

TAX ISSUES IN MORTGAGE BANKING

An Update

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Overview of Debt Modification Issues

- ◆ The § 1.1001-3 Debt Modification Rules
 - ◆ Under these rules, if the terms of a debt instrument are “significantly modified,” the debt instrument is deemed to have been re-issued in a taxable exchange.
 - ◆ A “modification“ vs. a “significant modification.”
- ◆ General Test - “economic significance”
 - ◆ A modification is significant only if, based on all of the facts and circumstances, the legal rights or obligations that are altered and the degree to which they are altered are economically significant.

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Tax Issues in Hedging of Mortgage Servicing (Cont.)

- ◆ Character of income / expense and gains or losses
 - Options, over the counter
 - ◆ Capital gain or loss
 - ◆ Options, exchange traded
 - ◆ 60 % long term, 40 % short term capital gain or loss
 - ◆ Floors
 - ◆ Purchase price amortization and periodic payments are ordinary expense and income
 - ◆ Early termination would produce capital gain or loss
 - ◆ Other ?

“Significant Modifications” of Debt

- ◆ Some “Significant Modification” Safe Harbors:
 - ◆ Safe harbors offer clear guidance for covered transactions, but rules for other (“general test”) transactions are ambiguous.
 - ◆ Change in yield: Significant if the yields differ by the greater of 25 bps or 5% of pre-modification yield.
 - ◆ Changes in timing of payments: Significant deferral of scheduled payments.
 - ◆ *Safe harbor - lesser of 5 yrs or 50% of the original term (not including extensions).*

“Significant Modifications” of Debt

- ◆ Change in obligor: Significant for recourse obligations.
- ◆ A release, substitution, addition or other alteration of collateral for, a guarantee on, or other credit enhancement for a debt instrument:
 - ◆ Recourse obligations – change in payment expectations.
 - ◆ Non-recourse obligations – only for a “substantial amount.”

“Significant Modification” Consequences

- ◆ REMICs and CDOs
 - ◆ Recent IRS guidance preserves REMIC/trust tax status for residential mortgage modifications under certain circumstances.
 - ◆ Rev. Procs. 2007-72, 2008-47 and 2008-28.
- ◆ US Holders of Distressed Debt
 - ◆ For debt that is not publicly traded, the amount realized on a deemed 1001 exchange is generally the “new” debt’s face amount, not its FMV.

Effect of Foreclosure on REMICs

- ◆ Modifications of mortgage loans held by a REMIC can trigger the prohibited transaction rules of § 860F(a)(2) and the substantial modification rules of §1.860G-2(b)(3).
- ◆ Both rules allow changes based on “reasonable foreseeable default.”
- ◆ The mortgage crisis has raised concerns over what constitutes a “reasonable foreseeable default.”

Effect of Foreclosure on REMICs (cont.)

- ◆ Three Rev. Procs. have been issued to address the problems.
 - ◆ Rev. Procs. 2007-72 and 2008-47 dealing with troubled loans under the American Securitization Forum (ASF) formulas.
 - ◆ Primarily targeted to sub-prime borrowers facing large jumps in interest rates.
 - ◆ Rev. Proc. 2008-28 dealing with other problem loans.
 - ◆ All three allow restructuring without triggering the substantial modification and prohibited transactions rules.

Effect of Foreclosure on REMICs (cont.)

- ◆ Rev. Procs. 2007-72 and 2008-47.
 - ◆ Treat modifications according to the ASF guidelines as due to reasonably foreseeable foreclosure.
- ◆ Rev. Proc. 2008-28.
 - ◆ Treats servicer's reasonable believe that there is a significant risk of foreclosure as justified if it is based on guidelines developed as part of a foreclosure prevention program.

Non-accrual of income

- ◆ For non-OID debt instruments, holders are permitted to stop accruing if no reasonable expectation of payment. Rev. Rul. 80-361 and CIP.
- ◆ Benefit of book-tax conformity for non-accrual issues.
- ◆ Different rules for original issue discount loans.

