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Tales from the Credit Crunch: Selected Issues in the Taxation of Financial Instruments and Pooled Investment Vehicles

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Thomas Humphreys analyzes the tax consequences of key issues at the forefront of today's credit crunch, including mortgage-backed securities, asset-backed securities and pooled investment vehicles. He also sheds light on areas of the law in need of clarity and discusses some of the effects of the Mortgage Forgiveness Debt Relief Act of 2007.

Introduction

The last year has seen an enormous upheaval in the credit markets.[2] Things that were not supposed to happen, have happened.[3] Instruments that were designed to be flexible, have become inflexible.[4] As is typical, these economic stresses are testing our financial systems, many of which have been found lacking. From a U.S. federal income tax perspective, our systems are being tested as well. The extreme financial stresses of the last year are causing us to focus on previously ignored tax aspects of various transactions including home-mortgage foreclosures and restructurings, stressed-out securitization vehicles, investments in these securitization vehicles and other seemingly unrelated financings, such as auction rate securities.

This article attempts to catalogue an assortment of tax issues faced by those on the front lines in the credit crunch. It focuses on tax consequences to the key financial transformers: mortgage-backed securities and asset-backed securities, as well as pooled investment vehicles. It starts with a basic home mortgage and then follows it through the various twists and turns of the securitization process. By necessity, it ranges over many U.S. federal income tax provisions as they apply to financial instruments and pooled investment vehicles. It is not exhaustive; however, it attempts to describe some of the credit-crunch problems facing the tax system today. In addition, it describes various changes already made to the tax law by Congress, the IRS and the Treasury in response to the credit crunch as well as changes currently being sought by the private sector. Finally, it attempts to analyze past tax administrative responses to economic crisis and suggests a frame-

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work for considering current potential changes in the administration of the U.S. tax laws as they relate to this unprecedented economic upheaval.

Home Mortgages

At the root of the credit crunch lies the individual homeowner's inability to pay his or her mortgage loan. One would have thought the federal income tax consequences to the mortgagor and mortgagee from a foreclosure or reworking of a simple home mortgage would be equally simple. Nothing, however, could be further from the truth. The following first analyzes the federal income tax consequences of a foreclosure sale and then analyzes the tax consequences of a modification to the mortgage loan in lieu of foreclosure. Mr. Jim Taxpayer, an average American subprime borrower and his local bank, Landsdale Community Bank ("Landsdale Bank"), a brick-and-mortar American bank, will help walk us through the analysis that follows.

Suppose Mr. Taxpayer borrowed $500,000 from Landsdale Bank to purchase his dream house with no money down. The mortgage is an adjustable-rate "2/28" subprime mortgage loan (ARM) that has a teaser interest rate for the first two years at a specified percentage that will reset to LIBOR plus [x] basis points for the remainder of the term of the mortgage.[5] Assume that the rate has reset and, due to the reset, Mr. Taxpayer can no longer make his mortgage payments.[6] Further assume that the value of Mr. Taxpayer's dream home has declined to $400,000, and he cannot refinance (because his bank is no longer making any loans).

Foreclosure Sales and Other Default Transfers

In the first scenario, assume Landsdale Bank forecloses and sells the home at auction.[7] Assume that Landsdale Bank sells the home for its fair market value of $400,000, and Mr. Taxpayer still owes $500,000 on his mortgage loan.

Tax Consequences to Mr. Taxpayer

A sale of the home to a third party pursuant to a foreclosure would be treated as a sale or exchange of the property by Mr. Taxpayer under Code Sec. 1001,[8] causing Mr. Taxpayer to recognize gain or loss (if any) equal to the difference between his adjusted basis in the property and the amount realized. Mr. Taxpayer may also recognize cancellation of indebtedness income if Landsdale Bank releases Mr. Taxpayer from any deficiency amount. Generally, a purchaser of property has a cost basis in the property purchased. For purposes of the remainder of the discussion, assume Mr. Taxpayer's basis in his dream home equals $500,000. Generally, the amount realized from a sale or exchange of property subject to a debt depends on whether the debt is recourse or nonrecourse. For the sake of completeness, the discussion analyzes the sale assuming the mortgage is alternatively recourse and nonrecourse.

If the mortgage was recourse, the amount realized would equal the amount of the sale proceeds, or $400,000.[9] Assuming Landsdale Bank holds Mr. Taxpayer liable for the excess of the mortgage balance over the sale proceeds, Mr. Taxpayer would recognize a $100,000 nondeductible capital loss and would have no cancellation of indebtedness income because he remains liable for the debt under the deficiency judgment.[10] However, Landsdale Bank may be inclined to discharge Mr. Taxpayer from his personal liability for the remaining balance because of Mr. Taxpayer's financial situation, the fact that courts are overloaded with foreclosures and deficiency judgments, and the processes' costs. If Landsdale Bank discharges the remaining balance, Mr. Taxpayer still would recognize a nondeductible capital loss of $100,000, but also would recognize cancellation of indebtedness income in the amount of the discharged debt, also $100,000.[11] The foregoing results would not change if Landsdale Bank itself purchased the property out of foreclosure for the full amount of the mortgage balance—the excess of the purchase price over the fair market value of the property would be recharacterized as a discharge of debt and, therefore, cancellation of indebtedness income to Mr. Taxpayer.[12] Nor would the result change if Mr. Taxpayer simply conveyed his property to the Bank or, for that matter, abandoned the property.[13]

Fortunately for Mr. Taxpayer, Congress has temporarily come to the rescue with the Mortgage Forgiveness Debt Relief Act of 2007 ("the Debt Relief Act"), which was signed by President Bush on December 20, 2007, and which solved the mismatch dilemma referenced above.[14] The Debt Relief Act amends Code Sec. 108 to exclude cancellation of indebtedness income from gross income if the indebtedness is "qualified principal residence indebtedness" discharged before January 1, 2010.[15]

The basis of the principal residence is reduced by the amount excluded from income.[16] Qualified principal residence indebtedness means acquisition indebtedness with respect to the taxpayer's principal residence. Acquisition indebtedness with respect to a principal residence generally means indebtedness incurred in the acquisition, construction or substantial improvement of the principal residence of the individual and secured by the residence.[17] It also includes refinancing of such indebtedness to the extent the refinancing debt does not exceed the refinanced debt.[18] The Debt Relief Act imposes a $2 million limit (or $1 million in the case of married taxpayers filing separately) on the amount of debt relief available. As applied to Mr. Taxpayer, his cancellation of indebtedness income would lower his adjusted basis in the property to the amount of the sale proceeds, such that he would not recognize any gain, loss or income on the foreclosure.[19]

Mr. Taxpayer may have achieved the same result anyway under other provisions of Code Sec. 108 that predate the Debt Relief Act. If Mr. Taxpayer had lost his home in the context of bankruptcy, or if Mr. Taxpayer had been sufficiently insolvent at the time of foreclosure, his cancellation of indebtedness income also would not have been included in gross income and his basis in the property may have been correspondingly reduced.[20] Here "insolvent" means "the excess of liabilities over the fair market value of assets" determined "on the basis of the taxpayer's assets and liabilities immediately before the discharge."[21] With respect to insolvency, cancellation of indebtedness income would be excluded from gross income to the extent of such excess. Presumably many folks like Mr. Taxpayer in foreclosure on their personal residences would fall under one of these two exceptions as well.[22]

The tax consequences of a nonrecourse mortgage are simpler.[23] Because the mortgage debt exceeds the fair market value of the property, the amount realized on the foreclosure sale would equal the mortgage principal balance.[24] Accordingly, Mr. Taxpayer's amount realized would equal $500,000, which also would equal his $500,000 adjusted basis. Given that no debt for which Mr. Taxpayer is liable has been discharged, Mr. Taxpayer would not recognize any gain, loss or other income on the foreclosure sale. As in the case with a recourse mortgage, the result should not change if Mr. Taxpayer directly conveyed his property to the Bank, whether by deed, sale or abandonment.[25]

Tax Consequences to Landsdale Bank

The regulations under Code Sec. 166 provide a reasonably coherent and comprehensive approach to the consequences of foreclosure sales to a mortgagee. When Landsdale Bank forecloses on the home and sells it at auction for fair market value, Landsdale Bank generally would recognize a loss equal to the amount realized less the amount of the outstanding mortgage debt, including accrued but unpaid interest that Landsdale Bank had previously recognized as income.[26] The loss would be considered a bad debt loss under Code Sec. 166.[27] The precise mechanics of how Landsdale Bank arrives at these results depend on whether the mortgage was recourse or nonrecourse and whether Landsdale Bank sold the home to a third party, acquired the home itself or was deeded the home by Mr. Taxpayer.

If the mortgage was recourse, the amount realized by Landsdale Bank would equal the proceeds of the foreclosure sale plus the amount of any deficiency Landsdale Bank was able to collect.[28] If Landsdale Bank pursued a deficiency judgment and was able to collect fully, the foreclosure would be a wash to Landsdale Bank, except for possible deductible expenses due to the expenses of foreclosure and collection. If Landsdale Bank was unable to collect on the deficiency judgment or did not pursue a deficiency judgment because the remaining debt was uncollectible, as would be the more likely case, Landsdale Bank would recognize a bad debt loss equal to the excess of the mortgage balance over the foreclosure sale proceeds, here $100,000, plus possible deductible expenses due to foreclosure expenses.[29]

If the mortgage was nonrecourse, the amount realized should simply equal the proceeds of the foreclosure sale as no deficiency judgment could possibly be obtained. Accordingly, Landsdale Bank would have a bad debt loss equal to the excess of the mortgage balance over the proceeds, here $100,000, plus possible deductible expenses.

The foregoing results should not change if Landsdale Bank simply accepted a conveyance of the mortgaged property in satisfaction of the mortgage debt. The amount realized by Landsdale Bank on receipt of a deed in lieu of foreclosure would be the fair market value of the property, again leaving Landsdale Bank with a $100,000 loss.[30] Incidental expenses of the transaction should reduce the amount realized or could be considered deductible against ordinary income under Code Sec. 162.

If Landsdale Bank itself bid for and purchased the property in the foreclosure sale, the transaction bifurcates. As in the third-party context, Landsdale Bank would take a bad debt loss equal to the excess of the uncollectible mortgage (*i.e.,* the adjusted basis) over the sale proceeds less expenses (*i.e.,* the amount realized). However, Landsdale Bank would also realize gain or loss equal to any difference between the bid price and the property's fair market value.[31] The property's fair market value and bid price are presumed equal in the absence of "clear and convincing proof" to the contrary.[32] According to the IRS, immediate gain resulting from a showing that the fair market value of the property exceeds the bid price is ordinary income under the tax benefit doctrine to the extent of the bad debt deduction[33]; presumably, immediate loss would also be ordinary.

