

Internal Revenue Service
CC:PA:LPD:RU (Rev. Proc. 2008-28)
Room 5203
P.O. Box 7604
Ben Franklin Station
Washington, DC 20044

**Public Comments Regarding
Rev. Proc. 2008-28, Proposed Tax Regulation Comments
Due JULY 15, 2008**

SECTION 8. EFFECTIVE DATE

This revenue procedure governs determinations made by the Service on or after May 16, 2008, with respect to loan modifications that are effected on or before December 31, 2010.

SECTION 9. REQUEST FOR COMMENTS

The Service invites public comment on this revenue procedure. In particular, the Service invites comments on whether this revenue procedure should be extended to loan modifications that are effected after 2010, whether the Service should consider changing other provisions of this revenue procedure, and whether the Service should consider issuing any additional guidance regarding Federal tax issues that are raised by modifications of mortgage loans to reduce the risk of foreclosure. Comments should be submitted no later than July 15, 2008, to the Internal Revenue Service, CC:PA:LPD:RU (Rev. Proc. 2008-28), room 5203, P.O. Box 7604, Ben Franklin Station, Washington, DC 20044. Comments may be hand delivered between the hours of 8 a.m. and 4 p.m. to CC:PA:LPD:RU (Rev. Proc. 2008-28), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue NW, Washington, DC 20224. Alternatively, comments may be submitted via the Internet at Notice.Comments@irsounsel.treas.gov (Rev. Proc. 2008-28). All comments will be available for public inspection and copying in their entirety. Therefore, comments received by the IRS and Treasury should not include taxpayer-specific information of a confidential nature. Comments should include the name and telephone number of a person to contact.

Preface:

Form should follow function. New functional solutions should design the “form” of regulation. The regulations should not design the “function” and solutions in the 21st Century. To effectively reconcile all diverse conflicting self-interests, for the betterment of housing and the economy at large, we must first consider all such interests in a comprehensive forum. The results of such discussions will yield principles-based standards with objectively obtainable safe harbors. New solutions allowable in such a framework, would lessen risks, and enhance certainty for all industry participants, including borrowers.

This Revenue Procedure may be one of the most important acts necessary in these troubled economic times. It must be comprehensive in principle as it resides at the heart of the problem, coordinated with all self-interests including Congress (which may have to act with authority grants), and promote (not prohibit) new industry (product) development. This will spark the genius of our democracy and lay the foundation and framework for creative and effective self-adjusting solutions for generations to come. Limitations that prohibit or hinder comprehensive solutions will preclude effective and efficient resolution of the pending economic challenges.

Pursuant to Internal Revenue Code Section 860F(a)(2)(A), the disposition of a qualified mortgage is a prohibited transaction unless the disposition is pursuant to (i) the substitution of a qualified replacement mortgage for a qualified mortgage; (ii) a disposition incident to the foreclosure, default, or imminent default of the mortgage; (iii) the bankruptcy or insolvency of the REMIC; or (iv) a qualified liquidation.

Since, the consequences of violating the proposed Rev. Proc. (.08) or IRC Section 860F(a)(1) is the imposition of a tax on a REMIC equal to 100 percent of the net income derived from “prohibited transactions”, special attention and guidance is warranted to infuse certainty into the heart of forth coming (en mass) modifications engine.

Brief Summary of Questions:

Shared Appreciation Mortgage Modifications: Would en mass Shared Appreciation Mortgage Modifications, and Quarantined (Shared Appreciation/Equity) Principal Modifications comply with the Rev. Proc. and/or Section 5 Conditions? Would Shared Appreciation Mortgage Modifications or Quarantined (Shared Appreciation/Equity) Principal Modification arrangements comply with the Rev. Proc. or fall within a safe harbor? Would modifications where the lender and insurer (FHA) are entitled to receive the lesser of 25% of gain appreciation or the amount forgiven or guaranteed, respectively comply? Would the ability of the lender to sell the guaranteed portion (to restore liquidity – whether or not to reduce the risk of foreclosure) be permissible or unacceptably vary the investment? Would it be a permissible investment? Would quarantined-principal, not necessarily forgiven principal, (with or without shared appreciation), and with or without built-in equity (5-15% under fair value) comply? Exactly what factors go into making the “less favorable” determination?

Section 5 Conditions: What best standards or guidelines would be acceptable or not acceptable under Section 5 conditions?

Tradable Insured Investment Credit Enhancements: How would the Rev. Proc. treat the new tradable foreclosure (default, bankruptcy, investor) insured investment fund(s) credit enhancement(s) (contracts) (arrangements); as the mortgage or pool of mortgages, or as a separate asset? Would it be a permissible investment? Would it comply with the Rev. Proc. or safe harbors?

