

Modifying Residential Mortgage Loans: Tax Consequences for REMICs and REMIC Investors

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Will Cejudo, James Gouwar and Brooke Hintmann analyze the tax consequences, including areas where the tax treatment is unclear, for REMICs and REMIC investors holding a residential mortgage loan that undergoes a “significant modification.” They discuss exceptions to “significant modifications,” including an analysis of two recently released revenue procedures, and explore the consequences for regular and residual interest holders. They also provide an example with different scenarios to illustrate the varying tax consequences.

As has been widely reported in the media, foreclosures on residential mortgage loans have recently soared to an all-time high¹ and are expected to climb even further as subprime adjustable mortgage rates reset and housing prices in some markets continue to decline.² Rising delinquencies and a weakening housing market have prompted legislators and regulators to apply increasing pressure on mortgage lenders to work out delinquent loans rather than initiating foreclosure. Consequently, it is likely that a significant number of mortgage loans will be modified in the coming months. Where such loans are held in real estate mortgage investment conduits (REMICs), these modifications will have federal income tax consequences for both the REMICs and their investors. This article summarizes these consequences and provides an overview of the issues that should be addressed by any proposal to modify residential mortgage loans held by a REMIC.

Efforts to Address Delinquencies and Foreclosures

Devising ways for borrowers to avoid foreclosure has become a top public policy concern for officials in both the federal and state governments. Several proposals to stem delinquencies and foreclosures have been promulgated at the federal executive level. For example, the Federal Housing Administration (FHA) has modified its refinancing program to enable borrowers to refinance their adjustable-rate mortgage loans into FHA-insured fixed-rate loans.³ In addition, the Department of Treasury (“the Treasury”) and other federal banking agencies have endorsed a voluntary plan to streamline the loan modification process for certain subprime adjustable rate mortgages.⁴ The Treasury has also recently reached an agreement with six of the largest residential mortgage loan servicers to reach out to borrowers who are 90 days delinquent and delay foreclosure for up to 30 days to determine if a workout plan is feasible.⁵ Also, the IRS has now

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issued two revenue procedures providing guidance regarding consequences to the REMICs making modifications in prescribed circumstances.⁶

Congress has also been active in crafting solutions to allow delinquent borrowers to stay in their homes. For example, legislation is being considered that would expand FHA financing to allow troubled borrowers to refinance their existing loans into government-guaranteed loans with lower principal amounts.⁷ Under this proposal, the existing senior lien-holder would agree to release its lien on the related property in exchange for a payment not exceeding 90 percent of the current appraised value of the property. To provide an incentive for an existing subordinate lien-holder to release its lien, depending on the circumstances, the borrower would be required to share with the subordinated lien-holder some of the appreciation in the value of the mortgaged property or some of the net proceeds received from the sale or refinancing of the related property. For defaulted residential mortgage loans already in the foreclosure process, Congress is considering legislation that would enable bankruptcy judges to modify the terms of a mortgage loan on the debtor's principal residence notwithstanding current prohibitions against such modifications under Chapter 13 of the Bankruptcy Code. Under these proposals, the judge would generally have the discretion to reduce the outstanding balance of the mortgage loan to the current fair-market value of the property or reduce the interest rate of the loan.⁸

At the state level, legislation has been passed or is pending in a variety of states that induces or compels servicers to reach out to borrowers to find ways to avoid foreclosure.⁹ In addition, one state governor has entered into nonbinding agreements with loan servicers to increase the servicers' efforts to contact at-risk borrowers and work out troubled loans.¹⁰

Overall, these proposals to assist borrowers in avoiding foreclosure actions potentially give rise to a variety of loan modifications which include (i) waiver of borrower default, (ii) deferral of foreclosure proceedings, (iii) reduction of interest rates, (iv) change of an adjustable rate to a fixed rate, (v) alteration in the amount of mortgage payments, (vi) forgiveness of principal owed and (vii) shifting the lien position on existing mortgage loans. As discussed below, such modifications may have significant federal income tax consequences for REMICs and REMIC investors.

Consequences of Loan Modifications to a REMIC

The REMIC Provisions¹¹ effectively prohibit a REMIC from acquiring or exchanging mortgage loans after its startup day, unless one or more exceptions are satisfied.¹² In certain cases, even the modification of an existing mortgage loan can run afoul of the REMIC Provisions. This is because under the Internal Revenue Code ("the Code"),¹³ a "significant modification" of a mortgage loan is treated as an exchange of the existing loan for the modified loan.¹⁴ As a result, the "significant modification" of a mortgage loan held by a REMIC could be treated as a disposition of an existing loan by the REMIC and the acquisition of a new loan.¹⁵ Accordingly, any proposal to encourage or compel modifications of mortgage loans held by a REMIC should take into account the resulting tax consequences to the REMIC and its investors.

Significant Modifications

The REMIC Provisions deem three federal income tax consequences to result when a loan held by a REMIC undergoes a "significant modification" that does not qualify under a specific exception. First, the REMIC is treated as having disposed of the existing loan.¹⁶ Consequently, the REMIC is subject to a 100-percent tax on any gain realized as a result of the deemed disposition.¹⁷ Second, the REMIC is subject to a 100-percent tax on any income (including interest) derived from the modified loan.¹⁸ Third, the modified loan is categorized as a nonpermitted asset of the REMIC for purposes of Code Sec. 860D(a)(4), which requires that "substantially all" of the assets of a REMIC be qualified mortgages or permitted investments. Thus, significant modifications of loans that fail to qualify for an exception result in penalty taxes being imposed on the REMIC and, to the extent that the modified loan, when combined with other nonpermitted assets of the REMIC, makes up a greater than *de minimis* portion of the assets of the REMIC, endanger the REMIC's status as a REMIC.¹⁹

Whether a particular loan modification is a "significant modification" is analyzed under Code Sec. 1001. The applicable regulations under Code Sec. 1001 consider first whether the alteration to the mortgage loan qualifies as a "modification."²⁰ If so, the regulations then consider whether such modification is "significant."²¹

In general, a "modification" is any alteration, including any deletion or addition, in whole or in

part, of a legal right or obligation of the issuer or a holder of a debt instrument, whether the alteration is evidenced by an express agreement, conduct of the parties or otherwise.²² A modification need not be in writing—it may be oral—and may be created by the course of dealings between the REMIC (or the servicer acting as its agent) and the borrower.²³ A modification does not include an automatic change in the terms of a loan pursuant to a provision of the original loan documents (e.g., the automatic adjustment to the interest rate of an adjustable rate loan does not constitute a modification).²⁴ However, a change in the loan's obligor or the recourse nature of the loan are never viewed as "automatic" for this purpose.²⁵ In addition, the exercise of a unilateral option pursuant to a provision of the original loan documents (e.g., the right of the borrower to convert an adjustable rate loan to a fixed rate loan) does not qualify as a modification as long as there is no fee associated with the exercise of such option other than (i) a fee that is specified as to amount or by an objective formula in the loan documents or (ii) a fee of a *de minimis* amount.²⁶ Finally, a temporary forbearance in the exercise of the REMIC's options after a borrower defaults in payment does not result in the modification of the loan.²⁷

Once it is determined that a modification of the loan has occurred, the next question is whether such modification is "significant." The regulations to Code Sec. 1001 address this question through two tiers of rules, with the first tier providing specific rules covering particular types of modifications and the second tier providing a general catch-all rule to the extent no specific rule applies.²⁸ The specific rules address common categories of modifications (e.g., an interest rate modification) and provide objective measures for determining whether that modification is "significant."²⁹ Under the specific rules, the following loan modifications are generally significant modifications:

- A change in the yield of more than the greater of (i) 25 basis points or (ii) five percent of the annual yield of the unmodified loan (e.g., 30 basis points per year in the case of a debt instrument with an annual yield of six percent)
- A material deferral of scheduled payments (A "safe harbor" provides that a deferral equal to the lesser of (i) five years and (ii) 50 percent of the original term of the loan is not a material deferral. It is not clear how to apply this rule to amortizing debt instruments, such as most residential loans.)

