



November 9, 2009

Michael S. Novey, Esq.
Associate Tax Legislative Counsel
U.S. Department of Treasury
1500 Pennsylvania Ave., NW
Washington, DC 20220

In re: Loan Modifications under the HAMP program

Dear Mr. Novey:

On February 18, 2009, the U.S. Treasury Department (the Treasury Department) unveiled the Homeowner Affordability and Stability Plan, including a Home Affordable Modification Program (the HAMP), in response to the deep contraction in the economy and the housing markets and the devastating consequences for homeowners and communities throughout the country. Mortgage Bankers Association¹ (MBA) members have identified a number of tax issues related to loan modifications under the HAMP that may need Treasury Department clarification to ensure smooth functioning of the program.

MBA urges the Treasury Department to issue guidance as to the tax consequences to the holders of and the debtors on loans that are modified under the HAMP.

The range and depth of modifications that are being made may result, in many instances, in constructive exchanges of the loans in the hands of the holder, under the principles of Treas. Reg. 1.1001-3. Reasonable people may differ as to which loan modifications result in constructive exchanges, and reasonable people may differ as to the proper application of the tax law in the event there has been a constructive exchange. Some of the tax consequences that could

¹ The Mortgage Bankers Association (MBA) is the national association representing the real estate finance industry, an industry that employs more than 280,000 people in virtually every community in the country. Headquartered in Washington, D.C., the association works to ensure the continued strength of the nation's residential and commercial real estate markets; to expand homeownership and extend access to affordable housing to all Americans. MBA promotes fair and ethical lending practices and fosters professional excellence among real estate finance employees through a wide range of educational programs and a variety of publications. Its membership of over 2,400 companies includes all elements of real estate finance: mortgage companies, mortgage brokers, commercial banks, thrifts, Wall Street conduits, life insurance companies and others in the mortgage lending field. For additional information, visit MBA's Web site: www.mortgagebankers.org.

result from constructive exchanges would not necessarily be consistent with the overriding tax policy interests of the Treasury Department, nor would they necessarily be consistent with the sound tax management of the holders.

MBA submits that uncertainty as to the holder's and the debtor's tax consequences should not impede lenders' participation in the HAMP program.

MBA therefore recommends that the Treasury Department issue guidance that provides that the Internal Revenue Service (IRS) will not challenge a holder's position that a loan modification under HAMP does not constitute a deemed exchange within the meaning of Treas. Reg. 1.1001-3.

In the event the Treasury Department concludes that such guidance exceeds its authority under existing law, MBA urges the Treasury Department to issue guidance to address the specific provisions, discussed below, that pose obstacles to participation in the HAMP and that are difficult to reconcile with sound tax management.

Discussion

Constructive exchanges of debt instruments can create anomalous tax consequences to the borrower and to the holder of the debt. MBA believes that allowing these tax anomalies to arise would be inconsistent with the underlying principles of the tax law at any time. MBA believes that allowing these tax anomalies to arise at this particular time would impede the success of the HAMP program and limit the HAMP's vital support of our nation's economic recovery.

Some of the tax anomalies which could arise are:

1. Phantom gain or loss to the holder – In the event that there has been a constructive exchange under Treas. Reg. 1.1001-3, the holder will be deemed to have sold the loan in a deemed exchange for a hypothetical new loan. The holder's proceeds would typically be the face amount of the hypothetical new loan (see Treas. Reg. 1.1001-1(g)(1)), irrespective of the value of the hypothetical new loan. In transactions in which the holder of the loan is the original lender, the holder's tax basis in the loan will often equal the face amount of the loan.

However, the holder's basis may differ from the face amount, as for instance when the holder has capitalized origination or acquisition costs into the basis of the loan or when the holder has purchased the loan from another party for either a discount or a premium. This may happen when loans are purchased in the market singly or in bulk. This would often be the case when a taxpayer acquires the assets of another lender, such as in the assisted acquisition of a troubled institution in a transaction to which Internal Revenue Code (IRC) Sec. 597

applies. In such cases, a constructive exchange would create taxable gain or loss to the holder. The Treasury Department has recognized the policy reasons against taxable gain to the holder in such situations, and has offered significant relief in many, but not all such cases, through Treas. Reg. 1.166-3.

Treas. Reg. 1.166-3 offers relief from phantom taxable income on constructive exchanges, but Treas. Reg. 1.166-3(a)(3)(ii)(A) limits this relief to those taxpayers who have claimed a deduction for the partial worthlessness of that loan in a prior year. A technical reading of this clause leads to the conclusion that a purchaser of this loan at a discount or a premium could not avail itself of this relief. MBA believes that such a technical reading would be inconsistent with the purpose of this regulation.

