Fed. Home Loan Mortg. Corp. v. Commissioner, 125 T. C. 248 (U. S. Tax Ct. 2005)

The U. S. Tax Court held that the Federal Home Loan Mortgage Corporation (Freddie Mac) correctly treated nonrefundable commitment fees as option premiums in its prior approval mortgage purchase program. The decision clarified that such fees should not be immediately recognized as income but deferred until the underlying mortgages are either delivered or the options lapse. This ruling underscores the distinction between option premiums and immediate income, impacting how similar financial arrangements are taxed.

Parties

The petitioner, Federal Home Loan Mortgage Corporation (Freddie Mac), sought a review of tax deficiencies determined by the respondent, the Commissioner of Internal Revenue, for the taxable years 1985 through 1990. The case originated in the U. S. Tax Court, docket numbers 3941-99 and 15626-99.

Facts

Freddie Mac, established by Congress to purchase residential mortgages and develop the secondary mortgage market, offered mortgage originators two programs for selling multifamily mortgages: the immediate delivery purchase program and the prior approval conventional multifamily mortgage purchase program. Under the prior approval program, originators paid a 2% commitment fee, with 0. 5% nonrefundable and 1. 5% refundable upon delivery of the mortgage. The program allowed originators to optionally deliver the mortgage within 60 days, and Freddie Mac treated the nonrefundable portion of the fee as an option premium, deferring recognition of this amount until the mortgage was delivered or the option lapsed.

Procedural History

The Commissioner issued notices of deficiency for Freddie Mac’s tax years 1985 through 1990, asserting that the nonrefundable portion of the commitment fees should have been recognized as income in the year received. Freddie Mac challenged these deficiencies in the U. S. Tax Court. The case was fully stipulated under Tax Court Rule 122. The court had previously decided other issues in the case in 2003 (121 T. C. 129, 121 T. C. 254, 121 T. C. 279, T. C. Memo 2003-298), but the commitment fee issue remained unresolved until the instant decision. The standard of review applied was de novo.

Issue(s)

Whether the nonrefundable portion of the commitment fees received by Freddie Mac under its prior approval mortgage purchase contracts should be treated as option premiums and deferred until the underlying mortgage is delivered or the

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option lapses, rather than being immediately recognized as income?

Rule(s) of Law

The Internal Revenue Code under section 451 generally requires accrual method taxpayers to recognize income when all events have occurred which fix the right to receive such income and the amount can be determined with reasonable accuracy. However, payments for option premiums are treated as open transactions until the option is exercised or lapses, as articulated in Kitchin v. Commissioner, <span normalizedcite="353 F. 2d 13“>353 F. 2d 13, 15 (4th Cir. 1965), Rev. Rul. 58-234, <span normalizedcite="1958-1 C. B. 279“>1958-1 C. B. 279, and Rev. Rul. 58-234.

Holding

The U. S. Tax Court held that the prior approval purchase contracts were in substance and form put options, and Freddie Mac properly treated the nonrefundable portion of the commitment fees as option premiums, to be deferred until the underlying mortgage was delivered or the option lapsed.

Reasoning

The court analyzed the formal requirements and economic substance of the prior approval purchase contracts to determine that they constituted option agreements. The contracts granted originators the right, but not the obligation, to sell mortgages to Freddie Mac within a specified period, fulfilling the first element of an option as a continuing offer that does not ripen into a contract until accepted. The second element was satisfied by the 60-day period during which the offer was left open. The court noted the economic substance of the transaction, where the nonrefundable portion of the fee served as consideration for granting the option, and the uncertainty regarding whether the mortgage would be delivered or the option would lapse justified treating the fees as option premiums. The court distinguished the case from Chesapeake Fin. Corp. v. Commissioner, <span normalizedcite="78 T. C. 869“>78 T. C. 869 (1982), noting that the commitment fees in that case were for services rendered, not options. The court also addressed the Commissioner’s argument that the fixed right to the nonrefundable fee should trigger immediate income recognition, but held that the uncertainty as to whether the fee would represent income or a return of capital upon delivery or lapse of the option justified the open transaction treatment.

Disposition

The U. S. Tax Court issued an order reflecting that Freddie Mac properly treated the nonrefundable portion of the commitment fees as option premiums, and the Commissioner’s determination of deficiencies related to this issue was incorrect.

Significance/Impact

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This decision provides important guidance on the tax treatment of option premiums in the context of financial arrangements similar to Freddie Mac's prior approval mortgage purchase program. It affirms that such nonrefundable fees should not be immediately recognized as income but should be deferred until the underlying transaction is completed or the option expires. The ruling has implications for the structuring of similar financial instruments and the timing of income recognition for tax purposes. It also highlights the distinction between fees for services and option premiums, which may affect how other entities structure their financial arrangements to achieve favorable tax treatment.

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