

Important 2009 Tax Information

WIDELY HELD MORTGAGE TRUSTS

You should have received your 2009 WHMT Reporting Statement including 1099-B and 1099-INT details for Widely Held Mortgage Trusts. This special statement includes supplementary information which is required by the Internal Revenue Service.

This letter of explanation will familiarize you with the information provided on the statement.

Background: All securities established as a grantor trust became subject to special tax reporting requirements effective on January 1, 2007; however, many of the changes were delayed until the 2009 tax year. The most significant change is that if you own a mortgage-backed security issued by an entity such as FHLMC ("Freddie Mac"), FNMA ("Fannie Mae") or GNMA ("Ginnie Mae"), you will receive a supplementary statement in March (the mandated postmark date is March 15) that provides additional information you will need to include with your tax return.

General tax reporting impacts: Since these securities are grantor trusts, all expenses and taxes paid by the trust is reportable to you. In addition, the reporting is required based on the trusts receipt date, rather than when you received it.

The result is that the Form 1099-INT income reported to you will generally be greater than what you received because it will be "grossed up" to add back any expenses and taxes that were deducted by the trust. In addition, it will include payments made in the current year must be "pulled back" for reporting in the prior year.

In addition, in addition to your sale of trust units your Form 1099-B will reflect all return of principal payments or proceeds if part of the trust assets were sold to pay expenses (as explained below) or some of the assets in the trust portfolio matured or were redeemed.

Therefore, the amounts reported on a Form 1099 will not match your monthly statement totals.

You should carefully review your Form 1099 and supplementary tax information statements with your tax advisor because many of the expense items cannot be reported on a Form 1099, and have multiple impacts to consider when completing your tax return. Please note that some older trusts that were created before the effective date of this new regulation are not subject to these reporting requirements. Also, they can structure their distributions in a way to avoid some of these reporting rules. So, all WHFITs are not subject to the same reporting requirements at this time.

The major impact of this reporting is that the "WHMT Statement" that has a March 15 postmark due date will include additional information you will need to complete your tax return. As noted above, if the issuer provided expense factors, we are required to "gross up" the net cash distribution you received to include the expenses deducted by the trustee prior to the distribution.

In addition, payments made in the current year which were received by the trustee in the prior year must be included on the prior year's tax form. In most cases, this will include payments made through February

15, which is a primary reason for the March 15 postmark date for the WHMT Statement. That is why you will see payments with a record or trade date in late 2009 being included with your 2010 tax information.

Special first year reporting note: Since this reporting requirement started with Tax Year 2009, payments you received in January and February 2009 which would otherwise have been reportable on your 2008 tax return are included. Starting with Tax Year 2010, the payments you received in January and February 2009 will not be included in your 2010 tax information.

Another reason for the delayed mailing date is the issuer has to calculate and provide us with factors and other information that you need to consider when completing your tax return.

Form 1099-B detail information:

The **principal balance** reflects the principal factor for the period, per \$1000. The **cost of purchase amount** is net any accrued interest.

The **adjusted basis percentage** is the ratio of the period's principal distribution over the principal balance at the start of the period. Your WHMT statement provided a formula you can use to determine your cost basis that would be allocated to the return of principal amount reported on the Form 1099-B.

Form 1099-INT detail information:

As of the record date, **gross interest** reflects any scheduled interest payment, accrued interest (due as of a record date or paid on a purchase) after being increased by any corresponding expense factor. **Net interest** reflects the gross interest less the expense factor(s). The **expense** amount is associated with the payment period or with trade interest and reflects the difference between the net amount paid (assuming it has been distributed) and gross amount reported.

The **market discount factor** reflects the ratio used by the issuer to compute amounts of either market discount or bond premium. For the **remaining market discount or bond premium**, a negative value indicates bond premium and a positive value reflects market discount.