Modification of a Home Mortgage

The U.S. government and the lending industry have collaborated on several "projects" to ameliorate the current housing crisis. Under such projects, and probably as a sound business policy, lenders have been encouraged to restructure home mortgages to avoid foreclosure. Landsdale Bank could take a number of courses of action along these lines, including an outright reduction in Mr. Taxpayer's principal balance, which the Code comfortably and clearly addresses as cancellation of indebtedness income subject to the various qualifications discussed above. Suppose instead Landsdale Bank agrees, *a la* Project Hope Now,[34] to freeze the interest rate of the mortgage at the original "teaser" rate for the next five years (the "Freeze"). Landsdale Bank and Mr. Taxpayer may be surprised to learn the Freeze could have federal income tax consequences, too.

Modifications like the Freeze will have direct federal income tax consequences to Mr. Taxpayer and Landsdale Bank if the Freeze constitutes a "significant modification" under the regulations promulgated under Code Sec. 1001. Under Reg. §1.1001-3(b), a "significant modification of a debt instrument … results in an exchange of the original debt instrument for a modified instrument that differs materially either in kind or in extent." If the Freeze does not fall within any of the exceptions to the general rule that alterations of a legal right or obligation under a debt instrument constitute a modification, the Freeze would be considered a "modification."[35] The regulations contain a number of tests regarding whether a modification is "significant," including whether the yield of the instrument exceeds an applicable threshold amount under Reg. §1.1001-3(e)(2). If the Freeze would reduce the yield on Mr. Taxpayer's mortgage by more than the applicable threshold going forward, the Freeze would be a "significant modification."[36]

Tax Consequences to Mr. Taxpayer

With respect to Mr. Taxpayer, the consequences of a "significant modification" do not, strangely enough, track the normal rules applicable to a sale or exchange under Code Sec. 1001. Instead, the Code appears to take a modified—and complicated—approach to Mr. Taxpayer's tax consequences that blends Code Sec. 1001 with Code Sec. 108(e)(10). Code Sec. 108(e)(10) provides for the possibility of cancellation of indebtedness when a debtor like Mr. Taxpayer issues a "debt instrument in satisfaction of indebtedness." Code Sec. 108(e)(10) then looks to the concept of "significant modification" under Reg. §1.1001-3 to determine whether a new debt instrument has, in fact, been issued.[37] Thus, while we do not have a proper sale or exchange under which Mr. Taxpayer recognizes gain, we do have a "significant modification" under those rules, which leaves open the possibility of income under Code Sec. 108. Taken together, this appears to mean a "significant modification" like the Freeze of a mortgage could only result in cancellation of indebtedness income to Mr. Taxpayer under Code Sec. 108(e)(10) and not under Code Sec. 1001.

Under Code Sec. 108(e)(10)(A), Mr. Taxpayer would be "treated as having satisfied the indebtedness with an amount of money equal to the issue price of such [new] debt instrument." Hence, Mr. Taxpayer will realize cancellation of indebtedness income to the extent the adjusted issue price of the original mortgage ("Old Loan") exceeds the issue price of the modified mortgage ("New Loan"). Under Code Sec. 108(e)(10)(B), "the issue price of any debt instrument shall be determined under sections 1273 and 1274." Legislative history indicates the provisions applicable to exchanges of debt for property, as opposed to money, would apply, meaning the issue prices would be determined under either Code Sec. 1273(b)(4) or Code Sec. 1274.[38]

Issue Price of New Loan

Under either Code Sec. 1273 or Code Sec. 1274, the issue price of the New Loan probably would equal its stated principal amount, which, presumably, would equal the outstanding principal balance of the Old Loan at the time of the Freeze.

Code Sec. 1274(a) provides that, in the case of any debt instrument to which the section applies, the issue price equals (1) where there is adequate stated interest, the stated principal amount, or (2) in any other case, the imputed principal amount. Presumably the issue price would equal the stated principal amount because the interest rate on the New Loan would likely exceed the applicable federal rate (AFR) and, therefore, there would be adequate stated interest.[39] However, Code Sec. 1274 may not apply to borrowers like Mr. Taxpayer for two potential reasons. First, Code Sec. 1274 may not apply because Code Sec. 1275(b)(1) precludes the application of Code Sec. 1274 to debt instruments "given in consideration for the sale or exchange" of personal use property.[40] Here, the Old Loan would be the personal use property (although this seems to extend Code Sec. 1275(b)(1) beyond its intended purpose, which was directed toward the purchase of personal use property with a debt instrument issued to a seller). Second, Code Sec. 1274 does not apply to debt instruments whose payments do not exceed $250,000.[41] Some mortgage loans would fall within this exception, although Mr. Taxpayer's would not.

Under Code Sec. 1273(b)(4), the issue price of the New Loan equals the "stated redemption price at maturity."[42] The regulations define "stated redemption price at maturity" as "the sum of all payments provided by the debt instrument other than qualified stated interest payments."[43] The regulations define "qualified stated interest" as stated interest that is unconditionally payable in cash or in property (other than debt instruments of the issuer), or that will be constructively received under Code Sec. 451, at least annually at a single fixed rate.[44] Because the New Loan would be a variable rate debt instrument with a rather long introductory teaser rate, some of the interest payable under the New Loan would not likely be "qualified stated interest."[45] However, Code Sec. 108(e)(10)(B) provides that, for purposes of determining the issue price of the New Loan for that section, "section 1273(b)(4) shall be applied by reducing the stated redemption price of any instrument by the portion of such stated redemption price which is treated as interest for purposes of this chapter." Thus, any nonqualified stated interest would be ignored.

Issue Price of Old Loan

Although not absolutely clear, Code Sec. 108(e)(10)(B) states "the issue price of any debt instrument shall be determined under sections 1273 and 1274," which suggests that an examination of the Old Loan under Code Secs. 1273 and 1274 is once again necessary. Bittker & Lokken provide a similar reading, suggesting an adjusted issue price would be appropriate.[46] Legislative history also indicates the "adjusted issue price" of the Old Loan would be the appropriate metric.[47] Generally, adjusted issue price has been defined as the issue price, less payments received (other than qualified stated interest), plus accrued but unpaid OID.[48]

Using this metric, the next step is to determine whether OID accrues on mortgages like Mr. Taxpayer's. Whether OID accrues on a variable rate debt instrument with an introductory teaser rate presents a complicated question. Code Sec. 1273(b)(2), dealing with non–publicly traded debt issued for money, should control, leaving the original issue price of the Old Loan as the amount of money Mr. Taxpayer originally received.[49] Because OID equals the excess of the stated redemption price over the issue price, the stated redemption price must be determined, which, as defined above, equals the sum of all payments provided by the debt instrument other than qualified stated interest payments.[50]

Generally, for a variable interest rate debt instrument, the interest will be considered "qualified stated interest" if the rate is a "qualified floating rate" or "objective rate."[51] A variable rate is a qualified floating rate if variations in the value of the rate can reasonably be expected to measure contemporaneous variations in the cost of newly borrowed funds.[52] A rate based on LIBOR can reasonably be expected to measure contemporaneous variations in the cost of newly borrowed funds.[53] However, the Old Loan essentially has two components: an introductory teaser rate, lasting two years; and the reset rate, an adjustable rate tied to LIBOR. Special complicated rules apply under such circumstances.

In the context of debt instruments with different interest rates throughout their terms, only amounts attributable to the lowest level of interest are considered qualified stated interest.[54] For example, if the Old Loan had two fixed rates, one of seven percent and the other of 10 percent, only amounts of interest attributable to a seven-percent rate would qualify. For the term during which 10 percent applied, amounts attributable to the excess three percent would not qualify and would become part of the stated redemption price. Unfortunately, the rules become particularly complicated in the context of variable rate debt instruments that begin with an introductory, fixed teaser rate, such as the Old Loan.

As a general rule, for a variable rate debt instrument one must construct an "equivalent fixed rate debt instrument" under Reg. §1.1275-5(e)(3). Essentially, this means fixing the variable rates at their current value. The rule is modified in the case of a debt instrument with a fixed rate and a variable rate, such as the Old Loan. Reg. §1.1275-5(e)(4) provides that, under these circumstances, first Mr. Taxpayer would have to hypothetically replace his fixed teaser rate with a qualified floating rate such that the fair market value of the Old Loan would be the same. Then Mr. Taxpayer would fix such qualified floating rate and the qualified floating rate applicable to the remainder of the term of the Old Loan at their current values. From there, Mr. Taxpayer would calculate qualified stated interest and the excess, if any, between such rates. Such excess would be included in the stated redemption price and would generate OID. Assuming accrued but unpaid OID occurred within the first two teaser years, such OID would increase the adjusted issue price of the Old Loan beyond the stated principal amount. However, an exception applies for OID below a *de minimis* threshold, which would ignore a *de minimis* amount of OID and treat all stated interest as qualified stated interest.[55] If this exception applies to the Old Loan, its stated redemption price would be the issue price and no OID would have accrued.[56] The regulations provide a special rule for calculating the OID against which this threshold is to be compared for teaser instruments like the Old Loan. Under this rule, OID, as applied to the Old Loan, would be the additional stated interest that would have to be payable during the period of the teaser rate in order for all stated interest to be qualified stated interest.

Summary

As described above, the methodology to determine whether Mr. Taxpayer's has cancellation of indebtedness income, and the exceptions that are provided therein, is complex. If the issue price of the Old Loan is greater than the issue price of the New Loan, as determined under Code Secs. 1273 and 1274 and the applicable regulations, a significant modification of Mr. Taxpayer's mortgage loan may cause cancellation of indebtedness income.

Even if the Freeze resulted in cancellation of indebtedness income, Mr. Taxpayer may have a strong argument that Code Sec. 108(e)(2) excludes such cancellation of indebtedness from his income because "payment of the liability would have given rise to a deduction" under Code Sec. 163(h)(3).[57] Mr. Taxpayer may argue that the cancelled debt was deductible personal residence interest, which presumably includes OID.[58] Given that the only difference between his Old Loan and New Loan relates to interest payments, his argument stands on solid, but not well-tread, ground.

Otherwise, Mr. Taxpayer should be protected under the Debt Relief Act and the same bankruptcy and insolvency exceptions applicable to foreclosure sales. However, under these exceptions, while Mr. Taxpayer would not include his cancellation of indebtedness income in gross income, he would have to reduce his basis in his home by such amount.

Tax Consequences to Landsdale Bank

Unlike Mr. Taxpayer, with respect to Landsdale Bank the Freeze would be treated as an exchange of the Old Loan for the New Loan. The tax consequences to Landsdale Bank of the deemed exchange would fall squarely under Reg. §1.1001-1(g)(1), which controls the treatment of a "debt instrument … issued in exchange for property," the debt instrument being the New Loan and the property being the Old Loan. Under this regulation, "the amount realized" equals the "issue price of the debt instrument as determined under §1.1273-2 or §1.1274-2," whichever is applicable. Presumably one would again use the adjusted issue price of the Old Loan as adjusted basis.