- A change in the obligor of a recourse loan
- A change of the loan from nonrecourse to recourse
- A change in (i) a "substantial amount" of the collateral for a nonrecourse loan or (ii) the credit enhancement for a nonrecourse loan
- A change in the "payment expectations" for the loan caused by (i) the addition or deletion of a co-obligor, (ii) a change in the collateral or credit enhancement for a recourse loan or (iii) a change in the lien priority of the mortgage securing the loan³⁰

If a type of modification is not addressed by a specific rule, then the modification is tested under the more general catch-all rule.³¹ The general rule provides that a modification is significant "only if, based on all the facts and circumstances, the legal rights or obligations that are altered and the degree to which they are altered are economically significant."³²

Exception for Defaults and Reasonably Foreseeable Defaults

Determining whether a particular alteration to the terms of a loan constitutes a "significant modification" under the Code Sec. 1001 regulations requires a complex analysis that may result in a conclusion that lacks certainty. Fortunately, the REMIC Provisions contain several exceptions under which a loan may be modified without endangering the status of the REMIC, regardless of whether such modification would be classified as a significant modification. All of these exceptions are aimed at practical situations that are commonly encountered by mortgage loan servicers. One such exception, which permits changes in the terms of an obligation "occasioned by default or a reasonably foreseeable default," is particularly relevant in light of the recent efforts to avoid foreclosures resulting from delinquencies.

The IRS recently issued two revenue procedures providing guidance as to the application of this exception. In Rev. Proc. 2007-72,³³ the IRS provided guidance with respect to REMICs making modifications pursuant to the ASF Framework (see endnote 4).³⁴ The revenue procedure provides that in the case of certain modifications made under the ASF Framework, the IRS will not challenge a securitization vehicle's qualification as a REMIC on the grounds that the modifications do not qualify under the exceptions listed in the REMIC Provisions. This guidance provides certainty with respect to the federal income tax consequences of modifications covered by the ASF Framework by setting forth specific cri-

teria to determine whether a loan may be modified. By providing such criteria, the revenue procedure decreases the burden on servicers in processing a growing number of loan modification requests because the standards set forth in the revenue procedure do not require a loan-by-loan analysis to determine whether any particular loan is in default or default is reasonably foreseeable.

The IRS provided additional guidance regarding loan modifications in Rev. Proc. 2008-28,³⁵ which addresses streamlined loan modifications performed as part of foreclosure prevention programs developed and implemented by servicers. In the revenue procedure, the IRS acknowledges the usefulness of foreclosure prevention programs to streamline the modification process for a large number of at-risk borrowers. The revenue procedure also describes the general guidelines established under these programs (e.g., FICO score, original loan-to-value ratio, changes in neighborhood property values and anticipated changes in monthly debt service) to identify borrowers who (i) are likely to go into foreclosure if the terms of their loans remain unmodified and (ii) are able to make timely payments on a modified loan with more favorable terms. The programs also suggest types of modifications that may allow the borrower to make timely payments on the loan. The revenue procedure accepts that these programs can assess “with a high degree of accuracy” whether a borrower poses “an unacceptably high risk of eventual foreclosure” on the mortgage loan, even when relevant information for a particular borrower is unavailable (e.g., current sources of income) and the borrower is not yet delinquent on his or her loan. Accordingly, the revenue procedure provides that, in the case of modifications covered by the revenue procedure, the IRS will not (i) challenge a securitization vehicle’s qualification as a REMIC on the grounds that the modifications are not permitted by the REMIC regulations or that the modifications result in a deemed reissuance of the REMIC regular interests, or (ii) contend that such modifications constitute prohibited transactions under the REMIC Provisions.³⁶

Both revenue procedures provide that no inference should be drawn regarding whether similar consequences would be obtained if a transaction falls outside the scope of the revenue procedure. Thus, unless a particular loan modification is clearly addressed by one of the revenue procedures, the determination as to whether a loan is in default or default is reasonably foreseeable should be made on

a loan-by-loan basis, based on information available with respect to a particular loan and borrower.

Beyond the two revenue procedures discussed above, there is little guidance concerning the nature or severity of defaults necessary to satisfy the exception provided in the REMIC regulations for modifying loans in “default.” Although the REMIC Provisions do not define the term “default,” the term is commonly understood to mean the failure of the mortgagor to perform any obligation that the mortgagor is required to perform under the terms of the mortgage loan, such as the failure to make payments under the mortgage loan when due. The IRS may take the view, however, that the default exception requires more than a minor or technical default before a loan may be modified under that exception.³⁷ In addition, nontax provisions in the securitization vehicle’s governing documents often preclude the modification of a loan held by a REMIC in cases of only minor default.

Additional guidance regarding the nature and extent of the default necessary for a REMIC to modify a loan may be gleaned from the REMIC Provisions addressing “foreclosure property.” In general, if upon foreclosure a REMIC acquires the real estate securing a loan, that property will be a permitted asset of the REMIC provided such property would be “foreclosure property” under Code Sec. 856(e) if acquired by a real estate investment trust (REIT).³⁸ Under the REIT provisions, property acquired upon the default of a lease or loan does not constitute “foreclosure property” if the REIT acquired the lease or loan with “an intent to evict or foreclose or when the [REIT] knew or had reason to know that default would occur.”³⁹ Such knowledge is referred to under the REIT provisions as “improper knowledge.”⁴⁰ Three IRS private letter rulings address whether a REMIC had improper knowledge with respect to certain commercial loans held by the REMIC.⁴¹ Each ruling reasons that the type of default that is relevant for purposes of the REIT provisions is the type of default that ordinarily leads to foreclosure.⁴² In light of this analysis, a REMIC that intends to modify a loan based on the fact that the loan is in “default” should be comfortable that the loan has a payment history of the type that ordinarily leads to foreclosure, absent further guidance from the IRS.