Only total amounts for a particular security are reported to the IRS rather than the detailed information provided per payment period so we can display various factors that were applied. Accrued interest on a purchase is not reported on a Form 1099 or to the IRS because elections can be made by you as to whether or not to offset a future interest payment with this amount, or to capitalize it.

Where to go for more help: If you or your tax advisor has additional questions, please refer to page 4 of the IRS "2009 General Instructions for Forms 1099, 1098, 3921, 3922, 5498, and W-2G" found at www.irs.gov.

In addition, the following revenue rulings might be beneficial in your discussions with your tax advisor as to whether or not to report expenses, market discount or bond premium on your tax return:

Revenue Ruling 84-10
January 1984

SUBJECT MATTER: Section 671.-Trust Income, Deductions, and Credits Attributable to Grantors and Others as Substantial Owners

APPLICABLE SECTIONS:

26 CFR 1.671-1: Grantors and others treated as substantial Owners (Also Sections 61, 162, 171, 212, 593, 856, 1232, 1232A, 7701; 1.61-1, 1.162-1, 1.171-1, 1.212-1, 1.593-11, 1.856-2, 1.1232-1, 301.7701-4, 301.7701-13A.)

TEXT:

Mortgage-backed certificates; residential mortgage "pool". Tax consequences associated with "straight pass-through" mortgage-backed certificates, representing undivided interests in a "pool" of residential mortgage loans created by the Federal National Mortgage Association and sold to investors are explained. *Rev. Ruls. 70-544 and 70-545* clarified.

ISSUE

What are the federal income tax consequences associated with the mortgage pool trusts described below?

FACTS

The Federal National Mortgage Association (*FNMA*) is a publicly held corporation established to provide assistance to the secondary market for home mortgage loans. *FNMA* has initiated a guaranteed mortgage pass-through securities program under Federal National Mortgage Association Charter Act §304 (d), *12 U.S.C.A. §1719 (d) (West 1980)*. Pursuant to a trust agreement, *FNMA* creates home mortgage pools and serves as trustee of each pool. Each pool consists of residential mortgages transferred to it by a single mortgage lender, *X*, in exchange for trust certificates. The trust certificates generally will be sold by *X* to investors. *FNMA* charges *X* a processing fee when it pools mortgages acquired from *X*.

In the capacity of pool trustee, *FNMA* collects principal and interest payments on each mortgage and makes monthly distributions to the certificate holders. *FNMA* receives a fee for its services as trustee consisting of a monthly service charge retained from the interest collected on the mortgages and other compensation including all late payment charges, assumption fees and prepayment penalties collected by *FNMA*. Pool proceeds are held in noninterest bearing accounts and cannot be reinvested. Neither the trustee nor *X* has the power to substitute a new mortgage for an original mortgage in the pool, except that within 120 days of the date the pool is established *FNMA* may require *X* to replace defective mortgages in the pool. Each of the pools will terminate when all mortgages are liquidated and all proceeds are distributed. *FNMA* may terminate a pool by purchasing all trust certificates with respect to the pool when the aggregate outstanding principal amount of mortgages in the pool is 10 percent or less of the initial pool principal balance.

FNMA guarantees that the certificate holders will receive timely payment of interest and collection of principal. If a mortgage is in default or if there is a foreclosure on mortgaged property, *FNMA* has the right to withdraw the mortgage from the pool and deem the mortgage prepaid.

The trust certificates, which are in registered form, state that they represent fractional undivided interests in the mortgage loans, pool proceeds, mortgaged property acquired by foreclosure that has not been withdrawn from the pool, and *FNMA*'s obligation to supplement the pool proceeds to the extent necessary to make distributions.

