition, Prop. Reg. §1.1221-1(e) might even be considered to confuse the proper characterization of excess servicing fees stripped from mortgage loans that were clearly inventory. Again, absent more specific guidance from the Treasury, MBA believes the proposed regulation could result in disputes about the proper tax characterization of excess servicing fees.

III. Proper Interpretation of Section 1221(a)(4).

A. Statutory Construction

Because of the primacy of statutory language over all other considerations, the language of Section 1221(a)(4) is the starting point in determining its proper interpretation. Section 1221(a)(4) provides that the term "capital asset" does not include "accounts or notes receivable acquired in the ordinary course of trade or business for services rendered or from the sale of property described in paragraph (1)." Paragraph (1) (Section 1221(a)(1)) describes stock in trade, inventory or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business.

In considering the language of this section, the Preamble states:

> Historically, a lending transaction was sometimes thought of as rendering a service to the borrower. See Rev. Rul. 70-540 (1970-2 CB 101); Rev. Rul. 69-

> 188 (1969-1 CB 54); Rev. Rul. 68-6 (1968-1 CB 325). That characterization, however, does not justify treating notes acquired by an originator in a lending transaction as ordinary assets under section 1221(a)(4). That treatment strains the language of the statute because the notes are not issued by borrowers solely or even predominantly for services rendered. Rather, the notes are, for the most part, issued by the borrower to the lender in exchange for money.

Although the Preamble specifically admits that lending transactions are sometimes treated as services, it concludes without any authority that only a service that does not involve a loan of money (a "nonfinancial service") was the type of service meant by the statute. This result is not only contrary to the specific holdings of Burbank Liquidating and Fannie Mae, but it is also contrary to the use of the word "services" in other sections of the Code.

For example, Section 904 of the Code uses the term "financial services income" which is generally described in Section 904(d)(2)(C)(ii) as meaning income derived from the active conduct of a banking, financing or similar business. Clearly, Section 904 considers lending transactions that are part of an active trade or business to be a service.

Similarly, Section 475 requires that a dealer must mark to market any securities in his inventory. Under Section 475(c)(2)(C), a "note, bond, debenture or other evidence of indebtedness" is treated as a security. However, Section 475(c)(4) was added to this section in 1998 to provide an exception from mark-to-market treatment for "nonfinancial customer paper," which is defined to mean any "receivable" which "arises out of the sale of nonfinancial goods or services by a person the principal activity of which is the selling or providing nonfinancial goods or services" and which is held by the original provider of the nonfinancial goods or services. In enacting Section 475(c)(4), Congress took particular care to expressly distinguish between providers of financial services and providers of nonfinancial goods and services. In sections where no such distinctions are made, the clear conclusion is that Congress intends that the unmodified use of the word "services" should be construed to include both financial and nonfinancial services. Because Section 1221(a)(4) uses the word "services" without any qualification, then financial services rendered in the ordinary course of business are within the scope of Section 1221(a)(4).

Interpretations of Section 1221 confirm that the exceptions to capital asset status are not to be narrowly construed. The Supreme Court in Arkansas Best Corp. v. Commissioner, 485 U.S. 212, 220-223 (1988), held that the disposition of property normally results in ordinary gain or loss only if the property falls within one of the statutory exceptions to capital asset treatment listed in Section 1221, but the Court affirmed at several points that the exceptions should be broadly interpreted and thus property (such as futures) may be so related to other property as to merit ordinary asset treatment even if the property does not fall squarely within any exception. See also, Fannie Mae, supra, 100 T.C. at 574-575. The proposed narrow reinterpretation of Section 1221(a)(4) runs afoul of the guidelines established by the Supreme Court for the proper construction of Section 1221.

