Federal National Mortgage Association v. Commissioner, 90 T. C. 405 (1988)

Tax losses can be recognized from exchanges of mortgage loans if the exchanged properties materially differ, but not from repayments of mortgages followed by the purchase of new mortgages.

Summary

Federal National Mortgage Association (FNMA) engaged in two types of transactions: Concurrent Mortgage Sales (CMS) and a Resale/Refinance program. In CMS transactions, FNMA exchanged mortgage loan interests with other institutions and claimed tax losses. The Tax Court held that FNMA could recognize these losses because the exchanged mortgages materially differed in obligors and collateral. Conversely, in the Resale/Refinance program, where FNMA's old mortgages were repaid and new ones purchased, the court ruled that these were not taxable exchanges, and FNMA had to recognize gains when the original mortgage bases were less than the repayment amounts.

Facts

From 1980 to 1982, FNMA faced financial difficulties due to its holdings of long-term, fixed-rate mortgage loans amidst rising interest rates. To address this, FNMA engaged in CMS transactions, exchanging 90% undivided interests in mortgage loan pools with other financial institutions, recognizing tax losses. Additionally, FNMA implemented a Resale/Refinance program, where old mortgages were paid off and replaced with new, higher-rate mortgages. FNMA claimed these as taxable exchanges on amended tax returns, seeking to recognize losses.

Procedural History

The IRS disallowed FNMA's claimed losses from both CMS and Resale/Refinance transactions. FNMA paid the assessed deficiencies and filed amended returns. The case was brought before the U. S. Tax Court, where FNMA sought to have the losses recognized and to establish overpayments for certain years.

Issue(s)

1. Whether FNMA realized recognizable losses in 1980 and 1981 when it exchanged interests in pools of mortgage loans?
2. Whether FNMA realized recognizable gains or losses in 1981 and 1982 when it received payment on old mortgage loans and purchased new mortgage loans under its Resale/Refinance program?

Holding

1. Yes, because the mortgages exchanged differed materially in terms of obligors and collateral, thus constituting a taxable exchange under IRC § 1001.

2. No, because the old mortgages were repaid and new mortgages purchased, not exchanged, resulting in taxable gains when the bases in the original mortgages were less than the amounts repaid.

Court's Reasoning

The court determined that for CMS transactions, the mortgages exchanged were materially different, citing different obligors and collateral, as supported by the differing economic performance post-exchange. The court rejected the IRS's argument that the mass asset rule should apply, as the individual mortgages were separately valued. The court also dismissed the application of IRC § 1091, which disallows loss deductions for substantially identical securities, finding the exchanged mortgages substantially different. For the Resale/Refinance program, the court found that the old mortgages were fully repaid and new ones purchased, not exchanged. The court emphasized the material differences between the old and new mortgages, including interest rates, terms, and obligors, and held that the original mortgages were properly characterized as repaid, triggering taxable gains when the repayment amounts exceeded the bases in the original loans.

Practical Implications

This case illustrates the importance of material differences in determining whether an exchange of property results in a taxable event. For mortgage-backed securities or similar financial instruments, differences in obligors and collateral can be significant in recognizing tax losses. However, the ruling on the Resale/Refinance program highlights that merely repaying and replacing mortgages does not constitute a taxable exchange, impacting how similar transactions should be structured for tax purposes. This decision affects how financial institutions manage their portfolios and structure transactions to minimize tax liabilities while complying with tax laws. Subsequent cases, such as *Comdisco, Inc. v. United States*, have referenced this ruling in discussions of the substance-over-form doctrine and taxpayer consistency in tax reporting.