LAW

The Service has discussed the federal income tax consequences of similar pooling arrangements in *Rev. Rul. 71-399, 1971-2 C.B. 433*, amplified by *Rev. Rul. 81-203, 1981-2 C.B. 137*, *Rev. Rul. 80-96, 1980-1 C.B. 317*, *Rev. Rul. 74-300, 1974-1 C.B. 169*, *Rev. Rul. 74-221, 1974-1 C.B. 365*, and *Rev. Rul. 72-376, 1972-2 C.B. 647* (concerning mortgage pools established by the Federal Home Loan Mortgage Corporation); *Rev. Rul. 70-544, 1970-2 C.B. 6*, and *Rev. Rul. 70-545, 1970-2 C.B. 7*, both modified by *Rev. Rul. 74-169, 1974-1 C.B. 147* (concerning mortgage pools guaranteed by the Government National Mortgage Association); and *Rev. Rul. 77-349, 1977-2 C.B. 20* (concerning a mortgage pool created by a commercial bank).

HOLDINGS

(1) Each pool will not be considered an association taxable as a corporation, but is classified as a trust of which the certificate holders are the owners under Subpart E of Subchapter J of the Internal Revenue Code.

(2) *FNMA* is the trustee of each trust and will be required to file Form 1041. See section 1.671-4 of the Income Tax Regulations.

(3) *FNMA* will recognize ordinary income in the amount of the processing fees charged *X* for pooling mortgages.

(4) Each certificate holder is treated as the owner of an undivided interest in the entire trust (corpus as well as ordinary income). See section 1.671-3 (a) (1) of the regulations.

(5) The sale of a trust certificate transfers to the certificate holder a proportionate share of equitable ownership in each of the mortgages in the pool.

(6) *X* will recognize ordinary income or loss on the sale of its interest in each of the mortgages in the pool (evidenced by the trust certificates) measured by the difference between the proportionate amount of the proceeds realized with respect to the sale of each of the mortgages and its adjusted basis in each of such mortgages.

(7) Certificate holders shall take into account their proportionate share of the mortgage interest and other items of income, including prepayment penalties, assumption fees, and late payment charges, consistent with their methods of accounting.

(8) The certificate holders must also report their proportionate share of the discount income realized on the purchase of each of the mortgages as ordinary income, consistent with their methods of accounting. The special rules of *section 1232 of the Code* will be applicable to the certificate holders' proportionate shares of the discount on any mortgages in the pool that are obligations of corporations, or of governments or their political subdivisions, if and to the extent that the other conditions for the application of that section are met. Similarly, the rules of *section 1232A (a) (1)* will apply to the certificate holders' proportionate shares of obligations in the pool that are not obligations described in *section 1232A (a) (2) (A) of the Code* (relating to any obligation issued by a natural person).

(9) Certificate holders may amortize their proportionate shares of any premium paid to acquire mortgages to the extent allowed by *section 171 of the Code*. The provisions of *section 171* will be applicable to the premium on mortgages in the pool that are issued by a corporation as described in *section 171 (d) of the Code*.

(10) Certificate holders may deduct their proportionate share of *FNMA's* fee for servicing the mortgages comprised of the monthly service charge late payment charges, assumption fees, and prepayment penalties under *section 162* or *section 212 of the Code*, consistent with their method of accounting.

(11) A certificate owned by a real estate investment trust is considered as representing "real estate assets" within the meaning of *section 856 (c) (5) (A) of the Code*, and the interest income is considered "interest on obligations secured by mortgages on real property" within the meaning of *section 856 (c) (3) (B)*.

(12) A certificate owned by a domestic building and loan association is considered as representing "loans secured by an interest in real property" within the meaning of *section 7701 (a) (19) (C) (v) of the Code*, provided the real property is (or from the proceeds of the loan will become) the type of real property described in that section of the Code.

(13) A certificate owned by a domestic building and loan association, within the meaning of *section 7701 (a) (19) of the Code*, is considered as representing "qualifying real property loans" within the meaning of *section 593 (d)* provided the real property underlying the mortgages is (or, from the proceeds of the loan, will become) the type of real property described in that section.

