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IRS Relieves Some of a REMIC's Distress from Relieving Distressed Mortgages

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The United States is experiencing an unprecedented crisis in the home mortgage industry, principally driven by sharp increases in borrower defaults and foreclosures in subprime mortgage loans. This mortgage crisis has had a rippling adverse effect on homeowners; on the investment portfolios of many institutions and individuals which hold these subprime loans, directly or indirectly, through securitization vehicles; and on the U.S. economy generally.

Subprime mortgage loan is a term often used to refer to a mortgage loan to a borrower with relatively weak credit. Some subprime mortgage loan borrower defaults and foreclosures have been due to fraud on the part of the borrowers and loose lending standards by mortgage lenders. However, a more recent phenomenon that is leading to the increase in defaults and foreclosure in subprime mortgage loans is the resetting of the initial interest rates on such loans. Many subprime mortgage loans were originated as adjustable rate mortgages (ARMs). These ARMs were initially set at a relatively modest fixed rate, but after an initial period, typically either 24 or 36 months, the initial interest rate is scheduled to reset, often as high as five percentage points above the initial interest rate.

Congressional testimony states that between year-end 2003 and mid-2007, some 5 million subprime ARM loans were originated by mortgage lenders in the U.S.[1] Of these, slightly over 2.5 million loans with outstanding balances of $526 billion remain outstanding.[2] Federal regulators expect that 1.5 million subprime ARM loans are due to reset in 2008 and 2009. Subprime ARM resets in the United States between September 2007 and December 2008 are

[1] Michael H. Krimminger, "Federal Deposit Insurance Corporation on Foreclosure Prevention and Intervention: The Importance of Loss Mitigation Strategies for Keeping Families in Their Homes; before the Subcommittee on Housing and Community Opportunity of the Financial Services Committee; U.S. House Of Representatives," available at http://www.fdic.gov/news/news/speeches/chairman/spnov3007.html.

[2] *Id.*

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predicted to total more than $330 billion.[3] It is expected that many borrowers will not be able to cover their mortgage loan payments under the reset rate. And, since many of them no longer qualify for any other loan products to refinance their loans, foreclosure could be inevitable.

Published reports conclude that roughly 1.4 million homes will enter the foreclosure process in 2007 and another 1.4 million in 2008, up from 0.7 million in 2005.[4] Unless something is done to prevent this crisis, the resetting of interest rates on subprime ARM loans will likely have an adverse impact on the overall economy.

A major concern now among U.S. government officials and the mortgage industry is the vicious cycle in which foreclosures push down home prices, making it more difficult for borrowers to refinance and causing more defaults and foreclosures. Federal Reserve Chairman Ben Bernanke told Congress that "a sharp increase in foreclosed properties for sale could . . . weaken the already struggling housing market and thus, potentially, the broader economy." [5] Treasury Secretary Henry Paulson and Federal Deposit Insurance Corporation Chairperson Sheila Bair pressed the mortgage industry, including those who securitized subprime ARM loans, to modify their terms in a sweeping way, rather than going through a time-consuming case-by-case evaluation that could result in pushing many borrowers into foreclosure.

The Bush Administration, the U.S. Treasury Department, and various federal bank regulatory agencies (Federal Reserve Board, Federal Deposit Insurance Corporation, Comptroller of the Currency, and Office of Thrift Supervision) encouraged the mortgage industry to develop a streamlined loss avoidance and foreclosure framework. The framework was to take into account the possibility that many subprime ARM loan borrowers will not be able to afford the first interest rate resets on their loans and will be unable to refinance into another type of mortgage. The framework was to allow borrowers to extend the introductory interest rate on the loan to assist those borrowers in avoiding foreclosure.[6]

Many subprime ARM loans were sold to REMICs or other securitization vehicles between 2003 and 2007.[7] The advantage of using REMICs is that, as provided in §860A, a properly structured and managed REMIC can be treated as a pass-through entity which is not subject to entity-level taxation. Any income received by the REMIC is, in effect, taxed at the investor level—the holders of the regular interests and residual interests issued by the REMIC. However, the REMIC rules have strict prohibitions on permitted activities after the initial startup day of the REMIC.[8] Certain modifications to qualified mortgages are permitted under the REMIC rules, but others that are deemed significant modifications under Regs. §1.1001-3 may trigger a constructive reissuance of the mortgage, resulting in a possible loss of the pass-through status of the REMIC or the imposition of a prohibited transaction tax on the REMIC.[9]

Servicers of securitized mortgage loans, who are professional asset managers, are typically hired by the REMIC as agents to perform services such as billing, collecting, and distributing principal and interest payments received from borrowers, maintaining reserve accounts, paying property taxes and insurance premiums when due, processing loan assumptions and payoffs, reporting loan performance, and monitoring the mortgaged properties. A special servicer, which would also be hired to act as an agent of the REMIC, typically handles all mortgage loans that are in default and need special handling, such as loan workouts and, if efforts to work out the loan fail, initiates foreclosure proceedings. Any references to servicers herein are

[3] *Id.*

[4] Common Sense Forecaster, "Bank of America says $85 B in subprime mortgages are resetting," available at http://www.huliq.com/43387/bank-america-says-85-b-subprime-mortgages-are-resetting.

[5] *Id.*

[6] American Securitization Forum, "Streamlined Foreclosure and Loss Avoidance Framework for Securitized Subprime Adjustable Rate Mortgage Loans — Questions and Answers" (Dec. 17, 2007), available at http://www.americansecuritization.com/.

[7] See "General Explanation of the Tax Reform Act of 1986," p. 427 (Comm. Print 1987) ("The Congress intended that REMICs are to be the exclusive means of issuing multiple-class real estate mortgage-backed securities without the imposition of two levels of taxation. Thus, the Act provides [in §7701(i)] that a "taxable mortgage pool . . . is treated as a taxable corporation.") Real Estate Mortgage Investment Conduits ("REMICs") are governed by §§860A through 860G. See generally, Silversmith, 741 T.M., *REMICs, FASITs and Other Mortgage-Backed Securities*.

