

Part III

Administrative, Procedural, and Miscellaneous

26 CFR 601.105: Examination of returns and claims for refund, credit or abatement; determination of correct tax liability.

(Also Part I, §§ 860D, 860F, 860G, 1001; 1.860G-2, 1.1001-3, 301.7701-2, 301.7701-3, 301.7701-4)

Rev. Proc. 2008-28

SECTION 1. PURPOSE

This revenue procedure describes conditions under which modifications of certain mortgage loans will not cause the Internal Revenue Service (the Service) either to challenge the tax status of certain securitization vehicles that hold the loans or to assert that those modifications create a liability for tax on a prohibited transaction.

No inference should be drawn about whether similar consequences obtain if a loan modification falls outside the scope of this revenue procedure. Furthermore, there should be no inference that, in the absence of this revenue procedure, transactions within its scope would have impaired the tax status of securitization vehicles or would have created liability for tax on a prohibited transaction.

SECTION 2. BACKGROUND—FORECLOSURE PREVENTION PROGRAMS

.01 Many servicers of mortgage loans have developed, and are implementing, foreclosure prevention programs. These programs are particularly useful in the current economic environment where there are an increasingly large number of borrowers who are not able to afford their current mortgage payments and are at risk of losing their homes. These servicers apply the programs both to loans that investors hold directly and to those that are held through securitization vehicles such as investment trusts and real estate mortgage investment conduits (REMICs). Typically, these sophisticated programs establish guidelines to streamline modifications of troubled mortgage loans. The guidelines take into account a broad range of information in an effort to identify borrowers whose loans are likely to go into foreclosure if the terms of the loans remain unmodified but who may be able to make timely payments on a modified loan with more favorable terms. The programs also indicate the type and extent of a modification that may allow the borrower to make timely payments under the modified terms and so avoid foreclosure. The modifications that are effected under these programs may include interest rate reductions, principal forgiveness, extensions of maturity, and alterations in the timing of changes in an interest rate.

.02 The terms of many residential mortgage loans provide that, if a borrower fails to make a scheduled payment on the date the payment is due, the borrower is in “default” on the mortgage but that transient lateness may not have any adverse consequences for the borrower. Most such loans provide for a “grace period” (typically, 15 days) during which an underpayment can be cured without the borrower being liable for a late fee.

.03 Servicers have concluded that foreclosure prevention programs such as those described in Section 2.01 of this revenue procedure can assess with a high degree of accuracy whether a borrower presents an unacceptably high risk of eventual foreclosure, even when some desired information is unavailable for a particular borrower and the borrower has not yet missed any payments due under the loan.

SECTION 3. BACKGROUND—REMICs

.01 REMICs are widely used securitization vehicles for mortgages and are governed by sections 860A through 860G of the Internal Revenue Code.

.02 Section 860D(a)(4) of the Code provides that an entity qualifies as a REMIC only if, among other things, 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. This asset test is satisfied if the entity owns no more than a *de minimis* amount of other assets. See § 1.860D–1(b)(3)(i) of the Income Tax Regulations. As a safe harbor, the amount of assets other than qualified mortgages and permitted investments is *de minimis* if the aggregate of the adjusted bases of those assets is less than one percent of the aggregate of the adjusted bases of all of the entity's assets. § 1.860D–1(b)(3)(ii).

.03 With limited exceptions, a mortgage loan is not a qualified mortgage unless it is transferred to the REMIC on the startup day in exchange for regular or residual interests in the REMIC. See section 860G(a)(3)(A)(i).

.04 The legislative history of the REMIC provisions indicates that Congress intended the provisions to apply only to an entity that holds a substantially fixed pool of real estate mortgages and related assets and that “has no powers to vary the

composition of its mortgage assets.” S. Rep. No. 99–313, 99th Cong., 2^d Sess. 791–92; 1986–3 (Vol. 3) C.B. 791–92.

.05 Section 1.1001–3(c)(1)(i) defines a “modification” of a debt instrument as any alteration, including any deletion or addition, in whole or in part, of a legal right or obligation of the issuer or holder of a debt instrument, whether the alteration is evidenced by an express agreement (oral or written), conduct of the parties, or otherwise. Section 1.1001–3(e) governs which modifications of debt instruments are “significant.” Under § 1.1001–3(b), for most federal income tax purposes, a significant modification produces a deemed exchange of the original debt instrument for a new debt instrument.