EFFECT ON OTHER REVENUE RULINGS

Rev. Rul. 70-544, 1970-2 C.B. 6, and Rev. Rul. 70-545, 1970-2 C.B. 7, are clarified with respect to the reporting of service fees, assumption fees, prepayment penalties and late charges by the certificate holders.

Revenue Ruling 70-544
July 1970

SUBJECT MATTER: Section 61.-Gross Income Defined

APPLICABLE SECTIONS:

26 CFR 1.61-1: Gross income. (Also Sections 162, 212, 501, 671, 856, 1232, 7701; 1.162-1, 1.212-1, 1.501 (a)-1, 1.671-1, 1.856-2, 1.1232-1, 301.7701-2, 301.7701-13.)

TEXT:

Tax consequences of transactions in "straight pass-through" certificates guaranteed by the Government National Mortgage Association that represent a proportionate interest in mortgages maintained in a "pool" by a savings and loan association.

Advice has been requested as to certain of the Federal income tax consequences associated with "straight pass-through" mortgage-backed certificates to various parties under the facts and circumstances set forth below.

N, a savings and loan association engaged in the financing of residential mortgages, established a "pool" of mortgages, all of which are insured by the Federal Housing Administration, the Farmers Home Administration, or are insured or guaranteed by the Veterans Administration.

Some of the mortgages were originated by *N* and some were acquired by it. The amount of the "pool" was for \$2 million, which represented the unpaid balances on the mortgages. The average cost of the mortgages in the "pool" was 94 percent of par or \$1,880,000 for the entire "pool". All of the mortgages in the "pool" bear interest at the rate of 8 1/2 percent per annum and were issued during the month prior to the establishment of the "pool". Once the "pool" is established no additional mortgages may be added to the "pool".

N after application to the Government National Mortgage Association (GNMA), received a commitment from GNMA to guarantee an issue of "straight pass-through" mortgage-backed certificates (certificates). The certificates represent a proportionate interest in each of the mortgages in

the above described "pool". After obtaining the GNMA commitment *N*, pursuant to a separate agreement, delivered the mortgages to a custodian (a commercial bank). The custodian's sole function is to hold the mortgages and it has no power of reinvestment.

In addition neither *N* nor GNMA will ever have the power to reinvest any of the proceeds attributable to the mortgages in the "pool". Within four months after GNMA issues its guarantee, GNMA may require *N* to replace defective mortgages included in the "pool". Thereafter, no substitution of mortgages may be required by GNMA. At no time will *N* have the power to substitute mortgages for the initial mortgages in the "pool" on its own initiative.

After the custodian verified to GNMA that it had the mortgages in its custody, *N* arranged for the sale of the entire issue of mortgage-backed certificates to various investors for 94.75 percent of par or a total of \$1,895,000.

The certificate holders included other savings and loan associations, real estate investment trusts, individuals, and exempt employees' pension and profit-sharing trusts. The certificates called for payments by *N* to the certificate holders of specified monthly installments. These installments were based on the amortization schedules of each of the mortgages in the "pool". If a default or late payment on any mortgage occurs, *N* may advance funds to keep up the payments to the certificate holders until the deficiency is corrected by the mortgagor or foreclosure occurs. In addition, the certificates provide for payment of each of the certificate holders of its proportionate share of prepayments or other early recoveries of principal including foreclosure proceeds. An amount equal to 1/24 of one percent of the outstanding principal amount on the mortgages is withheld by *N* each month, which amount is used by *N* to discharge the certificate holders' obligations to pay *N*'s servicing fee, the custodian's fee, and the GNMA guarantee fee.

When *N* notified GNMA of the sales agreement, GNMA prepared the certificates in the total amount of \$2 million. GNMA guaranteed to the certificate holders only the proper performance of the mortgage servicing by *N*, with the certificate holders entitled only to interest and principal actually

collected or collectable through due diligence. The sale of the certificates was consummated by delivery of the certificates to the certificate holders. The certificates were issued in minimum denominations of \$50,000. The GNMA regulations provide, in part, that the certificates are transferable, but the share of the proceeds collected on account of the "pool" of mortgages may not be payable to more than one holder with respect to any certificate.