[8] The "startup day" means generally the day on which a REMIC issues all of its regular interests and residual interests. §860G(a)(9). The term "regular interest" means any interest in a REMIC which is issued at the issue price on the startup day with fixed terms and which is designated as a regular interest if: (A) such interest unconditionally entitles the holder to receive a specified principal amount (or other similar amount), and (B) interest payments (or other similar amount), if any, with respect to such interest at or before maturity (i) are payable based on a fixed rate (or to the extent provided in treasury regulations, at a variable rate), or (ii) consist of a specified portion of the interest payments on qualified mortgages and such portion does not vary during the period such interest is outstanding. §860G(a)(1). The term "residual interest" means an interest in a REMIC which is issued at the issue price on the startup day, which is not a regular interest, and which is designated as a residual interest. §860G(a)(2).

[9] *See* Regs. §1.860G-2(b) and §860F(a)(1). A "prohibited transaction" generally includes the disposition of a qualified mortgage that is not incident to a foreclosure, default, or imminent default of that mortgage. §860F(a)(2).

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deemed to include special servicers as well. If a servicer implements a default or loss mitigation measure that causes the REMIC to lose its pass-through status or incur a tax, then under the securitization vehicle's governing documents — principally the pooling and servicing agreement (PSA) — the servicer could be held liable to the REMIC and its investors for any ensuing liabilities or damages.

During the summer of 2007, servicers of subprime ARM loans in REMICs were concerned that any prospective modifications they entered into with respect to such loans before the loan defaulted would violate the sale accounting rules established by the Statement of Financial Accounting Standards No. 140 (''FAS 140''). In such event, a securitization could be recharacterized, for financial accounting purposes, as a secured financing rather than a sale, thus requiring the transferor of the loans sold to a REMIC to consolidate the REMIC's assets and liabilities on the transferor's balance sheet. Transferors viewed this consolidation as highly undesirable.

In an effort to provide some relief to the mortgage industry, and stave off a possibly larger crisis, on July 24, 2007, the SEC confirmed it would not seek to recharacterize as secured financings the sale accounting treatment of loans sold in securitizations that complied with FAS 140 as a result of any modifications when default on such loans became reasonably foreseeable.[10]

Another concern that emerged from this subprime mortgage loan crisis is the possible adverse tax implications to REMICs of implementing any prospective borrower modifications before a default becomes imminent or reasonably foreseeable. On December 6, 2007, the American Securitization Forum (ASF), an industry group representing the interests of participants in the U.S. mortgage securitization market, developed a streamlined foreclosure and loss avoidance framework (Framework) and an Executive Summary to the Framework for securitized subprime ARM loans.[11]

The main goal of the Framework is to provide either a fast track to refinancing or a fast track to loan modifications for most subprime ARMs.[12] The Framework's goal is to minimize foreclosures and preserve homeownership by helping borrowers avoid foreclosure, as well as to minimize losses to securitization investors. Servicers are encouraged to apply the Framework to securitized subprime ARM loans that they service, but they are not obligated to do so. The ASF expects that many servicers will adopt the Framework because the Framework's procedures should make their operations more effective in meeting their obligations to investors and borrowers, and will promote greater uniformity, clarity, and certainty of application of these provisions throughout the securitized mortgage industry. Nevertheless, servicers will retain the ability to apply different methods and procedures, to the extent those methods and procedures are consistent with their existing contractual obligations in the PSAs and other operative documents governing the securitization vehicles (for purposes of this article referred to collectively as the servicing agreements) and applicable legal, regulatory, and accounting rules.

Simultaneously with the ASF's issuance of the Framework, the IRS issued Rev. Proc. 2007-72,[13] to provide certainty with respect to certain potential tax issues related to REMICs that may be implicated by ''fast track loan modifications'' under the Framework. This article will examine the ASF Framework and certain concerns related to REMICs in implementing the Framework, summarize Rev. Proc. 2007-72, and discuss certain issues that might arise from applying Rev. Proc. 2007-72.

THE FRAMEWORK

The Framework applies to all first mortgage residential subprime ARM loans that have an initial fixed rate period of 36 months or less and that: (1) were originated between January 1, 2005, and July 31, 2007; (2) are included in securitized pools; and (3) have an initial interest rate reset between January 1, 2008, and July 31, 2010.

The Framework provides guidance for servicers to streamline certain borrower evaluation procedures and to facilitate the effective use of all forms of foreclosure and loss prevention efforts, including refinancings, forbearances, workout plans, loan modifications,

[10] Christopher Cox, ''Letter to The Honorable Barney Frank,'' http://www.house.gov/apps/list/press/financialsvcs_dem/sec_response072507.pdf. However, the SEC had not concluded on when default is ''imminent'' or ''reasonably forseeable.'' See ''In Subprime Discussion, SEC Accountant Declines to Elaborate on 'Imminent Default','' 39 *BNA Securities Regulation & Law Reporter* 1874 (12/3/2007).

[11] American Securitization Forum, ''Statement of Principles, Recommendations and Guidelines for a Streamlined Foreclosure and Loss Avoidance Framework for Securitized Subprime Adjustable Rate Mortgage Loans'' (Dec. 6, 2007), available at http://www.americansecuritization.com.

[12] American Securitization Forum, ''Questions and Answers,'' note 6 above, states that approximately two-thirds of homeowners whose ARMs will reset during 2008 and 2009 ''are expected to be eligible under the ASF Framework for either a fast track to refinancing or a fast track loan modification. The actual numbers of completed refinancings and loan modifications will depend on economic conditions, home price appreciation or depreciation and individual decisions made by borrowers and loan servicers.''

[13] 2007-52 I.R.B. 1257.

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deeds in lieu of foreclosure, and short sales or short payoffs. The ASF believes that the Framework is consistent with the authority typically granted to a servicer under its servicing agreement. Existing servicing agreements generally authorize the servicer to modify loans for which default is reasonably foreseeable, provided that the modification is in the best interests of security holders and would not result in a violation of the REMIC rules. In the ASF's view, servicers should not engage in any fast track loan modification unless a default on the loan is "reasonably foreseeable" within the meaning of the applicable REMIC regulations. The ASF believes that the modification standard of "reasonably foreseeable" default should be deemed to be met where the servicer has evaluated the borrower's current ability to pay and has a reasonable basis for determining that the borrower is unlikely to be able to make scheduled payments on the loan in the foreseeable future.