Issue Price of the New Loan

Generally, with respect to Landsdale Bank, Code Sec. 1274 would apply to the exchange of debt instruments.[59] Under Code Sec. 1274, as discussed above, the issue price of the New Loan would be the stated principal amount if there is adequate stated interest.[60]

Issue Price of the Old Loan

This would be calculated in the same manner as discussed above. Accordingly, if the Old Loan has accrued OID (above the *de minimis* threshold) and, therefore, the adjusted issue price is greater than the New Loan's issue price, Landsdale Bank would be left with a loss.[61]

A Peculiarity

Note a peculiarity raised by the calculations above. Because of the five-year term of the interest rate freezes proposed under Project Hope Now, the new loan resulting from the modification would not likely qualify for the *de minimis* OID exception discussed above, meaning that, if Code Sec. 1273(b)(4) applied, the issue price of this loan would be greater than the stated principal amount. At the same time, some or all of the original subprime loans may qualify for such exception, meaning their adjusted issue price would equal their stated principal amount. In theory, therefore, the interest rate freezes contemplated by Project Hope Now could actually result in gain to lenders because the adjusted issue price of the original loans would be less than that of the loans as modified.

Comments

Foreclosure Sales

Under the above scenarios, Mr. Taxpayer would not recognize any gain or loss on foreclosure under current law as amended by the Debt Relief Act. If his mortgage was recourse, Mr. Taxpayer would have realized $100,000 of cancellation of indebtedness income and a $100,000 nondeductible capital loss. However, the income would disappear because he was in bankruptcy, he was insolvent or the debt was principal residence debt. If his mortgage was nonrecourse he would not recognize a gain or loss from the start because his amount realized would equal his basis. Regardless of the nature of the mortgage, Landsdale Bank should be able to deduct the $100,000 loss under Code Sec. 166.

Current federal income tax law appears reasonably developed with respect to foreclosure sales. However, given that mortgagees like Landsdale Bank usually would not pursue a deficiency judgment against a mortgagor like Mr. Taxpayer, regardless of whether his mortgage was recourse, one might wonder (i) whether the foregoing tax consequences should have depended on the recourse nature of the mortgage, and (ii) how the Debt Relief Act temporarily solves this problem. As to the first question, a simple and possible response is that the tax consequences to Mr. Taxpayer would not have depended on the recourse or nonrecourse nature of the mortgage despite the Debt Relief Act. Mortgagors losing their principal residence might very well be insolvent, particularly mortgagors on the lower end of income distributions. Such mortgagors would not have recognized cancellation of indebtedness income by virtue of the insolvency exception under Code Sec. 108. On the other hand, practically by definition solvent mortgagors in foreclosure have chosen that route as the most economic means of walking away from a bad investment, thereby shifting the risk of loss to the mortgagees. Of course, under such circumstances a mortgagee might be more inclined to pursue a deficiency judgment, rendering the cancellation of indebtedness question less relevant.

In light of the foregoing, turn now to the Debt Relief Act and consider the problem it solved. What the Debt Relief Act does is aid solvent mortgagors. This aid will cost the Treasury $606 million over the next three years until the provision sunsets in 2010 according to the Congressional Budget Office.[62] As justification, the Committee Report to H.R. 3648 provides only that:

> The Committee believes that where taxpayers restructure their acquisition debt on a principal residence or lose their principal residence in a foreclosure, that it is inappropriate to treat discharges of acquisition indebtedness as income.[63]

Certainly strong arguments could be made for excluding from gross income the debt relief of insolvent taxpayers, for whom the Debt Relief Act added nothing. The Debt Relief Act extends these principles. Take, for example, a solvent taxpayer benefiting from the $2 million of debt relief afforded tax-free treatment by the new legislation. This is the taxpayer Congress meant to help.

Debt Modification

If anything is clear from the discussion of the Freeze, above, it is that the rules governing the tax consequences of such a transaction lack clarity. Another way to view the Debt Relief Act is that it saves a broad group of taxpayers from the headache of computing possible cancellation of indebtedness income on modifications of their home mortgage loans. Congress has temporarily provided a reprieve from these headaches by making the point moot for many taxpayers with the Debt Relief Act. But this reprieve may not last forever, and would not apply to the slew of others who have purchased investment properties or vacation homes.[64] Deciphering whether Mr. Taxpayer recognizes cancellation of indebtedness income would prove a daunting task, a task taxpayers might ultimately ignore. Such complexity perhaps works for capital markets transactions and sophisticated investors in debt instruments, but does not seem appropriate for a homeowner with a mortgage. For now, the Debt Relief Act means Mr. Taxpayer largely will not be troubled about such issues or indeed ask why something seemingly simple is so complicated. The IRS could take this a step further by clarifying that folks like Mr. Taxpayer need not rely on the Debt Relief Act at all because Code Sec. 108(e)(2) should apply to homeowners regardless. Alternatively, Congress, the Treasury and the IRS might take a closer look at the OID rules to make sure they operate as intended with respect to home mortgages.

Laying the Foundation for the Next Housing Boom

The other thing about the Debt Relief Act is that it makes the American home even more tax favored than previously. A homeowner is entitled to deduct interest on up to $1.1 million of mortgage indebtedness.[65] He or she is also entitled to exclude the first $500,000 of gain on sale of the home.[66] Under the Debt Relief Act, the homeowner can exclude up to $2 million from gross income if the investment turns sour before January 1, 2010, or even longer if Code Sec. 108(a)(1)(E) is extended. Imagine today's homeowner. He or she can take out a $1.1 million mortgage to buy a home. Along the way, he or she can deduct interest on the home mortgage. If the credit crunch eases he or she can sell the home without tax on the first $500,000 of gain. If the credit crunch worsens, he or she can walk away without a tax penalty. Once taxpayers realize the benefits of this tax-favored treatment another round of the housing boom may be in order.

Securitization

The problem with Mr. Taxpayer's mortgage in 2008 is that Landsdale Bank does not own it anymore. Landsdale Bank securitized it in a real estate mortgage investment conduit (REMIC). As a result, it will be very hard to modify Mr. Taxpayer's mortgage. Foreclosure, on the other hand, works fairly well.[67]

The REMIC was designed to provide a statutory vehicle to securitize mortgages. It was modeled after the collateralized mortgage obligation transactions of the mid-1980s. Congress did not want a REMIC to be engaged in an active financing business. Accordingly, the Code and regulations require that the REMIC have a substantially fixed pool of mortgages and limited power to vary such assets.[68] Such requirements are codified in Code Secs. 860(D) and 860F, which require that "substantially all" of the REMIC's assets must constitute "qualified mortgages" and "permitted investments" and which impose a penalty tax on "prohibited transactions," including certain dispositions and deemed dispositions of qualified mortgages and receipt of income from nonqualified mortgages and investments, as discussed below.

The REMIC is derived from but is intended to be more flexible than the fixed investment trust commonly referred to as the "grantor" trust. Prior to the enactment of the REMIC rules, sponsors used fixed investment trusts to securitize pools of mortgages. In general, in order to qualify as a "fixed investment trust," there can be no power to vary the investment of the certificate holders, and the trust cannot issue more than one class of interests.[69] The Treasury and the IRS have expanded the fixed investment trust rules to accommodate perceived legitimate non-tax motivated investment transactions, but the fixed investment trust still has less flexibility than other securitization vehicles.[70] The REMIC rules were designed to provide for more flexible structures while maintaining the passive investment requirements of fixed investment trusts and limiting the type of investment asset. Accordingly, the REMIC provisions incorporate various rules that are designed to limit a REMIC to passive investment.[71]

To qualify as a REMIC, as of the close of the third month beginning after the startup day and at all times thereafter, "substantially all" of the REMIC's assets must constitute "qualified mortgages" and "permitted investments."[72] Qualified mortgages include any obligation that is principally secured by an interest in real property that is transferred on the startup day of the REMIC.[73] As is consistent with the intended purpose of the REMIC, the terms of such qualified mortgages cannot be changed by the REMIC, absent an exception. Accordingly, if a "qualified mortgage" is "significantly modified" and the modified obligation is not a "qualified replacement mortgage," the modified obligation will not be a "qualified mortgage," absent an exception. Therefore, an entity that initially qualifies as a REMIC may cease to qualify if enough of its qualified mortgages are significantly modified.[74]

If a REMIC enters into certain "prohibited transactions," Code Sec. 860F(a)(1) subjects the REMIC to a penalty tax equal to 100 percent of the net income derived from such prohibited transactions. Prohibited transactions include the disposition of any qualified mortgage by the REMIC other than in the following four situations: (i) a disposition pursuant to the substitution of a qualified replacement mortgage for a qualified mortgage (or the repurchase in lieu of substitution of a defective obligation); (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. Prohibited transactions also include the receipt of any income attributable to any asset which is neither a qualified mortgage nor a permitted investment; the receipt by the REMIC of any amount representing a fee or other compensation for services; and gain from the disposition of any cash flow investment other than pursuant to any qualified liquidation.[75] If a "qualified mortgage" is "significantly modified" and the modified obligation is not a "qualified replacement mortgage," there is a deemed disposition of the unmodified obligation. Such deemed disposition constitutes a "prohibited transaction" under Code Sec. 860F(a)(2).[76] Accordingly, the REMIC rules limit the activity of the REMIC to passive investing in qualified mortgages by confiscating profit from other activities, absent an applicable exception.

Reg. §1.806G-2(b)(2) defines a "significant modification" as any change in the terms of an obligation that would be treated as an exchange of obligations under Code Sec. 1001 and the related regulations. Reg. §1.1001-3 treats a "significant modification" as a deemed exchange of the original loan for a new loan. Reg. §1.860G-2(b)(3) permits four types of loan modifications without regard to Reg. §1.1001-3. These four permitted modifications are (i) changes in the terms of the obligation occasioned by default or a reasonably foreseeable default; (ii) assumption of an obligation; (iii) waiver of a due-on-sale clause or a due on encumbrance clause; and (iv) conversion of an interest rate by a mortgagor pursuant to the terms of a convertible mortgage. Accordingly, transactions within these four permitted modifications will not cause the REMIC to hold disqualified mortgages or enter into prohibited transactions.[77]

Under these rules, even if it wanted to, the Landsdale Bank REMIC could not modify Mr. Taxpayer's loan. The REMIC's pooling and servicing agreement likely contains several prohibitions designed to ensure that the REMIC maintains its status as such and that it avoid any "prohibited transactions." These prohibitions are designed to protect the REMIC's regular interest holders and were designed at a time when the architects did not imagine that there would be the need for wholesale loan restructurings.