When all the mortgages in the "pool" are paid, and the final payments on the certificates are made to the certificate holders, the "pool" will be terminated.

Based solely on the foregoing facts certain of the Federal income tax consequences are as follows:

- (1) The "pool" will not be considered an association taxable as a corporation, but is classified as a trust of which the certificate holders are the owners under Subpart E of Subchapter J of the Internal Revenue Code of 1954.
- (2) *N* is a fiduciary and will be required to file Form 1041. See *section 1.671-4 of the Income Tax Regulations*.
- (3) Each certificate holder is treated as the owner of an undivided interest in the entire trust (corpus as well as ordinary income). See *section 1.671-3 (a) (1) of the regulations*.
- (4) The sale of the mortgage-backed certificates transfers to the certificate holders the equitable ownership in each of the mortgages in the "pool". Thereafter, *N* has only a contractual right to service the mortgages for a specified fee.
- (5) *N* will recognize ordinary income or loss upon the sale of its interest in each of the mortgages in the "pool" measured by the differences between the proportionate amount of the proceeds realized with respect to the sale of each of the mortgages and its adjusted basis in each of such mortgages.
- (6) The certificate holders must report their ratable share of the entire interest income on each of the mortgages as ordinary income consistent with their method of accounting and may deduct the servicing, custodian, and guarantee fees under *section 162 or section 212 of the Code*.
- (7) The certificate holders must also report their ratable share of the discount income realized on the purchase of each of the mortgages as ordinary income, consistent with their methods of accounting. The special rules of *section 1232 of the Code* will be applicable to the certificate holders' proportionate shares of the discount on any mortgages in the "pool" which are obligations of corporations, or of governments or their political subdivisions if, and to the extent that, the other conditions for the application of that section are met.
- (8) The interest income is considered "interest on obligations secured by mortgages on real property" as that phrase is used in *section 856 (c) (3) (B) of the Code*.
- (9) A real estate investment trust which owns a certificate is considered as owning "real estate assets" as that

phrase is used in *section 856 (c) (5) (A) of the Code*.

- (10) A certificate owned by a savings and loan association is considered as representing "loans secured by an interest in real property" within the meaning of *section 7701 (a) (19) (C) (v) of the Code*, provided the real property is (or from the proceeds of the loan will become) the type of real property described in that section of the Code.
- (11) The exempt status of an employees' pension and profit-sharing trust under *section 501 (a) of the Code* is not adversely affected by the purchase of certificates.

Revenue Ruling 70-545
July 1970

SUBJECT MATTER: Section 61.-Gross Income Defined

APPLICABLE SECTIONS:

26 CFR 1.61-1: Gross income. (Also Sections 162, 212, 501, 671, 856, 7701; 1.162-1, 1.212-1, 1.501 (a)-1, 1.671-1, 1.856-2, 301.7701-2, 301.7701-13.)

TEXT:

Tax consequences of transactions in "fully-modified pass-through" certificates guaranteed by the Government National Mortgage Association that represent a proportionate interest in mortgages maintained in a "pool" by a savings and loan association.

Advice has been requested as to certain of the Federal income tax consequences associated with "fully-modified-pass-through" mortgage-backed certificates to various parties under the facts and circumstances set forth below.

M, a savings and loan association engaged in the financing of residential mortgages, established a "pool" of mortgages which are insured by the Federal Housing Administration, the Farmers Home Administration, or are insured or guaranteed by the Veterans Administration and which were originated by *M* at par.

The amount of the "pool" was \$2 million, which represented the sum of the unpaid balances on the mortgages. Each of the mortgages in the "pool" bears interest at the rate of 8 1/2 percent per annum. Once the "pool" is established no additional mortgages may be added to the "pool".

