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Internal Revenue Service
Office of Pre-Filing and Technical Services
Large and Mid-Size Business Division SE:LM:PFT
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Subject: Revenue Procedure 2003-36 – IIR Program Submission

To Whom It May Concern:

The Mortgage Bankers Association¹ (MBA) hereby submits the following issue for IRS guidance under the Industry Issue Resolution (IIR) program:

The reporting requirements under section 6050H of the Internal Revenue Code² in the year of and years following the significant modification³ of a mortgage where the principal amount of the modified mortgage exceeds the principal amount of the pre-modification mortgage (as if accrued-but-unpaid interest on the pre-modification mortgage becomes part of the principal of the modified mortgage).

¹ The Mortgage Bankers Association (MBA) is the national association representing the real estate finance industry, an industry that employs more than 280,000 people in virtually every community in the country. Headquartered in Washington, D.C., the association works to ensure the continued strength of the nation's residential and commercial real estate markets; to expand homeownership and extend access to affordable housing to all Americans. MBA promotes fair and ethical lending practices and fosters professional excellence among real estate finance employees through a wide range of educational programs and a variety of publications. Its membership of over 2,200 companies includes all elements of real estate finance: mortgage companies, mortgage brokers, commercial banks, thrifts, REITs, Wall Street conduits, life insurance companies and others in the mortgage lending field. For additional information, visit MBA's Web site: www.mba.org.

² All section references herein are to the Internal Revenue Code of 1986, as amended, or the Treasury Regulations promulgated thereunder.

³ As that term is defined in Treas. Reg. § 1.1001-3(e). A significant modification of a debt instrument is treated as an exchange of the original instrument for a new instrument with the terms of the modified instrument. Treas. Reg. § 1.1001-3(b). Given the low bar for a modification of a debt instrument to be considered a significant modification and the circumstances in which home mortgages are modified – typically, cases where the borrower is unable to meet the obligations of the mortgage as originally structured – it is likely that nearly all residential mortgage modifications involving Capitalized Amounts (as defined herein) constitute significant modifications.

Background

Between 2008 and mid-2014, roughly 8 million mortgages were modified, and a significant number of additional mortgages are modified each year. The current mortgage interest reporting rules do not explain whether, when, or how to report amounts of accrued-but-unpaid interest on a pre-modification mortgage that effectively becomes part of the principal of the modified mortgage upon modification (Capitalized Amounts). As a result, institutions in the mortgage lending and servicing industry (Reporting Institutions) must determine whether, when, and how to report the Capitalized Amounts on Form 1098. It seems likely that many Reporting Institutions have treated modified mortgages as new loans for information reporting purposes – consistent with the substantive tax treatment of such instruments – and have treated the ultimate repayment of Capitalized Amounts by borrowers as payments of principal, as dictated by the terms of the modified instrument. It may also be true that some Reporting Institutions report repayments of Capitalized Amounts as interest in some fashion.

While substantive tax law may permit cash-method mortgage borrowers to deduct payments of Capitalized Amounts, borrowers are ultimately responsible for keeping track of and calculating the amounts they are permitted by law to deduct each year.⁴ Nonetheless, guidance regarding whether, when and how to report Capitalized Amounts would provide clarity to and ensure consistency among Reporting Institutions, mortgage borrowers, and the IRS regarding what payments the amounts reported on Form 1098 reflect. Given current uncertainty and the number of potentially affected Reporting Institutions and borrowers, this issue is appropriate for the IIR Program.

We recommend that any guidance on this issue provide for the following: (i) a prospective effective date that gives Reporting Institutions adequate lead time to implement and systematize any new reporting requirements; (ii) prospective application only to loans modified after the effective date; (iii) clarity regarding the timing of reporting (if any) and amounts to be reported; and (iv) flexibility for mortgage borrowers who were permitted by law to deduct Capitalized Amounts in prior years but failed to do so.