Generally: How does Rev Proc 2008-28 interplay with loss mitigation options or procedures, interest rate reductions or extensions, principal forgiveness or reductions, or alternative quarantined principal, extensions of maturity, and alterations in the timing of changes in an interest rate, shared appreciation mortgage concepts, en mass modifications, foreclosure prevention programs and actual foreclosure, bankruptcy, securitization, writedowns, valuations, FASB rules, IASB rules, and various other aspects of self interests?

Comments and Queries:

Modifications Are Now Paramount

Modifications – Hope Now

Modifications are now the stated goal and public policy for industry and government. Hope Now reported on June 2, 2008 that approximately 106,000 of the prime and subprime loan workouts conducted by mortgage servicers in April were repayment plans, while approximately 77,000 were loan modifications. A summary table with all the April results can be found at www.hopenow.com/upload/misc/files/AprSummaryTable.pdf. A separate survey of subprime adjustable-rate mortgages determined that approximately 603,000 subprime loans were scheduled to reset between January and April of this year. A total of 30,545 (5.0%) of these loans have already been modified, and nearly 63% of these modifications are for five years or longer.

MortgageOrb™ reported on July 3, 2008 that Hope Now estimates (in pertinent part) that:

“The total number of foreclosures prevented by mortgage servicers since July 2007 has risen to more than 1.7 million;

Mortgage servicers provided loan workouts for approximately 170,000 at risk borrowers in May; and

Approximately 100,000 of the prime and subprime loan workouts provided by mortgage servicers in May were repayment plans, while approximately 70,000 were loan modifications.

The numbers reported by HOPE NOW differ from those recently reported by the Office of the Comptroller of the Currency and are likely to differ from those expected to be reported soon by the Office of Thrift Supervision. They may also differ from those reported by other regulators.”

Summary Observations for New Product Solutions:

Modifications:

The industry is now aggressively exploring principal reduction or forgiveness modifications, and leading in the direction of “quarantined principal modifications.” Clarification of how such modifications will fare under the revenue procedure is necessary.

Credit Enhancements – Mortgage Insurance:

Additionally, as we reach for true borrower affordability, we must create new products that pay for the enhanced risk, but not necessarily in monthly cash terms. New products will be necessary to reach affordability with non-cash or cash-equivalents; with the use of Equivalent Risk Pricing (ERP). Clarification or additional guidelines are necessary. Credit Rating Agencies and new credit enhancement product developers must be consulted prior to finalization of this revenue procedure.

New Products re Modifications:

Principal Reduction or Forgiveness Modifications:

Shared Appreciation Mortgage Modifications:

New products are being offered that are conceptually shared appreciation mortgage modification arrangements wherein the lender and insurer (FHA) are entitled to receive the lesser of 25% of gain appreciation or the amount forgiven or guaranteed, respectively. Would that arrangement comply with the proposed Rev. Proc.? Does it conflict or comply with related securitization guidelines, pooling and servicing agreements in general, regulations, rules or laws?

New products are being offered that would allow the FHA to guarantee \$1 of existing troubled mortgages on primary residences for each \$1 forgiven by the lender. The lender would be able to resell the guaranteed portion of its principal amount. Would that arrangement comply with the proposed Rev. Proc.? Does it conflict or comply with related securitization guidelines, pooling and servicing agreements in general, regulations, rules or laws?

Quarantined (Shared Appreciation/Equity) Principal Modifications

Does Rev. Proc. 2008-28 contemplate and allow for compliance protection for the creation of new product solutions, including modifications that allow not only for the reduction or forgiveness of principal, but for “quarantined principal” modifications? Quarantined principal modifications would allow for the events of zero loss of principal to the investors, borrowers and insurers (FHA).

“Quarantined Principal Modifications Converge with Fair Value Mark to Market or Mark to Model Valuation, Writedowns & Capital Rules and Requirements”

Based upon the product definition and assumptions, FAS 5 (and other rules) would calculate the expected loss of principal at a very nominal discount as preserved principal under the “Quarantined Principal Modifications” model would use a much longer duration as a factor in the calculation. Since the principal reduction is not forgiven per se, but preserved under contract per se, the entire principal is expected to be realized over time. Such a solution would serve all self and diverse interests to the mortgage

transaction, including the borrower, as the borrower would get the benefit of a more affordable (monthly cash burden or reduced payment) (without ceasing payments to the REMIC, trust or conduit causing Rating problems, loss of cash flow, etc.) as based upon the reduced principal (or interest, or reset) amount (and eventually return of all of its equity appreciation or a share of it depending upon the product model) (with or without equity appreciation sharing). The lender and the insurer would stand to receive up to 100% of its investment, and the insurer (FHA, etc.) would earn premium fees. An example of such products are called: Quarantined Built In Equity Shared Appreciation Mods™ (“QbieSAM™”), Shared Built In Equity Mortgage™, BKMods™, and OptInMods™.