M, after application to the Government National Mortgage Association (GNMA), received a commitment from GNMA to guarantee an issue of "fully-modified pass-through" mortgage-backed certificates (certificates). Each of the certificates represents a proportionate interest in each of the mortgages in the above described "pool" of mortgages. After obtaining the GNMA, commitment, pursuant to a separate agreement, *M* delivered the mortgages to a custodian (a commercial bank). The custodian's sole function is to hold the mortgages and it has no power of reinvestment.

In addition neither *M* nor GNMA will ever have the power to reinvest any of the proceeds attributable to the mortgages in the "pool". Within four months after GNMA issues its guarantee, GNMA may require *M* to replace defective mortgages included in the "pool". Thereafter, no substitution of mortgages may be required by GNMA. At no time will *M* have the power to substitute mortgages for the initial mortgages in the "pool" on its own initiative.

After the custodian verified to GNMA that it had the mortgages in its custody, *M* arranged for the sale of the entire issue of certificates to various certificate holders at par or \$2 million.

The certificate holders included savings and loan associations, real estate investment trusts, individuals, and exempt employees' pension and profit-sharing trusts. The certificates called for payment by *M* to the certificate holders of specified monthly installments. These installments were based on the amortization schedules of each of the mortgages in the "pool", but were to be made by *M*

irrespective of whether the mortgagors actually make the payments due on their loans.

In addition, the certificates provided for payment to each of the certificate holders of its proportionate share of prepayments or other early recoveries of principal including foreclosure proceeds. An amount equal to 1/24 of one percent of the outstanding principal amount on the mortgages was to be withheld by *M* each month, which amount is to be used by *M* to discharge the certificate holders' obligations to pay *M*'s servicing fee, the custodian's fee, and the GNMA guarantee fee.

When *M* notified GNMA of the sales agreement, GNMA prepared the certificates in the total amount of \$2 million with the full guarantee of GNMA to the certificate holders as to payment of principal and interest. The sale was consummated by delivery of the certificates to the certificate holders. The certificates were issued in minimum denominations of \$50,000. The GNMA regulations provide, in part, that the certificates are transferable, but the share of the proceeds collected on account of the "pool" of mortgages may not be payable to more than one holder with respect to any certificate. Each certificate contains a statement that the full faith and credit of the United States is pledged to the payment of all amounts required by the certificates. When all the mortgages in the "pool" are paid, and the final payments on the certificates are made to the certificate holders, the "pool" will be terminated.

Based solely on the foregoing facts certain of the Federal income tax consequences are as follows:

- (1) The "pool" will not be considered an association taxable as a corporation, but is classified as a trust of which the certificate holders are the owners under Subpart E of Subchapter J of the Internal Revenue Code of 1954.

- (2) *M* is a fiduciary and will be required to file Form 1041. See *section 1.671-4 of the Income Tax Regulations*.

- (3) Each certificate holder is treated as the owner of an undivided interest in the entire trust (corpus as well as ordinary income). See *section 1.671-3 (a) (1) of the regulations*.

- (4) The sale of the mortgage-backed certificates transfers to the certificate holders the equitable ownership in each of the mortgages in the pool. Thereafter, *M* has only a contractual right to service the mortgages for a specified fee.

- (5) The certificate holders must report their ratable share of the entire interest income on the mortgages, including those amounts advanced by *M*, as ordinary income consistent with their method of accounting and may deduct the servicing, custodian, and guarantee fees under *section 162* or *section 212 of the Code*.

- (6) The interest income is considered "interest on obligations secured by mortgages on real property" as that phrase is used in *section 856 (c) (3) (B) of the Code*.

- (7) A real estate investment trust which owns a certificate is considered as owning "real estate assets" as that phrase is used in *section 856 (c) (5) (A) of the Code*.