Recourse to the limited legislative history for Section 1221(a)(4) does not support the conclusion in the Preamble that Section 1221(a)(4) was intended to have a limited focus. The pertinent legislative history consists of the following paragraph in H.R. Rep. No. 1337, 83d Cong., 2d Sess., A273-74 (1954):

> Paragraph (4) is a new provision which excepts from the definition of capital assets accounts or notes receivable acquired in the ordinary course of trade or business for services rendered or from the sale of property described in

> paragraph (1), that is, stock in trade or inventory or property held for sale to customers in the ordinary course of trade or business. This will change present law treatment, for example, as follows: If a taxpayer acquires a note or account receivable in payment for inventory or services rendered, reports it as income and sells it at a discount, then this amendment will provide ordinary loss treatment. Under present law such loss treatment is only allowed if the taxpayer is also, in effect, a dealer in such accounts or notes. Alternatively, the taxpayer may sell the account or note for something more than the discounted value that was originally reported. Under present law this difference would be capital gain unless the taxpayer is such a dealer. The amendment will cause such gain to be ordinary income. [Emphasis added.]

The first sentence quoted above merely restates the statute. The Preamble lays undue emphasis on the use of the phrase in the second sentence "in payment for." The Preamble gleans from this single phrase that a loan of money should always be excluded from the term "services." There is no such emphasis in the House Report, and moreover, the second sentence clearly states that it sets forth only an example of one way in which present law treatment will be changed by Section 1221(4) (as it was then numerated). There is no express indication in the legislative history that financial services were intended to be excluded. Yet, based solely on this one sentence, which is at best ambiguous, the proposed regulation would interpret the term "services" in Section 1221(a)(4) inconsistently with the use of that term in other Code provisions and contrary to established court precedents of over forty years' standing that have been favorably cited as authority by the Internal Revenue Service in the past[4].

Similarly, the recourse in the Preamble to Reg. §1.1221-1(d) does not support the alleged limited focus of Section 1221(a)(4). Although the sentence from the regulation quoted in the Preamble does not specifically state that it is an example, the introductory words to that sentence ("Thus, if ….") clearly show that it is intended to be an example rather than a limitation.

The proposed regulations are interpretive regulations issued in the absence of specific authority. Section 7805(a) provides that the Secretary of the Treasury "shall prescribe all needful rules and regulations for the enforcement of this title…" Agency regulations generally are entitled to deference with respect to their validity. See U.S. v. Boyle, 469 U.S. 241 (1985); Chevron U.S.A., Inc. v. Natural Res. Def. Council, Inc., 467 U.S. 837 (1984); Nat'l Muffler Dealers Ass'n v. U.S., 440 U.S. 472 (1979). This deference is not unlimited, however. A regulation is not valid if it is inconsistent with the plain language of the statute it interprets. See, e.g., Nat'l Cable & Telecomm. Ass'n v. Brand X Internet Services, 125 S. Ct. 2688 (2005); Lamie v. U.S. Tr., 540 U.S. 526 (2004). A recent Tax Court decision, Swallows Holding, Ltd. v. Commissioner, 126 T.C. No. 6 (2006), appeal docketed, No. 06-3388 (3d Cir. July 18, 2006), struck down a tax regulation that was contrary to judicial precedent. The Tax Court invalidated a timely filing requirement provided by the regulation at issue because the regulation "flies in the face of the judiciary's prior holdings" that that statute did not include such a requirement. Id.

The Tax Court in Swallows Holding also held that the statute's repeated legislative reenactment indicated Congress' ratification of prior judicial interpretation. See Swallows Holding (citing, inter alia, Newark Morning Ledger Co. v. U.S., 507 U.S. 546, 574-576 (1993)). The legislative reenactment doctrine holds that "Congress is 'presumed to be aware of an administrative or

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[4] Rev. Rul. 72-238, 1972-1 C.B. 65; Rev. Rul. 73-558, 1973-2 C.B. 298; Rev. Rul. 80-56, 1980-1 C.B. 154; and Rev. Rul. 80-57, 1980-1 C.B. 157.

