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Capital Markets
Accounting Developments
Advisory 2008-13
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Revenue Procedures 2008-28 and 2008-47
IRS Guidance on REMICs and Investment Trusts Subject to Mortgage Loan Modifications

Introduction

Market turmoil has created the debate as to whether mortgage lenders should foreclose on troubled debtors or modify the mortgage in some way to avoid foreclosure. The mortgage modifications typically take the form of forgiving past due amounts, reducing outstanding principal balance or lowering interest rates.

Various proposals have been introduced to alleviate some of the impediments such as the American Securitization Forum Statement of Principles, Recommendations, and Guidelines for a Streamlined Foreclosure and Loss Avoidance Framework for Securitized Subprime Adjustable Rate Mortgage Loans (the "2008 ASF Report"). In addition, the IRS and Treasury have issued various revenue procedures that are designed to alleviate any perceived or real impediments to securitized mortgages being modified.

Although mortgage modifications are often the best course of action, there are often legal, accounting, economic and tax concerns that can impede the ability to modify. This is especially the case where mortgages are securitized. The IRS has recently issued guidance that is designed to alleviate concerns over tax issues associated with securitized mortgage modifications.

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Background Summary of the Tax Issues

Most U.S. mortgage securitizations are structured utilizing entities that are treated as REMICs for U.S. tax purposes. The REMIC tax rules are quite complex and typically have been viewed as impediments to many types of mortgage modifications. It is important to note that the REMIC rules provide for loan modifications. However, until the IRS provided guidance there were not many examples to help interpret their application. Consequently, many were hesitant to modify loans in certain instances.

FICG Observation: Historically, REMIC structures are not used where modifications of mortgages are anticipated. This is one reason why many commercial mortgage securitizations have been structured in non-REMIC transactions.

More specifically, modifications of securitized mortgages raise the following tax issues:

- **REMIC Prohibited Transaction 100% Tax** - If a loan modification is significant, the loan is considered to be reissued. The newly issued mortgage would not be considered a REMIC "qualified replacement mortgage" unless the modification occurred within the first three months of the REMIC, or the original mortgage was in default or deemed defective and the modification occurred within the first two years of the REMIC. If the reissued mortgage is not a REMIC qualified replacement mortgage, then all income from the mortgage would be subject to a 100% tax.

- **Failure of the REMIC** - Similar to the above, if modifications cause more than a deminimis amount of a REMIC's mortgages to be non-"qualified replacement mortgages" (newly reissued mortgages), then the securitization's status as a REMIC would fail and the entity would become a taxpaying entity. From a practical standpoint, if this were to occur, the REMIC would likely be terminated.

- **Failure of Trust Status** - In addition to REMICs, mortgages are often securitized in transactions that are treated as grantor trusts for tax purposes (pass-through transactions). In these transactions, if the servicer has the right to modify mortgages, the power could cause the trust to fail to be treated as a trust for federal income tax purposes. This could lead to several tax issues including withholding tax failure and failure to file penalties.

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FICG Observation: The REMIC rules generally provide that the status of REMICs will not be affected so long as the modifications were made in the event of default or if the default was foreseeable. However, the REMIC rules did not provide guidance on what was foreseeable. Since servicers of REMICs cannot take an action that would risk the REMIC status, most servicers would take the conservative route on deciding whether to modify.

The following are short summaries of revenue procedures issued by the Internal Revenue Service to alleviate servicer concerns regarding the tax issues associated with modifications of securitized mortgages.

Rev. Proc. 2008-28 Potential Relief

In Rev. Proc. 2008-28, the IRS stated that with respect to modifications of securitized loans, it will not (i) impose the prohibited transaction tax or (ii) call into question the status of a REMIC or trust if the following conditions are satisfied:

- The real property securing the mortgage loan is a residence that contains fewer than five dwelling units and is owner-occupied.
- The REMIC held mortgages in which payments are 30 days or more overdue cannot constitute more than 10 percent of the stated principal of the total assets of the REMIC as of the startup day of the securitization or the end of the 3-month period beginning on the startup day.
- For trust held mortgage loans, no more than 10 percent of the stated principal of all the debt instruments held by the trust can be represented by instruments where the payments overdue by 30 days or more as of all the dates when assets were contributed to the trust.
- The holder or servicer reasonably believes that there is a significant risk of foreclosure on the original loan.
- The terms of the modified loan are less favourable to the holder than were the unmodified terms of the original loan.
- The holder or servicer reasonably believes that the modified loan presents a substantially reduced risk of foreclosure, as compared to the original loan.

FICG Observation: The most important portion of the revenue procedure is an example that shows when servicers could modify loans and not run afoul of the REMIC rules. The example shows how servicers can rely on their statistical data

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and business judgment to determine if default is foreseeable. This is often referred to as servicers' foreclosure prevention programs.

Rev. Proc. 2008-47 Potential Relief - Modifications of Teaser Loans

In short, Rev. Proc. 2008-47 was intended to provide guidance to the tax issues associated with locking of interest rates on "teaser" loans. As discussed above, prior to the guidance, if a teaser rate is reset, the action could result in a modification and trigger the same REMIC issues as discussed above. Consequently, in Rev. Proc. 2008-47, which updated and superseded the Rev. Proc. 2007-72, the IRS stated that with respect to modifications of securitized loans, it will not (i) impose the prohibited transaction tax or (ii) call into question the status of a REMIC or trust if the modifications are governed by the framework set fort in the 2008 ASF Report. As described in greater detail in the 2008 ASF Report, this lenience only applies to:

- Certain loans that, among other things, have a fixed rate period, followed by a floating rate period (a teaser rate);

- Modifications occurring on or before July 31, 2010; and

- Modifications that are a "Fast Track Modifications", as defined under the 2008 ASF report, which, in short, are modifications that lock the interest rates on loan at the current rate, before the rate resets to a higher rate the debtor cannot afford.

FICG Observation: Since Rev. Proc. 2008-47 relies on the 2008 ASF Report for defining the scope and type of permissible modifications, a detailed reading of the 2008 ASF Report is recommended. The intent of the revenue procedure was to allow proactive modifications of loans with "teaser" rates before homeowners went into default.

Questions

Please contact Trent Johnson at (202) 414-1484 for more information concerning either REMICs or other securitization, financial instruments or credit strategies.

Any other questions related to financial instruments or credit in general should be addressed to:

Frank Serravalli (646--471-2669)
Debbie Rappopport-Bigman (646-471-2876)
Jeff Allen (646-471-2937)
Chip Currie (646-471-3661)
David Lukach (646-471-3150)
Frank Gaetano (646-471-1356)
Yogesh Gupta (202-414-1354)
John Gibson (202-414-4691)
Woody Wallace (646-471-2850)
Fred Elmy (646-471-2830)
Neal Dykes (646-471-2359)
Mark Tibaldi (646-471-5566)

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