Under the Framework, first mortgage residential subprime ARM loans will be divided into three segments. Segment 1 includes subprime ARM loans that are current and where the borrower is likely to be able to refinance into any available mortgage product, including Federal Housing Administration ("FHA"), FHA Secure, or readily available mortgage industry products. The Framework defines the term "current" to mean the loan must be not more than 30 days delinquent and must not have been more than 60 days delinquent more than once in the last 12 months, both under the Office of Thrift Supervision method. Corresponding tests would apply under the Mortgage Bankers Association method if the servicer uses that standard.

Generally, the servicer will determine whether loans may be eligible for refinancing into readily available mortgage industry products based on ascertainable data not requiring direct communication with the borrower, such as loan-to-value ratio, loan amount, FICO scores, and payment history.[14] Servicers generally will not determine current income or debt-to-income to determine initial eligibility for refinancing. Any holder of a second mortgage on the same property will generally need to agree to subordinate its interest to the refinanced first mortgage.

The Framework provides that borrowers of Segment 1 loans should refinance their loans if they are unable or unwilling to meet their reset payment. Thus, the Framework provides that REMICs will not necessarily undertake any modification of subprime ARM loans in Segment 1. However, a servicer may evaluate each Segment 1 loan on a case-by-case basis or apply any other loss mitigation framework consistent with the servicing standard in the applicable servicing agreement.

Segment 2 includes subprime ARM loans that are current and where the borrower is unlikely to be able to refinance into any readily available mortgage industry product. All subprime ARM loans that are current with a first-mortgage-to-value ratio greater than 97% are ineligible to refinance into any available product and, thus, are within Segment 2.

The servicer will determine the following for each Segment 2 borrower: (1) the occupancy status of the mortgaged property, including whether the property is the borrower's primary residence (based on information known to the servicer, including billing and property address), (2) the borrower's current FICO score, and (3) the borrower's FICO score at origination of the loan.

If the current FICO score is less than 660 and less than a score 10% higher than the FICO score at origination, the borrower is considered to have met the "FICO test." If the borrower meets the FICO test, the servicer generally will not determine the borrower's current income. However, if either (1) the current FICO score is 660 or higher, or (2) the current FICO is at least 10% higher than the FICO score at origination, the borrower does not meet the FICO test.

If a borrower does not meet the FICO test, the servicer will use an alternate analysis to determine if the borrower is eligible for a loan modification, as well as the terms of the modification, which may vary. This alternative analysis may include (1) conducting an individual review of current income and debt obligations, debt-to-income analysis, and considering a tailored modification for a borrower; or (2) applying any other loss mitigation framework consistent with the servicing standard in the applicable servicing agreement to determine if a borrower is eligible for a loan modification.

Segment 2 subprime ARM loans will be eligible for a "fast track loan modification" only if (1) the borrower currently occupies the property as his or her primary residence, (2) the borrower meets the FICO test, and (3) the servicer determines that, at the upcoming reset, the payment amount would go up by more than 10%.

With respect to Segment 2 subprime ARM loans that are eligible for a fast track loan modification, the servicer may make the following presumptions: (1) that the borrower is able to pay under the loan modification; (2) that the borrower is willing to pay under

[14] FICO is the acronym for Fair Isaac Corporation, a publicly traded corporation. FICO scores are used in 75% of mortgage originations. The FICO score is calculated statistically, with information from a consumer's credit files. See http://www.fairisaac.com/fic/en. One source classifies FICO scores from 660 to 720 as "acceptable" and FICO scores from 620 to 660 as "uncertain." http://financialplan.about.com/cs/creditdebt/a/FICOCreditScore.htm

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the loan modification, as evidenced by (a) an agreement to the modification after being contacted, or (b) in the event that the affirmative agreement of the borrower cannot be obtained, the borrower's payment of two payments under the loan as modified after receiving notice of the modified terms; and (3) that the borrower is unable to pay, and default is reasonably foreseeable, after the upcoming reset under the original loan terms, based on the size of the payment increase that would otherwise apply.

Borrowers whose loans are in Segment 2 and that are eligible for a fast track loan modification may be offered a loan modification under which the interest rate will be kept at the existing rate, generally for five years following the upcoming reset. However, the fast track loan modification option for these borrowers in Segment 2 is not exclusive and does not preclude a servicer from using an alternate framework to determine if a borrower is otherwise eligible for a modification or for offering the borrower different modifications.

Proponents of the Framework's fast track loan modification suggest that the modification satisfies the reasonably foreseeable default test. That is because refinancing opportunities are not likely to be available to the borrower, based on the mortgage's exclusion from Segment 1, and the borrower is unlikely to be able and willing to pay the mortgage payments under the pre-modification reset rate, based on the borrower's meeting the FICO test and the more than 10% increase in monthly payments.

Advocates of the Framework thus argue that the fast track loan modification maximizes the net present value of recoveries to the securitization vehicle and that such modifications are in the best interests of investors in the aggregate. They note that, with respect to Segment 2 borrowers who are eligible for fast track payments, being current shows their ability to meet the pre-reset payments. Thus, the Framework contemplates that a fast track loan modification can ordinarily be implemented within the existing standards provided under a typical servicing agreement, which call for the servicer to limit relief to situations of reasonably foreseeable default and to maximize the net present value of recoveries of the securitization vehicle.

Segment 3 includes subprime ARM loans that are not current, indicating that the borrowers are having difficulty meeting the introductory rate. For Segment 3, the servicer will determine the appropriate loss mitigation approach in a manner consistent with the servicing standard provided in the applicable servicing agreement, but without employing the fast tracking procedures described under Segment 2. The approach chosen should maximize the net present value of the recoveries to the applicable securitization vehicle. The available approaches may include loan modification (including rate reduction and principal forgiveness), forbearance, short sale, short payoff, or foreclosure.