judicial interpretation of a statute and to adopt that interpretation when it re-enacts a statute without change.'" See Reese Bros., Inc. v. U.S., No. 05-2135 (3d. Cir May 9, 2006) (quoting Lorillard v. Pon, 434 U.S. 575, 580 (1978)). The Supreme Court has held that once a "statutory construction has been 'fully brought to the attention of the public and the Congress,' and the latter has not sought to alter that interpretation although it has amended the statute in other respects, then presumably the legislative intent has been correctly discerned." See United States v. Rutherford, 442 U.S. 544, 554 n.10 (1979) (dealing with agency construction of a statute); North Haven Bd. of Educ. v. Bell, 456 U.S. 512, 535 (1982). The proposed regulation is inconsistent with longstanding judicial precedent with which Congress has never indicated its disapproval. Congress has made numerous changes to section 1221 without amending section 1221(a)(4). It strains credulity to believe that Congressional tax writers were unaware of the longstanding interpretation of section 1221(a)(4), given the existence of two significant federal court decisions, an IRS acquiescence in one case, four revenue rulings following the decisions, and a well-publicized IRS closing agreement consistent with the interpretation. See, Burbank Liquidating, supra; Fannie Mae, supra (discussing the closing agreement, to which the petitioner was a party); Rev. Rul. 72-238, 1972-1 C.B. 65; Rev. Rul. 73-558, 1973-2 C.B. 298; Rev. Rul. 80-56, 1980-1 C.B. 154; and Rev. Rul. 80-57, 1980-1 C.B. 157.

B. Tax Policy Considerations

The Preamble further argues that the current interpretation of Section 1221(a)(4) is "unsound as a matter of tax policy." Apparently, this statement is based on the supposed lack of a character mismatch in the case of a loan for money as opposed to a receivable for nonfinancial goods or services. The example in the legislative history and the example in Reg. §1.1221-1(d) could be construed as dealing with the character mismatch where the provider of nonfinancial goods or services accrues ordinary income at the time that the receivable is earned but then sells the receivable at less than the face amount. The loss on sale is clearly ordinary under Section 1221(a)(4) as currently interpreted and as it would be modified by the proposed regulation.

However, in the case of mortgage loans, there is a potential for character mismatch even if it is not as easy to see as in the above examples. Judith Dunn, in her November 3, 2006 letter on behalf of Fannie Mae commenting on the proposed regulation, notes that mortgage loans are typically subject to prepayment without penalty at the option of the borrower. The borrower's prepayment right substantially limits the potential for gain in a mortgage note when interest rates fall. On the other hand, the mortgage notes will lose value when interest rates rise. A business that holds mortgage notes demands an additional return in the form of a higher rate of interest in exchange for the risk of economic losses in a rising interest rate environment. Losses realized on mortgage notes in rising interest rate environments should be ordinary in character in order to match against the additional interest received on mortgage notes in other times that economically offsets the risk of loss. MBA concurs with the statements of Ms. Dunn as to the economic effect on a business like Fannie Mae, and further notes that any mortgage banker is subject to the same risks except with respect to any loans that are originated or acquired subject to a forward commitment by Fannie Mae or some similar buyer to purchase (and then only to the extent of the interest that the buyer is obligated to purchase). Thus, mortgage loans that are not sold immediately pursuant to specific commitments and mortgage loans that are held in portfolio share similar economic risks requiring additional compensation through a higher yield that would be taxed as ordinary income.

Finally, the Preamble states that the standards established in Burbank Liquidating and Fannie Mae impede effective administration of the tax laws by causing the status of notes to hinge on judgments as to whether a lending transaction or a subsequent secondary market purchase of

the notes provides a service to the borrower or the mortgage lending industry. Reliance on such judgments allegedly fosters uncertainty and disputes.

