



DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

OFFICE OF
CHIEF COUNSEL

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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR DISTRICT COUNSEL,

FROM: DEBORAH A. BUTLER
Assistant Chief Counsel (Field Service) CC:DOM:FS

SUBJECT: Unpaid loss reserves on mortgage guaranty insurance

This Field Service Advice responds to your memorandum dated November 10, 1999. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be cited as precedent.

LEGEND

Taxpayer =
X =
Year 1 =

ISSUE

Whether Taxpayer's subsidiary, X, a mortgage guaranty insurer, may increase its unpaid loss reserve upon notification by the insured lender that the loan is in default, or whether it is precluded from increasing its reserve until foreclosure proceedings have been completed.

CONCLUSION

X may increase its unpaid loss reserve when the insured lender notifies X of the borrower's default.

FACTS

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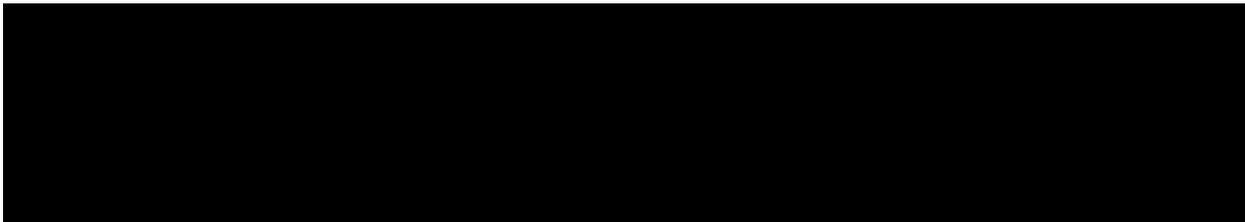
This issue is presently before Appeals for Year 1. Taxpayer's wholly-owned subsidiary, X, is a private mortgage guaranty insurance company. X issued policies to mortgage lenders which insured the lenders against the risk of a borrower's default in payments on its loan. Pursuant to these policies, X became liable to a lender upon the borrower's default on the underlying loan.

For purposes of the deduction for losses incurred provided in I.R.C. § 832(b), X increased its reserve for unpaid losses with respect to each mortgage guaranty insurance policy when it was notified that the borrower had defaulted on its obligation to the insured lender. The revenue agent in this case concluded that a mortgage guaranty insurer is generally entitled to increase its unpaid loss reserve when its liability under the policy has been fixed by the conveyance of title to the insured lender, and not when the insurer has been notified of the borrower's default. On the other hand, Taxpayer contends that X is entitled to calculate its unpaid losses by reference to borrowers' default dates. In so doing, Taxpayer argues that the facts in this case are nearly identical to the facts in Sears, Roebuck and Co. v. Commissioner, 972 F.2d 858 (7th Cir. 1992), rev'g. on this issue 96 T.C. 61 (1991) and American Int'l Group, Inc. v. United States, 38 Fed. Cl. 274 (1997) ("AIG"), where the taxpayers prevailed on this issue.

LAW AND ANALYSIS

This issue has been addressed by the United States Court of Appeals for the Seventh Circuit in Sears, and by the United States Court of Federal Claims in AIG. In both cases, the courts held that mortgage guaranty insurers were entitled to calculate unpaid loss reserves with reference to the date on which they were notified by the lender that the borrower had defaulted. Both courts reasoned that the method employed by the insurers was appropriate because their liability under the policies was triggered by a borrower's default. Sears, 972 F.2d at 867-68; AIG, 38 Fed. Cl. at 280. In similar fashion to the mortgage guaranty insurers in Sears and AIG, X in the present case calculated unpaid losses by reference to the default of the borrower and not by reference to conveyance of title of the underlying property to the lender pursuant to or in lieu of foreclosure. In addition, the policies issued by X are similar to the policies issued by the taxpayers in Sears and AIG insofar as X's liability is triggered by the borrower's default.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS



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Please call if you have any further questions.

Deborah A. Butler
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By: _____
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