What are the problems with restructuring Mr. Taxpayer's loan? They all turn on whether the proposed changes are modifications within the meaning of Code Sec. 1001-3. If the changes are not sufficient to result in a deemed exchange of Mr. Taxpayer's loan, the only possible problem is a reissuance of the REMIC's regular interests. Thus, depending on the REMIC's governing documents, small changes in some or all of the REMIC's qualified mortgages might result in a material modification of one or more classes of regular interests.[78] If even one class of regular interest is significantly modified then the REMIC arguably fails. That is because a REMIC can only have regular and residual interests.[79] What had been a regular interest now fails that test because it was not issued on the startup day.[80] Accordingly, we arguably have an entity that no longer meets the REMIC tests.

If the changes to Mr. Taxpayer's loan are treated as a modification under Code Sec. 1001 then there are various other problems at the REMIC level, as well as the problem with potential reissuance of one or more classes of regular interests. First, Mr. Taxpayer's mortgage may no longer be a qualified mortgage.[81] Second, if there was gain on the deemed exchange then the REMIC may have a prohibited transactions tax to pay.[82] Third, if enough loans are significantly modified in deemed exchanges, the REMIC fails the requirement that "substantially all" of its assets must be qualified mortgages.[83]

The Treasury recognized these problems when it rolled out the Paulson-Jackson Plan[84] in December 2007. At the same time the plan was announced, it issued Rev. Proc. 2007-72.[85] That guidance effectively waives the REMIC rules for two years for freezes under the plan. Rev. Proc. 2007-72 provides that the IRS will not challenge a securitization vehicle's qualification as a REMIC on the grounds that the transactions are not among the exceptions listed in Reg. §1.860G-2(b)(3) (as described above); the IRS will not contend that the transactions are prohibited transactions under Code Sec. 860F(a)(2) on the grounds that the transactions are not among the exceptions listed in Code Sec. 860F(a)(2)(A)(i)(iv) (as described above); the IRS will not challenge a securitization vehicle's qualification as a REMIC on the grounds that the transaction resulted in a deemed reissuance of the REMIC regular interests; and the IRS will not challenge a securitization vehicle's classification as a trust on the ground that the transactions manifest a power to vary the investment of the certificate holders. The revenue procedure is limited in scope, and only applies to transactions occurring on or before July 31, 2010, and that are a fast-track modification of certain loans pursuant to the American Securitization Forum Framework (ASF Framework) and a second-lien holder's action of subordinating its lien to any new lien that may arise under certain loans as a result of a fast track modification. The ASF Framework provides fast track modification of certain mortgage loans to certain mortgage borrowers that would generally freeze the interest rate of an adjustable rate mortgage that will reset.[86] For loans outside the Paulson-Jackson Plan, until mid-May REMIC servicers were effectively handcuffed by the REMIC rules from providing material assistance to Mr. Taxpayer and his fellow citizens.

In mid-May, the IRS also issued Rev. Proc. 2008-28.[87] The revenue procedure is similar to Rev. Proc. 2007-72, but expands the situations where the IRS will not attack the securitization's REMIC status beyond the Paulson-Jackson Plan. Particularly, if certain requirements are met, the IRS will not challenge the REMIC status (as with Rev. Proc. 2007-72) if mortgage loans are modified pursuant to certain streamlined foreclosure prevention programs created by servicers or other holders of mortgages if such servicers or holders reasonably believe that there is a significant risk of foreclosure of the original loan. Such reasonable belief may be based on any "credible systemic determination" (and accordingly without the determination that the borrower will default when the rate has reset).

Suppose, however, despite the relief provided by the IRS, the REMIC modifies enough of the loans and the REMIC fails. What happens? Under Code Sec. 860D(b)(2), if any entity ceases to be a REMIC at any time during the tax year, such entity is not treated as a REMIC for such tax year or any succeeding tax year absent an "inadvertent termination" exception.

What is an entity that holds assets principally composed of real estate mortgages and that issues fast-pay, slow-pay securities? Without the REMIC statute, most mortgage backed securitizations would be classified as "taxable mortgage pools." Code Sec. 7701(i) defines a taxable mortgage pool as any entity (other than a REMIC) if (i) substantially all of the assets of such entity consists of debt obligations (or interests therein) and more than 50 percent of such debt obligations (or interests) consists of real estate mortgages (or interests therein); (ii) such entity is the obligor under debt obligations with two or more maturities; and (iii) under the terms of such debt obligations (or underlying arrangement), payments on such debt obligations bear a relationship to payments on the assets it holds under clause (i). According to the legislative history of the Tax Reform Act of 1986,[88] Congress "intended that REMICs are to be the exclusive means of issuing multiple class real estate mortgage-backed securities without the imposition of two levels of taxation."[89] Accordingly, an entity classified as a taxable mortgage pool is treated as a corporation for federal income tax purposes, thereby adding a layer of corporate taxation.[90] Additionally, an entity that is classified as a taxable mortgage pool cannot file a consolidated return with any other corporation (the consolidated return rule),[91] and an entity that is classified as a taxable mortgage pool may not elect to be an S corporation under Code Sec. 1362(a) or maintain S corporation status (the S corporation rule).[92] The consolidated return rule limits the ability to use net operating losses of other corporations to offset income of the taxable mortgage pool. The S corporation rule limits the ability to avoid a double layer of a tax.[93]

As a consequence of failing to qualify, the REMIC would be considered to liquidate, distributing its assets to the regular and residual interest holders. They, in turn, would contribute the assets to the new corporation in exchange for debt and equity interests in a transaction qualifying under Code Sec. 351. An interest holder would recognize gain or loss on the liquidation and would take a fair market value basis in the new corporate debt and equity.[94]

In order to determine the consequences of the contribution, the sponsor would have to determine which classes of REMIC interests are equity in the entity and which are debt. In the first instance, noneconomic residual interests would likely be disregarded in determining the capital make-up of the new corporation. Instead, the sponsor would presumably start from the bottom of the 'credit stack" in the case of REMICs that have senior and subordinated classes. At least some of the subordinated classes would have to be classified as equity. The more senior classes would be debt. Assuming the classes treated as debt have multiple maturities, the entity would be a taxable mortgage pool.

To the extent the taxable mortgage pool has income in the future, the income less the interest expenses on regular interests classified as debt would be subject to a corporate level tax. Dividends paid on the equity may be eligible for the 70-percent Code

Sec. 243 dividends-received deduction.[95] However, the regular interests could have their value seriously impaired by the corporate level tax. Of course, given what caused the predicament, it is possible that the taxable mortgage pool will have substantial losses.

Given all this, it seems that the original REMIC statute was never designed for the stress of mass delinquencies in home mortgage loans. Instead, it evidences a binary approach: The mortgage is either performing or it is defaulted and must be foreclosed upon. From a tax policy standpoint, it would seem unobjectionable to loosening the REMIC rules to permit loan workouts as opposed to foreclosures. It is hard to see how this activity competes with that of financial institutions that pay a corporate level tax. Accordingly, to solve these problems, a REMIC should be allowed, in certain circumstances, to modify its mortgage loans without disqualification. With this basic principle in mind, the REMIC statute should be amended to permit a REMIC to modify the terms of its qualified mortgages without penalty and without disqualifying the REMIC. A reasonable restriction would be that a REMIC could not acquire distressed loans with the intention of modifying them or foreclosing.

Auction Rate Securities

Although Mr. Taxpayer may not know it, somewhere on Wall Street an auction rate security is "frozen" because of his problems paying his mortgage. Even now, the connection is a little hard to understand. An auction rate security is one where periodic auctions are used to reset the interest or dividend rate. Bidders in the auction specify the rate at which they will purchase the securities at par. If there are insufficient bidders then the auction fails. In that case, the rate on the securities is reset to a pre-specified maximum rate.

Auction rate securities are used in a number of different financing transactions. Municipal bond issuers use them in so-called tender option bonds. Various investment banks repackage long-term tax exempt bonds into short-term auction rate instruments using a trust taxed as a partnership for federal income tax purposes. Closed-end taxable and tax-exempt bond funds treated as regulated investment companies for federal income tax purposes issue auction rate preferred stock. In the case of tax-exempt funds, the dividends on the auction rate securities pass through the underlying tax exempt character.[96]

For the last 25 years, taxpayers have used auction rate securities to provide long-term funds for the issuer while giving holders short-term liquidity. The first auction rate security was preferred stock issued by American Express in 1984. Since then, auction rate securities have been used in a number of different contexts. In Rev. Rul. 90-27,[97] the IRS ruled that auction rate stock was equity of the corporate issuer for federal income tax purposes and that a holder did not have an option to sell within the meaning of Code Sec. 246(c). The ruling was predicated on the notion that while auctions were designed to succeed, there was no guarantee that an auction would not fail.[98] The ruling emphasizes the notion that the holder's rights are equity-like from the perspective of the holders:

> [D]utch-auction rate preferred stock is an investment alternative to commercial paper or other short-term debt. In certain critical respects, however, the legal rights embodied in the dutch-auction rate preferred described above are similar to those found in traditional preferred stock and are unlike those usually associated with debt. As a holder of the preferred, *Y* has no right to receive a sum certain either on demand or on a specified date, and, in liquidation or in bankruptcy, *Y*'s rights are subordinate to the claims of *X*'s creditors. Subject to that limitation, *X* may redeem the stock, but the holder cannot compel redemption. Moreover, *X* has not guaranteed or otherwise arranged to ensure that *Y* can sell its stock in an auction. *Y*'s receipt of dividends is dependant upon dividends being declared by *X* and paid out of legally available funds.

Prior to 2007, however, there were few reported instances of auction failures, although the possibility existed. Notably, it is rumored that Citigroup had a failed auction in 1990, around the time of its last period of financial distress.[99] Beginning in early fall 2007, however, the auctions began to fail. Quite simply, there were not enough buyers of the auction rate securities. By February 2008, there were wholesale auction failures in the marketplace. Many investors were left owning securities with dividends reset to maximum rates.

At first blush, the problems in the auction rate market do not appear to involve tax issues. Admittedly, they are a result of constraints imposed on the structure by tax considerations, but they stem wholly from economic considerations—an imbalance between supply (lots) and demand (none). There is little the tax law can do about that.

On further reflection, however, it appears that tax can assist in solving the problem. Thus, it appears that some taxpayers are suggesting that one way to ease the liquidity crisis is to ease, on a temporary basis, the requirements for auction rate preferred to be treated as equity for federal income tax purposes. A recent letter suggested that liquidity providers be permitted to provide a liquidity back-stop to the auction process in the case of auction rate securities issued by tax-exempt closed-end investment companies.[100] However, the liquidity provider would be permitted a liquidity right back against the issuer should that be necessary. The liquidity provider's liquidity right would take effect after six months during which the liquidity provider attempted but failed to sell the securities at auction.