In point of fact, however, the most important factual distinction is likely to be whether the taxpayer is conducting any trade or business at all. Thus, in the only reported case involving Section 1221(a)(4), Bielfeldt v. Commissioner, 76 TCM 776, aff'd 231 F.3d 1035 (7th Cir. 2000), cert. denied, 534 U.S. 813 (2001), the Seventh Circuit spent most of the opinion disposing of the taxpayer's primary contention that he was a dealer in Treasury securities and thus the Treasury securities were held for sale to customers in the ordinary course of business under Section 1221(1) of the Code. After disposing of that contention, the Seventh Circuit dismissed the alternate contention under Section 1221(4) as "frivolous." In connection with its analysis of Section 1221(1), the Seventh Circuit noted:

> The standard distinction between a dealer and a trader is that the dealer's income is based on the service he provides in the chain of distribution of the goods he buys and resells, rather than on fluctuations in the market value of those goods, while the trader's income is based not on any service he provides, but rather on, precisely, fluctuations in the value of the securities or other assets that he transacts in.

Consequently, the issue of whether a "service" is involved in a loan transaction is at heart a determination of whether the taxpayer is engaged in the trade or business of lending or marketing loans. Taxpayers and the IRS already must make this determination under many other Code sections, most notably, Section 162 and Section 1221(a)(1). With respect to most taxpayers, including all typical mortgage lenders, this is a simple and easy determination and will not foster uncertainty or disputes.

On the other hand, the proposed regulation will foster disputes and uncertainty. The proposed regulation is an attempt of doubtful validity to overturn longstanding judicial precedents. There will clearly be uncertainty unless and until the IRS prevails in court that the proposed regulation is valid. At the very least, doubt will remain until the Tax Court has rendered a reviewed decision accepting a regulatory reversal of Fannie Mae, and even then doubt may linger. Moreover, even if the IRS does prevail, uncertainty as to the scope of the regulation may continue thereafter until the impact of the new regulation on mortgage notes (and interests therein) held for sale to customers in the ordinary course of business is clarified. Currently, a mortgage lender originating or acquiring mortgages in the ordinary course of business will classify its mortgage loans as ordinary assets under Section 1221(a)(1) or (4). Once it is determined that the mortgage lender is engaged in a business, none of the loans that it originates or acquires should be capital assets and all should be ordinary assets under one subsection or the other. This simple "all or nothing" result facilitates tax compliance and administration. Reinterpreting Section 1221(a)(4) pursuant to the proposed regulation raises the possibility that some of the mortgage loans (or interests therein) may be capital assets even though the vast majority of mortgage loans originated or acquired by a typical mortgage lender will clearly still be ordinary assets under Section 1221(a)(1). Tax compliance and administration will surely become more complicated as a result.

IV. MBA Recommendations

MBA is concerned that the proposed regulation could raise, rather than settle, disputes about the proper tax characterization of mortgage loans and retained interests in the loans (namely,

excess servicing fees). Consequently, MBA strongly recommends that the Treasury Department and the IRS withdraw the proposed regulation.

If, however, a decision is made to proceed with the proposed regulation, MBA recommends that any final regulation clearly state that the new interpretation of Section 1221(a)(4) does not affect the scope of Section 1221(a)(1) and that mortgage loans in the hands of mortgage bankers and coupons deemed to be stripped from these loans will remain ordinary assets when originated or acquired for sale to customers in the ordinary course of business or when stripped from such loans. If finalized in its present form, Prop. Reg. §1.1221-1(e) might be misinterpreted by some IRS Revenue Officers as establishing a general Treasury or IRS policy that mortgage loans are not ordinary assets of any sort, including inventory described in Section 1221(a)(1).

Such an interpretation would clearly be erroneous as to the vast majority of mortgage loans in the hands of a typical mortgage company. In order to forestall confusion, it would only be prudent to include a statement with any newly adopted regulations that no adverse inference is created by the regulation with respect to the qualification of mortgage loans as inventory or property held for primarily for sale to customers in the ordinary course of a trade or business under Section 1221(a)(1). Such a statement would reduce (but in the opinion of MBA not eliminate) the disputes that are likely to arise if the proposed regulation is adopted.

MBA appreciates the opportunity to share our members' comments at this date. Any questions about the comments or recommendations in this letter should be directed to Alison Utermohlen, Senior Director of Government Affairs, at 202/557-2864 or autermohlen@mortgagebankers.org.

Most sincerely,

Jonathan L. Kempner
President and Chief Executive Officer

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