Likewise, outside of the two revenue procedures discussed above, the REMIC Provisions do not provide any specific guidance as to when default by a borrower under a mortgage loan is considered “reasonably foreseeable.” At a minimum, however,

this exception presumably contemplates some type of indication that the borrower will have difficulty making scheduled payments, even though the borrower is currently making all payments required by the loan. Nothing in the REMIC regulations suggests that the REMIC must wait for a borrower to contact the REMIC before considering a loan modification. Thus, the servicer of a loan held by a REMIC should be able to initiate contact with a borrower in advance of an impending upward adjustment in the amount of a scheduled monthly payment in order to determine whether such adjustment will make it likely that the borrower will default. In this situation, however, because the borrower has not actually defaulted on the loan, the servicer should proceed cautiously with respect to any proposed modification that would rely on the conclusion that default is reasonably foreseeable, absent further guidance from the IRS.

Types of Modifications Anticipated by Various Proposals

The existing REMIC Provisions regarding loan modifications are flexible enough to accommodate many modifications made pursuant to the various proposals aimed at avoiding foreclosures. For example, changes to the amount or timing of the borrower's payments would seem to fit well within the default exception, provided the loan is in default or default is reasonably foreseeable and the modification is consistent with the servicing standard required to be used by the servicer in carrying out its obligations under the securitization vehicle's governing documents.

Other types of modifications may require additional consideration and further guidance from the IRS. For example, under one proposal, the existing lender would accept a partial principal payment in connection with a refinancing, agree to different payment terms with respect to the remaining balance and agree to have such remaining balance secured by a junior lien. The new lender would have a senior lien on the property with respect to the amount loaned in the refinancing.⁴³ This proposal raises a question as to whether the REMIC (as the existing lender) will have "released" its lien on the property securing the loan if it participates in such a refinancing.

Under Reg. §1.860G-2(a)(8), if a "REMIC releases its lien on real property that secures a qualified mortgage, that mortgage ceases to be a qualified mortgage" unless the loan is defeased under prescribed circumstances. Although this regulation could be read as merely permitting defeasance, the

language referring to a REMIC releasing its lien can be troublesome. Specifically, the language suggests that any release of a lien must be accompanied by a defeasance, rather than simply permitting defeasances. Moreover, this provision applies even if the modification is made at a time that the borrower is in default or default is reasonably foreseeable. As a result, even if a modification is made at the time the loan is in default, a modification that results in a "release" of the lien could mean that the loan is no longer a "qualified mortgage" of the REMIC.⁴⁴

It is not clear whether an agreement by a senior lien-holder to accept a junior lien under the proposal described above would constitute a "release" under the REMIC regulations. A recent proposal by the IRS to amend this regulation creates additional uncertainty. Proposed Reg. §1.860G-2(b)(3)(v) would add an additional exception to the list of changes to a mortgage loan that would not cause an existing mortgage loan to be treated as a new mortgage loan under the REMIC Provisions.⁴⁵ It would permit a "modification that releases, substitutes, adds or otherwise alters a substantial amount of the collateral for, a guarantee on, or other form of credit enhancement for a recourse or nonrecourse obligation, so long as the obligation continues to be principally secured by an interest in real property following such release, substitution, addition or other alteration." Under this language, it is not clear whether the acceptance of a junior lien position causes an alteration of the collateral. That is, the collateral may be the same property but the existing lender has accepted a junior position with respect to the collateral. On the other hand, the lender may be in the same position with respect to the collateral as it was before the modification (*i.e.*, with a loan balance that exceeds the value of the security). The overall approach of the proposed regulation raises a question as to whether a change in lien position that does not cause the mortgage loan to be treated as a new mortgage loan (because the modification was made when the loan was in default) nevertheless requires that the modified loan be retested for qualification under the general requirement that a debt obligation held by a REMIC be "principally secured by an interest in real property."

If the modification described in the proposal causes the loan to cease to be a qualified mortgage for a REMIC, it does not appear the modified loan would constitute a permitted investment of the

REMIC. To be considered “foreclosure property” and thus a “permitted investment,” the modified loan would need to be property that secured the original loan, which does not appear to be the case.⁴⁶ Further, it does not appear that the modified loan would fit one of the remaining categories of permitted investments for a REMIC.⁴⁷ Thus, those acting on behalf of a REMIC will need to consider how to deal with such a modification if this proposal advances.

Reissuance of a REMIC’s Regular Interests

One final way in which loan modifications might affect a securitization vehicle’s status as a REMIC arises from the potential alteration of the regular interest holders’ entitlement to cash flows from the mortgage loans held by the REMIC. As discussed in greater detail below, regular interests in a REMIC are treated as debt issued by the REMIC and any modification of a loan held by the REMIC may affect the regular interests’ entitlement to cash flows. In Rev. Proc. 2007-72 and Rev. Proc. 2008-28, the IRS states that to the extent that a modification is covered by one of the revenue procedures, the “Internal Revenue Service will not challenge a securitization vehicle’s qualification as a REMIC on the grounds that the transactions resulted in a deemed reissuance of the REMIC regular interest.” As noted above, however, a change that occurs by operation of the terms of the loan instrument itself is not a modification unless it involves a change in the obligor or recourse nature of the instrument or the loan is converted into property that is not debt.⁴⁸ Because the servicer of a REMIC generally has the power to modify loans to address defaults under the governing documents, it would seem that any modification of the collateral would not result in a “modification” (within the meaning of Reg. §1.1001-3) to any entitlement of the regular interests issued by the REMIC and thus could not result in a “significant modification.” If, however, the consent of regular interest holders is needed to provide the servicer with sufficient flexibility to modify mortgage loans, reissuance of the regular interests may be of more concern. Given that a REMIC must issue all its regular interests on the “startup day,”⁴⁹ the consequences of a REMIC being deemed to have reissued one or more regular interests would cause the securitization vehicle to lose its status as a REMIC.

Consequences of Loan Modifications to Regular Interest Holders

Assuming that a REMIC can modify a loan without creating any tax issues for itself, the next question is how those modifications will affect the taxation of investors in the REMIC. First to be addressed are the federal income tax consequences to regular interest holders.

In general, the types of modifications typically undertaken with respect to a borrower in default result in either reduced or deferred entitlements to cash flow (*i.e.*, interest, principal or prepayment penalties). The REMIC’s structure determines which regular interests will suffer the effects of a modification. In some structures, the entitlements to cash flow are determined without regard to modifications. In those cases, the senior classes of regular interests will be insulated from the effects of the modification provided there are sufficient subordinate classes to absorb the reduced cash flow. For example, where an interest rate modification reduces the amount of interest received by the REMIC, the available funds will be used to pay the stated rate of interest on the senior regular interest before any funds are available to pay the subordinate regular interests. For the regular interest holders suffering such shortfalls, the question arises as to how and when such shortfalls are taken into account for federal income tax purposes.

The starting place for this analysis is Code Sec. 860B, which provides that (i) regular interests are treated as debt and (ii) regular interest holders must use an accrual method of accounting with respect to their income from such interests. As noted above, the modification of loans held by a REMIC will generally not result in the reissuance of the regular interest. However, Reg. §1.1275-2(j) provides that if the “terms of a debt instrument are modified to defer one or more payments, and the modification does not cause an exchange under Code Sec. 1001, then, solely for purposes of Code Secs. 1272 and 1273, the debt instrument is treated as retired and then reissued on the date of the modification for an amount equal to the instrument’s adjusted issue price on that date.” If this rule applies, the income or loss recognized by the affected REMIC regular interest holders may be altered.