- (8) A certificate owned by a savings and loan association is considered as representing "loans secured by an interest in real property" within the

meaning of *section 7701 (a) (19) (C) (v) of the Code*, provided the real property is (or from the proceeds of the loan will become) the type of real property described in that section of the Code.

- (9) The exempt status of an employees' pension and profit-sharing trust under *section 501 (a) of the Code* is not adversely affected by the purchase of certificates.

SUBJECT MATTER: Section 7701.-Definitions

APPLICABLE SECTIONS:

26 CFR 402.1-2: Post 1969 domestic building and loan association. (Also 301.7701-2) (Also *Sections 61, 162, 451, 501, 593, 671, 1232; 1.61-1, 1.162-1, 1.451-1, 1.501 (a)-1, 1.593-11, 1.671-1, 1.1232-1.*)

TEXT:

Tax consequences of the purchase of mortgage participation certificates by the Federal Home Loan Mortgage Corporation and the sale of corresponding certificates to other savings and loan associations and exempt employees' trusts.

Advice has been requested as to certain of the Federal income tax consequences associated with mortgage participations under the facts and circumstances set forth below.

The Federal Home Loan Mortgage Corporation (FHLMC) purchased from *N*, an insured savings and loan association, five mortgage participation certificates. The mortgage participation certificates represent fractional undivided interests aggregating 85 percent in each mortgage contained on a list of mortgages ("List"). All of the mortgages on the List are loans within the meaning of *section 7701 (a) (19) (C) (v) of the Internal Revenue Code of 1954* and are qualifying real property loans as defined in *section 593 (e) of the Code*. The mortgage participation certificates are in denominations of approximately \$100,000 and are purchased by FHLMC at face value.

FHLMC issues a certificate corresponding to each mortgage participation certificate it purchases from *N*, endorses thereon its guarantee of principal and interest payment by the mortgagor, and sells these certificates at face value to other savings and loan associations and exempt employees' pension and profit sharing trusts (certificate holders). The FHLMC guarantee to the certificate holders is a guarantee of timely payment of interest and collection of principal by *N*.

The mortgage participation certificates acquired by FHLMC from *N* and those certificates sold to certificate holders are transferable only upon the books of FHLMC.

FHLMC has the power within two years after it purchases mortgage participation certificates to require *N* to repurchase any mortgage on the List. In lieu of repurchase, *N* may, with FHLMC's consent, substitute other mortgages in substantially similar amounts and of a quality acceptable to FHLMC. FHLMC's replacement power is only applicable with respect to defective mortgages, i.e., mortgages which are not of the quality established for the particular List prior to the date of sale of the mortgage participation certificates by *N* to FHLMC. The two year period provides FHLMC sufficient time to ascertain whether the quality of the mortgages conforms to representations made by *N* at the time the mortgage participation certificates are sold to FHLMC. After the expiration of the two year period, no substitution of mortgage loans may be required by FHLMC. At no time will *N* have the power to substitute mortgage loans for the original mortgage on the List on its own initiative. There will be no change in the criteria applied to a particular List of mortgages after the sale of the mortgage participation certificates to FHLMC.

N is permitted by FHLMC to make "open-end" advances to the mortgagor on any given mortgage up to the original amount of the loan. Such advances will be subordinated to the rights of the certificate holders in the event of default by the mortgagor(s) on the loan or loans with respect to which open-end advances were made. In other words, neither FHLMC nor the certificate holders will have any interest, right, or obligation in the open-end advances or any income earned thereon.

N is required to service the mortgages on the List and pass through to FHLMC payments of principal and interest thereon to the extent necessary to produce the yield specified on each certificate (certificate yield). To the extent that the certificate yield rate exceeds any specific mortgage interest rate, *N* makes up the difference to FHLMC from the interest it (*N*) receives on its 15 percent participation in such mortgage.

