

Client Alert

August 2012

IRS Issues Ruling on Excess Servicing Spreads

The IRS recently issued a [private letter ruling](#) (the “PLR”) concluding that the excess servicing spread portion of a mortgage servicing right (an “Excess IO”) is a qualifying asset for the REIT 75 percent asset test and produces qualifying income for the REIT 75 percent income test. The PLR is the first published guidance issued by the IRS concerning its position on the proper treatment of Excess IOs for REIT qualification purposes.

The PLR contains a number of important points:

- Consistent with prior IRS guidance, the PLR holds 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 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 REIT purposes.
- Excess IOs can have priority over, be pari passu with or be subordinate to the servicer’s right to the compensatory portion of the mortgage servicing fee.
- Consistent with earlier IRS guidance, the PLR concludes that the remote possibility that termination of the servicer could also terminate the REIT’s right to receive the Excess IO does not adversely affect its treatment as an ownership interest in the interest payments on the underlying mortgages.
- The following facts appear critical to the PLR’s determination that no portion of the Excess IOs consists of fee or compensation income: (i) the Excess IO documents require the servicer to perform all mortgage servicing activities and to retain all obligations with respect to the underlying mortgages; (ii) the REIT will not, and will not be permitted to, perform any services or undertake any obligations in connection with acquiring or maintaining its interest in the Excess IOs; and (iii) the REIT will have no right to control the manner in which the servicer performs its servicing duties. The PLR did not address whether a taxable REIT subsidiary (“TRS”) of the REIT could perform servicing activities or derive income from the servicer, but there is no reason to believe that a TRS is prohibited from conducting such activities.
- The PLR explicitly reserved on whether the REIT properly determined what portion of the underlying mortgage servicing fees constituted Excess IOs (as opposed to reasonable servicing compensation).

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 PLR or its analysis or conclusions, please contact any of the attorneys listed on this alert.

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