Whether the “terms” of a regular interest have been changed as a result of a loan modification is often unclear. For example, assume a REMIC holds

a loan bearing interest at a net rate of seven percent and issues a regular interest with an interest rate of seven percent. The REMIC later modifies that loan to pay a net rate of five percent, with the result that there will not be enough interest payable on the loan to pay the regular interest its full stated interest rate, even assuming no further defaults or delinquencies. In such a case, have the terms of the regular interest been changed?

In the event that a loan modification causes a regular interest to be subject to Reg. §1.1275-2(j), the effects of the change in the regular interest's future entitlements is spread across the remaining term of the regular interest under the original issue discount (OID) rules. Thus, a loan modification that reduces the cash flow entitlement of a regular interest may cause the regular interest holder to recognize decreased, or even negative, OID accruals in future periods.⁵⁰ Any negative accruals would reduce the regular interest holder's ordinary income with respect to such interest.

Even if Reg. §1.1275-2(j) does not apply to a particular regular interest, the modification of a mortgage loan held by the REMIC arguably reduces OID accruals on the regular interest if the modification causes an alteration in the remaining payment schedule for the loan. For example, if an interest-only regular interest is entitled to a specified portion of each interest payment on a mortgage loan and that loan is modified in a way that reduces the amount of interest payable to that regular interest, the regular interest holder's future OID accruals should be reduced in much the same way as if the borrower had made a *pro rata* prepayment. Thus, OID accruals for future periods would be reduced, and in some cases, negative OID could result if the reductions in interest were sufficiently severe.

Alternatively, the reduced payment stream from a modified loan could be viewed as separate from the entitlement of a regular interest. Under this theory, the regular interest has not experienced a reduction in its entitlement. Rather, the REMIC is simply not paying the regular interest its full entitlement because it does not have sufficient assets to do so. Under this view, the regular interest would be treated like any other debt instrument where the borrower has failed to pay all amounts owed in a timely fashion. For example, qualified stated interest and OID would continue to accrue until ultimate payment of the full entitlement becomes "doubtful,"⁵¹ which might result in different timing of income than if the OID schedule

were immediately adjusted. In addition, the regular interest holder might be permitted to recognize its loss only upon the sale, exchange or redemption of the regular interest, in which case such loss might be characterized as a capital loss.⁵² On the other hand, some regular interest holders might take the position that Code Sec. 166, relating to bad debts, would apply to allow a deduction with respect to the regular interest in the event that the modified mortgage loan would not provide sufficient cash flows to fulfill the regular interest's full entitlement.⁵³

Thus, although the Code and regulations do provide some guidance, the tax treatment of a regular interest evidencing the right to receive cash flows from a modified loan remain unclear. Under one view, the effects of the modification should be characterized as a change in the regular interest's cash flow entitlement, and dealt with by making adjustments to the accrual of OID. Under another view, the modification simply results in the REMIC being unable to satisfy its debt, with the consequence that the regular interest holder's remedy is dictated by the provisions of the Code dealing with credit losses. Such a method potentially subjects the regular interest holder to inequitable timing and character mismatches.⁵⁴ Given the lack of guidance on this subject and the principles reflected in Reg. §1.1275-2(j), there is a strong argument that regular interest holders should take modifications into account by adjusting future OID accruals, effectively balancing previous over-inclusion of ordinary income with reduced amounts of ordinary income in the future. Even under this approach, however, the holder of the regular interest might end up with negative OID accruals, thus increasing the demand for IRS guidance on the treatment of negative OID.⁵⁵

Consequences of Loan Modifications to Residual Interest Holders

The lack of clarity regarding the taxation of regular interests carries over to the taxation of residual interests. REMICs generally are not subject to federal income taxation.⁵⁶ Instead, the income of a REMIC is allocated to its residual interest, and the holder of such interest is required to take into account any REMIC income or loss when computing its own income tax liability.⁵⁷ The income or loss of a REMIC is determined by netting the income arising from

the REMIC's assets (*i.e.*, its qualified mortgages and permitted investments) and the REMIC's expenses (*e.g.*, interest and OID deductions arising from its regular interests, along with servicing costs and other fees).⁵⁸ Accordingly, the residual interest in a REMIC is subject to the federal income tax consequences (positive and negative) that result from the timing differences between the inclusion of income earned on the assets held by the REMIC and the accrual of interest and OID deductions with respect to the regular interests issued by the REMIC and other expenses of the REMIC.⁵⁹

Given the sensitivity of the residual interest to timing differences between the income from REMIC assets and accrued deductions with respect to REMIC regular interests, modifications to the loans held by a REMIC can have a significant impact on the tax liability of a residual interest. This is because a loan modification may cause the REMIC to realize a loss on its assets (*e.g.*, if the principal amount of the loan is written down), while at the same time increasing the REMIC's income because a reduced amount will be paid on its liabilities as a result of the modification.

Effects of Loan Modifications on the REMIC's Income

The modification of a loan held by a REMIC can affect the REMIC's income under two separate Code provisions. First, the REMIC Provisions contemplate that a REMIC may have "bad debt" deductions and provide that debt owed to a REMIC is not treated as nonbusiness debt under Code Sec. 166(d).⁶⁰ Consequently, deductions for worthless or partially worthless debts are available to REMICs. Second, a loan modification could constitute a "significant modification" under Code Sec. 1001, resulting in a deemed exchange of the unmodified loan for the modified loan. Putting aside the possibility that the modified loan may no longer qualify as a permitted asset of the REMIC, this deemed exchange would require the REMIC to recognize gain or loss with respect to the original loan.⁶¹ The application of either of these provisions requires a determination of the REMIC's tax basis in the original loan. For example, the bad debt deduction permitted by Code Sec. 166 is based on the taxpayer's basis in the debt giving rise to the deduction,⁶² and the gain or loss computation required by Code Sec. 1001 necessarily relies on the basis of the unmodified debt instrument.⁶³ Computing the REMIC's basis in any given loan, however, can prove to be challenging.

In general, a taxpayer's basis in a loan is equal to:

- (i) the amount paid for the loan, *plus*
- (ii) the amount of any OID or market discount recognized with respect to the loan, *minus*
- (iii) the amount of any premium amortized with respect to the loan, *minus*
- (iv) the amount of any receipt of the "stated redemption price at maturity" of the loan (generally, the principal amount of the loan).⁶⁴

Attempting to apply this formula to a loan held by a REMIC highlights the lack of guidance available with respect to several fundamental issues. First, it is not clear how a REMIC should determine its cost basis in a loan. When a REMIC is formed, the REMIC's "bases" in its assets equals the aggregate of the issue prices of its regular and residual interests.⁶⁵ However, the REMIC Provisions do not address how this aggregate amount is to be allocated among the REMIC's assets. Allocating basis according to the relative fair market value of each asset is a possible approach (*e.g.*, allocating basis to mortgage loans based on a weighting formula that takes into account each loan's principal balance, the borrower's FICO score and the loan's interest rate). Nevertheless, it is generally more practical to allocate basis according to the principal balances of the REMIC's loans.

