

Clients & Friends Memo

IRS Guidance on the Home Affordable Modification Program

April 13, 2009

Introduction

On April 10, 2009, the Internal Revenue Service (IRS) released two items of guidance of importance to residential mortgage loan securitization transactions with respect to loan modifications under the Treasury Department's Home Affordable Modification Program (HAMP). The HAMP was announced by Treasury on February 18, 2009, and further details of its operation were provided on March 4, 2009.¹ The HAMP seeks to help at-risk homeowners by facilitating modification of mortgage loans to avoid foreclosure. It does this by establishing certain protocols for mortgage loan servicers to identify borrowers who are at imminent risk of default, and by creating a regime of certain government "incentive" payments to borrowers, servicers and lenders who effect modifications in accordance with the HAMP. The IRS guidance was provided in the form of a revenue procedure (Rev. Proc. 2009-23), addressing modifications under the HAMP, and a notice (Notice 2009-36) addressing the status of certain "incentive" payments under the HAMP.²

Rev. Proc. 2009-23

Under this revenue procedure, the IRS states that it will not (i) challenge the tax status of securitization vehicles (REMICs or fixed investment trusts (i.e., grantor trusts)) that modify mortgage loans under the HAMP guidelines, or (ii) assert that such modifications give rise to prohibited transactions for REMICs.

Under the applicable REMIC provisions, the requirement that a REMIC hold only "qualified mortgages" after its initial formation period can be violated by the deemed exchange that occurs when a mortgage loan is "significantly modified," within the meaning of Treasury Regulations § 1.1001-3(e). Such a deemed exchange can also be a prohibited transaction for a REMIC, resulting in a 100% tax on any gain realized.³ Similarly, such a deemed exchange violates the requirement

¹ See http://www.cadwalader.com/assets/client_friend/022409_Highlights_of_the_Stability_Plan.pdf; see also http://www.cadwalader.com/assets/client_friend/031009HomeownerAffordabilityStabilityPlan.pdf

² See <http://www.irs.gov/pub/irs-drop/n-09-36.pdf>; <http://www.irs.gov/pub/irs-drop/rp-09-23.pdf>

³ Section 860F(a)(1) of the Internal Revenue Code of 1986, as amended (the "Code").

that a fixed investment trust not have the power to “vary the investment of the certificate holders.”⁴ An exception is provided for both REMICs and fixed investment trusts for modifications made to a mortgage loan as to which default has occurred or is reasonably foreseeable.⁵

Rev. Proc. 2009-23 provides comfort that the eligibility protocol for loan modifications under the HAMP meets the standard of default being reasonably foreseeable, by stating that the IRS will not assert any of the following as a result of such modifications:

- that a REMIC is disqualified because the modification does not meet the exception for default having occurred or being reasonably foreseeable, or that the REMIC's regular interests are deemed reissued,
- that a prohibited transaction has occurred, or
- that a fixed investment trust is disqualified as a result of a power to vary the investment of the certificate holders.

Rev. Proc. 2009-23 provides guidance similar to that issued in connection with the American Securitization Forum's “streamlined modification framework” and certain servicer “foreclosure mitigation” programs.⁶

Rev. Proc. 2009-23 is effective for modifications made on or after March 4, 2009.

Notice 2009-36

In Notice 2009-36, the IRS and Treasury provide assurance that payments made to a REMIC under the HAMP will not be subject to the 100% tax on certain “contributions” to a REMIC after the start-up day.⁷

Under the HAMP, the Government will make certain incentive payments to encourage sustainable modifications of at-risk loans, including:

- Payments to servicers of up to \$1,000 up-front for each eligible modification, plus up to \$1,000 per year, awarded monthly, for up to 3 years, payable as long as the borrower stays current on the modified loan.

⁴ Treas. Reg. § 301.7701-4(c).

⁵ Treas. Reg. § 1.860G-2(b)(3)(i) (REMICs); see Rev. Rul. 73-460, 1973-2 C.B. 424 (fixed investment trusts).

⁶ See Rev. Proc. 2008-47, 2008-3 I.R.B. 272, Rev. Proc. 2008-28, 2008-23 I.R.B. 1054.

⁷ See Code Section 860G(d).

- Payments to servicers of up to \$500 for modifications of at-risk loans prior to the occurrence of a default and up to \$1,500 to mortgage holders (including a REMIC or fixed investment trust) who agree to such modifications.⁸
- Payments of up to \$1,000 per year, awarded monthly, for up to 5 years, to borrowers who enter into eligible modifications payable as long as the borrower stays current on the modified loan. Payments to borrowers under this program will directly reduce the outstanding principal balance of the mortgage loan.

In addition, Treasury will make payments to mortgage holders to share the cost of interest rate reductions needed to reduce a borrower's monthly mortgage payment from 38% to 31% of the borrower's monthly income, or equivalent reductions in principal.

Code Section 860G(d)(2) provides exceptions to the 100% REMIC "contributions" tax, including "[a]ny payment in the nature of a guarantee," and "[a]ny other contribution permitted in regulations." Notice 2009-36 provides comfort that the payments described above are either covered by the statutory exceptions or that regulations will be issued that provide an exception for such payments.

Notice 2009-36 does not necessarily resolve all issues regarding payments under the HAMP. It is possible that Treasury will provide additional comfort on issues such as the status of such payments as qualified assets of the REMIC or the effect on REMIC status of the addition of guarantees of interest and principal payments.

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⁸ A securitization vehicle's cash flow waterfall will determine the ultimate disposition of these payments.