2. Original Issue Discount (OID) for the holder, but not the lender, as the result of a constructive exchange – A constructive exchange could create OID income to the holder in the event that the interest rate on the loan after modification is lower than the Applicable Federal Rate. Note that this OID would be asymmetrical – it appears that there would be no OID for the borrower, by virtue of IRC Sec. 1275(b)(1), which provides that IRC Secs. 483 and 1274 do not apply to debts given in exchange for personal use property.

MBA believes that such asymmetrical treatment is antithetical to the underlying principles of the OID rules of IRC Secs. 1272 – 1275.

3. Information reporting requirements – In the event a loan modification results in the discharge of some portion of principal residence indebtedness before January 1, 2013, the debtor does not generally recognize taxable income (IRC Secs. 108(a)(1)(E), 108(h)). However, IRC Sec. 6050P and the regulations thereunder still require that most holders file IRS Form 1099-C when an identifiable event of discharge occurs. Most applicable financial entities follow the practice of filing IRS Form 1099-C (and IRS Form 1099-A) when an identifiable event has occurred, and suggesting the debtor contact their tax advisor as to whether the reported amount is taxable. We understand the general policy reason underlying the regulations under IRC Sec. 6050P, and the need for loan workouts and foreclosure transactions to be reported to the IRS, so that the IRS can audit such transactions and assure that in fact the borrowers qualify for the exemptions provided under IRC Sec. 108.

However, we submit that in a constructive exchange in which the creditor has not actually forgiven any principal, the requirement to issue IRS Form 1099-C would impede the process. The debtor's concerns about the taxability of a loan modification and the lender's concern that a loan modification might be a reportable event, should not be allowed to complicate the process of modifying loans under the HAMP.

Moreover, it is possible that in a loan modification under the HAMP, the interest rate on the modified loan could be less than the Applicable Federal Rate (as discussed at point 2 above). MBA believes the better view under existing law is that in such a situation, unless there has been a discharge of principal already owed, there would be no debt forgiveness income under IRC Sec. 61(a)(12), thus no reportable event under IRC Sec. 6050P. However, we also believe that there is an opportunity for reasonable people to be confused about the reporting requirements.

Precedent

The Treasury Department has, on occasion, recognized those instances in which a mechanical application of the IRC and the regulations thereunder would produce a result which was not intended by Congress and which would not further the sound administration of the tax law and of the larger economic programs of the executive branch. For instance, in Rev. Proc. 2009-23 and its predecessors, the Treasury Department noted that loan modifications under the HAMP program and its predecessors would not cause REMICs or investment trusts to lose their defined tax status. In addition, Treas. Reg. 1.166-3, previously noted, relieves lenders of anomalous gain recognition in many (but not all) instances in which a loan is constructively modified under Treas. Reg. 1.1001-3.

MBA's Recommendations

MBA suggests that the Treasury Department provide administrative relief consistent with the letter and the spirit of these pronouncements.

Specifically, MBA urges the Treasury Department to issue guidance providing that the IRS will not challenge a holder's position that a loan modification under HAMP does not constitute a deemed exchange within the meaning of Treas. Reg. 1.1001-3.

In the event the Treasury Department concludes that such guidance exceeds its authority under existing law, MBA urges the Treasury Department to issue guidance to address the specific anomalies that we have identified here:

1. Guidance clarifying that in the event of a loan modification under the HAMP that may constitute a constructive exchange under Treas. Reg. 1.1001-3, the rule in Reg. 1.166-3(a)(3)(ii)(A) applies so as to offer the holder the additional deemed charge-off even in the event the holder has not previously claimed a deduction for the partial worthlessness of that loan.
2. Guidance clarifying that in the event of a loan modification under the HAMP that may constitute a constructive exchange under Treas. Reg.

- 1.1001-3, in those instances where IRC Sec. 1275(b)(1) provides that the borrower does not have OID, the creditor will not have OID, and no OID will be reportable on form 1099-OID.
3. Guidance clarifying that in the event of a loan modification under the HAMP that may constitute a constructive exchange under Treas. Reg. 1.1001-3, information reporting under IRC Sec. 6050P will not be required unless there has been an actual legal discharge of amounts already owed by the borrower.

MBA would be happy to discuss these and any other tax issues that emerge as a result of the HAMP program, and look forward to the Treasury Department working through each of the issues with the mortgage banking industry so that tax laws and regulations do not stand in the way of implementing the loan modifications specified in HAMP. Any questions or response should be directed to Jim Gross, Associate Vice President and Staff Representative to MBA's Financial Management Committee, at (202) 557-2860 or jgross@mortgagebankers.org.

Most sincerely,



John A. Courson
President and Chief Executive Officer
Mortgage Bankers Association