The technical issue, therefore, is whether by adding the liquidity facility the instrument becomes debt for federal income tax purposes rather than equity. If so, the holder would not be entitled to receive exempt interest dividends. Apart from the obvious analysis that the security once being equity could not be reclassified as debt, there appear to be strong arguments why adding a liquidity provider would not change that result. However, debt versus equity is a factual question, and the answer to the question would never be known until the Supreme Court rules on the case. The more interesting question is whether the government should act in a case like this; that is addressed below under the heading "A Framework for Tax Policy Responses to the Credit Crunch."[101]

Offshore Distressed Debt Funds

One piece of good news in the credit crunch is that in 2008, foreign investors have lots of money and are willing to help Mr. Taxpayer out. Not directly, of course, but through the purchase of distressed U.S. assets at a steep discount. For example, any number of foreign investors, including foreign sovereigns, have stepped up to buy the devalued equity securities of major U.S. banks and brokerage firms.[102]

One area where foreign investors have offered a helping hand is in the creation of offshore distressed debt funds. Such a fund would be organized in a low-tax foreign jurisdiction. It would purchase distressed U.S. debt instruments (maybe even the Landsdale Bank REMIC regular interests that packaged Mr. Taxpayer's mortgage) and attempt to work them out through the bottom fisher's normal tools: forbearance, new money or foreclosure. There is a concern, however, about the federal income tax treatment of such a fund.

In April, the Managed Funds Association (MFA) wrote to the Treasury to propose guidance to clarify the securities trading safe harbor of Code Sec. 864(b)(2) so that a foreign person may invest in "distressed debt" without being subject to the risk of U.S. net income taxation (the "MFA Proposal").[103] The MFA requested that the Treasury issue guidance such that the securities trading safe harbor of Code Sec. 864(b)(2) would apply to the purchase of previously issued debt instruments, whether or not restructuring was intended at the time of purchase, and to any restructuring negotiations, collections, services and similar activities related to such acquisition. The MFA suggests that ambiguity surrounding the securities trading safe harbor may be a factor in the current liquidity crisis, as foreign persons may be unwilling to invest in distressed debt because of the potential risk of U.S. net income taxation.[104] Additionally, the MFA requested clarification whether engaging in such activities on a larger scale creates dealer status.

A foreign person that purchases distressed debt and restructures such debt with borrowers may be considered to be engaged in a U.S. trade or business (ETB) because such activities may resemble activities of a traditional lending business. Additionally, as discussed above, under Reg. §1.1001-3, the restructuring of distressed debt instruments may result in a "significant modification" and accordingly a potential reissuance (*i.e.,* origination of a new loans) of such debt securities, with loan originations being activities of a traditional lending business. The risk of ETB status (and therefore U.S. net income taxation and a branch tax), whether or not the risk is remote, may discourage foreign investors from purchasing distressed debt.

The MFA Proposal can be broken down into three basic scenarios:

- **Scenario 1.** Foreign person (FP) purchased debt securities issued by U.S. issuer at a time when default is not anticipated and borrowers subsequently default. FP and borrowers restructure the debt securities.
- **Scenario 2.** U.S. issuer issues debt securities and certain borrowers default. FP purchases such distressed debt securities without the intention

to restructure. FP and borrowers subsequently restructure such debt securities.

- **Scenario 3**. Same as scenario 2, but FP purchases the distressed debt securities with the intention to restructure. After purchasing the securities, FP immediately restructures the debt securities with borrowers.

Under each of the three scenarios, the MFA Proposal would protect FP from ETB status.

Interested parties have previously requested guidance on whether a foreign person is ETB and subject to U.S. net income taxation in prior years. In 2007, the New York City Bar wrote a report that proposed various safe harbors (essentially codifying already-established market practices).[105] In 2002, a paper suggested that guidance should be issued to provide clarity on whether foreign persons that engage in certain lending activities are ETB.[106] The paper suggested that other areas of the Code that distinguish active financing from passive investing could be used as a model to distinguish when one taxpayer is ETB and another is not.[107]

Under Code Secs. 871(b) and 882, if a foreign person (nonresident individual or foreign corporation) is ETB, then the Code taxes such foreign person on all income that is effectively connected income. Accordingly, the taxation of a foreign person depends on the definition of ETB. Under the securities trading safe harbor, trading in stocks and securities does not create a U.S. trade or business.[108] What constitutes trading in stocks and securities? Reg. §1.864(b)(2) provides that the term ETB does not include the "effecting of transactions" in the United States in stocks and "securities" for the taxpayer's own account. The term "securities" is defined broadly to include "any note, bond, debenture, or other evidence of indebtedness, or any evidence of an interest in or right to subscribe to or purchase any of the foregoing."[109] The term "effecting of transactions" includes "buying, selling, or trading in stocks, securities, or contracts or options to buy or sell stocks or securities, on margin or otherwise, for the account and risk of the taxpayer, and any other activity closely related thereto."[110] In determining ETB status, the volume of transactions effected is not taken into account.[111]

The securities safe harbor appears broad enough to encompass restructuring of distressed debt, at least where there was no intention to derive profit from restructuring when the debt was acquired. The term "effecting of transactions" includes traditional trading activities and "any other activity closely related thereto," which should include incidental activities to such trading activities.

Case law has historically distinguished a trader from investor and dealer status by the volume of trades, the lack of customers and the taxpayer's profit-seeking motive (*i.e.,* to derive profit from short-term swings in the value of securities) in the context of determining whether a taxpayer has engaged in a trade or business in a nondealer capacity in order to receive deductions for the taxpayer's expenses.[112] Code Sec. 864(b)(2), however, in the context of foreign investors and their trading activity, excludes such activity from the definition of a U.S. trade or business. Restructuring distressed debt securities is not in the common sense of the term a trading activity. However, taking actions incidental to the trading activities, such as taking steps to protecting one's investment, should not arise to a trade or business without significant activity.[113] Accordingly, a limited safe harbor may be appropriate.

In order to address these concerns, Code Sec. 864 could be clarified to permit foreign investment companies to restructure distressed loans without being engaged in a trade or business. A more limited clarification, in the least, should permit foreign investment companies to restructure distressed loans, if, at the time of purchase of such loans, such companies do not have an intent to restructure such loans for profit. Such companies should not be considered to be engaged in a U.S. trade or business because the restructuring efforts are to protect the principal of their investment, rather than profit from purchasing distressed debt at a cost that is lower than they expect, with restructuring efforts, to obtain at the time of purchase. In some ways, this would be consistent with the approach suggested above for distressed REMICs. A change in law would clarify that working out distressed debt that was not distressed when acquired is not a business activity but merely an investment activity.

A Framework for Tax Policy Responses to the Credit Crunch

A common thread running through the tale of Mr. Taxpayer's mortgage is whether and how the government should respond to the myriad tax problems exposed by the credit crunch. Treasury officials recently made it known that they were considering various "tax policy" initiatives to respond to the credit crunch.[114] They appear to have invited taxpayers and industry groups to suggest ways they might help. Even with what has been done so far, we are seeing an unprecedented relaxation of various tax rules to accommodate the current economic difficulties. To conclude our story of Mr. Taxpayer, it may be useful to analyze the theoretical underpinnings for such actions.

Old and New Precedents

History provides some guidance, but not much, as to whether and when the government should change the tax treatment of financial instruments in bad economic times. In addition, the government has already started to issue guidance relaxing some tax rules in response to the credit crunch.

Rev. Rul. 85-119

In Rev. Rul. 85-119,[115] the IRS ruled that mandatorily convertible debt issued by a bank holding company was debt for federal income tax purposes. The instrument in question provided Tier One capital for the bank holding company. The year before, Continental Illinois National Bank and Trust Company had become insolvent,[116] and one suspects the timing was not coincidental. From a federal income tax standpoint, the instrument in the ruling was likely debt; however, it had a number of equity features. For example, the instrument was subordinated to the bank holding company's general creditors. Also, failure to pay interest did not occasion default; instead the holder only had the right to sue for each defaulted interest coupon as it became due. The instrument was payable in equity of the issuer with an appraised value equal to the principal amount. At maturity the holder could elect to take the equity. If it did not, the bank holding company was required to sell the equity on the holder's behalf and the bank holding company was saddled with any shortfall.

Nearly 10 years later, the problem was that taxpayers began to venture beyond the facts of the ruling. For example, in one iteration, a corporate issuer would set up a partnership and sell preferred partnership interests to investors. The partnership would buy mandatorily convertible notes styled after the ones described in Rev. Rul. 85-119. When the stock was ultimately issued, the partnership was used to allocate a fixed number of shares to the preferred holders, rather than a fixed value. Any excess value was allocated to the general partner, an affiliate of the issuer.

In Notice 94-47[117] the government expressed its concerns about misuses of Rev. Rul. 85-119:

> The Service is aware of recent offerings in which taxpayers may be relying on Rev. Rul. 85-119, 1985-2 CB 60. In that ruling, a bank holding company issued instruments (the Notes) that permitted the principal amount to be repaid with the company's stock at maturity. The Service held that the Notes constituted debt based on all the facts and circumstances, including the fact that, in substance, a holder of the Notes had the right to obtain repayment either in cash or in stock.
>
> Rev. Rul. 85-119 is limited to the facts of that ruling. Instruments that are similar to the Notes but that, on balance, are more equity-like are unlikely to qualify as debt for federal income tax purposes. For example, an instrument does not qualify as debt if it has terms substantially identical to the Notes except for a provision that requires the holder to accept payment of principal solely in stock of the issuer (or, in certain circumstances, a related party). Similarly, an instrument does not qualify as debt if it has terms substantially identical to the Notes except that (a) the right to elect cash is structured to ensure that the holder would choose the stock, or (b) the instrument is nominally payable in cash but does not, in substance, give the holder the right to receive cash because, for example, the instrument is secured by the stock and is nonrecourse to the issuer.

Then, Congress adopted Code Sec. 163(l) in 1997. That provision denies a corporation a deduction for interest on indebtedness that is payable in the equity of the issuer or a related party or (under 2004 amendments) equity held by the issuer or a related party in any other person.[118] Although not entirely clear, it appears that an instrument described in Rev. Rul. 85-119 might be caught by the provision.

It is hard to analyze this episode without knowing whether Rev. Rul. 85-119 did anyone any good. Because the SEC's electronic database of filings only goes back to 1993, it is hard to establish how many Rev. Rul. 85-119 instruments were issued. It is even harder to establish how many instruments relied on the ruling for "evil" (at least in the government's mind). However, if the instrument saved one large financial institution from collapse, the cost may have been worth it.