REMIC TAX CONCERNS WITH THE FRAMEWORK

General Servicing Agreement Provisions Related to Loan Modifications

In June 2007, the ASF published a document containing an ''Overview of Typical Securitization Document Modification Provisions.'' [15] The ASF Overview notes that servicing agreements typically require the servicer to follow customary and accepted servicing practices and procedures that it would employ in its good faith business judgment and that are usual in its general mortgage servicing activities. In addition, the ASF Overview notes that the servicing agreement typically requires the servicers to refrain from taking any action that results in the securitization vehicle's loss of its REMIC status. As a result, any modification of a securitized loan, even one that would be desirable from the REMIC's economic viewpoint of maximizing the net present value of its returns, must be scrutinized carefully by the servicer from the standpoint of continuing the securitization vehicle's REMIC status.

Although not mentioned in the ASF Overview, a related concern is the 100% tax imposed by §860F(a) on a REMIC's net income from prohibited transactions. Servicing agreements often require a servicer to endeavor to avoid entering into transactions that result in the imposition of any tax on the REMIC. In those situations, any modification of a securitized loan must likewise be scrutinized carefully by the servicer from the standpoint of avoiding a prohibited transactions tax.

As noted by the ASF Overview, most servicing agreements governing REMICs and other securitization vehicles authorize the servicer to modify loans that are either ''in default'' or for which ''default is either imminent or reasonably foreseeable.'' Generally, permitted modifications include (1) changing the interest rate on a prospective basis, (2) forgiving principal, (3) capitalizing arrearages, and (4) extending the maturity date.

[15] This is contained in American Securitization orum, ''Statement of Principles, Recommendations and Guidelines for the Modification of Securitized Subprime Residential Mortgage Loans'' (June 2007), available at http://www.americansecuritization.com/uploadedFiles/ASF%20Subprime%20Loan%20Modification%20Principles_060107.pdf.

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The ASF Overview observes that most market participants interpret the two standards of future default—''imminent default'' and ''reasonably foreseeable default''—to be substantially the same. The modification provisions that govern loans that are in default or reasonably foreseeable default typically also require that the modifications be in the best interests of the securitization investors or not materially adverse to the interests of the securitization investors. In addition to the authority to modify the loan terms, most subprime ARM loan servicing agreements permit other loss mitigation techniques, including forbearance, repayment plans for arrearages and other deferments that do not reduce the total amount owing but extend the time for payment.

Beyond the general provisions described above, the ASF Overview points out that numerous variations exist with respect to loan modification provisions in the servicing agreements of subprime ARM loans. For example, a minority of servicing agreement provisions may limit the total number of loans that may be modified to 5% of the initial pool aggregate balance unless approved by the securitization vehicle's investors.

General Requirements for REMIC Qualification

A securitization vehicle generally qualifies as a REMIC only if (1) as of the close of the third month beginning after the startup day and at all times thereafter, substantially all of its assets consist of qualified mortgages and permitted investments[16] (the ''asset test''), and (2) all of its securities offered to investors consists of regular interests and residual interests issued on the startup day.[17]

An entity that initially qualifies as a REMIC may cease to qualify if a sufficiently large portion of its qualified mortgages become nonqualified mortgages. A qualified mortgage generally becomes a nonqualified mortgage if there is a significant modification of that mortgage and the modification is not occasioned by a default or a reasonably foreseeable default of such mortgage.[18] To determine whether there is a significant modification to a qualified mortgage, Regs. §1.860G-2(b) looks to the standards in the constructive reissuance regulations, Regs. §1.1001-3.[19] Commentators conclude that what constitutes a default is determined by the terms of the mortgage.[20] The REMIC regulations are silent as to what constitutes a ''reasonably foreseeable'' default. If a REMIC owns more than a *de minimis* percentage of its assets in the form of nonqualified mortgages, then the asset test would not be met and the status of the securitization vehicle as a REMIC could be jeopardized.[21]

Potential Problems from the ASF Framework

The Framework contemplates that borrowers must be not more than 30 days delinquent in order for their loan to be classified in Segment 1 or Segment 2. Moreover, a loan that is not more than 30 days delinquent but that has been more than 60 days delinquent more than once in the last 12 months will be classified as a Segment 3 loan. Thus, the Framework generally contemplates that Segment 1 loans, Segment 2 loans, and many Segment 3 loans are not in default. Therefore, modifications of Segment 1 loans, Segment 2 loans, and many Segment 3 loans cannot qualify for relief under the REMIC tax regulations and, thus, do not qualify for relief under the servicing agreements unless their default is ''reasonably foreseeable.''

As mentioned above, if more than 1% of the REMICs assets were nonqualified mortgages resulting from a material modification of a mortgage not in default and not in a status of reasonably foreseeable default, the REMIC could be disqualified under the asset test. And, despite the 1% safe harbor, servicers needed to be cautious about permitting any nonqualified mortgages to be included in a REMIC because, for example, even though at first such mortgages may account for less than 1% of the overall REMIC assets, with scheduled payments and prepayments and foreclosures of the qualified mortgages in the REMIC, over time the nonqualified mortgages may account for more than 1% of the overall REMIC assets.

Moreover, if a qualified mortgage that is not in default and whose default is not reasonably foreseeable

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[16] Each as defined in §860G(a).

[17] §§860D(a), 860G(a). There are certain additional requirements under §860D(a), which are not relevant here.

[18] Regs. §1.860G-2(b). A change in a mortgage, even a modification that would otherwise disqualify the REMIC because it triggers a constructive reissuance under Regs. §1.1001-3, will not create a nonqualifying REMIC asset and, thus, will not disqualify a REMIC, if the change is occasioned by default or a reasonably foreseeable default of the pre-modification mortgage.

[19] Regs. §1.860G-2(b)(2). A modification in the yield of a mortgage is a significant modification if the yield varies from the annual yield on the unmodified note by more than the greater of 25 basis points or 5% of the annual yield of the unmodified note. Regs. §1.1001-3(e)(2)(ii).

