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Subprime Lending Response Team
Tax Transactions Practice

Tax Guidance Issued on Modifications of Securitized Mortgage Loans

On May 16, 2008, the Internal Revenue Service (the "Service") issued Revenue Procedure 2008-28 (the "Revenue Procedure") describing the conditions under which certain securitized mortgage loans held by REMICs or fixed investment trusts may be modified without adverse US tax consequences.

The Revenue Procedure states that if a securitized mortgage loan is modified under certain prescribed conditions (discussed below), the Service:

- Will not challenge REMIC qualification on the grounds that the modifications (i) do not fall within otherwise designated exceptions for modifications of mortgage loans that are in default or for which default is reasonably foreseeable or (ii) result in a deemed reissuance of the REMIC's regular interests.
- Will not contend that the modifications result in a REMIC "prohibited transaction" (the income and any gain from which otherwise would be subject to a 100% tax).
- Will not challenge a securitization vehicle's federal tax classification as a fixed investment trust under Treas. Reg. §301.7701-4(c) on the grounds that the modifications constitute a prohibited power to vary the trust's investment.

The protections afforded by the Revenue Procedure should enhance the ability of servicers to modify certain securitized mortgage loans pursuant to so-called "foreclosure prevention" or similar programs. Prior to the issuance of the Revenue Procedure, holders and servicers have been hesitant or unwilling under current US tax law to modify the terms of currently performing securitized mortgage loans that nonetheless reflect a high risk of eventual foreclosure (e.g., due to prevailing adverse economic conditions in a particular geographic area) until either the loan has defaulted, or the individual borrower and mortgage loan circumstances have deteriorated to the point that default on the particular loan has become reasonably foreseeable.¹

The Revenue Procedure applies to a modification of a mortgage loan held by a REMIC, or by a fixed investment trust, if all of the following conditions are satisfied (the "Conditions"):

- (1) The real property securing the mortgage loan is a residence that contains fewer than five dwelling units;
- (2) The real property securing the mortgage loan is owner-occupied;
- (3) (i) In the case of a REMIC, either as of the startup date or the end of the 3-month period beginning on the startup date, no more than 10 percent of the stated principal of the REMIC's total assets was represented by mortgage loans the payments on which were then

overdue by 30 days or more; or

(ii) In the case of a fixed investment trust, as of all dates when assets were contributed to the trust, no more than 10 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;

(4) The holder or servicer reasonably believes that there is a “significant risk of foreclosure” of the original loan, which may be based on either guidelines developed as part of a foreclosure prevention program (a program in which guidelines are established to streamline modifications of troubled mortgage loans in an attempt to identify borrowers whose loans are likely to go into foreclosure if loan terms remain unmodified, but who may be able to make timely payments and avoid foreclosure if the loan terms are favorably modified) or any other credible systematic determination;

(5) The terms of the modified loan are more favorable to the holder than were the unmodified terms of the original mortgage loan (for example, reductions in interest rates, alterations in the timing of interest rate changes, principal forgiveness, and scheduled payment and maturity extensions); and

(6) The holder or servicer reasonably believes that the modified loan presents a substantially reduced risk of foreclosure, as compared to the original loan.

According to the Revenue Procedure, servicers have concluded that foreclosure prevention programs of the type generally described above are highly accurate in evaluating whether a borrower presents an unacceptably high risk of eventual foreclosure, even in circumstances where all desired loan level information for a particular borrower is unavailable and the borrower has not yet missed any payments. The Service has apparently accepted this view also. Thus, in an effort to enhance the ability of holders and servicers to deal with the greater range of issues confronting securitized mortgage loans in the current economic climate, and to reduce foreclosures, the Service promulgated the Revenue Procedure.

The Revenue Procedure governs determinations made by the Service on or after May 16, 2008, with respect to loan modifications that occur on or before December 31, 2010. The Service has invited public comment on this guidance including, in particular, whether the Revenue Procedure should be extended to loan modifications that are effected after 2010.

If you have any questions, or would like additional information about this topic, please contact [Jeffrey P. Cantrell](#), [William A. Levy](#), or the Mayer Brown lawyer with whom you regularly work.

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1. A “real estate mortgage investment conduit,” or REMIC, and a “fixed investment trust,” are widely used structured finance tax vehicles for US mortgage loan securitizations. Each of these entities is effectively entitled to “pass-through” tax treatment,

so long as it meets certain requirements imposed on the vehicle under federal income tax law, including specific provisions of the Internal Revenue Code. Under certain circumstances, a securitization vehicle may not qualify or continue to qualify as a REMIC or fixed investment trust if the terms of one or more of its mortgage loan assets are modified in an economically meaningful way. In the case of a REMIC, such a modification is commonly referred to as a "significant modification." In the case of a fixed investment trust, the mere ability to implement such a change to the terms of the vehicle's mortgage loan assets may manifest that the trust's beneficial holders possess a prohibited "power to vary" their investment in the vehicle within the meaning of applicable federal tax law.

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