Services

Public Finance

Single Family Housing

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MRB Loan Modifications – Tax and Indenture Considerations

Recently announced federal programs to aid homeowners challenged with mortgage loan payments have generated questions about the federal tax implications, and possible bond indenture considerations, of modifying single-family loans financed by tax-exempt single-family mortgage revenue bonds (MRBs). The following is a summary of (1) the applicable federal tax (MRB) rules and (2) typical MRB indenture provisions, both of which may affect the ability of housing finance agencies (HFAs) to modify MRB single-family loans.

Federal Tax (MRB) Rules

The federal tax/MRB rules prohibit the use of MRB loan proceeds to finance loans which "refinance" existing mortgages. Various provisions of the regulations indicate that this prohibits the "refinancing" of conventional loans, but does NOT prohibit the modification of MRB financed loans, even though for other regulatory purposes a modification of a loan may be considered a "refinancing." So HFAs are permitted to modify single-family loans financed by MRBs (e.g., lowering interest rates, extending maturities, forbearing payments, and so on).

A key part of the tax analysis is that the HFA must be the owner of the loan, for federal income tax purposes, throughout this process. Normally this is not an issue for whole loans. However, if a loan is in a GNMA that is owned by the HFA (and financed by MRBs), a modification normally triggers a GNMA requirement that the seller/servicer "buy out" the loan (i.e., remove it from the GNMA, which is treated as a "prepayment" by GNMA) as part of any modification. If the seller/servicer is the HFA which owns the GNMA, there should be no tax problems with modifying the loan and either then holding it as a whole loan or putting it back into another GNMA (with only MRB loans). Also, if prior to the modification that GNMA is allocated to an MRB which financed the GNMA loan, the modification will not be considered a "prepayment" for purposes of the 10-year anti-recycling rule, provided that the modified loan stays allocated to that MRB tax plan or an MRB refunding tax plan.

If the GNMA seller/servicer is a third party which buys out the loan, the MRB tax analysis is more complex. If the HFA has an agreement whereby it effectively owns the loan (for tax purposes, "control" being the key factor) after the loan is removed by the seller/servicer, and the HFA modifies the loan (or

Contacts

John Wagner
Omaha
(402) 231-8811
john.wagner@kutakrock.com

Michelle Adams
Atlanta
(404) 222-4646
mihcelle.adams@kutakrock.com

Kevin Barney
Chicago
(312) 602-4117
kevin.barney@kutakrock.com

Jeffrey Blumenfeld
Philadelphia/Chicago
(215) 299-4317
jeffrey.blumenfeld@kutakrock.com

Mitchell Bragin
Washington, D.C.
(202) 828-2450
mitchell.bragin@kutakrock.com

Sisera Daniel
Washington, D.C.
(202) 828-2327
sisera.daniel@kutakrock.com

Jim Hathaway
Little Rock
(501) 975-3137
jim.hathaway@kutakrock.com

Karilyn Kober
Omaha
(402) 231-8770
karilyn.kober@kutakrock.com

Steve Likes
Omaha/Minneapolis
(402) 661-8648
steve.likes@kutakrock.com

David Lu
Washington, D.C.
(202) 828-2468
david.lu@kutakrock.com

Erika Lynch
Omaha
(402) 231-8722
erika.lynch@kutakrock.com

Fred Marienthal
Denver
(303) 292-7817
frederic.marienthal@kutakrock.com

Drew Page
Omaha
(402) 661-8631
drew.page@kutakrock.com

Patti Peterson
Omaha
(402) 231-8785
patricia.peterson@kutakrock.com

Leslie Powell
Atlanta
(404) 222-4639
leslie.powell@kutakrock.com

Dawn Roth
Omaha
(402) 231-8772
dawn.roth@kutakrock.com

directs the modification by the seller/servicer), then the modified loan can go back into a GNMA, or a whole loan, under the same tax plan. But if the HFA does not exercise effective controls over the seller/servicer and the loan is modified by the seller/servicer, the seller/servicer (not the HFA) is treated as the owner of the modified loan and in most cases the loan can no longer go into an MRB tax plan.

In any event, if the HFA is the owner of the loan or the GNMA, the modification would relate back to the original loan to determine whether the loan qualifies for MRB financing. Thus, if the modification occurs before the loan or the GNMA is allocated to an MRB tax plan (for example, if it is in a warehousing facility), then either the original loan or the modified loan can be allocated to an MRB tax plan (assuming, of course, that the applicable tax reimbursement rules have been met). If the modification occurs before the loan is owned by the HFA for tax purposes, then either the original loan or the modified loan can be acquired by the HFA with MRB proceeds if the loan was originated pursuant to an origination agreement with the HFA.

Bond Indenture

Rarely do bond indentures have provisions that directly address the modification of single- family loans. Rather, there is generally an affirmative covenant to receive and collect loan payments, and take steps reasonably necessary to enforce terms and conditions of mortgages “consistent with sound banking practices.” Banks (and servicers) routinely modify loans (as, historically, have HFAs whose statutory directive is to provide affordable housing for low- and moderate-income persons), so clearly modifications to continue the ability of the homeowner to remain in their residence are not per se prohibited. Of course, however, attention must be paid to any significant adverse effect on projected indenture cash flows and the ability of the HFA to pay debt service on the MRBs which are secured by the loan or related GNMA (and to maintain bond ratings). For HFA indentures, which are usually substantially over parity, modifications of whole loans should not be a major issue, nor should modifications of loans in GNMAs supporting MRBs, assuming the number of modifications is rather nominal.

An incidental issue is whether, under the terms of the MRB indenture, and especially the MRB redemption provisions, a modification of a loan constitutes a “prepayment” which may create redemption rights. If the loan is in a GNMA, the fact that there is a GNMA partial prepayment is certainly a better fact pattern. Nevertheless, this is often a very complex analysis, and depends on the technical wording of the indenture (and, generally, disclosure in the related official statement).

Additional Information

If you have questions about any of the foregoing, please contact any of the attorneys listed on the left in Kutak Rock’s Housing Finance Agency Practice Group. We would be happy to discuss this with you.

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