[20] Peaslee and Nirenberg, ''The Federal Income Taxation of Mortgage-Backed Securities,'' p. 123 fn. 112 (Probes Publishing 1994).

[21] Regs. §1.860D-1(b)(3)(ii) provides a 1% safe harbor for determining whether nonqualified assets are *de minimis.* If the adjusted basis of the nonqualified mortgages and other nonqualified assets is less than 1% of the adjusted basis of the REMIC's total assets, the REMIC asset test will be met.

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is significantly modified, thus resulting in a constructively issued new mortgage, a tax is generally imposed on the REMIC's income with respect to such exchange.[22] In addition, a tax may apply to the income from such constructively issued new mortgage even if such constructively issued mortgage, and other nonqualifying REMIC assets, were below the 1% *de minimis* threshold.[23]

Accordingly, before the adoption of Rev. Proc. 2007-72, the major concern raised by the Framework for REMICs was that if a servicer granted modifications under the Framework to any current subprime ARM loan, in the event that the IRS were to determine that a default on such loans was not reasonably foreseeable, the REMIC could be subject to disqualification or a prohibited transaction tax. Since servicing agreements generally require a servicer to avoid entering into transactions that result in disqualification of the REMIC or the imposition of any tax on the REMIC, the servicer would also be in violation of its servicing agreement.

Thus, servicers would have had to be extremely cautious when approving loan modifications on subprime ARM loans that were current pursuant to the Framework. Therefore, further guidance from the IRS as to these concerns was necessary to achieve the intended purpose of the Framework. However, as discussed below, Rev. Proc. 2007-72 addresses these REMIC tax concerns only as they relate to a subset of the Segment 2 loans described in the Framework.

REV. PROC. 2007-72 CLASSIFICATION RELIEF

Summary

Section 2.03 of Rev. Proc. 2007-72 provides that, like the Framework, Rev. Proc. 2007-72 applies only to first-lien subprime residential ARM loans that: (1) have an initial fixed rate period of 36 months or less, (2) were originated between January 1, 2005, and July 31, 2007, (3) are included in securitized pools, and (4) have an initial interest rate reset between January 1, 2008, and July 31, 2010. Rev. Proc. 2007-72 is effective on December 6, 2007, and extends to transactions occurring up to July 31, 2010.

Section 5.01 of Rev. Proc. 2007-72 provides that the protection of that revenue procedure extends only to: (1) a ''fast track loan modification'' of a first-lien subprime residential ARM loan pursuant to the Framework, and (2) a second-lien holder's action of subordinating its lien to any new lien that may arise under a loan as the result of a fast track loan modification.

Rev. Proc. 2007-72 provides that the protection extends to at least the two generally applicable major REMIC concerns by providing: (1) that the IRS will not challenge a REMIC's qualification on the grounds that the transactions are outside the scope of the exceptions in Regs. §1.860G-2(b)(3), which permit significant modifications of REMIC mortgages occasioned by a reasonably foreseeable default of the pre-modification mortgage; and (2) that the IRS will not contend that the transactions are prohibited transactions under §860F(a)(2) on the grounds that the transactions are outside the scope of the exceptions in §860F(a)(2)(A)(i)–(iv), which permit a disposition of a mortgage incident to a reasonably foreseeable default of the pre-modification mortgage.[24] Thus, in practical effect, Rev. Proc. 2007-72 concedes that, for REMIC classification purposes and absence of prohibited transaction tax purposes, mortgages that receive a fast track loan modification under the Framework satisfy the reasonably foreseeable default standard. This is evidently designed to alleviate the two major REMIC tax concerns and, thus, the two major related servicer contractual concerns about granting fast track relief on behalf of REMICs.

Thus, it seems that Rev. Proc. 2007-72 was intended to represent only an IRS concession that, in the case of a REMIC granting fast track relief to Segment 2 homeowners meeting the FICO test and whose reset payments will increase by more than 10%, ''reasonably foreseeable'' and ''imminent'' default of the mortgage status was conclusively established. By apparently limiting itself to fast track loan modification relief, Rev. Proc. 2007-72 apparently applies only to a limited number of non-defaulted loans described in the Framework.[25] Rev. Proc. 2007-72 does not apply to loans in Segment 1. Rev. Proc. 2007-72 does not apply to many Segment 2 loans. For example, Segment 2 loans that are secured on properties that are

[22] §860F(a)(2)(A); Regs. §1.860G-2(b)(1)(i).

[23] §860F(a)(2)(B).

[24] Although not entirely clear, it seems likely that it was intended that the income from the otherwise new constructively issued mortgage likewise will not be subject to a prohibited transactions tax by reason of §860F(a)(2)(B).

[25] Thus, it appears that the following transactions with respect to loans are covered by Rev. Proc. 2007-72: modifications of first-lien subprime residential ARM loans described in Segment 2 of the Framework, in which: (1) the borrower currently occupies the mortgaged property as his or her residence; (2) the borrower meets the FICO test; (3) the servicer determines that, at the upcoming reset, the payment amount would go up by more than 10%; and (4) there is a modification of the mortgage in which the interest rate will be kept at the existing rate, generally five years following the upcoming reset. This type of Segment 2 loan, five-year modification, is referred to herein as a ''fast track loan modification.''

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rental properties, vacation homes, or vacant properties are ineligible for Rev. Proc. 2007-72 relief. Similarly, Segment 2 owner-occupied home loans on which the borrower does not meet the FICO test are ineligible for Rev. Proc. 2007-72 relief. Segment 3 loans that are now current and not in default but were more than 60 days delinquent within the preceding 12 months are ineligible for Rev. Proc. 2007-72 relief. For these Segment 1, Segment 2, and Segment 3 loans, even after Rev. Proc. 2007-72, servicers likely will continue to be reluctant to conclude there is a ''reasonably foreseeable default'' so as to permit the servicers to offer the non-defaulting borrowers relief consistent with the REMIC regulations.

Can the IRS Attack a Servicer's Framework Application?