Cottage Savings

In the late 1970s, the federal government devised a scheme to permit savings and loans to trigger the tax losses inherent in their devalued mortgage loan portfolios without triggering the accompanying book loss.[119] The scheme involved reciprocal sales of mortgage loan pools by two institutions. It appears the reason for the sales was to trigger the tax loss inherent in the mortgages. The only problem was that not all of the government was happy with the scheme. The IRS attacked the transactions in the case that became *Cottage Savings.*[120] The U.S. Supreme Court ruled that the "loan swap" resulted in a material modification and upheld the tax loss. While the IRS argued for an "economic substance" approach to determine whether a Code Sec. 1001 exchange occurred, the Supreme Court adopted a mechanical test: "[A]n exchange of property gives rise to a realization event so long as the exchanged properties are 'materially different', that is, so long as they embody legally distinct entitlements."[121] Finding that the mortgage loans sold and purchased "were made to different obligors and secured by different homes," the Supreme Court held they embodied "legally distinct entitlements" and permitted Cottage Savings to claim a loss on the sale.

An obvious lesson of *Cottage Savings* is that the IRS has not always "played along" with other parts of the government when it comes to transactions in times of financial distress that produce tax benefits. Also, the transaction described in *Cottage Savings* resulted in a substantial tax loss. So far guidance that has been issued or proposed is arguably more than "tinkering around the edges" but does clearly not sanction tax abuse. Moreover, today's Treasury seems more aligned with the government's overall policy goals, at least to the extent these have been articulated.

Rev. Rul. 92-32

Reg. §301.7701-4(c) permits senior-subordinated arrangements to qualify as trusts for federal income tax purposes. Example 2 of the regulations innocuously provides that M (the loan originator) "sells the Class C certificates (the senior certificates) to investors and retains the Class D certificates (the subordinated certificates)." At the time the regulations were promulgated, the IRS let it be known that retaining the subordinated interest was not merely a suggestion but rather a requirement. It backed that up with a private letter ruling in 1989.[122]

By 1992, however, the tables were turned. The U.S. government, in the guise of the Resolution Trust Corporation, then owned most of the savings and loans. Those savings and loans owned hundreds of subordinated interests, by that time seriously devalued. The government came up with a practical solution: Rev. Rul. 92-32.[123] That ruling holds that sale of the subordinated interests in a senior-subordinated grantor trust does not affect classification of the investment trust as a trust for federal income tax purposes.

The lesson here, which should surprise no one, is that the government will act to preserve its own economic interests through interpretation of the tax laws.

Recent Municipal Bond Guidance

The IRS has responded to the credit crunch problems in two notices applicable to municipal tender option bonds: Notice 2008-27 and Notice 2008-41.[124] Notice 2008-41 substantially liberalizes the rules for modification of debt under Code Sec. 1001:

- A bond purchased by, or on behalf of, a governmental issuer pursuant to a tender right contained in the bond is not treated as retired for 90 days, subject to an additional 90 day extension with the extension only available for issuer purchases before October 1, 2008. (The issuer may refund the bond with a refunding bond upon a failed remarketing).
- A tax-exempt auction rate bond purchased by a governmental issuer where the bond does not contain a tender right is not treated as retired for 180 days.
- Modification of a hedge is not a termination of the hedge for arbitrage purposes if a *de minimis* rule is met and payments on the hedge are taken into account for computing yield for arbitrage purposes.
- The rule under Reg. §1.1001-3(e)(4)(iv)(B) for determining whether changes to the security or credit enhancement on a nonrecourse bond is changed to the rule for recourse bonds (*i.e.,* significant modification results only if there are changes in payment expectations).
- A temporary waiver of an interest rate cap is disregarded for purposes of the Reg. §1.1001-3(e)(2) yield test so long as agreement and period during which waiver is in effect are both between November 1, 2007, and October 1, 2008.

Rev. Proc. 2008-26

In Rev. Proc. 2008-26,[125] the IRS announced that it would not challenge whether a mortgage-backed security or corporate debt is "readily marketable" under Code Sec. 956(c)(2)(J) if it is of a type that was readily marketable at any time within three years prior to May 12, 2008. The revenue procedure thus permits taxpayers to avoid Code Sec. 956 "bring back" issues if a controlled foreign corporation had invested in such securities at a time when they were readily marketable but now cannot sell them because of the credit crunch.

One way to view Rev. Proc. 2008-26 is that the IRS is telling taxpayers that definitions under the Code should be read in the context of a "normal" state of affairs. To the extent that we are living through an "abnormal" state of affairs then we should interpret the law the way we would in normal times. On the other hand, presumably the government would say this is reading too much into the revenue procedure and that it represents an isolated instance where intervention was appropriate and necessary.

When Should the Tax Law on Financial Instruments Be Modified in Response to the Credit Crunch?

Today, the question is whether the IRS should modify the tax laws to promote greater market liquidity. For example, in the case of auction rate securities, the policy question presented is whether the IRS should relax the standards for treating an instrument as corporate equity in order to bolster liquidity in the financial markets. In the offshore distressed debt fund context, the question is whether the government should clarify when a foreign person is "engaged in a trade or business within the United States" under Code Secs. 871 and 882. Presumably, there will be other cases where taxpayers want clarifications or relaxation of the tax law before the credit crunch ends.

There are a number of considerations surrounding when and how administrative guidance should be issued in response to an economic crisis. Any administrative action is normally subject to challenge in the courts. That tends to keep the administrator honest. However, the types of actions that the government has taken, or is contemplating, in response to the credit crunch likely will have few people objecting. Not enforcing the REMIC rules for two years in the case of loan modifications means that the government theoretically will have less tax than it would have, however, that is pure speculation given the level of losses being generated in these deals. Also, not pursuing these claims may be justified because it avoids the administrative headaches in auditing thousands of REMICs and trying to collect taxes from them. The policy objective of keeping people in their homes seems to far outweigh any concerns about possible competition for U.S. banking institutions or other lenders. Relaxing the rules on debt versus equity for two years in the case of auction rate securities will not really disadvantage anyone and may help restart a frozen market. On the other hand, taking all this to its illogical extreme, the IRS could simply announce that it was going to suspend audits for two years. The likely response would provide a substantial stimulus to the economy. No one would seriously suggest that the Treasury should or could make those sorts of judgments. Also, if the IRS loosens the debt equity rules when times are bad, should it also tighten up the rules (*i.e.,* make more instruments equity) when economic times are good?[126]

In closing Mr. Taxpayer's saga, I offer a few thoughts about when and how the government should relax the tax laws in today's environment to help him (and those who depend on him):

- First do no harm. The government should not tighten the tax rules relating to financial instruments in a way that adds to the stresses of the credit crunch.
- The Treasury should be willing to clarify the law promptly when necessary; it should do so, however, only when the credit crunch has drawn attention to an issue and it concludes it would have resolved the issue in the same way in better times.
- Temporary relaxation of rules should be avoided and used only as a last resort. By definition, temporary relaxation means the Treasury is not comfortable with the underlying conclusion and does not want taxpayers to rely on it forever.
- Certain remedies are beyond the powers of the IRS and Treasury; in these cases, even though painful, legislation may be necessary.

Endnotes

* The author would like to thank his colleagues, Armin Gharagozlou and Shane Shelley, for their invaluable assistance in preparing this article.

1 An earlier version of this paper was presented to the Tax Club in New York City on May 19, 2008.

2 So far, the subprime crisis has resulted in well over $200 billion in losses. These losses have hit almost every major domestic and international financial institution including Citigroup (approximately $40 billion in losses), Union Bank of Switzerland (approximately $37 billion in losses), Merrill Lynch & Co., Inc. (approximately $29 billion

in losses), Royal Bank of Scotland (approximately $15 billion in losses) and Morgan Stanley (approximately $11.5 billion in losses). Keven Kingsbury, *Citigroup Looks to Slim Down, Shed Over $400 Billion in Assets,* Wall St. J., May 9, 2008; Digby Larner, *Write-Downs in Europe,* Wall St. J., Apr. 1, 2008; News Roundup, *Merrill Says 8% of Assets Difficult,* Wall St. J., May 7, 2008; Jed Horowitz, *Morgan Stanley Board Feels Heat Over Loss,* Wall St. J., Apr. 7, 2008; Neil Shah and Diva Gullapalli, *UBS Mortgage Sale a Cautionary Tale,* Wall St. J., May 7, 2008. The record losses led to the collapse of Bear Stearns, the fifth largest investment bank, which was bailed out by JP Morgan Chase and the federal government. Robin Sidel, Dennis K. Berman and Kate Kelly, *J.P. Morgan Buys Bear in Fire Sale, As Fed Widens Credit to Avert Crisis,* Wall St. J., Mar. 17, 2008. The losses are not limited to financial institutions, but include insurance companies that have sold credit protection through credit default swaps or financial guarantee insurance. Such insurance companies include American International Group, Inc. (approximately $20 billion in losses), Ambac Financial Group Inc. (approximately $3.5 billion in losses) and MBIA Inc. (approximately $3 billion in losses). While no one actually knows how much loss will be sustained in the credit crunch (partly because of the large notional amounts of credit derivatives outstanding), total estimated losses range from $400 billion to $1 trillion. Liam Pleven, *AIG Posts Record Loss, As Crisis Continues Taking Toll,* Wall St. J., May 9, 2008; Liam Pleven, *What's Suprime's Magic Number?* Wall St. J., May 3, 2008; Liam Pleven and Lavonne Kuykendall, *Ambac Shares Tumble 43%; $1.66 Billion Loss Posted,* Wall St. J., Apr. 24, 2008; Liz Moyer, *The $400 Billion Black Hole,* Forbes, Feb 29, 2008. For typical subprime mortgages issued between the second half of 2005 and the first half of 2007, approximately 25 percent to 40 percent of borrowers on average are more than 60 days delinquent. Liam Plevin, *What's Suprime's Magic Number?* Wall St. J., May 3, 2008.

3 For example, various former "AAA" rated collateralized debt obligations (CDOs) are now rated BBB or lower. *See* Allan Sloan, *House of Junk—A Close-up of One Deal Shows How Subprime Mortgages Went Bad,* Fortune, Oct. 29, 2007.

4 For example, auction rate securities that were designed to allow the holder a periodic exit have suffered failed auctions and are now turning into long-term investments for the holders. *See* the discussion under the heading "Auction Rate Securities."

5 Between 2005 and 2007, the one-year LIBOR rate ranged from about three percent to about five and one-half percent.

6 Although Mr. Taxpayer may not realize it, things have gotten so bad that many are questioning the process by which LIBOR, the London Interbank Offered Rate, is calculated. The suspicion is that certain London banks are lying about their borrowing rates in order to stave off questions about their solvency. *See, e.g.,* Ben Leivoshn and Lauren Young, *The Lowdown on LIBOR*, Businessweek, May 29, 2008. And the British Bankers' Association has announced it is changing the process. *See* Julia Werdigier, *New Effort to Monitor Benchmark Loan Rate,* N.Y. Times, June 11, 2008.