Issue

Existing guidance does not address whether, when, or how Reporting Institutions must report Capitalized Amounts. Reporting Institutions thus face uncertainty on an issue that affects potentially large numbers of their customers. Moreover, while mortgage borrowers have, in their loan documents, the information necessary to calculate their permitted deduction and may seek to deduct payment of Capitalized Amounts regardless of whether the amounts are reported, many borrowers may deduct only interest reported to them on Form 1098. In late 2014, a class action lawsuit was filed on behalf of borrowers who did not claim deductions for these amounts, requesting, among other things, a court ruling that reporting is required. The court declined to address the reporting issue, holding

⁴ See Rev. Rul. 70-647, 1970-2 CB 38.

instead that the IRS “possesses exclusive authority to enforce” section 6050H if a Reporting Institution does not comply with the reporting requirements at issue.⁵

Statement

When a borrower and lender agree to the significant modification of a loan, amounts of interest that have accrued on the original loan and are unpaid as of the time of modification often effectively become part of the principal of the modified mortgage (such amounts previously defined as Capitalized Amounts). While section 6050H and the regulations thereunder require “an interest recipient who receives at least \$600 of interest on a qualified mortgage for a calendar year” to report the amount received to both the IRS and the borrower on Form 1098, current guidance does not address whether, when, or how to report Capitalized Amounts. In particular, guidance does not state whether such amounts constitute reportable interest, and if so, when such amounts should be treated as received for purposes of section 6050H and the regulations thereunder.

The lack of guidance regarding whether, when, and how Capitalized Amounts must be reported arises in the context of substantive law that treats the significant modification of a mortgage as an exchange of the original mortgage for a new mortgage with modified terms. Under Treasury Regulation section 1.6050H-2(a)(1), Reporting Institutions must issue separate Forms 1098 for “each qualified mortgage,” suggesting that reporting obligations must be evaluated on a mortgage-by-mortgage basis. Current guidance does not require that Capitalized Amounts – which constitute principal on the modified mortgage for which the Form 1098 is being filed – be treated as interest and reported on a Form 1098 filed for a modified mortgage. Instead, current guidance appears to require that Capitalized Amounts not be reported on Forms 1098, because Capitalized Amounts are not interest on the mortgage to which the reporting obligation relates.⁶ We also note that the student loan rules at Treasury Regulation sections 1.221-1, 1.221-2, and 1.6050S-3, finalized in 2004, explicitly do not provide guidance on the treatment of modified loans, expressly reserving on the issue.⁷

⁵ Memorandum and Order Granting Defendant's Motion to Dismiss at 5, *Smith v. Bank of Am., N.A.*, No. CV 14-6668 DSF (PLA) (C.D. Cal. Feb. 3, 2015), ECF No. 28. In two other cases addressing a similar issue – accrued-but-unpaid interest on payment option adjustable rate mortgages – a federal district court judge in the Southern District of California held that the IRS has “primary jurisdiction” to interpret section 6050H, and therefore required the plaintiffs in those cases to initiate proceedings to obtain the IRS’s views on the issue. Order Granting in Part Defendant's Motion to Dismiss and Stay at 4, 7, *Pemberton v. Nationstar Mortg. LLC*, No. 14-cv-1024-BAS (WVG) (S.D. Cal. Feb. 4, 2015), ECF No. 17; Order (1) Granting in Part Defendant's Motion to Dismiss; and (2) Staying the Case, *Rovai v. Select Portfolio Servicing, Inc.*, No. 14-cv-1738-BAS (WVG) (C.D. Cal. May 11, 2015), ECF No. 16. The plaintiffs in *Pemberton* and *Rovai* filed a status update with the court on July 2, 2015, attaching a letter in which the IRS informed them that current law permits borrowers to deduct more mortgage interest than the amount shown on a Form 1098, including via an amended return.

⁶ The substantive law also does not indicate whether Capitalized Amounts should be treated as “acquisition indebtedness,” which is subject to a \$1,000,000 cap, or “home equity indebtedness,” which is subject to a \$100,000 cap. See § 163(h)(3)(B) and (C). Guidance on the reporting treatment of Capitalized Amounts may provide the opportunity to clarify which cap, if any, the Capitalized Amounts are subject to.

