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IRS Rules Freddie Mac MBS Restructuring Does Not Trigger Gain or Loss

By Mark Leeds[1]

Following our release of this legal update, representatives of Freddie Mac contacted us to clarify certain facts related to the conversion transaction. This updated legal update reflects those clarifications.

The United States residential mortgage market is among the most complex financial ecosystems in the world. Although the Federal Home Loan Mortgage Corporation ("Freddie Mac") has been in conservatorship since September 6, 2008, it continues to be an important player in this market. Specifically, Freddie Mac purchases mortgages, and mortgage loan participations, from unrelated financial institutions, packages the mortgages in trusts, wraps the trusts with its guarantee and then sells interests in the trusts (referred to as "Participation Certificates" or "PCs") to investors worldwide. The mortgage servicing on PCs is labor-intensive and payments are made over an extended part of the month. As a result, payments on the mortgages are passed through to investors 45 days after the first day of the month in which the payment is received. The time between payment on the mortgage and the distribution of cash to investors is referred to as the "Remittance Cycle."

The Federal National Mortgage Association ("Fannie Mae") serves a similar function to that performed by Freddie Mac and is also in conservatorship. Fannie Mae also purchases mortgages, and mortgage loan participations, from unrelated financial institutions. Instead of issuing PCs, however, Fannie Mae issues mortgage-backed securities ("MBS") wrapped with a Fannie Mae guarantee to investors. The Remittance Cycle for a Fannie Mae MBS is 55 days. Thus, a holder of a Fannie Mae MBS receives payment 10 days later than a holder of a Freddie Mac PC.

On March 28, 2018, the Federal Housing Finance Agency ("FHFA") announced that it had decided to standardize Freddie Mac PCs and Fannie Mae MBSs.[2] Beginning on June 3, 2019, Freddie Mac will no longer issue PCs and Fannie Mae will no longer issue MBSs. Instead, both agencies will issue Uniform Mortgage Backed Securities ("UMBS"). The Freddie Mac and Fannie Mae UMBS will have identical terms, and all UMBS will have a 55-day Remittance Cycle.

In addition, Freddie Mac will allow holders of PCs issued prior to June 3, 2019, to exchange the PCs for UMBSs. The Freddie Mac UMBSs will remain interests in trusts holding the mortgages.[3] The terms of the UMBSs to be received for outstanding PCs will have the same terms as the existing PCs but will be subject to a 55-day Remittance Cycle. The newly issued UMBSs will be assigned a new CUSIP number as well. Since holders of PCs who elect to exchange their PCs for UMBSs will receive payments on the UMBSs 10 days later than they would have if they had not made the exchange, Freddie Mac will make a one-time compensating payment to electing holders ("Make Whole Payment"). In addition, to encourage PC holders to elect to exchange, Freddie Mac will pay an "Inducement Fee" to those holders who made the exchange election. Revenue Ruling 2018-24 refers to the aggregate of these transactions as a "Conversion."

What the Market Is Saying

While the FHFA has stated that the change from PCs and MBSs to UMBSs is expected to increase market liquidity, market participants have expressed concern that the change may result in lower quality loans being securitized.[4] Other investors have questioned whether liquidity will truly be improved and have suggested that liquidity actually could be impaired.[5] Specifically, investors are concerned that price differentials that take into account different prepayment performance will disappear. This challenge could arise because of the ability of banks to choose to the "cheapest to deliver" in the to-be-announced ("TBA") market. Investors cannot price in prepayment speed differentials in the TBA market because the actual mortgages to be delivered have not be identified. When Freddie Mac and Fannie Mae are issuing identical securities, it won't be possible to use the prepayment expectations of the issuers separately. The FHFA has established an oversight board, the Single Security Governance Committee, to oversee this issue.[6]

The TBA securities market is a forward market in mortgage-backed securities. Specifically, a TBA security is a forward agreement to purchase and sell a basket of mortgage securities on a monthly settlement cycle with certain characteristics of the basket specified. The exact pools are not known until two days before settlement, when the actual features are "announced." The duration of a TBA security is relatively short—in general, one to three months. This market is very liquid with very thin bid/ask spreads.

