PUBLICATION

New Regulations Facilitate Real Property Mortgage Modifications

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On September 16, 2009, the U.S. Treasury took steps to assist in the modification of various loans held by Real Estate Mortgage Investment Conduits (REMICs), which have been recognized by the Internal Revenue Code since the Tax Reform Act of 1986. REMICs are designed to invest in a static pool of mortgages which are principally secured by real estate and are not intended to dispose of mortgages before maturity.

Background

Operationally, REMICs acquire mortgages on a given day, referred to as the "start up" date. REMICs have a limited amount of time to become fully invested. The major issuers are the Federal Home Loan Mortgage Corporation (Freddie Mac) and the Federal National Mortgage Association (Fannie Mae) as well as privately operated mortgage conduits owned by mortgage bankers, mortgage insurance companies and savings institutions.

REMICs are not subject to federal income taxes. Rather, the income of a REMIC flows through to its owners.

Consistent with the stated purpose of REMICs holding a static pool of mortgages, the Internal Revenue Code imposes a 100% excise tax on "prohibited transactions." Among the class of prohibited transactions are "dispositions" of mortgages, other than by payment at maturity and a mortgage no longer "being principally secured by real property." The term "disposition" includes many transactions other than an outright sale or exchange for another mortgage. As a general rule, for a loan to be considered "principally secured by real property," the value of the real property must be at least 80% of the face value of the loan. This test is applied on the front end when the loan is acquired by the REMIC and again if there is a significant modification of the loan.

There is a vast body of law on the subject of when the modification of a debt instrument is a disposition. In the usual context, if the modification rises to the level of a disposition, the holder is treated as having sold the debt instrument for the value of what the holder has after the transaction.

The present rules on whether a modification of a debt instrument constitutes a disposition have their origin in a 1991 decision of the United States Supreme Court in the case of *Cottage Savings Association v. Commissioner*. In the years under consideration by that decision, it was the usual practice of thrift institutions to hold the mortgages they originate. At that time, most thrifts had loans on their books which were made at relatively low interest rates, and which were worth less than their face amounts. The thrifts desired to dispose of such loans and thereby generate losses which could offset income and thus result in tax refunds due to carrying the losses back to early years.

The Federal Home Loan Bank Board, which then regulated thrifts, published a directive to the effect that if a thrift exchanged a portfolio of loans for substantially identical portfolio, the thrift, while being able to take a tax loss, would not be required to take a loss for purposes of thrift accounting. The Internal Revenue Service took the position that the loans were fungible and denied the loss.

The Supreme Court held in the *Cottage Savings* case that the loss was allowable because the borrowers and the collateral were different. The holding of the case, which became known as the "hair trigger" test, generated considerable confusion, particularly in the context of whether the modification of a debt instrument constitutes a disposition of the debt instrument and thus a taxable event resulting in the recognition of gain or loss.

The Internal Revenue Service published regulations in 1996 to provide guidance on whether the modification of a debt instrument results in a deemed disposition of the instrument. In general, those regulations state that a modification results in a disposition only if there is a significant modification.

The Internal Revenue Service also published regulations concerning whether the modification of a debt instrument held by a REMIC constitutes a disposition of the debt instrument for purposes of applying the 100% excise tax. The existing regulations state that a modification of a debt instrument results in the disposition of the debt instrument only if the modification of the debt instrument would be considered a disposition under the *Cottage Savings* regulations. In addition the following types of modification would not result in a disposition for purposes of the excise tax:

(a) Changes occasioned by a default or a foreseeable default;

(b) Assumption of the obligation by another person;

(c) Waiver of a due on sale or due on encumbrance clause;

(d) Conversion of an interest rate pursuant to a convertible mortgage.

From the beginning of the present financial crisis, REMICs have been hesitant to agree to modify debt instruments for fear of incurring a 100% excise tax on the value of the debt instrument modified.

Given that many loans will need to be reworked in the near future and will not fit under the safe harbors mentioned above, various industry groups have been asking Treasury to set forth some additional safe harbors.

<u>September 16 Regulations</u>

On September 16, 2009, Treasury published final regulations expanding the types of modifications that will not result in a deemed disposition or disqualification of the mortgage for purposes of the 100% excise tax. The following modifications, even if they would result in a deemed sale of the debt instrument for purposes of recognizing gain or loss, will not cause the imposition of the excise tax:

(a) A release of a lien on real property will not disqualify the mortgage so long as the loan is principally secured by other real property;

(b) A change from recourse to nonrecourse or vice versa so long as the obligation continues to be principally secured by real property; and

(c) The addition or deletion of credit enhancement, so long as the obligation continues to be principally secured by real property.

The final regulations continue the fundamental rule of REMIC qualification that an obligation is principally secured by real property if the value of the real property is at least 80% of the face amount of the loan. Fortunately, there is no need for an independent appraisal as the regulations provide that the "principally secured" requirement is satisfied if the holder reasonably believes that the modified mortgage satisfies the 80% test at the time of the modification.

Should you have any questions or desire further information regarding the foregoing development, please contact any attorney in the Firm's Tax Department.