In addition, the REMIC Provisions do not make clear how any discount or premium with respect to a loan should be amortized, because such amortization first requires a determination as to how to apply the REMIC's prepayment assumption, which itself is not clear. The REMIC Provisions require that a REMIC use a prepayment assumption for purposes of calculating the amortization of premium and the accrual of original issue and market discount on the mortgage loans it holds. This same prepayment assumption is used by the REMIC to calculate the amortization of premium and accrual of OID on the regular interests issued by the REMIC.⁶⁶ Neither the Treasury nor the IRS has provided specific guidance regarding how to apply a prepayment scheme, leaving taxpayers to interpret the bare bones structure set forth in the Code and a limited discussion in the legislative history. These authorities do not address the difficult question of how to integrate a prepayment assumption, which is most easily applied on a pool-wide basis, into calculations that would generally require a loan-by-loan analysis, such as determining the tax basis in a particular loan.

A prepayment assumption, in its simplest form, assumes that a certain percentage of principal will be prepaid in each month. Applying a prepayment assumption to a particular loan, however, rarely reflects

reality because residential mortgage loans generally either prepay in full or pay only the scheduled amount.⁶⁷ Any calculation of premium or discount, however, must take into account adjustments for events that have occurred prior to the close of the accrual period.⁶⁸ Therefore, if it is assumed that a small prepayment will be received on each loan every month, and these loans in fact either prepay in full or not at all, adjustments must be made to the accrual of each loan on a monthly basis to account for the fact that the reality of the loans' payments differed from the amortization contemplated by the prepayment assumption. Although applying the prepayment assumption in this manner on a loan-by-loan basis, with corresponding adjustments, allows for a precise calculation of the REMIC's basis in any particular loan, complying with this method may be costly and time-consuming for the REMIC.

It is not clear whether the REMIC Provisions require a REMIC to adopt a loan-by-loan method in applying a prepayment assumption. Thus, to avoid the complexities associated with that method, REMICs often aggregate all of their loans into a single "mass loan" for purposes of applying the prepayment assumption. Under this method, the REMIC essentially allocates any premium or discount in proportion to the outstanding principal balance of each loan, adjusting the amortization only to the extent that the pool in the aggregate is paying down faster or slower than assumed. To determine the REMIC's basis in any particular loan under this method, a portion of any unamortized premium or discount at the pool level is allocated to that loan based on its outstanding principal balance.

Regardless of which method is used to determine the REMIC's basis in a loan, to the extent that the loan is held at a discount (or a premium), any "significant modification" of the loan under Code Sec. 1001 will necessarily result in an ordinary gain (or loss) to the REMIC. This is because the unmodified loan would be treated under that section as having been exchanged for a modified loan having an adjusted issue price equal to its outstanding principal balance.⁶⁹ Thus, for purposes of amortizing any premium or discount, the modification would trigger the same tax consequences that would have resulted had the loan been retired (*i.e.*, acceleration of the amortization of premium or accrual of discount).

Once the REMIC has recognized any income or loss with respect to the original loan, it must adjust its computations to take into account the tax characteristics of the modified loan. This change gives rise to several issues for the REMIC. First, the REMIC is treated as

having acquired the modified loan for its issue price. It is unclear, however, whether a REMIC that has taken a "mass loan" approach to its basis allocations should now track the modified loan's basis separately, or whether it can simply make any necessary adjustments to its overall basis in the pool. Second, the REMIC must continue to amortize any premium or discount on the original loans in the pool, but it is uncertain whether a REMIC taking the "mass loan" approach can now make the necessary adjustments to exclude the modified loan from those calculations. Finally, there are questions regarding how a modified loan issued with OID (*e.g.*, modified loans with teaser rates) will be tracked under the "mass loan" approach. For example, there is no guidance as to whether separate OID calculations are necessary under these circumstances or whether those calculations could be combined with other modified loans or the remainder of the pool. These open questions illustrate the perplexing tax accounting issues faced by REMICs holding a substantial number of modified loans.

Considering the Asset Effects Together with the Liability Effects

As described above, the federal income tax consequences of a loan modification to a residual interest holder are driven not only by resulting changes in the REMIC's assets, but also by the effect of the modification on the REMIC's liabilities, *i.e.*, its regular interests. The modification of a mortgage loan affects the amount and timing of payments to the REMIC regular interests. In general, the loss realized by a REMIC as a result of a loan modification should be offset by either cancellation of indebtedness income or reduced OID deductions resulting from decreased cash flow to the regular interests. However, as discussed above under "Consequences of Loan Modifications to Regular Interest Holders," the manner in which those reductions with respect to the regular interests should be taken into account is unclear. Because of the uncertainty as to whether such adjustments should be made under the OID rules or through the cancellation of indebtedness rules, the effect a loan modification will have on the timing of income and loss to the residual holder is unclear.

For example, if a REMIC writes off a portion of the principal balance of a loan as a result of a modification, the REMIC may take the position that its loss on the loan is currently deductible. It is unclear, however, how the REMIC should address the fact that one or more of its regular interests will eventually suffer a

Example

The example below, admittedly very simple, demonstrates that losses realized on mortgage loans that result in reductions of more subordinated classes have the same consequence as paying down those classes as far as the REMIC residual holder is concerned. Assuming those classes are higher yielding classes, putting aside whether there may be other timing consequences further reducing a REMIC's income, the tendency is for the losses to reduce the absolute amount of phantom income to the REMIC and shorten the period that the REMIC produces phantom income (and in some cases, potentially causing the REMIC to realize losses before income).

Assume that a REMIC holds two mortgage loans, each with a principal balance of \$100x and an interest rate of 10 percent per annum. The REMIC issues two regular interests: Class A with a stated coupon of 10 percent, a principal balance of \$100x, and an issue price of 105 percent and Class B with a stated coupon of 10 percent, a principal balance of \$100x, and an issue price of 95 percent. Class A, entitled to the first principal payments received, is expected to be retired in a single principal payment at the end of year one, and Class B is expected to be retired in a single principal payment at the end of year two. Class A has an expected yield to maturity of about 4.75 percent and Class B has an expected yield to maturity of about 13 percent. The blended yield of these two classes is initially just under nine percent, and once Class A pays off, will be about 13 percent (the Class B yield). The collateral has a stated rate and yield of 10 percent because the aggregate issue prices of the Class A and Class B interests equals \$200x, the par amount of the loans.

Alternative 1. Now assume that the Class A interest is paid off at the end of year one with a single principal payment, and that the Class B interest is paid off at the end of year two with a single principal payment. The REMIC residual will recognize \$2.65x of income in year one and an offsetting loss of \$2.65x in year two. For year one, the REMIC has cash flow of \$120 and gross income of \$20x. The REMIC pays \$110x to the Class A interest and deducts a net \$5x (\$10x of interest offset by the amortization of the \$5x of premium). The REMIC also pays \$10x to the Class B interest and deducts \$12.35x (\$10x of stated interest plus an accrual of \$2.35x of the total of \$5x of discount). Hence, \$20x of income in year one with only \$17.35x of regular interest deductions. For year two, the REMIC receives \$110x from its remaining mortgage, pays \$110x to the Class B interest, and deducts \$12.65x (\$10x of stated interest and accrual of the remaining \$2.65x of discount). Hence, there is a loss of \$2.65x in year two.