TBA securities enable mortgage lenders to partially hedge the interest rate risk inherent in locking in mortgage rates for borrowers by providing the lenders with the ability to sell the to-be-made mortgages forward in the TBA securities market. Since only the parameters of the mortgages (or mortgage-backed securities) are specified, sellers in the TBA security transactions choose the "cheapest-to-deliver" securities that meet the requirements of the TBA security transactions.[7]

TBA securities are frequently used in "dollar roll" transactions. A dollar roll transaction involves two positions. In a typical dollar roll transaction, the taxpayer sells a TBA security for delivery in the nearest month. Simultaneously, the taxpayer purchases a new TBA security (that has substantially identical features) for delivery in the next succeeding month. The dollar roll is the price differential between the two contracts. The price differential is a function, *inter alia*, of the cost of carrying the mortgages between the two settlement dates. A dollar roll resembles a sale-repurchase transaction in which the taxpayer is the seller-repurchaser of the short contract and the buyer-reseller of the long contract. Profit opportunities are available when TBA security rolls trade "special." This phenomenon occurs when the discount applicable to the long position is higher than what the fundamentals of the transaction might suggest. It is our understanding that the different Remittance Cycles should result in a price differential between PCs and MBS of approximately $0.07, but arbitrage opportunities have existed when the difference is more or less than this amount.[8]

When TBA securities are cash-settled, the taxpayer recognizes gain or loss.[9] Although certain taxpayers have claimed ordinary gains and losses from such settlements with the consent of the Internal Revenue Service ("IRS"), the IRS subsequently pushed back against such treatment.[10] In general, the underlying securities and mortgages would be treated as capital assets in the hands of the taxpayer and any resulting gain and loss from the TBA securities is treated as capital gain or loss.[11] If a TBA security is employed to purchase a mortgage-backed security, the amount paid for the TBA security is added to the basis of the acquired securities.[12]

The IRS Weighs In on the Proposed Conversions

On August 17, 2018, the IRS addressed a key issue for investors in Freddie Mac PCs that are interested in exchanging their PCs for UMBSs beginning in June 2019. Specifically, the IRS addressed whether a Conversion would trigger gain or loss. PC investors with built-in gain in their PCs could be inhibited from converting their PCs for UMBSs if the conversion resulted in a tax liability. Conversely, PC investors with built-in losses in their PCs could reap a tax advantage if they could currently recognize a loss from the conversion.[13] The IRS ruled, however, that no gain or loss would be recognized by reason of a conversion of a PC for a UMBS. This ruling was based on a holding that the change of a PC into a UMBS was not a significant modification. We'll explain below.

As a general rule, a taxpayer must recognize gain or loss realized from an exchange of property where the property exchanged differs "materially either in kind or in extent" from the property received.[14] This rule is not limited to actual exchanges. For example, a modification to a bilateral arrangement may be so substantial as to amount to a deemed exchange of the "old" property for "new" property.[15] Prior to the issuance of Treasury Regulation § 1.1001-3 in 1992, interpretation of the "material difference" principle of Treasury Regulation § 1.1001-1(a) was most notably addressed by the IRS in Revenue Ruling 90-109[16] and the Supreme Court in *Cottage Savings Assn. v. Comm'r*.[17] Revenue Ruling 90-109 dealt with a taxpayer that purchased a key person insurance policy on the life of an employee listing the taxpayer as the sole beneficiary under the policy. The policy provided the taxpayer with the right to change the insured. The taxpayer eventually exercised this right. The only change effected by the exercise of the right was the employee insured under the policy; the benefits and premiums under the policy were not changed. In its analysis, the IRS articulated the "fundamental change" concept which provides, in relevant part, that "[a] change in contractual terms . . . is treated as an exchange under [S]ection 1001 if there is a sufficiently fundamental or material change [such] that the substance of the original contract is altered." The IRS, looking at the exercise of the right by the taxpayer, determined that the essence of a life insurance contract is the life that is insured under the contract and viewed the exercise of the right as substantively the same as an actual exchange of contracts. As a result, the IRS held that the exercise of the option by the taxpayer resulted in a taxable sale or disposition of the policy under Section 1001 of the Internal Revenue Code of 1986, as amended ("Code").

In the year following the issuance of Revenue Ruling 90-109, the Supreme Court addressed Code § 1001 exchange principles in *Cottage Savings*. This case involved a strategy by a savings and loan association to trigger losses for federal income tax purposes without impairing net worth for regulatory purposes. Specifically, the taxpayer entered into "reciprocal sale" transactions. The strategy arose from a rule change adopted by the Federal Home Loan Bank Board ("FHLBB") that permitted savings and loan associations to exchange pools of residential mortgages without recognition of accounting losses where the mortgage pools are "substantially identical."[18] In a transaction structured to qualify for the rule change, the taxpayer sold 90-percent participation interests in mortgage pools to four savings and loan associations while simultaneously purchasing 90-percent participation interests in mortgage pools held by the same savings and loan associations. All of the loans involved in the transaction qualified as "substantially identical," as defined in the FHLBB rule.

The taxpayer claimed a loss deduction from the exchange on its tax return for the year of the transaction. The loss was disallowed by the IRS but was ultimately held to be deductible by the

Supreme Court. The Supreme Court determined that the realization principle in Code § 1001(a) incorporates a "material difference" requirement and provided guidance on what the requirement amounts to and how it applies.[19] The Supreme Court focused on the fact that the mortgages were recourse obligations and the obligors on the mortgages were different. An exchange of a mortgage issued by individual X was held to be fundamentally different than a mortgage issued by individual Y.