There appears to be no prohibition against the IRS attacking a servicer's interpretation of the Framework. For example, suppose, with respect to a subprime ARM loan that is current, the IRS determines that the servicer too narrowly interpreted current FHA guidelines or otherwise was incorrect in determining that the borrower failed to meet FHA Secure refinance criteria. Suppose that the servicer thereby erroneously classified the loan in Segment 2 and not Segment 1 and granted the borrower the five-year interest rate relief described in Rev. Proc. 2007-72. It would seem then that the IRS could find that the modification was not ''pursuant to the Framework,'' and therefore outside the protection of §5.01(1) of Rev. Proc. 2007-72, possibly leading to disqualification of the REMIC or a prohibited transaction tax.

Nevertheless, in general, it would seem that a servicer's classification as a Segment 2 Loan eligible for Rev. Proc. 2007-72 relief, rather than an ineligible Segment 1 Loan, should ordinarily be entitled to deference, since the servicer presumably intends for commercial reasons to maximize realization by having the homeowner prepay the REMIC from FHA or other refinancing rather than by granting the five-year relief.

It is unclear how the fixed rate continuation of ''generally five years'' will be interpreted. Neither §2.05 of Rev. Proc. 2007-72 nor the Framework Executive Summary indicates which criteria are to be used to determine whether or not an interest rate continuation of shorter than or longer than five years is to be used under the fast track loan modification. This may create a risk that if a period different from five years is used, the IRS may collaterally attack the modification as inconsistent with the Framework and thus ineligible for relief.

Where the Framework itself contains the methodology for establishing eligibility as a Segment 2 loan, Rev. Proc. 2007-72 should accept that methodology. For example, if the servicer reasonably follows the Framework to establish the mortgaged home's valuation, rather than engaging an independent appraiser, arguably the REMIC is protected.

Prop. Regs. §1.860G-2(b)(7), which was proposed in November 2007 and generally applies to securitized loans secured by commercial real estate, may be distinguished from Rev. Proc. 2007-72 and the Framework. The proposed regulation establishes the standards needed to support a valuation of commercial real estate used by a REMIC to avoid a constructive reissuance. Under the proposed regulation, an independent appraiser must perform the valuation.[26] In contrast to the approach in Prop. Regs. §1.860G-2(b)(7), the Framework states that the determination that the value of a mortgaged home has declined to the point where the first-mortgage-to-value ratio exceeds 97%, so as to automatically qualify for classification as a Segment 2 loan, can be made based upon the loan-to-value ratio at inception, upon an automated valuation method (AVM), upon a broker's price opinion (BPO), or by other means. The Framework does not require an independent appraisal.

OTHER REV. PROC. 2007-72 RELIEF

Trust Status Continued

Regs. §1.860G-2(a)(5) treats as qualifying assets of a REMIC undivided interests in an investment trust that owns mortgages, provided that the investment trust is classified as a trust under Regs. §301.7701-4(c).[27] Regs. §301.7701-4(c) provides that an investment trust is not classified as a trust if the trust agreement provides the power to vary investments. Section 6.03 of Rev. Proc. 2007-72 states that, for a fast track loan modification within the scope of the procedure, the IRS will not challenge a securitization vehicle's classification as a trust on the grounds that the modifications manifest a power to vary investments. Thus, apparently a REMIC will be protected from disquali-

[26] Prop. Regs. §1.860G-2(b)(7) applies in the different context of establishing that the valuation of the mortgaged commercial real estate is sufficiently high that the REMIC's modified mortgage remains ''principally secured by real property'' as required by Regs. §1.860G-2. The proposed regulation's independent appraisal requirement has been criticized by representatives of REMICs on the grounds that an independent appraisal is an unnecessary cost.

[27] Regs. §1.860G-2(a)(6) further provides that the investment trust's modification of an underlying mortgage, even one not in default nor in foreseeable default, will not be treated as a modification of the REMIC's undivided trust interest so long as the investment trust structure was not created to avoid the prohibited transaction rules of §860F(a).

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fication if the servicer of a trust in which the REMIC is a certificate holder exercises a fast track loan modification covered by Rev. Proc. 2007-72.

Section 6.03 of Rev. Proc. 2007-72 apparently also will protect securitization vehicles formed as trusts, even those whose certificate holders include persons other than REMICs, from reclassification as partnerships. Under §7704, if the trust interests were publicly traded, a tax risk from partnership recharacterization would be that the trust could be viewed as engaged in a financial business and therefore be subject to corporate classification.[28]

Further, reclassification of a trust as a partnership could cause the trust to be subject to a large §6698 penalty for failure to file a partnership return without reasonable cause. The Mortgage Forgiveness Debt Relief Act of 2007 increased the maximum §6698 annual penalty to $1,020 per trust-beneficiary ''partner.''

Absence of Constructive Reissuance of a REMIC's Regular Interests

As noted by §3.02 and §3.04 of Rev. Proc. 2007-72, a REMIC can be disqualified if any interests in the REMIC are issued after the startup day. However, §6.04 of Rev. Proc. 2007-72 states that, with respect to a modification described in Rev. Proc. 2007-72, the IRS will not challenge a securitization vehicle's qualification as a REMIC on the grounds that the transaction resulted in a deemed reissuance of the REMIC regular interests.

The potential REMIC concern addressed by §6.04 of Rev. Proc. 2007-72 relates to the change in timing of cash flows associated with fast track loan modification relief. Fast track loan modification relief terminates, for the next five years, expected REMIC cash flow from principal prepayments due to sale of property taken in foreclosure and any REMIC cash flow from reset interest rates in excess of the continued introductory interest rate. It may perhaps be necessary for a REMIC to reduce scheduled interest payments on its regular interests to accommodate the REMICs lower expected cash flows. Further, since prepayments typically are distributed to different classes of REMIC regular interests than are current interest payments, fast track loan modification relief changes the relative rights of the various classes of REMIC regular interests to the REMIC's projected cash flow from the relieved fast track loan modification mortgages. Regs. §1.1001-3(e)(3) provides that a ''modification'' of a debt instrument, such as a REMIC regular interest, is significant if the yield is significantly modified, payments are materially deferred, or a form of credit enhancement is altered in such a way as to change the payment expectations.