Alternative 2. Now assume that the Class B interest is paid off at the end of year one with a single principal payment, and that the Class A interest is paid off at the end of year two with a single principal payment. The REMIC residual will recognize \$2.59x of loss in year one and an offsetting income of \$2.59x in year two. The Class B interest would receive \$110x of cash flow and the REMIC would deduct \$15x (\$10x of stated interest and \$5x of accrued discount). The Class A interest would receive \$10x of cash and the REMIC would deduct a net \$7.59x for a total deduction of \$22.59x (resulting in a loss of \$2.59x). In year two, the REMIC would pay the Class A interest \$110x and deduct \$7.41x on the Class A interest (resulting in net income of \$2.59x).

Alternative 3. Now assume that the REMIC suffers a loss of \$100x of principal on its mortgages at the end of year one and allocates all of the loss to the Class B interests. The Class B interest would receive \$10x of cash and suffer a net \$85x loss. The REMIC would have \$85x of income in addition to \$20x of income from its mortgage loans and a \$100x loss. The REMIC would also receive a net deduction on the Class A interest of \$7.59x (resulting in a net loss of \$2.59x). In year two, the REMIC would pay the Class A interest \$110x and deduct \$7.41x on the Class A interest (net income of \$2.59x).

Although the results of Alternative 3 may seem counterintuitive, essentially the same phenomena occurred with prepayment protection structures and rapid prepayment rates in earlier interest rate cycles. The support classes, which were issued with higher yields, paid off more rapidly than the prepayment protected classes, and the REMIC residuals in those structures often reported losses before the corresponding income. Although the reduction in principal would be occurring for different economic reasons, the trends would be similar with the effects being accelerated and being allocated to subordinate, higher-yielding classes.

shortfall equal to the aggregate amount of the write off. The fact that the REMIC will ultimately pay a reduced amount to its regular interests as a result of the modification could be accounted for in one of two ways. First, the REMIC could treat the reduction as income from the discharge of indebtedness under Code Sec. 61(a)(12). This approach raises the further question as to whether the discharged amount would be taken into income by the REMIC currently or whether Code Sec. 108 would apply to permit deferral of the income.⁷⁰ Alternatively, the REMIC could take the reduction in expected payments to the regular interests into account through its OID calculations by reducing the stated redemption price at maturity of the affected regular interests. This approach would have the result of spreading the effect of the modification over future payment periods. There has been no definitive guidance from the IRS as to which of these two approaches is required, or preferred.

Notwithstanding these uncertainties, it seems clear that the modification of a mortgage loan held by a REMIC will result in the reduction of the REMIC's phantom income, and thus the present value of the residual interest's anticipated tax liability. The primary generator of phantom income for a residual interest is the disparity between (i) the level yield produced by the REMIC assets and (ii) the upward sloping yield curve tracked by the regular interests issued by the REMIC (*i.e.*, the interests expected to pay off first have a lower yield than the interests expected to pay off later). Whether the upward slope is a result of timing or credit risk does not change the calculus as to how income is calculated for the REMIC residual. In either case, to the extent that the higher yielding classes are

retired faster than the lower yielding classes (whether through principal prepayments or losses), the upward slope of the yields of the regular interests is reduced.⁷¹ Accordingly, although individual structures may differ, in general the modification of mortgage loans of a REMIC will result in a reduction of the total anticipated phantom income allocated to a residual interest. Consequently, the residual interest will reach the point where it begins to experience phantom losses (as opposed to phantom gains) earlier than originally expected.⁷² Thus, the modification of mortgage loans in a REMIC will generally result in a benefit for holders of noneconomic residual interests.

Conclusions

As mortgage loan delinquencies continue to increase, we can expect policymakers to increase their efforts to develop and adopt proposals that may help to stem the tide of foreclosures. As discussed above, the REMIC Provisions provide significant flexibility for the modification of mortgage loans held by a REMIC in the event of a default or to prevent a reasonably foreseeable default. Nevertheless, as new proposals are advanced, it is important that lawmakers and industry groups work with the IRS to consider the potential federal income tax consequences that proposed modification programs may have for REMICs that hold these mortgage loans, as well as for their residual and regular interest holders. Finally, as loan modification proposals are adopted, the IRS should provide additional guidance regarding the federal income tax consequences of the anticipated modifications to REMICs and taxpayers holding interests in REMICs.

Following the submission of this article, the American Securitization Forum published a revised ASF Framework that allows servicers to apply the fast-track loan modification procedures described in footnote 4 to "segment 2" loans, in appropriate circumstances, in advance of an initial or subsequent reset date. On July 8, 2008, the IRS released Rev. Proc. 2008-47, which amplifies and supersedes Rev. Proc. 2007-72 by extending its provisions to cover the additional loan modifications described in the revised ASF Framework. Rev. Proc. 2008-47 cautioned, however, that if the revised ASF Framework is further modified after July 8, 2008, the revenue procedure will not necessarily apply to fast-track modifications or second-lien subordinations under that modified Framework.

ENDNOTES

* The authors wish to thank Jennifer Williams, counsel at McKee Nelson LLP, for assistance in describing the various proposals aimed at assisting troubled borrowers.

¹ See Press Release, Mortgage Bankers Association, Delinquencies and Foreclosures Increase in Latest MBA National Delinquency Survey (Mar. 6, 2008), available at

www.mortgagebankers.org/NewsandMedia/PressCenter/60619.htm.

