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**Rev. Proc. 2007-72
Potential Tax Relief for Modification of Securitized Mortgages**

Recent market turmoil has led to suggestions on how to stem losses on securitized mortgages. Some have proposed the locking of interest rates on variable rate mortgages at levels that the debtors can afford. One example is the American Securitization Forum's *Statement of Principles, Recommendations and Guidelines for a Streamlined Foreclosure and Loss Avoidance Framework for Securitized Subprime Adjustable Rate Mortgage Loans* that was issued on December 6, 2007 (the "AFS Report").

In addition to legal, economic, and accounting issues associated with modifying securitized mortgages, the tax rules, including the real estate mortgage investment conduit ("REMIC") rules, have imposed obstacles to making such modifications. In Rev. Proc. 2007-72, the Internal Revenue Service (the "IRS") essentially provides that it will not adversely impose certain tax rules to loan modifications that are outlined in the AFS Report. It is important to note that the IRS is not repealing or amending the tax rules, rather it is merely letting specified modifications occur in certain narrow situations.

Background

Most US mortgage securitizations are done utilizing entities that are treated as

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REMICs for US tax purposes. The REMIC tax rules are quite complex and typically have impeded many types of mortgage modifications.

SFG Observation: Historically, REMIC structures are often not used where modifications of mortgages are anticipated. This is one reason why many commercial mortgage securitizations have been done 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 de minimis amount of a REMIC mortgages to be non-"qualified replacement 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 and failure to file penalties.

Rev. Proc. 2007-72 Potential Relief

In 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 a trust if the modifications are governed by the

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framework set forth in the ASF Report. As described in greater detail in the ASF Report, this lenience only applies to:

- Loans, as defined below;
- Modifications occurring on or before July 31, 2010; and
- Modifications that are a "Fast Track Modifications", as defined below, and any second lien holder's action of subordinating its lien to any new lien is a result of the Fast Track Modification.

SFG Observation: Since Rev. Proc. 2007-72 relies on the ASF Report for defining the scope and type of permissible modifications, a detailed reading of the ASF Report is recommended. This Capital Markets Advisory merely tries to summarize some of the general points of the ASF Report.

The ASF Report

In general, the ASF Report provides recommendations regarding the servicing and modifications of subprime loans in the current market. In addition to recommending loan modifications, it also provides suggestions on how performing loans could be refinanced and how impaired loans should be liquidated. Rev. Proc. 2007-72 only looks to the recommendations relating to the modification of loans.

The following definitions outline the types of loans that a servicer can modify under the ASF Report while at the same time being protected by Rev. Proc. 2007-72.

Loans

Loans consist of first-lien subprime residential adjustable rate mortgage (ARM) loans ("Loans") that:

- have an initial fixed rate period of 36 months or less (including "2/28s" and "3/27s")
- were originated between January 1, 2005 and July 31, 2007
- are included in a securitized pools; and

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- have an initial interest rate reset between January 1, 2008, and July 31, 2010.

Fast Track Modifications

According to the ASF Report, in a Fast Track Modification, the servicer is allowed to lock the existing interest rate for five years following the date on which the rate would have reset in the absence of the modification.

Loans and Borrowers Subject to Fast Track Modification

The ASF Report provides that the Fast Track Modification will only be available where the Loan and the borrower meet the following requirements:

- The Loan currently is not more than 30 days delinquent and has not been 60 days delinquent more than once over the prior twelve months;
- The borrower is unlikely to be able to refinance into any readily available mortgage product (which can generally be established by showing that the loan has an LTV of greater than 97%);
- The borrower currently occupies the property as his or her primary residence;
- The borrower's current FICO score is less than 660 and such borrower's FICO score has not increased more than 10% from the time of origination (if the FICO test is not met, the servicer can use an alternate individual analysis); and
- If the modification is not made, the borrower's payment will increase by more than 10% when the loan resets.

SFG Observation: It is important to note that Rev. Proc. 2007-72 does not amend or change existing law. In effect, it is merely allowing leniency in very specific factual situations. In fact, the IRS made it clear that Rev. Proc. 2007-72 should not be applied outside its scope. Further, since it relies on the ASF Report for scope and application, care should be given to ensure all modifications of securitized loans not only fall under Rev. Proc. 2007-72 but also under the applicable provisions of the ASF Report.

Questions

Please contact Trent Johnson at (202) 414-1484 for more information concerning either REMICs or other securitization and structured finance strategies.

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