New Products re Credit Enhancements – Mortgage Insurance:

Tradable Insured Investment Credit Enhancements

Does Rev. Proc. 2008-28 contemplate and allow for compliance protection for the creation of new product solutions, including credit enhancement products that go beyond the “contract” enhancement as enunciated in the regulations? Would this regulation allow for “tradable credit enhancements” such as tradable insured investment funds with risks aligned to the future events of foreclosure, default, bankruptcy, or investor losses; such as Foreclosure Mortgage Insured Investment Funds™ (FMII™)? Would this regulation allow such protection for new product solutions that traded as options or futures?

New Solutions for Credit and Capital Markets - An example of the products and regulators that may be involved on such new products are as follows:

New Product: Credit Risk Insured Options on Futures Events™ ("CRIOFE™")
New Mortgage Pool Securitization Credit Enhancements for Credit Ratings
The Regulator: Commodity Futures Trading Commission (CFTC) Principles Based Self -Regulation & Self-Certification; US Futures Exchange (CBOT/CME/ICE)

An example of such products are called: FMII™- Foreclosure Mortgage Insured Investment Funds™, DMII™ - Default Mortgage Insured Investment Funds™, BMII™ - Bankruptcy Mortgage Insured Investment Funds™, and IMII™ - Investors Mortgage Insured Investment Funds™. These funds would produce "certainty" in supplying funds necessary to, advance investor shortfalls for lost payments of principal and interest on non-performing assets, and return (residential) real estate from a foreclosed posture back to the resale market with less loss severity in non-performing assets, thereby stabilizing home prices and avoiding price decline severity plaguing the real estate markets today. Loan pools would receive payments necessary for curing loan by loan deficiencies for carrying expenses such as Taxes and Insurance (and/or P&I), and Property Preservation (P&P). Funds would build equity and certainty and act as a limited surety for mortgage loan securitizations.

Concept and Definition Queries:

How would the Rev. Proc. treat the new tradable foreclosure (default, bankruptcy, investor) insured investment fund(s) credit enhancement(s) (contracts) (arrangements); as the mortgage or pool of mortgages, or as a separate asset?

What about new product credit enhancements that might pay on default or delinquencies as well as on future(s) events of bankruptcy, default, etc., or on losses or expenses incurred by not only the REMIC but other (related or unrelated) parties?

What is the scope of the meaning of defective obligation, and permitted investments? How would the Rev. Proc. treat the new tradable foreclosure (default, bankruptcy, investor) insured investment fund(s) credit enhancement(s) (contracts) (arrangements)?

What is the scope of the safe harbor - no more than 10% of its original principal balance or substantially all of its assets consist of qualified mortgages and permitted investments - no more than *de minimis* with respect to the new tradable foreclosure (default, bankruptcy, investor) insured investment fund(s) credit enhancement(s) (contracts) (arrangements), and Quarantined (Shared Appreciation/Equity) Principal Modification and Shared Appreciation Mortgage Modifications?

What is the scope of the meaning of the 1% Safe Harbor - *de minimis* - if the aggregate of the adjusted basis of those assets is less than 1% of the aggregate of the adjusted bases of all of the entity's assets (1.860D-1(b)(3)(ii)) with respect to the new tradable foreclosure (default, bankruptcy, investor) insured investment fund(s) credit enhancement(s) (contracts) (arrangements), and Quarantined (Shared Appreciation/Equity) Principal Modifications and Shared Appreciation Mortgage Modifications?

What is the scope in limitations re powers to vary the composition of its mortgage assets (S. Rep. No. 00-313, 99th Cong., 2nd Sess. 791-92) with respect to the new tradable foreclosure (default, bankruptcy, investor) insured investment fund(s) credit enhancement(s) (contracts) (arrangements), and Quarantined (Shared Appreciation/Equity) Principal Modifications and Shared Appreciation Mortgage Modifications?

Would quarantined (Shared Appreciation/Equity) Principal Modifications be "prohibited transactions", permissible investments, or qualify for safe harbor contractual credit enhancements?

Would en mass, Shared Appreciation Mortgage Modifications, and Quarantined (Shared Appreciation) Principal Modifications comply with Section 5 Conditions - .03(1) re no more than 10% of ...total assets...represented by loans the payments on which were then overdue by 30 days or more?

What best standards or guidelines would be acceptable or not under Section 5 conditions?

What foreclosure prevention guidelines are authoritative and which are not, to determine if the holder or servicer reasonably believes that there is a significant risk of foreclosure of the original loan?