² Ben S. Bernanke, Chairman, Fed. Reserve, Speech at the Independent Community

- Bankers of America Annual Convention, in Orlando, FL (Mar. 4, 2008).
- ³ See FHA, *FHASecure Initiative Fact Sheet—Refinance Options*, available at http://portal.hud.gov/portal/page?_pageid=33,717446&_dad=portal&_schema=PORTAL, last visited June 2, 2008.
- ⁴ The American Securitization Forum Streamlined Foreclosure and Loss Avoidance Framework (“ASF Framework”) applies to securitized first lien subprime residential adjustable rate mortgages (ARMs) that have initial fixed rate periods of 36 months or less, were originated between January 1, 2005, and July 31, 2007, and have an initial interest rate reset between January 1, 2008, and July 31, 2010. Servicers that elect to follow the ASF Framework will classify subprime mortgage loans in one of three “segments” based on their perceived ability to obtain refinancing or to repay their loans under modified terms. Loans with high loan-to-value ratios, whose borrowers are unable to refinance but who have been generally current in their loan payments, are “segment 2” loans, and may be eligible for a fast track loan modification. If such a borrower occupies the mortgaged property as the primary residence and has a relatively low credit score, and if as a result of a pending interest rate adjustment the borrower’s monthly payment would increase by more than 10 percent, then without a more detailed analysis or contact with the borrower, the servicer is entitled to presume that default is reasonably foreseeable. The interest rates on these borrowers’ loans will be frozen at the applicable initial fixed rate, generally for five years.
- ⁵ Henry M. Paulson, Jr., Secretary, U.S. Treasury, *Statement by Secretary Henry M. Paulson, Jr. on New Private Sector Effort to Reach Homeowners Facing Foreclosure* (Feb. 12, 2008).
- ⁶ Rev. Proc. 2008-28, IRB 2008-23, 1054; Rev. Proc. 2007-72, IRB 2007-52, 1257.
- ⁷ American Housing Rescue and Foreclosure Prevention Act of 2008, H.R. 3221 (May 8, 2008); Staff of S. Comm. On Banking, Housing, and Urban Affairs, *Federal Housing Finance Regulatory Reform Act of 2008* (Comm. Print 2008). A similar bill, the Federal Housing Finance Reform Act of 2007, H.R. 1427 (May 22, 2007), has already passed in the House.
- ⁸ Emergency Home Ownership and Mortgage Equity Protection Act of 2007, H.R. 3609 (introduced Sept. 20, 2007); *Helping Families Save Their Homes in Bankruptcy Act of 2007*, S. 2136 (introduced Oct. 3, 2007).
- ⁹ For example, legislation enacted in Virginia requires that a mortgage lender or servicer notify borrowers of its intention to foreclose on certain residential mortgage loans and grant a 30-day foreclosure pause for borrowers requesting assistance to avoid foreclosure. Va. S.B. 797, *Laws 2008* (enacted Apr. 23, 2008).
- ¹⁰ Press Release, State of Ohio, Governor Strickland Announces Nine Mortgage Loan Servicers Sign Compacts to Assist Ohioans in Avoiding Foreclosure (Apr. 7, 2008) (available at www.governor.ohio.gov/Default.aspx?tabid=927).
- ¹¹ The provisions allowing the formation of REMICs (the “REMIC Provisions”) were added to the Internal Revenue Code in 1986. Congress intended that REMICs be the exclusive vehicle relating to the issuance of multiple class, mortgage-backed securities. See Senate Finance Committee Report, S. REP. NO. 313, at 791 (1986).
- ¹² See Reg. § 1.860G-2(b)(3).
- ¹³ References herein to the “Internal Revenue Code” or the “Code” are to the Internal Revenue Code of 1986, as amended.
- ¹⁴ Reg. § 1.1001-3(b).
- ¹⁵ Reg. § 1.860G-2(b)(1).
- ¹⁶ Reg. § 1.860G-2(b)(1)(i).
- ¹⁷ Code Sec. 860F(a)(1) and (a)(2)(A).
- ¹⁸ Code Sec. 860F(a)(2)(B).
- ¹⁹ See Reg. § 1.860D-1(b)(3).
- ²⁰ Reg. § 1.1001-3(b), (c) and (d).
- ²¹ Reg. § 1.1001-3(b), (e) and (f).
- ²² Reg. § 1.1001-3(c).
- ²³ Reg. § 1.1001-3(c)(1).
- ²⁴ Reg. § 1.1001-3(c)(1)(ii).
- ²⁵ Reg. § 1.1001-3(c)(2)(i).
- ²⁶ Reg. § 1.1001-3(c)(3).
- ²⁷ Reg. § 1.1001-3(c)(4)(ii). Specifically, absent a written or oral agreement to modify the terms of the loan, an agreement by the servicer (on behalf of the REMIC) to temporarily waive the exercise of its default rights is not a modification unless and until the forbearance remains in effect for a period that exceeds the sum of (i) two years following the borrower’s initial default and (ii) any additional period during which the parties conduct good faith negotiations or the borrower is in bankruptcy proceedings.
- ²⁸ Reg. § 1.1001-3(e).
- ²⁹ Reg. § 1.1001-3(e)(1).
- ³⁰ Reg. § 1.1001-3(e)(2) through (e)(6).
- ³¹ Reg. § 1.1001-3(f)(1)(i).
- ³² Reg. § 1.1001-3(e)(1).
- ³³ Rev. Proc. 2007-72, IRB 2007-52, 1257.
- ³⁴ See note 4, *supra*.
- ³⁵ Rev. Proc. 2008-28, IRB 2008-23, 1054.
- ³⁶ The revenue procedure leaves several questions unresolved. For example, the IRS does not make clear what, if any, borrower-specific information a servicer must obtain before modifying a loan that otherwise meets the guidelines set forth in the revenue procedure. Also, although the IRS indicates that it is possible for a servicer to satisfy the conditions for modifying a mortgage loan without obtaining information directly from the borrower, it does not provide specific guidance. Also, the revenue procedure requires that the loan servicer “reasonably believe” that there is a “significant risk” of foreclosure of the original loan and that the modified loan presents a “substantially reduced risk” of foreclosure, as compared with the original loan, but no guidance is provided as to how these requirements can be met.
- ³⁷ In Rev. Proc. 2008-28, the IRS noted that the terms of many residential mortgage loans provide that the borrower has “defaulted” if he fails to make a timely payment but that “transient lateness may not have any adverse consequences for the borrower” and may not even require a late fee. Although the revenue procedure does not explain why such a fact was cited, it may be likely that the IRS wanted to distinguish more serious defaults and limit the relief provided by the revenue procedure to more serious defaults.
- ³⁸ Code Sec. 860G(a)(5)(C) and (a)(8).
- ³⁹ Reg. § 1.856-6(b)(3).
- ⁴⁰ *Id.*
- ⁴¹ LTR 9721005 (Feb. 6, 1997); LTR 9720014 (Feb. 6, 1997); LTR 9630004 (Apr. 11, 1996). “Although private letter rulings are not precedent, [Code Sec. 6110(j)(3)], they do reveal the interpretation put upon the statute by the agency charged with the responsibility of administering the revenue laws.” *C.D. Canterbury*, 99 TC 223, 247, Dec. 48,420 (1992) (quoting *Hanover Bank*, SCT, 62-1 USTC ¶ 9487, 369 US 672, 686; see also *Rowan Cos., Inc.*, SCT, 81-1 USTC ¶ 9479, 452 US 247, 261, at note 17, 101 S Ct 2288, 2298, at note 17).
- ⁴² See, e.g., LTR 9630004 (Apr. 11, 1996). (“Thus, the type of default that is relevant for purposes of § 1.856-6(b)(3) of the regulations is the type of default that ordinarily leads to foreclosure.”)
- ⁴³ See Home Ownership Preservation Loans, available at www.fdic.gov/consumers/loans/hop/, last visited June 6, 2008.
- ⁴⁴ Code Sec. 860D(a)(4) requires that, as of the close of the third month following a REMIC’s startup day and at all times thereafter, substantially all of the assets of the REMIC must consist of qualified mortgages and permitted investments.
- ⁴⁵ Although the preamble to this proposed regulation indicates that the amendments were aimed at commercial real estate loans, nothing in the text of the proposed regulation restricts its application to commercial loans.
- ⁴⁶ See Code Sec. 856(e)(1).
- ⁴⁷ See Code Sec. 860G(a)(5) (providing that “permitted investments” for a REMIC means any cash flow investments, qualified reserve asset or foreclosure property).
- ⁴⁸ See Reg. § 1.1001-3(c)(2).
- ⁴⁹ Code Sec. 860G(a)(1); Reg. § 1.860G-2(k). Reg. § 1.860G-2(k) permits a sponsor to contribute property to a REMIC in exchange for regular and residual interests over a 10-day period and the REMIC to elect any one of those days as its startup day. All of the REMIC’s interests are treated as issued on that day.
- ⁵⁰ In general, OID with respect to a REMIC regular interest is calculated for any period

as the excess if any of:

(a) the sum of (i) the present value of future payments on the interest and (ii) the payments received during the period (other than payments of qualified stated interest) over

(b) the adjusted issue price at the beginning of the period.