Nevertheless, an alteration in the terms of a debt instrument is not a ''modification'' for purposes of Regs. §1.1001-3 and, thus, does not cause a constructive reissuance of such debt instrument, if such alteration ''occurs by operation of the terms of a debt instrument.'' [29] For example, commentators apparently have concluded that a reduction of interest rates on a mortgage owned by the REMIC, even if it would incidentally significantly reduce the outstanding yield on REMIC regular interests that bear interest rates equal to a weighted average of interest rates on the REMIC's mortgage pool, would not cause a constructive reissuance of the REMIC regular interests.[30]

One may question why even a significant alteration to a REMIC's regular interests by reason of the REMIC's implementation of the Framework would be viewed as not ''occur[ring] by operation . . . of the terms of the debt instrument,'' generally a predicate for a finding of constructive reissuance under Regs. §1.1001-3(c)(1)(ii). The Framework states that ''the ASF firmly believes that the Framework outlined in this statement is consistent with the authority typically granted to a servicer under the operative documents governing a subprime loan securitization.''

It may be that §6.04 of Rev. Proc. 2007-72 was promulgated in an over-abundance of caution to protect REMICs and servicers. Section 1 of Rev. Proc. 2007-72 states that ''there should be no inference that this revenue procedure is necessary to prevent transactions within its scope from impacting the tax status of securitization vehicles.''

It may also be that §6.04 of Rev. Proc. 2007-72 is designed to address situations involving consent of the REMIC regular interest holders in order to implement the Framework. For example, the ASF Overview states that a minority of servicing agreements provide that, in order to modify more than 5% of the initial mortgages, consent of the ''investors'' would be required. Perhaps the ''investors'' referred to in the ASF Overview include the REMIC regular interests. Even the exercise by a REMIC regular interest holder of a unilateral option in the original regular interest to accept a deferral or reduction in any interest payment is a ''modification'' subject to testing under Regs. §1.1001-3 to determine constructive reassurance of the regular interest.[31]

[28] ''Securitization of Financial Assets,'' 10-21 (Wolters Kluwer 2007 Supp.).

[29] Regs. §1.1001-3(c)(1)(ii).

[30] ''Attorneys Suggest Changing FASIT Rules,'' 2001 TNT 130-32, at fn. 22.

[31] *See* Regs. §1.1001-3(c)(2)(B)(iii). Suppose that a second

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Second Mortgage Subordination

Section 7.02 of Rev. Proc. 2007-72 protects a REMIC's classification even if the holder of a second mortgage, in accordance with the Framework, subordinates its lien to a new first mortgage lien that arises under a loan that was the subject of a fast track loan modification. The REMIC classification concern addressed apparently relates to a REMIC that itself is a subordinating second mortgagee. A lender's voluntary forbearance from accelerating repayment to which it is entitled, for more than temporary period, can create a constructive reissuance.[32]

REMIC INCOME RECOGNITION

Gain or Loss on Constructive Reissuance

Rev. Proc. 2007-72 does not exempt a material modification of a loan eligible for REMIC-level relief from recognition of gain or loss under Regs. §1.1001-3.[33] Measurement of gain or loss recognition raises several questions. These include the timing of the recognition, given that the Framework acknowledges some ambiguity in determining the time which the agreement is entered into.

Generally, an agreement to change the terms of a mortgage is a modification at the time the borrower and lender enter into the modification agreement, even if the change is not immediately effective.[34] While the Framework requires that servicers contact borrowers at least 120 days before the rate reset date, the Framework provides that it may not be practical to contact borrowers and obtain their written agreement. The Framework thus concludes that "it would appear reasonable to consider a borrower has consented to the terms of the modification if notice of the modification has been sent to the borrower and the borrower has made two monthly payments under the loan as modified after receiving notice of the modified terms in accordance with the modification." Regs. §1.1001-3(c)(1)(i) generally provides that a modification occurs "whether the alteration is evidenced by an express agreement (oral or written), conduct of the parties, or otherwise." [35]

Perhaps, in the absence of an earlier written modification, the IRS will, to be consistent with the Framework, accept the timing of a borrower's second payment under the fixed rate as determining the timing of the modification. In view of the dearth of authority interpreting Regs. §1.1001-3(c)(1)(i), however, it seems conceivable that the IRS could adopt other rules for timing of the modification. These could include using the date of the borrower's notice, using the date of the borrower's first payment under the continued fixed rate, or applying analogous tax precedents, such as those relating to the timing of a creditor's determination of partial worthlessness of a debt or timing of a debtors' forgiveness of indebtedness or to state law.

Once the date of modification is determined, the various computations required in the regulations to determine whether there has been a material modification, and thus a constructive reissuance, must be undertaken. The Framework contemplates that the modified obligation under a fast track loan modification would have a fixed rate for five years from the originally scheduled reset date, but then revert to its originally negotiated reset rate. Given that the reset rate would often be far more than the greater of 25 basis points or 5% of the pre-modification yield above the initial fixed rate, it appears likely that fast track loan

REMIC, pursuant to §860G(a)(3)(C), received a regular interest in a first REMIC on the startup day in exchange for issuing an interest in the second REMIC. If that first REMIC's regular interests, in connection with the first REMIC granting fast track loan modification relief to the first REMIC's borrowers, were constructively reissued, the first REMIC possibly would be protected from loss of REMIC classification status under §6.04 of Rev. Proc. 2007-72. However, it is unclear whether §6.04 of Rev. Proc. 2007-72 would provide any relief to the second REMIC.

[32] *See* Regs §1.1001-3(e)(4)(ii).

[33] See §4 of the Preamble to Prop. Regs. §1.860G-2(b), 72 Fed. Reg. 63523 (11/9/07).

[34] Regs. §1.1001-3(c)(6).

[35] *See* IRS Office of Chief Counsel Memorandum NSAR 010806 (2000) ("a statement of intent [to defer collection] is a modification because it is evidenced by the letter and by the conduct of the parties," but was excepted from "modification" characterization under Regs. §1.1001-3(c)(4)(ii) because it was a forbearance occurring within two years after the issuer's initial failure to perform).