The use of a certificate yield computation amounts to a sale of each individual mortgage at a premium or discount depending upon the

relationship of the certificate yield to the mortgage interest rate. For example, if the certificate yield is 71/2 percent, mortgages on the List with an interest rate of exactly 71/2 percent are sold at par. Mortgages on the List with an interest rate of less than 71/2 percent are sold at a discount, and mortgages on the List with an interest rate of more than 71/2 percent are sold at a premium. The amount of the interest payable (at the mortgage interest rate) on any specific mortgage on the List will never be less than the amount of the interest payable (at the certificate yield rate) on the certificate holders' participations in that mortgage.

In the month following the month of receipt by FHLMC from *N*, FHLMC passes through to the certificate holders the principal and interest payments received by FHLMC from *N* after deducting a specified amount therefrom to discharge the certificate holders' obligations to pay FHLMC's guarantee and management fees.

With the exception of any late charges collected by *N*, all receipts of principal and interest, prepayment premiums, net proceeds from the sale of foreclosed properties, income from property management, and any costs incident to protection and preservation of the real property security for the mortgage loans will be shared by each certificate holder in direct proportion to each certificate holders' pro rata interest in the mortgage loans.

Based solely on the foregoing facts, certain of the Federal income tax consequences are as follows:

- (1) The arrangement described does not create an association taxable as a corporation, but constitutes a trust.
- (2) The certificate holders are owners of the trust under Subpart E of Subchapter J of the Code. Each certificate holder is treated as the owner of an undivided interest in the entire trust (corpus as well as ordinary income). See *Section 1.671-3 (a) (1) of the Income Tax Regulations*.

- (3) FHLMC is a fiduciary and will be required to file Form 1041. See *section 1.671-4 of the regulations*.
- (4) *N* will recognize ordinary income or loss upon the sale of the 85 percent undivided interest in each of the mortgages on the List measured by the differences between the proportionate proceeds realized with respect to the sale of the 85 percent undivided interest in each of the mortgages on the List and the appropriate portion of its adjusted basis in those mortgages.
- (5) The sale of certificates by FHLMC to the certificate holders transfers to the certificate holders 85 percent equitable ownership in each of the mortgages on the List.
- (6) Each certificate holder using the cash receipts and disbursements method of accounting shall take into account its pro rata share of the mortgage interest and other items of income as and when they are collected by FHLMC.
- (7) Each certificate holder using an accrual method of accounting shall take into account its pro rata share of the entire interest on each mortgage and other items of income as they become due to FHLMC.
- (8) The special rules of *section 1232 of the Code* will be applicable to the certificate holders' proportionate shares of any mortgages which are obligations of corporations, or of governments or their political

subdivisions if, and to the extent that, the other conditions for the application of the section are met. With respect to any interest in a mortgage purchased at a discount, and not subject to *section 1232*, the excess of the ratable portion of the certificate yield over the ratable portion of the entire interest income on the mortgages constitutes ordinary income to the certificate holders.

of the Code and its exemption under *section 501 (a)* will not be adversely affected by the purchase of certificates, provided that the purchase meets the applicable investment requisites set forth in *Revenue Ruling 69-494, C.B. 1969-2, 88*.

- (9) With respect to any undivided interest in a mortgage purchased at a premium, the certificate holder may be entitled to a deduction for amortization in accordance with applicable rules.

- (10) The certificate holders may deduct FHLMC's guarantee and management fees under *section 162 of the Code* consistent with their method of accounting.

- (11) A certificate held by a savings and loan association (certificate holder) is considered as representing "loans secured by an interest in real property" within the meaning of *section 7701 (a) (19) (C) (v) of the Code*.

- (12) A certificate held by a domestic building and loan association (certificate holder) within the meaning of *section 7701 (a) (19) of the Code* is considered as representing "qualifying real property loans" within the meaning of *section 593 (e) of the Code*.

- (13) The qualification of an employees' pension or profit-sharing trust (certificate holder) under *section 401*