Non-accrual of income – Qualified stated interest

- ◆ Under Rev. Rul. 80-361, a fixed right to a determinable amount does not require accrual if the income item is uncollectible when the right to receive the item arises. *See also Jones Lumber Co. v. Commissioner*, 404 F.2d 764 (6th Cir. 1968).
 - ◆ Mere fact of delinquency insufficient to stop accruing interest.
 - ◆ Accrued interest on loans classified as loss for regulatory purposes can be charged off if book-tax conformity has been elected.
 - ◆ On loans not charged off, the taxpayer must, on a loan by loan basis, substantiate that the interest is uncollectible in accord with Revenue Ruling 80-361.

Non-accrual of income – OID

- ◆ IRS takes the position that accrual must continue for OID instruments. TAM 9538007.
 - ◆ The “doubtful collectibility” exception to this rule simply recognizes that it is inappropriate to include interest in anticipation of receipt when there is no reasonable expectation of receipt.
 - ◆ OID, by contrast, is not included in income in advance of receipt; it is included in lieu of receipt.
 - ◆ Many practitioners think this TAM is wrong.

Character of Gain or Loss on Sale

- ♦ **Character of gain or loss on sale of mortgage servicing sales.**
 - ♦ Commissioner v. P.G. Lake, Inc., 365 U.S. 260 (1958)
 - ♦ TAM 8744002 – servicing rights were ordinary assets
 - ♦ Arkansas Best v. Commissioner, 485 U.S. 212 (1988).
 - ♦ PLR 9443005 – Analogous income stream treated as section 1231 property.

Section 1221(a)(4)

- ◆ A Historical Survey of Character treatment
 - ◆ Capital assets do not include accounts or note receivables acquired in the ordinary course of trade or business for services rendered or from the sale of inventory.
 - ◆ The business of a savings and loan company could properly be described as “rendering the service” of making loans. *Burbank Liquidating Corp. v. Commissioner*.
 - ◆ Thus, mortgage loans directly made to borrowers in the ordinary course of business by a savings and loan association were “notes receivables acquired for services rendered” and thus came within the ambit of § 1221(a)(4).

Section 1221(a)(4) (cont.)

- ◆ “Rendering the service” analysis is extended beyond mortgage originator to secondary purchasers as liquidity providers. See Federal National Mortgage Association v. Commissioner, 100 T.C. 541 (1993).
 - ◆ Although FNMA was not the originating lender, the court did not believe that the difference between an originating lender and FNMA was determinative of the services issue. Rather, the court looked to whether FNMA provided a service in acquiring the mortgages in its portfolio. Id. at 578.
 - ◆ While acknowledging that FNMA was established to provide stability to the secondary mortgage market and liquidity for originating lenders thereby allowing them to extend additional loans, the court looked beyond Congressional intent and past the originating documents.
 - ◆ **The mortgage issuers benefitted from FNMA’s activity -- which was found to increase the level of bank lending.** This was a service to the mortgage lending business and its members.

Section 1221(a)(4) (cont.)

- ◆ Burbank Liquidating and FNMA. See 71 Fed. Reg. 44600 (Aug. 7, 2006). Thirteen years after FNMA, proposed regulations were issued that essentially would have overturned both
 - ◆ Reflected a conclusion by the government that the extension of section 1221(a)(4) to notes acquired by a creditor in a lending transaction or to notes purchased in the secondary market is inconsistent with Congressional intent and is unsound as a matter of tax policy.
 - ◆ “The interpretation of section 1221(a)(4) set forth in Burbank Liquidating and FNMA impeded effective administration of the tax laws by causing the status of the notes to hinge on judgments as to whether the lending transaction or a subsequent secondary market purchase of the notes provides a service to the borrower or the mortgage lending industry. Reliance on judgments as this fosters uncertainty and disputes.”

Section 1221(a)(4) (cont.)