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modifications under the Framework would involve a constructive reissuance.[36]

Once the date of, and existence of, a constructive reissuance is determined, the amount realized must be determined under Regs. §1.1001-1(g). Then, the gain or loss, if any, must be determined by subtracting the basis of the old constructively reissued mortgage from the amount realized.[37] Certain other computational issues may be involved.[38]

Other Recognition

As indicated above, §6.04 of Rev. Proc. 2007-72 suggests the possibility that REMIC regular interest holders, in some cases, may face constructive reissuance issues. This, in turn, could create cancellation of indebtedness income for the REMIC.[39]

Further, any holder of a second mortgage that agrees to subordinate its lien may face constructive reissuance issues. A second mortgage holder's agreement to waive any acceleration rights and leave the second mortgage in place for two years generally is not exempt from the constructive reissuance rules of Regs. §1.1001-3.[40]

BORROWER CANCELLATION OF INDEBTEDNESS INCOME

Rev. Proc. 2007-72 provides no relief to debtors from discharge of indebtedness income caused by a REMIC's loan modification. The excess of the adjusted issue price of the pre-modification mortgage, over the issue price of the new constructively reissued mortgage, is discharge of indebtedness income of the borrower.[41]

Nevertheless, there are mitigating factors. In general, if a newly constructively reissued non-publicly traded mortgage yields at least the AFR, and if (as, for example, in fast track relief) there is no reduction in principal, there typically is no cancellation of indebtedness income under Regs. §1.61-12(c)(2)(ii).[42] Secondly, the Mortgage Forgiveness Debt Relief Act of 2007 enacted §108(a)(1)(E) and §108(h) to provide an exclusion of forgiveness with respect to up to $2 million of qualified acquisition indebtedness during 2007 through 2009, although the taxpayer generally would have to reduce its basis in the residence in the amount of the excluded forgiveness. The servicer's decision to grant a modification must be directly related to "a decline in the value of the residence or to the financial condition of the taxpayer." [43] This exclusion is not explicitly coordinated with the Framework and Rev. Proc. 2007-72. However, it seems likely that Segment 2 modifications (including, but not limited to, those eligible for fast track loan modifications) and Segment 3 modifications ordinarily should qualify under §108(h).

CONCLUSION

Rev. Proc. 2007-72 indicated that the IRS should not be a bar to REMIC implementation of the fast track loan modification. Following the release of Rev. Proc. 2007-72, on January 8, 2008, the SEC Staff issued similar guidance, which accepted the Framework's approach that a homeowner's more than 97%

[36] *See* Krimminger, note 1 above (reset rate often 500 basis points higher than 7% to 9% initial interest rate).

[37] *See* Karlin, "Debt Modification May Result in a Taxable Exchange," *Tax'n for Accountants* (Dec. 1993) (where interest rate, but not principal, was reduced incident to a constructive reissuance of a non-publicly traded obligation, but modified lower rate was still above AFR on date of constructive reissuance, amount realized was principal amount). Subprime ARM loans made between 2004 and mid-2007 typically have a starter rate between 7% and 9%. Krimminger, note 1 above. By contrast, Rev. Rul. 2008-4, 2008-3 I.R.B. (1/22/08), sets the Jan. 2008 AFRs at below 5%.

[38] *See generally* Garlock, "Federal Income Taxation of Debt Instruments," Chs. 14 (Debt Modifications), 16 (Distressed Debt Instruments — Creditor Issues) (CCH 2007 Supp.); McCawley, 535 T.M., *Time Value of Money: OID and Imputed Interest.*

[39] Even if there is no alteration beyond that occurring under the terms of the REMIC residual interest, and thus no modification or constructive reissuance described in Regs. §1.1001-3, a REMIC that in effect discharges its future obligation to pay a portion of principal and previously accrued interest on a regular interest as a result of the REMIC's diminished future interest income under the Framework could perhaps recognize discharge of indebtedness income. *See* Peaslee and Nirenberg, note 20 above, at 282 ("A REMIC that . . . discharges its obligation to pay a portion of the principal and accrued interest as a result of a mortgage credit loss, would realize discharge of indebtedness income. The REMIC may be able to defer such income under §108 to the extent it does not exceed the amount by which the REMIC is 'insolvent'.") In situations where the interest rate on the REMIC regular interest varies with the interest rate on the REMIC's mortgage portfolio, as permitted under Regs. §1.860G-1(a)(3)(ii), this deemed discharge should be avoidable.

[40] *See* Regs. §1.1001-3(d), Ex. (13).

[41] Regs. §1.61-12(c)(2)(ii).

[42] *See* Shop Talk, "Lenders Beware of Section 1001 Regulations," 86 *J. Tax'n* 188 (March 1997) ("as long as the post-modification debt instrument is *not* publicly traded *and* bears an interest rate at least equal to the applicable federal rate (AFR), the debtor generally will have minimal adverse tax consequences as a result of a deemed exchange of an 'old' debt instrument for a 'new' debt instrument. If a non-publicly traded debt instrument bears interest above the AFR, the adjusted issue price (AIP) of the debt instrument will equal its face amount, thereby avoiding cancellation of indebtedness (COD) income under Section 108(e)(10)."). Subprime ARM loans made between 2004 and mid-2007 typically have a starter rate between 7% and 9%. Krimminger, note 1 above. By contrast, Rev. Rul. 2008-4, 2008-3 I.R.B. (1/22/08), sets the Jan. 2008 AFRs below 5%.

[43] §108(h)(3).

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first-mortgage-to-value ratio, satisfaction of the FICO test, and a more than 10% increase in monthly payments, constitutes the homeowner's imminent default for purposes of FAS 140.[44] The SEC Staff stated that this was only an interim measure until the FASB finishes a pending project concerning the discretion permitted servicers of qualified special purpose entities.

[44] http://www.sec.gov/info/accountants/staffletters/hanish010808.pdf.

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