7 The precise foreclosure process varies by state. Generally the process begins with the first missed mortgage payment. After a month of delinquency the mortgagee may send the mortgagor a demand letter. After several months of missed payments, the mortgagor would record a formal notice of default at the county recorder's office. If the default is not corrected, a foreclosure sale date is established. The homeowner will receive a notice of sale, which may be posted on the property, recorded and published in local media. Many states provide two avenues to the foreclosure sale itself: a judicial sale and a nonjudicial sale. As the names imply, a judicial sale proceeds through the courts while a nonjudicial sale proceeds according to set statutory guidelines. In either case, the property will be auctioned to the public. At auction, an opening bid on the property is set by the foreclosing mortgagee. This opening bid may equal the outstanding loan balance, interest accrued and any additional fees and attorney fees associated with the sale. If there are no bids higher than the opening bid, the property will be purchased by the mortgagee. If this occurs, and the opening bid is not met, the property is deemed "real estate owned" or an REO property. Judicial sales generally take considerably longer but, in some states, are the only means to pursuing a deficiency judgment.

8 *Hammel*, SCt, 41-1 ustc ¶ 9169, 311 US 504, 61 SCt 68; Rev. Rul. 73-36, 1973-1 CB 372.

9 *See, e.g.,* Reg. §1.1001-2(a)(2); *J.Y. Aizawa,* 99 TC 197, Dec. 48,401 (1992).

10 *J.Y. Aizawa*, 99 TC197, Dec. 48,401 (1992). The capital loss is nondeductible because the property is personal use property. *See* Code Sec. 165.

11 Reg. §1.1001-2(c), Example (8).

12 *R.D. Frazier,* 111 TC 243, Dec. 52,876 (1998).

13 Reg. §1.1001-2(c), Example (8); *B. Rogers*, CA-9, 39-1 ustc ¶ 9490, 103 F2d 790, *cert. denied*, SCt, 308 US 580, 60 SCt 98 (1939); *P. Pender,* CA-4, 40-1 ustc ¶ 9302,110 F2d 477, *cert. denied*, SCt, 310 US 650, 60 SCt 1103 (1940).

14 Mortgage Forgiveness Debt Relief Act of 2007 (P.L. 110-142). A number of additional housing related bills currently are percolating in Congress. For example, on May 8, 2008, the House passed the American Housing Rescue and Foreclosure Prevention Act of 2008, H.R. 3221. Among other things, the bill provides first-time homeowners a refundable tax credit of up to $7,500. Homeowners would be required to repay the credit ratably over 15 years. The credit would be available for qualifying home purchases between April 8, 2008, and April 1, 2009. The bill also increases and simplifies the low-income housing tax credit, among other things. In light of comments from the Senate and White House, the bill's future remains uncertain.

15 Code Sec. 108(a)(1)(E). Proposed legislation would extend the provision another year.

16 Code Sec. 108(h)(1).

17 *See* Code Sec. 163(h)(3)(B).

18 Code Sec. 108(h)(2).

19 Code Sec. 108(h)(1).

20 Code Sec. 108(a)(1)(A) and (B); Code Sec. 108(b)(2)(E).

21 Code Sec. 108(d)(3).

22 In either case, Landsdale Bank would distribute a Form 1099 showing the amount of debt discharge and Mr. Taxpayer would have to elect to exclude such discharge from income under one of the above exceptions on Form 982, *Reduction of Tax Attributes Due to Discharge of Indebtedness (and Section 1082 Basis Adjustment).*

23 Mortgages in most states are technically recourse in that a mortgagee has the option of pursuing a deficiency judgment against the mortgagor. However, often a mortgagee only can pursue a deficiency judgment through a judicial foreclosure sale, which generally takes more time and is more costly than a nonjudicial sale. In some states, such as California, deficiency judgments are only available under limited circumstances. *See* Cal. Civ. Proc. Code §580a-580d.

24 *J.F. Tufts,* SCt, 83-1 ustc ¶ 9328, 461 US 300, 103 SCt 1826.

25 *See, e.g., L&C Springs Associates,* CA-7, 99-2 ustc ¶ 50,777, 188 F3d 866; *E.L. Freeland,* 74 TC 970, Dec. 37,127 (1980); *Lutz & Schramm Co.,* 1 TC 682, Dec. 13,014 (1943).

26 *See generally* Reg. §1.166-6.

27 Code Sec. 166(a) and (b); Reg. §1.166-6(a).

28 *See generally* Reg. §1.166-6(a).

29 *Id.* To recognize the bad debt loss presumably Landsdale Bank would have to demonstrate the debt had become worthless or partially worthless, an inherently factual determination. Reg. §1.166-2(a). Statutory rights of redemption, however, may be irrelevant to the determination. *W.C. Heinemann & Co.,* 40 BTA 1090, Dec. 10,921 (1939).

30 *H.P. Bingham,* CA-2,39-2 ustc ¶ 9636,105 F2d 971; Rev. Rul. 68-523, 1968-2 CB 82.

31 Reg. §§1.166-6(a)(1) and 1.166-1(b)(1). Former Code Sec. 595 excluded thrift institutions from gain or loss recognition. Instead,

gain or loss was recognized on eventual disposition of the underlying property. Any loss was treated as a Code Sec. 166 bad debt. *See also* Reg. §1.166-6(d). The repeal of Code Sec. 595 accompanied the repeal of the Code Sec. 593 reserve method of accounting for such institutions.

32 Reg. §1.166-6(b)(2).

33 Rev. Rul. 80-56, 1980-1 CB 155.

34 For a description of Project Hope Now and other government-sponsored initiatives, *see http://hopenow.us/*, last visited June, 2008.

35 Reg. §1.1001-3(c)(4) does provide an exception for forebearances lasting less than two years, but the Freeze (under Project Hope Now) would last five years.

36 The applicable threshold is the greater of 25 basis points or five percent of the annual yield of the Old Loan. Reg. §1.1001-3(e)(2)(ii).

37 The House Conference Report accompanying the enactment of Code Sec. 108(e)(10) (formerly Code Sec. 108(e)(11)) states that application of that section depends on whether the transaction at issue "qualifies as a realization event under section 1001 for the holder." H.R. Conf. Rep. No. 964, at 1098 (1990). The preamble to Proposed Reg. §1.1001-3 took the conference report at its word, looking to Code Sec. 108(e)(10) for the effects to a debtor following a realization event of the holder under a Reg. §1.1001-3 modification. Specifically, the preamble states:

> Even if a modification results in a deemed exchange under the proposed regulations, the holder and issuer may not realize gain or loss. For example, the refinancing of a residential mortgage with the same lender or the modification of a small business loan typically will not have tax consequences for either the issuers or the holders. The realization by the issuer of income from discharge of indebtedness under section 108(e)(11) of the Code will depend on whether the adjusted issue price of the original instrument is less than or greater than the issue price of the new instrument, which is determined under sections 1273 and 1274 of the Code. The realization of gain or loss by the holder generally will depend on whether the issue price of the new instrument is less than or greater than the holder's basis in the original instrument. In addition, even if a gain or loss is realized, certain nonrecognition provisions of the Code may apply.

38 H.R. Conf. Rep. No. 101-964, 1991-2 CB 560 (1990): "the issue price of the new obligation will be determined under the general rules applicable to debt instruments issued for property (*i.e.,* section 1273(b) and 1274)."

39 Reg. §1.1274-2(c).

40 *See* Code Sec. 1275(b)(1) (exempting from Code Sec. 1274 debt arising from the purchase of personal use property).

41 Code Sec. 1274(c)(3)(C).

42 Code Sec. 1273(b)(4).

43 Reg. §1.1273-1(b).

44 Reg. §1.1273-1(c)(1).

45 *See* Reg. §1.1273-1(c)(3); Reg. §1.1275-5(e); Reg. §1.1273-1(f), Ex. 3.

46 Boris I. Bittker & Lawrence Lokken, Federal Taxation of Income, Estates, and Gifts, §7.3.2 (Supp. 2008). On the other hand, Code Sec. 108(e)(10)(A) only refers to satisfying "the indebtedness with an amount of money equal to the issue price of such debt instrument," suggesting one would only look to the remaining outstanding principal balance of the Old Loan under most circumstances. After all, had Mr. Taxpayer refinanced with a third party and paid off the Old Loan with cash there would not be any cancellation of indebtedness income. Of course, the whole point of the modification is that this is truly a form of debt forgiveness and not a refinancing—if refinancing were an option the modification would not be necessary.

47 H.R. Conf. Rep. No. 101-964, 1991-2 CB 560 (1990): "The amount of cancellation of indebtedness created on a debt-for-debt exchange is properly determined by comparing the adjusted issue price of the old obligations being discharged to the issue price of the new obligations, and … the OID rules, as modified by the bill, provide the appropriate framework for determining the issue price of a new obligation."

48 Bittker & Lokken, *supra* note 46. *See also* Code Sec. 1272(a)(4).

49 *See* Reg. §1.1273-2(a)(1). ("For example, in the case of a debt instrument evidencing a loan to a natural person, the issue price of the instrument is the amount loaned.")

50 Reg. §1.1273-1(b).

51 Reg. §1.1275-5(e)(2)(i).

52 Reg. §1.1275-5(b)(1).

53 Reg. §1.1275-5(d), Example 1.

54 Reg. §1.1273-1(c); Reg. §1.1273-1(f), Example 3.

55 Reg. §1.1273-1(d)(2) and (3). The general rule is that the *de minimis* amount is an amount equal to 0.0025 multiplied by the product of the stated redemption price at maturity and the number of complete years to maturity from the issue date. However, in the case of installment obligations, one must substitute for the number of complete years to maturity the weighted average maturity. Alternatively, in the case of a debt instrument that provides for payments of principal no more rapidly than self-amortizing installment obligation (an obligation that provides for equal payments composed of principal and qualified stated interest that are unconditionally payable at least annually during the entire term of the debt instrument with no additional payment required at maturity (*i.e.,* a typical mortgage loan)), the *de minimis* amount may be calculated by substituting 0.00167 for 0.0025. Query whether the alternative method applies to a teaser-rate mortgage loan that has nonqualified stated interest.

56 Generally this exception would apply to variable rate debt instruments like the Old Loan. *See* Reg. §1.1275-5(e)(3)(v), Example 2.

57 At least one case has mentioned the fact that Code Sec. 108(e)(2) applies to personal residence interest. *See J.M. Johnson,* 77 TCM 2005, Dec. 53,380(M), TC Memo. 1999-162.

58 *See generally* Code Sec. 163(e). Assuming Code Sec. 1275(b)(2) applied to Mr. Taxpayer, under Reg. §1.1275(b)(2), OID under the Old Loan would not be deductible by Mr. Taxpayer until "paid." Under Reg. §1.1275-2(a), to determine whether OID has been paid, Mr. Taxpayer would apply payments he had made first to qualified stated interest, second to accrued but unpaid OID and third to principal. Payment under Reg. §1.1275(b)(2) should have no bearing on the hypothetical deductibility required by Code Sec. 108(e)(2).

