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NEWSLETTER OF THE **BANKING AND SPECIALTY FINANCE** PRACTICE GROUP OF MANATT, PHELPS & PHILLIPS, LLP

Subprime Loan Modifications and Tax Implications

The federal government took a major step in implementing its program for alleviating the subprime mortgage crisis when the Internal Revenue Service, on December 26, 2007, issued Revenue Procedure 2007-72. In its pronouncement, the IRS has said that it will not seek to disqualify a REMIC (that is, a real estate mortgage investment conduit, under Internal Revenue Code Sec. 860A et. seq.) if a mortgage loan that is included in the REMIC is modified, under the conditions stated in this Revenue Procedure. Also, the IRS will not seek to categorize the loan modification as a "prohibited transaction" under the REMIC rules.

Most securitization transactions involving residential mortgage loans have been structured to take advantage of the REMIC tax rules, which have the effect of avoiding what would otherwise be an entity-level tax on the securitization trust, pool or similar securitization vehicle. The REMIC rules are quite restrictive as to the circumstances in which loans may be modified or removed from the REMIC, and impose heavy taxes upon transactions that are characterized as "prohibited transactions." Transaction documents for securitizations impose contractual obligations on the loan servicer to preserve the tax status of the REMIC, and to avoid "prohibited transactions." By defining certain loan modifications as being consistent with REMIC status, and as not constituting "prohibited transactions," the IRS has removed a major obstacle to implementation of the streamlined program of loan modification that the Bush administration proposed earlier in December (referred to as the "Framework").

To be protected under the Revenue Procedure, a modified mortgage loan must satisfy the following criteria:

- First lien
- Subprime (this term is not defined in the Revenue Procedure)
- Adjustable rate

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- Initial fixed period of 36 months or less
- Originated between 1/1/05 and 7/31/07
- Included in a securitized pool
- Initial interest rate reset between 1/1/08 and 7/31/10
- The modification is consistent with the Framework

For a modification to be consistent with the Framework, the following characteristics of a mortgage loan must exist as of the date of modification:

- Loan-to-value ratio of 97% or more
- Not more than 30 days delinquent
- Was not delinquent over 60 days more than one time in the last 12 months
- Not eligible for refinance under the FHA Secure program
- Owner occupied as primary residence
- FICO score below 660 and less than 10% higher than it was at time of origination
- Upcoming payment reset would increase payment by more than 10%
- Modification extends the initial interest rate for 5 years
- Borrower is able to pay based on this modification, but would be unable to pay in the absence of the modification (as determined by the servicer)

The tax relief afforded by Revenue Procedure 2007-72 is crucial to the implementation of the Framework. It is, however, just the first bit of tax relief, relating to the taxation of the securitization vehicle, and thereby indirectly of investors. This first step does not deal with the tax burden on homeowners that occurs when their debt burden is decreased, under the concept of "forgiveness of indebtedness income." That tax relief cannot be provided by the IRS, as it will require a statutory amendment by Congress. The administration has proposed such an amendment, so stay tuned for further developments.

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