- ◆ Following industry comments, the IRS withdrew the proposed regulations in Announcement 2008-41.
- ◆ “The IRS will not challenge return reporting positions of taxpayers under section 1221(a)(4) that apply existing law, including Burbank Liquidating; FNMA; and Bielfeldt v. Commissioner ... See also Rev. Rul. 80-56 and Rev. Rul. 80-57” (citations omitted).

Methods of Acquiring Mortgage Servicing Rights

- ◆ Origination
- ◆ Wholesale Origination
- ◆ Purchase of Bulk Servicing
- ◆ Purchase of Mortgage Banking Operations

Tax Rules for Acquisition of Mortgage Servicing Rights

- ◆ Origination
 - ◆ No tax imposed on value of “normal servicing”
 - ◆ Excess servicing treated as striping transaction with an IO strip retained
- ◆ Wholesale Originations
 - ◆ Same as above

Tax Rules for Acquisition of Mortgage Servicing Rights (cont)

- ◆ Purchase of Bulk Servicing
 - ◆ Treated as the acquisition of a 1231 asset
 - ◆ Purchase price amortized over 9 years
 - ◆ Regulations require pool amortization
 - ◆ Need to allocate price between “normal” and excess uncertain

Tax Rules for Acquisition of Mortgage Servicing Rights (cont)

- ◆ Purchase of Mortgage Banking Operation
 - ◆ Purchase that includes good will is subject to a 15 year amortization
 - ◆ No acceleration of the amortization period allowed
 - ◆ Need to allocate price between “normal” and excess uncertain

Acquisition of Mortgage Servicing - Safe Harbor Rules

- ◆ .25 percent (25 basis points) -- Conventional, fixed rate mortgage.
- ◆ .44 percent -- Mortgage less than one year old and insured or guaranteed by the FHA, VA, or FmHA.
- ◆ .44 percent -- Original principal balance of mortgage is \$50,000 or less.
- ◆ .375 percent -- Any other one- to four-unit residential mortgage (includes variable rate mortgages).

Acquisition of Mortgage Servicing - Safe Harbor Rules (cont)

Absent Safe Harbor, What Is Reasonable Compensation?

- ◆ Multi-family loans (possibly lower rates than safe harbors)
- ◆ Second mortgage loans (no escrow)
- ◆ Mobile home loans (agency minimums greatly in excess of safe harbors)
- ◆ SBA loans (may or may not be mortgages -- no escrow involved)
- ◆ Non-mortgage servicing (automobile loans, credit card receivables)

Amortization of Mortgage Servicing Rights

- ◆ Separate “normal” from “excess”
- ◆ Amortization of PMSRs (Sections 197 & 167(f)(3))
- ◆ Acquired as part of a trade or business or substantial portion thereof - 15 year straight line
- ◆ Not acquired as part of a trade or business or substantial portion thereof - 9 year straight line
 - ◆ Allocate basis to homogeneous pool or a loan-by-loan basis rather than on a mass asset basis

Hedging in Mortgage Banking

- ◆ There are two basis economic hedges used in mortgage banking
 - ◆ Pipeline hedges
 - ◆ Servicing Income hedges

Tax Issues in Hedging of Mortgage Servicing

- ◆ Not a proper tax hedge because mortgage servicing rights are capital assets
- ◆ Should have memorandum in file stating why no hedge identification has been made
- ◆ Should also exempt hedge from Section 475 as security not held for sale

Tax Issues in Hedging of Mortgage Servicing (Cont.)

Timing of gains and losses subject to general tax rules

- ◆ Options, over the counter
 - ◆ No tax until option exercised or canceled
- ◆ Options, exchange traded
 - ◆ Marked to market
- ◆ Floors
 - ◆ Purchase price amortized, payments income when received
- ◆ Other ?

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Forgiveness of Indebtedness Information Reporting

- ◆ § 6050P requires banks and other entities to report the amount of indebtedness forgiven.
- ◆ § 108(h) allows individuals to reduce the basis of their principal residence rather than take the amount discharged into income.