

RECENT LEGISLATIVE DEVELOPMENTS WILL CREATE HEADACHES AND INCREASE FINANCIAL RISKS FOR MORTGAGE SERVICERS AND ORIGINATORS

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Tax Alert

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Two recent legislative developments, which have largely gone unnoticed, will dramatically raise the stakes for mortgage servicers and originators who file IRS Forms 1098. First, the Trade Preferences Extension Act of 2015, signed into law on June 29, 2015, more than doubled the financial penalties imposed for filing IRS Forms 1098 with incorrect information. Second, proposed legislation approved by the Senate Finance Committee on July 21, 2015 to extend certain expired tax provisions (a so-called "extenders bill") would require servicers to include new information on IRS Form 1098. Although the extenders bill's new required information may be relatively straightforward in basic situations, delinquent and modified loans present unique challenges. With the new increased penalties in place, the stakes to get it right have never been higher. Because there is scant IRS guidance upon which servicers may rely regarding various information reporting issues, it will be increasingly critical for the IRS to adhere to the legal standard that penalties do not apply when a servicer adopts and follows reasonable reporting methods in good faith.

SUMMARY OF CURRENT LAW

Section 6050H of the Internal Revenue Code (the "Code") and the Treasury Regulations promulgated thereunder require any person who in the course of a trade or business received from an individual \$600 or more of interest during a calendar year on any mortgage to file an information return with the IRS and furnish a copy of that return to the payer of record, the payer statement, on IRS Form 1098. The information required to be reported on IRS Form 1098 includes the name, address, and taxpayer identification number of the borrower from whom the interest was received and the amount of interest and points received for the year.^[1]

The penalty regime for the failure to file correct information returns and payer statements employs a tiered structure, with the penalties increasing the longer a filer takes to provide correct information returns and statements. The maximum penalty (absent an intentional or willful failure to file correct returns) is \$100 per information return with a maximum penalty of \$1.5 million per year. If a filer intentionally disregards the filing requirements, the penalty is at least \$250 per information return with no maximum penalty amount. The same penalty amounts apply to the failure to furnish correct payer statements.^[2]

The Trade Preferences Extension Act of 2015 increases the maximum penalty, from \$100 per return to \$250 with a maximum penalty of \$3 million per year. The penalty for intentionally disregarding the requirements has

doubled to \$500 per information return. These increased amounts also apply to payer statements. The increased penalties apply to information returns and payer statements required to be filed after December 31, 2015.

LEGISLATIVE DEVELOPMENTS

The extenders bill, currently named the Original Bill to Extend Certain Expired Tax Provisions, was approved by the Senate Finance Committee on July 21, 2015. The proposed changes to IRS Form 1098 reporting would require the following three new items to be reported:

- the amount of outstanding principal balance on the mortgage as of the beginning of the calendar year;
- the address of the property securing the mortgage; and
- the loan origination date.

These same additions to the reporting requirements are included in the House Ways and Means Committee Chair Paul Ryan's recent bill, the Highway and Transportation Funding Act of 2015, Part II (the "Highway Bill"), which was approved by the House on July 15, 2015.^[3] Section 2003 of the Highway Bill, if passed, would amend Sections 6050H(b)(2) and 6050H(d)(2) of the Code by adding the three items identified above to the statutory list of information that must be reported on IRS Form 1098. In both the extenders bill and the Highway Bill, these changes would apply to information returns and payer statements required to be furnished after December 31, 2016. The provision is estimated to raise \$1.8 billion of revenue over 10 years.

EFFECTS ON MORTGAGE LENDERS AND SERVICERS

In most cases, mortgage lenders and servicers should be able to include the address of the property securing the mortgage and the date of the origination of the mortgage with relative ease. However, the proposed legislation provides no guidance regarding how to interpret its phrase "outstanding principal balance on the mortgage." The outstanding principal balance should be easy to determine with a mortgage that has always been current and only been serviced by one entity. However, delinquent or modified mortgages may carry delinquent or deferred interest as principal on the books of the servicer. Likewise, servicers may advance funds to the borrower (for example, for property taxes or insurance) and may capitalize these amounts in principal balances. Late fees and other charges also may be capitalized into a loan balance in various circumstances. Servicers that acquire modified loans from prior servicers may not be provided with sufficient information to determine whether (or what) additional amounts may have been capitalized into a loan's principal balance.

Without legislative or regulatory guidance as to what is intended by "outstanding principal balance," mortgage lenders and servicers face uncertainty regarding how the IRS will interpret this requirement across the full range of possible situations. If the proposal becomes law, there can be no guarantee that the IRS will recognize servicers' discretion to adopt reasonable practices, leaving servicers exposed to the potential of massive penalties.

CONCLUSION

Given that both chambers of Congress each separately have proposed the same changes to the mortgage interest reporting rules in these recent bills, it would appear that a change is likely coming. Mortgage servicers

will want to begin preparing for these changes and confirm that their reporting practices are reasonable, particularly in light of the enhanced penalties that now apply.

Notes:

[1] See Code Sections 6050H(b) and (d) and Treasury Regulation Sections 1.6050H-2(a)(2) and (b)(2) for the complete list of information required to be reported on IRS Form 1098. The current version of IRS Form 1098 is available at <http://www.irs.gov/Forms-&-Pubs>.

[2] See Code Sections 6721 and 6722 for a complete description of the penalty regime.

[3] H.R. 3038, Highway and Transportation Funding Act of 2015, Part II.

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