The IRS issued the Modification Regulations in 1992, which were finalized in 1996, to address when changes to the terms of a debt instrument cause the debt instrument to be considered to be re-issued.[20] The Modification Regulations clarified the instances in which a change in a debt instrument will be treated as an exchange by limiting the application of Code § 1001 to instances where (i) the change results in a "modification" of the debt instrument and (ii) such modification is "significant."[21]

The Modification Regulations define a "modification" as "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 (oral or written), conduct of the parties, or otherwise."[22] In general, an alteration that occurs by operation of the terms of a debt instrument is not a modification; however, certain fundamental changes (e.g., change in obligor of a recourse debt instrument, nature of debt and tax classification of debt) are treated as modifications even if permitted by the terms of the debt instrument.[23]

Once it is determined that a change in the terms of a debt instrument constitutes a "modification," a deemed exchange will result only where such modification is "significant." In general, and except as otherwise provided in the detailed rules discussed below, a modification is significant "only if, based on all facts and circumstances, the legal rights or obligations that are altered and the degree to which they are altered are economically significant."[24] In determining whether changes to legal rights or obligations are economically significant, all modifications to a debt instrument are considered collectively. Outside of the general significance rule, the Modification Regulations provide that the following changes will result in a deemed exchange:

- **Change in Yield:** A modification to the yield of a debt instrument if the modification varies the yield on the unmodified debt instrument by the greater of ¼ of 1 percent (.0025) or 5 percent of its original yield.[25] This rule, however, does not apply to contingent payment debt instruments.[26]
- **Change in Timing of Payments:** A modification to the timing of payments if the modification results in the material deferral of scheduled payments.[27] The materiality of the deferral depends on all the facts and circumstances, including the length of the deferral, the original term of the instrument, the amounts of the payments that are deferred and the time period between the modification and the actual deferral of payments.[28] A safe harbor is provided (i.e., a deemed exchange will not result) where deferred payments are unconditionally payable no later than the lesser of five years or 50 percent of the original term for the instrument.[29]
- **Change in Obligor:** Subject to limited exceptions, the substitution of a new obligor on recourse debt instruments.[30] However, the substitution of a new obligor on a nonrecourse debt instrument is not a significant modification and thus does not result in a deemed exchange.[31]
- **Change in Security:** A modification to the collateral for, a guarantee on or other form of credit enhancement for a recourse debt instrument that results in a change in payment expectations is a significant

modification.[32] A change in payment expectations results where there is: (i) a substantial enhancement of the obligor's capacity to meet payment obligations and that capacity was primarily speculative prior to the modification and is adequate after the modification; or (ii) a substantial impairment of the obligor's capacity to meet payment obligations and that capacity was adequate prior to the modification. Subject to limited exceptions, a modification to a credit enhancement contract or a substantial amount of the collateral for a nonrecourse debt instrument is a significant modification.[33]

- **Change in Nature of Debt Instrument:** Subject to limited exceptions, a modification that results in a non-debt instrument or property right or a change in the nature of a debt instrument from recourse to non-recourse or vice versa.[34]

Revenue Ruling 2018-24 recites the analysis set forth above and simply concludes that a conversion of a Freddie Mac PC for a UMBS "will not constitute a taxable exchange of property for purposes of [Internal Revenue Code] section 1001." The ruling does not directly apply the rules described above to a Conversion. It does not appear, however, that the Make Whole Payment will change the yield of the PC; it is intended to preserve the original yield of the PC. The Inducement Fee, however, will change the yield of the PC, but it appears unlikely to move the yield on the PC by more than ¼ of 1 percent. The UMBS will change the timing of payments on the PC, but the change should be within the safe-harbor for non-material changes in payments.

Prior to the Conversion, the holders of a PC held undivided interests in the underlying mortgage loans, the obligors of which are multiple individuals, albeit guaranteed by Freddie Mac. Following the Conversion, we are informed that the investors still will be holding an undivided interest in the mortgage loans. This is a welcome structure, because if the UMBS were debt instruments of Freddie Mac, it could be challenging to conclude that the Conversion does not result in a change in obligor—from the mortgagors to Freddie Mac.[35]

Concluding Observations

The holding of Revenue Ruling 2018-24 should encourage investors with built-in gains on their Freddie Mac PCs to undertake Conversions because they will be able to do so without incurring a tax liability, even though the exact basis for this conclusion is unclear. Holders of outstanding PCs will reap a small windfall by way of the Inducement Fee. The FHFA hopes to address industry issues through the Single Security Governance Committee. Accordingly, the process for a single security process for both of Freddie Mac and Fannie Mae is underway.