⁷ See, e.g., Treas. Reg. § 1.221-1(e)(3)(v)(A); Treas. Reg. § 1.221-2(f)(3)(v)(B); TD 9125 (2004).

Against this backdrop, it seems likely that Reporting Institutions have taken a variety of approaches on whether, when, and how to report these amounts. Thus, whether Capitalized Amounts, which may be deductible when paid,⁸ appear on Forms 1098 sent to mortgage borrowers likely varies from institution to institution. The multiplicity of approaches reduces the utility of Form 1098 as a tool for the IRS to confirm the accuracy of borrowers' claimed deductions: If the amounts are generally deductible, the IRS would need to devote resources to verifying the legitimacy of claimed mortgage interest deductions for amounts not shown on Forms 1098.

The uncertainty created by the lack of guidance in this area impacts all Reporting Institutions that issue Forms 1098 on modified mortgages – including national banks, community banks, credit unions, and loan servicers. It also affects recipients of such forms, who number in the millions: A study by the Office of the Comptroller of the Currency examining data from a group of Reporting Institutions holding 46% of all first-lien residential mortgages in the United States found that, between January 1, 2008 and June 30, 2014, those Reporting Institutions implemented roughly 3.6 million mortgage modifications.⁹ Extrapolating from these numbers to the entire mortgage industry, nearly 8 million mortgages may have been modified during that time period, and more have been modified since. Thus, the issue is one of industry-wide importance, affecting Reporting Institutions as well as their customers.

Request for Guidance

MBA is requesting this IIR to seek guidance clarifying whether, when and how Reporting Institutions should report Capitalized Amounts. Guidance on this issue would have three significant benefits: It would ease and unify interpretation of section 6050H for Reporting Institutions; it would simplify the process for borrowers claiming deductions for such amounts; and it would enhance the IRS's ability to monitor borrower compliance with substantive deductibility rules.

Ideally, such guidance would take into account several practical considerations. First, given the variety of approaches likely employed by Reporting Institutions in the absence of guidance, any newly issued guidance should give Reporting Institutions sufficient time to modify their systems, and should apply only to mortgage loans modified after that time has elapsed.¹⁰ Second, guidance should balance the burden that tracking

⁸IRS forms and publications allow mortgage borrowers to deduct amounts of home mortgage interest paid by the borrower but not reported on Form 1098 (see, e.g., IRS, Schedule A (Form 1040) (2014) (providing space to deduct "Home mortgage interest not reported to you on Form 1098"); IRS, Publication 936, Home Mortgage Interest Deduction 9 (2014) ("If you paid more deductible interest to the financial institution than the amount shown on Form 1098, show the larger deductible amount on line 10")), and borrowers possess loan documentation necessary to determine the proper amount of such deductions.

⁹ Office of the Comptroller of the Currency, OCC Mortgage Metrics Report: Third Quarter 2014 4 (2014).

¹⁰ In issuing new information reporting regulations in the student loan context, for example, the Treasury Department acknowledged the burden on Reporting Institutions by requiring reporting on a prospective

these amounts places on Reporting Institutions with the burden it places on borrowers; for example, newly issued guidance could require that Reporting Institutions report the entire Capitalized Amount on Form 1098 in the year of modification, but then require the borrower to keep track of how much of that total Capitalized Amount they are permitted by law to deduct each year going forward, as payments are made on the modified mortgage, under rules to be provided in guidance by the government. Lastly, guidance should take into account the fact that there may be borrowers who have not deducted these amounts, notwithstanding that they may have been permitted by law to do so, and give those borrowers a way to claim those deductions going forward, perhaps by treating the attempt to claim deductions on an amended return as a change in method of accounting.

Any questions about the information provided herein should be directed to Jim Gross, Vice President Financial Accounting and Public Policy and Staff Representative to MBA's Financial Management Committee, at 202 557-2860 or at jgross@mba.org.

Sincerely,



David H. Stevens
President and Chief Executive Officer
Mortgage Bankers Association

basis only (see Treas. Reg. § 1.6050S-3(e)(1)(i)), and by giving Reporting Institutions time to update their systems to comply with the new regulations (see TD 9125 (2004)).