If the amount computed pursuant to clause (a) is less than the amount computed pursuant to clause (b), the interest is said to have "negative OID." Note that modifications of mortgage loans that either reduce or defer future payments will reduce the amount otherwise computed pursuant to clause (a)(i) and thus could result in negative OID. The legislative history to the OID rules states that any such negative OID is not currently deductible. For a more detailed discussion of "negative OID," see James M. Peaslee and David Z. Nirenberg, *FEDERAL INCOME TAXATION OF SECURITIZATION TRANSACTIONS*, at 595 (3rd ed. 2001).

⁵¹ To see how the IRS has approached this issue for both stated interest and OID, see TAM 9538007 (June 13, 1995).

⁵² See Code Sec. 1271(a)(1).

⁵³ A REMIC regular interest is not debt of a corporate issuer or government entity, and accordingly, is not a security covered by the worthless security rules of Code Sec. 165(g)(2)(C). Accordingly, REMIC regular interests are governed by the bad debt rules of Code Sec. 166.

⁵⁴ This result occurred in *E.B. Glick*, DC-IN, 2000-1 USTC ¶ 50,372, 96 FSupp2d 850. There, the taxpayer suffered losses from an investment in a so-called IOette, a REMIC security having a relatively nominal principal amount relative to its stated interest rate. Because such a large portion of its cash flows are expected to be in the form of interest, an IOette functions much like an interest-only security. The taxpayer in *E.B. Glick* suffered losses resulting from faster than expected prepayments on the underlying mortgage loans. The court held that the taxpayer was not permitted to treat the security as having been acquired at a premium and could not treat the losses as giving rise to negative OID to offset prior OID accruals.

The opinion does not cover the tax year in which the IOette was retired by the REMIC. The IRS asserted that any loss would be deductible in such tax year as a capital loss under Code Sec. 1271(a)(1). *Id.*, at 866. In addition, the court included a cite to Code Sec. 1271(a)(1) when discussing the proper time for Glick to recognize the loss. *Id.*, at 873. Code Sec. 1271(a)(1) provides that amounts received by the holder on retirement of any debt instru-

ment shall be considered as amounts received in exchange therefor, which would result in capital gain or loss for the taxpayer in *E.B. Glick*. It is not clear whether a corporate holder in the position of Glick could eventually claim a bad debt deduction pursuant to Code Sec. 166 (perhaps when it was clear the remaining payments on the IOette would not exceed the taxpayer's adjusted basis in the IOette), resulting in an ordinary loss.

⁵⁵ In Announcement 2004-75, 2004-2 CB 580, the IRS announced that it was considering the treatment of negative OID attributable to an interest-only regular interest. No guidance has been issued in this regard.

⁵⁶ Code Sec. 860A(a).

⁵⁷ Code Sec. 860C(a).

⁵⁸ Code Sec. 860C(b).

⁵⁹ In a typical REMIC holding residential mortgages, these timing differences produce significant phantom income in the early years of the REMIC's existence, followed by phantom losses in the later years. Thus, REMIC residuals often function like an inverted tax shelter in that they produce phantom income in early years (income that can never be matched by cash) and offsetting phantom losses in future years.

⁶⁰ Reg. §1.860C-2(b)(3).

⁶¹ As discussed above, Reg. §1.860G-2(b)(3) provides that, if a mortgage loan is modified due to a default or a reasonably foreseeable default, the loan is not treated as being modified for certain purposes. The scope of this rule, however, is not clear. The regulation could be read to mean that the permitted modifications are also disregarded for purposes of calculating a REMIC's income. See Peaslee and Nirenberg, *supra* note 50, at 419. In Rev. Proc. 2007-72 and Rev. Proc. 2008-28, the IRS provided that certain modifications would not cause the mortgages to fail to be qualified mortgages, result in prohibited transactions or cause the REMIC to lose its status as a REMIC as a result of any deemed reissuance of its regular interests, but the IRS did not provide that the REMIC would not be required to recognize gain or loss resulting from the modifications. As evidenced in a preamble to proposed regulations released last year, however, the IRS believes that any such modification would be taken into account in computing the REMIC's income, even though the modification might be ignored for purposes of other REMIC rules. See Notice of Proposed Rulemaking, IRB 2007-50, 1171 (setting forth a notice of proposed rulemaking for Modifications

of Commercial Mortgage Loans Held by a Real Estate Mortgage Investment Conduit (REMIC)).

⁶² Reg. §1.166-1(d)(1).

⁶³ Reg. §1.1001-1(a).

⁶⁴ See Code Secs. 1011, 1012, 1016(a)(2), 1272(d)(2) and 1278(b)(4).

⁶⁵ Reg. §1.860F-2(c) (providing that "the aggregate ... bases in the assets contributed by the sponsor to the REMIC" in connection with the formation of the REMIC is equal to the aggregate of the issue prices of the regular and residual interests in the REMIC) (*emphasis added*).

⁶⁶ See Code Sec. 1272(a)(6)(C)(i).

⁶⁷ Curtailments (*i.e.*, partial prepayments) do occur, but much less frequently than prepayments in full or scheduled payments.

⁶⁸ See Code Sec. 1272(a)(6)(B)(ii).

⁶⁹ Under Reg. §1.1001-1(g)(1), the amount realized with respect to a debt instrument issued in exchange for property is the issue price of the debt instrument as determined under Reg. §1.1273-2 or 1.1274-2, whichever is applicable. If the interest rate on the modified mortgage is not less than the applicable federal rate, the issue price of the modified mortgage loan will be its stated principal balance.

⁷⁰ In general, Code Sec. 108 provides that gross income does not include income from the discharge of indebtedness if the discharge occurs when the taxpayer is insolvent. It is possible that a REMIC could be considered insolvent if the fair market value of its assets were less than its liabilities (*i.e.*, its regular interests). If a REMIC were to have income resulting from the write down of one of its regular interests and if Code Sec. 108 were to apply to the REMIC, the REMIC could defer its income by reducing certain tax attributes (*e.g.*, its basis in its assets) rather than recognizing that income currently. If the REMIC reduced its basis in its mortgage loans, the REMIC would recognize less premium amortization or increased discount from the loans in future periods, thus effecting the deferral of income. For a more complete discussion of this issue, see Peaslee and Nirenberg, *supra* note 50, at 640-41.

⁷¹ It may even become inverted—*i.e.*, higher yielding classes having shorter lives than lower yielding classes so that over time the weighted average yield of a REMIC's regular interests declines rather than increases.

⁷² The foregoing observations are illustrated in the example contained in the Example to this article.

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