Would the new NACTT best standards adopted (on or about June, 2008) by the NACTT Mortgage Committee in a document entitled: **BEST PRACTICES FOR TRUSTEES and MORTGAGE SERVICERS IN CHAPTER 13** be authoritative? www.procouncil.com/html/new_best_practices.html

Would attorney foreclosure associations who set or coordinate best practices, such as the AFN, be authoritative? www.e-afn.org

What factors are considered credible and systematic?

What factors must be used and which may not:

FICO, LTV, CLTV, ABILITY TO PAY, PAYMENT HISTORY, CHANGES IN PROPERTY VALUES OF A PARTICULAR PROPERTY WITH OR WITHOUT CHANGE OF NEIGHBORHOOD VALUES; DEBT SERVICE RATIOS, EMPLOYMENT, MEDICAL STATUS, INSURED vs UNINSURED MORTGAGE OR LOSSES, DOCUMENTATION OF INCOME AND ASSETS EVEN IF NONE WERE REQUIRED ON ORIGINAL LOAN, LOAN OR NON LOAN LEVEL DATA OR MODELS, MACRO OR MICRO STATISTICAL DATA OR MODELS?

Concerning Section 5 conditions as stated at .05 (wherein the terms of the modified loan are less favorable to the holder than were the unmodified terms of the original mortgage loan), if Shared Appreciation Mortgage Modifications and Quarantined (Shared Appreciation/Equity) Principal Modifications would allow mutually beneficial or equal favorability to the holder of the loan (lender or investor) as well as the borrower, would it be in compliance? Fairness would say that it should, correct?

Exactly what factors go into making the “less favorable” determination?

Does the “less favorable” determination require or allow the factors of - how a Modification with a reduction in principal and a devaluation of home prices affect the reporting, taxes, reimbursements and relative conflicts of interest among the participants, including the tier investors, borrower, servicer, lender and REMIC; or how that compares to the Foreclosure Option when you net out the tax affect to the foreclosing Lender/Servicer/Holder?

What if new product modifications don't seemingly render the lender or investor in a less favorable position? Under the Shared Appreciation Mortgage Modifications or

Quarantined (Shared Appreciation/Equity) Principal Modifications arrangements the lender or investor incurs economic and contractual risks and detriment of the new arrangement. Would it comply? What factors, exactly, would go into this determination?

Shared Appreciation Mortgage Modifications: What about shared appreciation mortgage modification arrangements where the lender and insurer (FHA) are entitled to receive the lesser of 25% of gain appreciation or the amount forgiven or guaranteed, respectively. Would that arrangement comply?

Would Quarantined (Shared Appreciation/Equity) Principal Modifications arrangements comply in general?

If the investor (lender) and the borrower voluntarily agreed or opted into Quarantined (Shared Appreciation/Equity) Principal Modification arrangements, would it comply? Individually or en mass?

How would the Rev. Proc. and Section 5 'obligations principally secured test' - 80% test re fair market value or adjusted issue price, fare with Shared Appreciation Mortgage Modifications and the Quarantined (Shared Appreciation/Equity) Principal Modification arrangements?

How would the Rev. Proc. defeasance - release of liens - substitute collateral rules fare with Shared Appreciation Mortgage Modifications and the Quarantined (Shared Appreciation/Equity) Principal Modification arrangements?

How would the Rev. Proc. Fair Market Value rules that govern how IFRS and BASEL II impact FAS rules, or acceptable or safe harbor methods of valuation, reconcile with [OFHEO's FINAL RULE FOR LOSS SEVERITY CALCULATIONS UNDER RISK-BASED CAPITAL REGULATION](#), and ASF GUIDELINES found in the [American Securitization Forum: Recommended Definitions and Investor Reporting Standards for Modifications of Securitized Residential Mortgage Loans December, 2007](#) ([American Securitization Forum Streamlined Foreclosure and Loss Avoidance Framework for Securitized Subprime Adjustable Rate Mortgage Loans Executive Summary December 6, 2007](#))?

Conclusion:

We inch closer, but are we there? The need for comprehensive reconciliation and clarification of various authorities and accepted (best) practices hold back the damn for en mass modifications (or in number or amounts that violate current Rev. Proc. tests), including GSE type modifications, but also non-agency paper modifications. We cannot just seek governmental (regulatory) or legislative solutions without addressing the need to fix the core problem revealed in non-agency (jumbo) markets during the mortgage meltdown. Regulations must allow for certainty, objectively obtainable principles-based standards, and protections under law, or industry will either fail to implement certain solutions that are needed or design or "form" the products around a patch-quilt of

regulations and risk exposures, instead of “function” that will serve the needs of the industry (lender, investor, REMIC, trust, conduit, insurer (FHA and private label), etc.) participants as well as its consumer, the borrower.

Richard Ivar Rydstrom, Professor, J.D., LL.M.,
(949) 678-2218
rrydstrom@gmail.com