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Endnotes

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2 FHFA News Release, FHFA Announces June 2018 Implementation of the New Uniform Mortgage-Backed Security.

3 FHFA, *Single Security Initiative FAQs*, What are first-level and second-level securities? (May 2018 Final Ver).

4 *See Uniform MBS may prove a two-edged sword for mortgage investors* (National Mortgage News, April 27, 2018).

5 Cantrill, Cudzil, Hyman and Smith, *Uniform Mortgage-Backed Initiative ('Single Security'): Stop Throwing Good Money After Bad*, PIMCO Viewpoints (April 3, 2018); Novick, Chaver, Sion & Barry, *Federal Housing Agency's Single Security Initiative* (Blackrock March 2016).

6 FHFA, *Single Security Initiative FAQs*, What will FHFA and the Enterprises do to ensure their securities stay aligned in performance once the Single Security Initiative is implemented? UPDATED (May 2018 Final Ver).

7 Cheapest to deliver in a futures contract is the cheapest security that can be delivered to the long position to satisfy the contract specifications and is relevant only for contracts that allow a variety of slightly different securities to be delivered. This is common in treasury bond futures contracts, which typically specify that any treasury bond can be delivered so long as it is within a certain maturity range and has a certain coupon.

8 Novick, Chavers, Sion & Barry, *Federal Housing Finance Agency's Single Security Initiative*, supra.

9 TAM 200651003 (Dec. 22, 2006).

10 *Id.*

11 *See* Code § 1234A; Rev. Rul. 78-182, 1978-1 C.B. 265 (situation 2).

12 Rev. Rul. 78-182, supra (situation 4). In this latter case, since the amount paid in connection with the TBA Security is added to the basis of the mortgage-backed securities, any resulting gain or loss on the mortgage-backed securities would be gain or loss from the disposition of a real estate asset within the meaning of Code § 856(c)(3)(H) for a real estate investment trust ("REIT").

13 It's worth noting that the wash sales rules of Section 1091 of the Internal Revenue Code of 1986, as amended ("Code") would likely prevent a taxpayer with built-in losses from recognizing a current loss from the exchange.

14 IRC § 1001(c); Treas. Reg. § 1.1001-1(a).

15 See, e.g., Treas. Reg. § 1.1001-3; Treas. Reg. § 1.1001-4; Rev. Rul. 90-109, 1990-2 C.B. 191.

16 1990-2 C.B. 191.

17 111 S.Ct. 1503 (1991).

18 Exchanged mortgage loans were substantially identical, and thus qualified for the special treatment, if they were residential mortgages of the same type, bearing the same interest rate, stated maturity and seasoning.

19 Both the Tax Court and Sixth Circuit determined that the realization principle in Section 1001(a) did not incorporate a "material difference requirement. *Cottage Savings Association v. Comm'r*, 90 TC 372 (1988); *Cottage Savings Association v. Comm'r*, 934 F.2d 739 (6th Cir. 1991). On appeal, the Supreme Court determined that Section 1001(a) incorporates a "material difference" requirement for two reasons: (i) Treasury Regulation § 1.1001-1(a) was viewed as a reasonable interpretation of Section 1001(a) as it was essentially unchanged through various reenactments; and (ii) Treasury Regulation § 1.1001-1(a) was consistent with Supreme Court precedents on realization.

20 See T.D. 8675.

21 Treas. Reg. § 1.1001-3(b).

22 Treas. Reg. § 1.1001-3(c)(1)(i).

23 Treas. Reg. § 1.1001-3(c)(1)(ii); (c)(2).

24 Treas. Reg. § 1.1001-3(e)(1).

25 Treas. Reg. § 1.1001-3(e)(2)(ii).

26 Treas. Reg. § 1.1001-3(e)(2)(i) (limiting the application of the change in yield rule to fixed payment debt instruments, debt instrument with alternative payment schedules and variable rate debt instruments).

27 Treas. Reg. § 1.1001-3(e)(3)(i).

28 *Id.*

29 Treas. Reg. § 1.1001-3(e)(3)(ii).

30 Treas. Reg. § 1.1001-3(e)(4)(i)(A).

31 Treas. Reg. § 1.1001-3(e)(4)(ii).

32 Treas. Reg. § 1.1001-3(e)(4)(iv)(A).

33 Treas. Reg. § 1.1001-3(e)(4)(iv)(B)(1).

34 Treas. Reg. § 1.1001-3(e)(5).

35 At least one commentator has argued that the focus on obligors is misplaced and an exchange should be considered to have occurred only if there is a change in legal rights. See Peaslee, *Disregarded Entities and Debt Modifications*, Tax Notes (March 7, 2016). The approach of the IRS in Revenue Ruling 2018-24 could be viewed as adopting a similar approach to the deemed exchange question.

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