

Section 1001.—Determination of amount of and recognition of gain or loss

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(Also §§ 1.1001-1; 1.1001-3)

Rev. Rul. 2018-24

ISSUE

Does the Conversion (as defined below) constitute a taxable exchange of property for purposes of section 1001 of the Internal Revenue Code?

FACTS

Participation Certificates

The Federal Home Loan Mortgage Corporation (Freddie Mac) acquires mortgages and participation interests in residential mortgage loans (Mortgages) that were originated by unrelated financial institutions and deposits the Mortgages into a trust in exchange for Participation Certificates (PCs), which are sold to investors. Each PC is a pass-through certificate that is backed by the pool of Mortgages that are held in an arrangement that is classified as a trust under § 301.7701-4(c) of the Procedure and Administration Regulations for the benefit of the person that holds the PC. Freddie Mac acts as trustee, depositor, master servicer, administrator, and guarantor with respect to the PCs. As trustee for these trusts, Freddie Mac creates and issues under a trust

agreement PCs representing undivided beneficial ownership interests in pools of mortgages and related assets held by those trust funds (Mortgage Pools).

Freddie Mac fulfills its duties as master servicer for the Mortgages by contracting with third parties to perform most servicing functions on Freddie Mac's behalf in accordance with standards that Freddie Mac has established. PC holders receive a coupon with respect to the outstanding principal amount of the Mortgages. Payments on the PCs do not include the amounts of any fees, charges, or interest in excess of the applicable certificate coupon that may be paid on the Mortgages.

In its capacity as administrator of the PCs, Freddie Mac generally pays principal and interest to PC holders on a specified date (Payment Date) in the month following the month in which payments on the underlying Mortgage are received. The Payment Date is generally 45 days following the first day of such preceding month. This period from the time Freddie Mac collects payments from the mortgage servicers to the time that it remits payments to holders on the Payment Date is referred to as the Remittance Cycle. As guarantor of the PCs, Freddie Mac guarantees that PC holders receive timely payments of amounts provided for in the terms of the PC whether or not Freddie Mac receives payments from the servicers of the Mortgages.

Mortgage-Backed Securities

The Federal National Mortgage Association (Fannie Mae) issues Mortgage-Backed Securities (MBSs) to the market. The terms and conditions of MBSs are substantially identical to PCs. In particular, the key features and terms of the MBSs largely align with the key features and terms of the PCs. A difference between PCs and MBSs is their respective Remittance Cycle. While the Remittance Cycle for PCs is 45 days, the

Remittance Cycle for MBSs is 55 days, meaning that an MBS holder receives monthly payments 10 days later than a PC holder.

Uniform Mortgage-Backed Securities

Freddie Mac and Fannie Mae are both regulated by the Federal Housing Finance Agency (FHFA). The FHFA proposes to standardize pass-through certificates issued by Freddie Mac and Fannie Mae. Accordingly, the FHFA will require Freddie Mac to cease issuing PCs and Fannie Mae to cease issuing MBSs, and will require both entities to issue Uniform Mortgage-Backed Securities (UMBSs) instead. UMBSs issued by Freddie Mac and Fannie Mae will have the same features and terms, including identical 55-day Remittance Cycles.

Freddie Mac will also permit holders of existing PCs the opportunity to exchange their PC for a UMBS that represents the same proportionate undivided beneficial interest in the pool of Mortgages as their existing PC on a voluntary basis (Conversion). Thus, a PC holder that agrees to the exchange will receive a UMBS that provides for the same coupon rate as the PC coupon rate and is guaranteed to the same extent as the PC they surrender, except that the UMBS will provide for Payment Dates that are determined under a 55-day Remittance Cycle instead of the 45-day Remittance Cycle associated with a PC and a UMBS that is issued in exchange for a PC will be given a new CUSIP number. Freddie Mac will not charge holders of PCs a fee for an exchange made pursuant to the Conversion.

The Make Whole Payment

Because a UMBS provides for a 55-day Remittance Cycle instead of the 45-day Remittance Cycle associated with the corresponding PC, the holder of a UMBS will

receive scheduled payments of principal and interest 10 days later than the holder would receive those payments under the PC. Freddie Mac will make a one-time payment to PC holders that choose to participate in the Conversion (Make Whole Payment). The Make Whole Payment will be calculated based on the present value of 10 additional days of payment delay over the expected term of the relevant PC. At present market rates, the amount of the Make Whole Payment is expected to be between 5 and 15 basis points multiplied by the outstanding principal balance of the PC, though a compensation schedule has not been published and the exact amount of compensation is unknown at this time.

The Inducement Fee

For a limited time when Freddie Mac first makes the Conversion available, Freddie Mac may also offer a holder of a PC a payment intended to induce the holder to participate in the Conversion (Inducement Fee). Any Inducement Fee, should it be offered, would be paid to any PC holder that agrees to participate in the Conversion within a timeframe prescribed by Freddie Mac.

The combined amount of the Make Whole Payment and any Inducement Fee will not be more than 25 basis points multiplied by the outstanding principal balance of the PC.

LAW

Section 1001 provides rules for the computation and recognition of gain or loss from a sale or other disposition of property.

Section 1.1001-1(a) of the Income Tax Regulations generally provides that gain or loss is realized upon an exchange of property for other property differing materially either in kind or in extent. See Cottage Savings Association v. Commissioner, 499 U.S.

554, 566 (1991), 1991-2 CB 34, 38 (“Under [the Court’s] interpretation of section 1001(a), an exchange of property gives rise to a realization event so long as the exchanged properties are ‘materially different’--that is, so long as they embody legally distinct entitlements.”)

Section 1.1002-1(d) provides that, ordinarily, to constitute an exchange, a transaction must be a reciprocal transfer of property, as distinguished from a transfer of property for a money consideration only.

Section 1.1001-3(a)(1) provides rules for determining whether a modification of the terms of a debt instrument results in an exchange for purposes of § 1.1001-1(a). This section applies to any modification of a debt instrument, regardless of the form of the modification. For example, § 1.1001-3 applies to an exchange of a new instrument for an existing debt instrument, or to an amendment of an existing debt instrument. This section also applies to a modification of a debt instrument that the issuer and holder accomplish indirectly through one or more transactions with third parties.

Section 1.1001-3(b) provides that for purposes of § 1.1001-1(a), a significant modification of a debt instrument results in an exchange of the original debt instrument for a modified instrument that differs materially either in kind or in extent; and a modification that is not a significant modification is not an exchange for purposes of § 1.1001-1(a).

Section 1.1001-3(e) describes when a modification is significant.

Section 1.1001-3(e)(1) provides that (unless an exception applies) a modification is a significant modification only if, based on all facts and circumstances, the legal rights or

obligations that are altered and the degree to which they are altered are economically significant.

Under § 1.1001-3(e)(2)(ii), a modification is treated as significant if it changes the yield of a debt instrument by more than the greater of $\frac{1}{4}$ of 1 percent (25 basis points) or 5 percent of the annual yield of the unmodified instrument.

Under § 1.1001-3(e)(3), a modification that changes the timing of payments is a significant modification if it results in a material deferral of scheduled payments. See also § 1.1001-3(g), Example 2 (deferral of payments tested under § 1.1001-3(e)(2) and (e)(3)).

HOLDING

The Conversion will not constitute a taxable exchange of property for purposes of section 1001.

DRAFTING INFORMATION

The principal author of this revenue ruling is Caitlin Holzem of the Office of the Associate Chief Counsel (Financial Institutions and Products). For further information regarding this revenue ruling, please contact Ms. Holzem at (202) 317-6842 (not a toll-free call).