59 Reg. §1.1274-1(a).

60 However, Code Sec. 1274 would not apply to a loan the aggregate amount of whose payments is less than $250,000.

If Code Sec. 1274 did not apply, Code Sec. 1273(b)(4) would apply and the issue price of the New Loan would be the "stated redemption price at maturity." Reg. §1.1273-2(d)(1). This would involve the same calculation described above under Issue Price of New Loan, only there would be no exclusion of nonqualified stated interest from the stated redemption price. *See* Code Sec. 108(e)(10) (appears to apply only to debtors and not creditors). Thus, to the extent the New Loan has nonqualified stated interest, such amounts would increase its issue price beyond the stated principal amount.

61 The loss would be an ordinary loss under Code Sec. 582. Presumably Landsdale Bank would not have to rely on Code Sec. 166 because there has been an actual disposition of the indebtedness by virtue of the modification. What if Landsdale Bank had not been a bank? Recently the IRS withdrew proposed regulations that would have expanded the classification of certain loans as capital assets for non-banks under Code Sec. 1221(a). *See* Proposed Reg. §1.1221-1(e)(1); Withdrawal of Notice of Proposed Rulemaking, 73 FR. 21,861 (Apr. 23, 2008).

62 *JCT Estimates Revenue Effects of Mortgage Forgiveness Debt Relief Act,* J.C.T. Rep. No. JCX-118-07, 2007 TNT 244-20 (Dec. 18, 2007).

63 H.R. Rep. No. 110-356, at 5 (2007).

64 *See* Jonathan Glater, *Lose Home, Pay More Tax,* N.Y. Times, May 30, 2008.

[65] Code Sec. 163(h)(3).
[66] Code Sec. 121(a) and (b).
[67] *See* Code Sec. 860G(a)(5) (foreclosure property is a "permitted investment"); Code Sec. 860G(b) (net income from foreclosure property subject to corporate level tax rather than 100-percent tax penalty tax).
[68] *See* S. Rep. No. 313, 1986-3 CB, at 792.
[69] Reg. §301.7701-4(c).
[70] *See, e.g.,* Reg. §301.7701-4(c)(2), Example 4 (trust used to issue interests representing interests in stripped bonds and coupons under Code Sec. 1286 does not violate multiple class limitation).
[71] "In general, a REMIC is a fixed pool of mortgages with multiple classes of interests held by investors." H.R. Conf. Rep. No. 99-841 at 4,313 (1986).
[72] Code Sec. 860D(a)(4).
[73] Code Sec. 860G(a)(3).
[74] Reg. §1.860G-2(b)(1)(i).
[75] Code Sec. 860F(a).
[76] Reg. §1.860G-2(b)(1)(ii).
[77] The IRS has proposed regulations that would relax these rules in the case of certain commercial mortgage loans. *See* Proposed Reg. §1.860G-2(b).
[78] For example, if the REMIC's documents do not give the servicer leeway to modify loans but it still does so, an issue arises because the modification is arguably not pursuant to the terms of the regular interest.
[79] Code Sec. 860D(a)(2).
[80] Reg. §1.860D-1(c)(2).
[81] Reg. §1.860G-2(b)(i).
[82] Reg. §1.860D-2(b)(ii).
[83] Code Sec. 860D(a)(4). Under a *de minimis* test safe harbor, the REMIC maintains its qualification if less than one percent of its assets (measured by aggregate adjusted basis) are not qualified mortgages or permitted investments. Reg. §1.860-1(b)(3).
[84] The Paulson-Jackson Plan is named after Treasury Department Secretary Henry Paulson and then Department of Housing and Urban Development Secretary Alphonso Jackson. It embraces the Freeze described above under Project Hope Now.
[85] Rev. Proc. 2007-72, IRB 2007-52, 1257.
[86] American Securitization Forum, *Streamlined Foreclosure and Loss Avoidance Framework for Securitized Subprime Adjustable Rate Loans, available at www.americansecuritization.com/uploadedFiles/FinalASFStatementonStreamlinedServicingProcedures.pdf. See also* Alan S. Lederman *et al., IRS Relieves Some of a REMIC's Distress from Relieving Distressed Mortgages,* 24 Tax Mgmt. Real Est. J. 2 (2008).
[87] Rev. Proc. 2008-28, IRB 2008-23, 1054.
[88] Tax Reform Act of 1986 (P.L. 99-514).
[89] *See General Explanation of the Tax Reform Act of 1986,* J.C.T. Rep. No. JCS 10-87, at 427.
[90] Code Sec. 7701(i)(1).
[91] *Id.*
[92] Reg. §301.7701(i)-4(c)(1).
[93] Another special rule exists for REITs, as REITs are already treated as a corporation that cannot file a consolidated return, but have effectively a single layer of tax for income distributed. Code Sec. 7701(i)(3). The special rule for REITs requires a REIT to provide, under regulations prescribed by the Secretary, adjustments similar to excess inclusion income of REMICs, thereby converting a REIT to a quasi-REMIC. *Id.* For a further analysis, *see, e.g.,* James M. Peaslee & David Z. Nirenberg, Federal Income Taxation of Securitization Transactions, Ch. 10 (3d ed. 2001).
[94] The REMIC would recognize gain or loss on the distribution of its assets to the regular and residual interest holders under Code Sec. 860F(c) which provides that (i) if a REMIC makes a distribution of property with respect to any regular or residual interest then the REMIC recognizes gain in the "same manner as if it had sold such property to the distributee at its fair market value" and (ii) the basis to the distribute in such property is its fair market value. A holder would have a taxable exchange and would take a basis equal to fair market value in the assets. Code Secs. 1001 and 1012.
[95] Code Sec. 243(a)(1).
[96] Code Sec. 852(b)(5).
[97] Rev. Rul. 90-27, 1990-1 CB 50.
[98] In the ruling, a failed auction would result in the dividend rate being adjusted to a maximum rate. The maximum rate was a percentage of a composite commercial paper rate ranging from 110 percent if the auction rate securities were rated AA/aa or above and 250 percent if they were rated below BB/ba.
[99] The first failed auction in the municipal market occurred in 1990 for bonds issued by the Pima County, Arizona, Industrial Development Authority for Tucson Electric Power Co., now a unit of UniSource Energy Corp., based in Tucson. Martin Z. Braun and Michael McDonald, *Port Authority Auction Bonds Reset at 8% After Surge (Update5),* Bloomberg, Feb. 20, 2008.
[100] *See* Letter from Skadden Arps to Eric Solomon and Donald Korb, Re: Debt/Equity Analysis of Auction Preferred Stock, 2008 TNT 74-21 (Apr. 4, 2008).
[101] On June 13, 2008, the IRS issued Notice 2008-55, IRB 2008-27, to confirm that it would not challenge the equity characterization of auction rate preferred stock issued by certain regulated investment companies as the result of the addition of a liquidity facility. For a detailed description of the Notice, *see* David Z. Nirenberg, James A. Gouwar, Steven L. Kopp and Sharon Kim, Current Federal Tax Developments, *Notice 2008-55 Permits Adding Liquidity Facilities to Auction Rate Preferred Stock,* in this issue of the Journal of Taxation of Financial Products.
[102] *See, e.g.,* Johnathan Karp and Michael Corkery, *Middle East Players Arrive,* Wall St. J., Mar. 12, 2008. The foreign sovereigns have benefited from the longstanding exemption of investment income for foreign sovereigns in Code Sec. 892. It seems, however, that the press has only recently discovered this provision. *See, e.g.,* Kristen A. Parillo, *Treasury, IRS May Issue Guidance on Sovereign Wealth Funds,* 2008 TNT 92-28 (May 12, 2008).
[103] Letter from MFA to Douglas Shulman and Eric Solomon, *Re: Increasing Liquidity in the U.S. Capital Markets,* 2008 TNT 75-33 (Apr. 9, 2008).
[104] *Id.*
[105] Letter from New York City Bar to Eric Solomon and Mark W. Everson, *Re: New York City Bar Report Offering Proposed Guidance Regarding U.S. Federal Income Tax Treatment of Certain Lending Activities Conducted Within the U.S.,* 2006 TNT 158-14 (May 3, 2007).
[106] Stuart L. Leblang and Rebecca Rosenberg, *Toward an Active Finance Standard for Inbound Lenders,* 31 Tax Mgmt. Int. J. 3 (2002).
[107] *Id.*
[108] Code Sec. 864(b)(2).
[109] Reg. §1.864-2(c)(2)(i) (flush language).
[110] *Id.*
[111] *Id.*
[112] *See, e.g., G.R. Kemon,* 16 TC 1026, Dec. 18,271 (1951) and *J.M. Ferguson,* 33 TCM 1082, Dec. 32,776(M) (1974), TC Memo. 1974-244.
[113] *See, e.g., A.J. Whipple,* SCt, 63-1 ustc ¶9466, 373 US 193, 83 SCt 1168.
[114] *See, e.g.,* John Herzfeld, *Treasury Seek Views on Steps to Help Economy, Official Says,* Daily Tax Rep., Apr. 25, 2008, at G-11.
[115] Rev. Rul. 85-119, 1985-2 CB 60.
[116] Continental Illinois was bailed out by the FDIC in May 1984, after what the FDIC describes as a "high-speed electronic bank run." *See* FDIC, An Examination of the Banking Crises of the 1980s and Early 1990s, Ch. 7 at 243, *available at www.fdic.gov/bank/historical/history/235_258.pdf,* last visited June 2008.
[117] Notice 94-47, 1994-1 CB 357.
[118] Code Sec. 163(l)(1) and (2).
[119] The Federal Home Loan Bank Board implemented the plan by relaxing the requirements for reporting losses on mortgages. In Memorandum R-49, dated June 27, 1980, "the FHLBB determined that S&Ls need not report losses associated with mortgages that are exchanged for 'substantially identical mortgages held by other lenders.'" *Cottage Savings,* SCt, 91-1 ustc ¶50,187, 499 US 554, at 557.
[120] *Cottage Savings,* 499 US, at 557.
[121] *Id.,* at 566.
[122] LTR 8929030 (Apr. 21, 1989).
[123] Rev. Rul. 92-32, 1992-1 CB 434.
[124] Notice 2008-27, IRB 2008-10, 543; Notice 2008-41, IRB 2008-15, 742.

125 Rev. Proc. 2008-26, IRB 2008-21, 1014.

126 On June 13, 2008, the IRS issued Notice 2008-55, IRB 2008-27, to confirm that it would not challenge the equity characterization of auction rate preferred stock issued by certain regulated investment companies as the result of the addition of a liquidity facility. For a detailed description of the Notice, *see* David Z. Nirenberg, James A. Gouwar, Steven L. Kopp and Sharon Kim, Current Federal Tax Developments, *Notice 2008-55 Permits Adding Liquidity Facilities to Auction Rate Preferred Stock,* in this issue of the JOURNAL OF TAXATION OF FINANCIAL PRODUCTS.