.06 Under § 1.860G–2(b), related rules apply to determine REMIC qualification. Except as specifically provided in § 1.860G–2(b)(3), if there is a significant modification of an obligation that is held by a REMIC, then the modified obligation is treated as one that was newly issued in exchange for the unmodified obligation that it replaced. See § 1.860G-2(b)(1). For this purpose, the rules in § 1.1001–3(e) determine whether a modification is “significant.” See § 1.860G-2(b)(2). Thus, even if an entity initially qualifies as a REMIC, one or more significant modifications of the loans held by the entity may terminate the qualification if the modifications cause less than substantially all of the entity’s assets to be qualified mortgages.

.07 Certain loan modifications, however, are not significant for purposes of § 1.860G-2(b)(1), even if the modifications are significant under the rules in § 1.1001–3 and thus cause section 1001 to apply. In particular, under § 1.860G–2(b)(3)(i), if a change in the terms of an obligation is “occasioned by default or a reasonably

foreseeable default,” the change is not a significant modification for purposes of § 1.860G-2(b)(1), regardless of the modification’s status under § 1.1001-3.

.08 Section 860F(a)(1) imposes a tax on a REMIC equal to 100 percent of the net income derived from “prohibited transactions.” The disposition of a qualified mortgage is a prohibited transaction unless the disposition is pursuant to (i) the substitution of a qualified replacement mortgage for a qualified mortgage; (ii) a disposition incident to the foreclosure, default, or imminent default of the mortgage; (iii) the bankruptcy or insolvency of the REMIC; or (iv) a qualified liquidation. Section 860F(a)(2)(A).

SECTION 4. BACKGROUND—TRUSTS

.01 Section 301.7701-2(a) of the Procedure and Administration Regulations defines a “business entity” as any entity recognized for federal tax purposes (including an entity with a single owner that may be disregarded as an entity separate from its owner under § 301.7701-3) that is not properly classified as a trust under § 301.7701-4 or otherwise subject to special treatment under the Code.

.02 Section 301.7701-4(a) provides that an arrangement is treated as a trust if the purpose of the arrangement is to vest in trustees responsibility for the protection and conservation of property for beneficiaries who cannot share in the discharge of this responsibility and, therefore, are not associates in a joint enterprise for the conduct of business for profit.

.03 Section 301.7701-4(c) provides that an “investment” trust is not classified as a trust if there is a power under the trust agreement to vary the investment of the certificate holders.

SECTION 5. SCOPE

This revenue procedure applies to a modification of a mortgage loan that is held by a REMIC, or by an investment trust, if all of the following conditions are satisfied:

.01 The real property securing the mortgage loan is a residence that contains fewer than five dwelling units.

.02 The real property securing the mortgage loan is owner-occupied.

.03 (1) If a REMIC holds the mortgage loan, then as of either the startup day or the end of the 3-month period beginning on the startup day, no more than ten percent of the stated principal of the total assets of the REMIC was represented by loans the payments on which were then overdue by 30 days or more; or

(2) If an investment trust holds the mortgage loan, then as of all dates when assets were contributed to the trust, no more than ten percent of the stated principal of all the debt instruments then held by the trust was represented by instruments the payments on which were then overdue by 30 days or more.

.04 The holder or servicer reasonably believes that there is a significant risk of foreclosure of the original loan. This reasonable belief may be based on guidelines developed as part of a foreclosure prevention program similar to that described in Section 2 of this revenue procedure or may be based on any other credible systematic determination.

.05 The terms of the modified loan are less favorable to the holder than were the unmodified terms of the original mortgage loan.

.06 The holder or servicer reasonably believes that the modified loan presents a substantially reduced risk of foreclosure, as compared with the original loan.

SECTION 6. APPLICATION

If one or more modifications of mortgage loans are described in Section 5 of this revenue procedure—

.01 The Service will not challenge a securitization vehicle's qualification as a REMIC on the grounds that the modifications are not among the exceptions listed in § 1.860G-2(b)(3);

.02 The Service will not contend that the modifications are prohibited transactions under section 860F(a)(2) on the grounds that the modifications resulted in one more dispositions of qualified mortgages and that the dispositions are not among the exceptions listed in section 860F(a)(2)(A)(i)-(iv);

.03 The Service will not challenge a securitization vehicle's classification as a trust under section 301.7701-4(c) on the grounds that the modifications manifest a power to vary the investment of the certificate holders; and

.04 The Service will not challenge a securitization vehicle's qualification as a REMIC on the grounds that the modifications resulted in a deemed reissuance of the REMIC regular interests.

SECTION 7. EXAMPLE

The following example illustrates the application of this revenue procedure:

.01 Facts. As part of its business, S services mortgage loans that are held by R, a REMIC that is described in Section 5.03(1) of this revenue procedure. S has developed a foreclosure prevention program to guide it in determining the risk of a foreclosure eventually becoming necessary on a loan that it is servicing. For each loan that the program identifies as presenting an undesirable risk of foreclosure, the program

also attempts to determine whether a modification to the terms of the loan might materially reduce the risk of foreclosure and, if so, what modification strikes the best balance between minimizing the sacrifice of some required cash flows under the loan and maximizing the reduction in foreclosure risk.

The factors that the program generally takes into account include the borrower's payment history on the loan; the borrower's payment history (as reported by a credit bureau) on the borrower's other indebtedness; the borrower's FICO score; the loan-to-value ratio of the loan when it was originated; changes in property values in the neighborhood where the property securing the loan is located; an estimate of the current loan-to-value ratio; whether the monthly debt service under the loan has recently changed or will soon change; and, where available, any additional data obtained from the borrower (for example, changes in employment and other income sources, family medical status, uninsured losses, adverse court judgments, inheritances, etc.). Because S's program takes into account statistical models that were developed using extensive amounts of data involving diverse information from very many borrowers, S has found the program to be generally reliable at assessing with a high degree of accuracy whether a borrower presents an unacceptably high risk of eventual foreclosure, even when some desired information is unavailable for a particular borrower.

Borrower B is the issuer of one of the mortgage loans that is held by R. The real property securing B's mortgage loan is described in Section 5.01 and 5.02 of this revenue procedure. None of B's payments on the mortgage loan has been late in the few years that the loan has been outstanding. On the other hand, a very large increase

in B's monthly debt service is scheduled in the near future; the loan had a high loan-to-value ratio when it was originated; home values in the neighborhood of the collateral have declined significantly; B's FICO score has dropped; and a credit bureau reports that B is developing a pattern of increasingly late payment on rising levels of consumer debt. Although S tried several times to contact B, both by phone and by mail, B did not answer any of the phone calls and did not respond to any of the letters or any of the phone messages that were left.

Even without the benefit of individual information that S could have obtained from a conversation with B, S's model determines that, if the loan to B is not modified, there is a significant risk of eventual foreclosure. The model also indicates, however, that reducing both the principal amount of, and the interest rate on, the loan would substantially reduce the risk of foreclosure. The anticipated benefit of reducing the risk of foreclosure outweighs the lower payments that would be required under the modified terms of the loan. Under S's foreclosure prevention program, therefore, the loan is modified by reducing both the principal amount and the interest rate.

.02 Analysis. The modified terms of B's loan are less favorable to R than were the unmodified terms of the original loan. Moreover, the modification was undertaken because of S's reasonable beliefs that the unmodified loan presented a significant risk of foreclosure and that the modification would substantially reduce that risk.

Accordingly, the modification is within the scope of this revenue procedure.

SECTION 8. EFFECTIVE DATE

This revenue procedure governs determinations made by the Service on or after May 16, 2008, with respect to loan modifications that are effected on or before December 31, 2010.

SECTION 9. REQUEST FOR COMMENTS

The Service invites public comment on this revenue procedure. In particular, the Service invites comments on whether this revenue procedure should be extended to loan modifications that are effected after 2010, whether the Service should consider changing other provisions of this revenue procedure, and whether the Service should consider issuing any additional guidance regarding Federal tax issues that are raised by modifications of mortgage loans to reduce the risk of foreclosure. Comments should be submitted no later than July 15, 2008, to the Internal Revenue Service, CC:PA:LPD:RU (Rev. Proc. 2008-28), room 5203, P.O. Box 7604, Ben Franklin Station, Washington, DC 20044. Comments may be hand delivered between the hours of 8 a.m. and 4 p.m. to CC:PA:LPD:RU (Rev. Proc. 2008-28), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue NW, Washington, DC 20224. Alternatively, comments may be submitted via the Internet at *Notice.Comments@irsounsel.treas.gov* (Rev. Proc. 2008-28). All comments will be available for public inspection and copying in their entirety. Therefore, comments received by the IRS and Treasury should not include taxpayer-specific information of a confidential nature. Comments should include the name and telephone number of a person to contact.

SECTION 10. DRAFTING INFORMATION

The principal author of this revenue procedure is Diana Imholtz of the Office of Associate Chief Counsel (Financial Institutions and Products). For further information, contact Ms. Imholtz on (202) 622–3930 (not a toll-free call).