

# TAXATION OF REAL ESTATE MORTGAGE INVESTMENT CONDUITS

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## I. Taxation of Real Estate Mortgage Investment Conduits

### A. Qualification as a REMIC

1. REMICs are fixed pools of mortgages, in which investors hold various classes of interests.

2. Eligible entities

The REMIC may be a corporation, a trust, a partnership, or other entity. Section 860D.

3. Election of REMIC status

a. Section 860D(a)(1) requires that an entity must elect REMIC status.

b. Section 860D(b) governs the election, and provides rules applicable to inadvertent terminations. Treas. Reg. § 1.860D-1(d).

4. “Interest” composition requirements

a. The REMIC must issue only regular and residual interests. Section 860D(a)(2). Treas. Reg. § 1.860D-1.

b. Regular interests

(1) Regular interests may be issued in the form of debt, stock, partnership or trust interests, etc.

(2) Regardless of their form, regular interests are treated like debt instruments. Section 860B.

(3) The terms of the regular interest must be fixed on the “startup day.” Section 860G(a)(1).

(4) The terms of the regular interest must entitle the holder to receive a specified principal amount. Section 860G(a)(1)(A).

(a) Section 835(b)(5)(A) allows a REMIC interest to qualify as a regular interest despite the fact that the specified principal amount of the interest (or the amount of interest accrued on the regular interest) can be reduced as a result of the nonoccurrence of one or more contingent payments with respect to a reverse mortgage loan held by the REMIC, so long as the REMIC sponsor “reasonably believes” that

all principal and interest due under the regular interest will be paid on or before the date the REMIC liquidates.

- (5) Interest payments may be based on a fixed or variable rate. Section 860G(a)(1)(B)(i). See IRS Notice 87-41, 1987-1 C.B. 500; and IRS Notice 87 67, 1987-2 C.B. 377, regarding variable rates. Interest payments may also be based on a specified portion of the interest payments on qualified mortgages, as long as such portion does not vary during the period the regular interest is outstanding. Section 860G(a)(1)(B)(ii).
  - c. The REMIC must issue only one class of residual interest, and that class must receive distributions on a pro rata basis. Section 860D(a)(3).
  - d. Residual interests
    - (1) Residual interests are interests other than regular interests, that are designated as residual interests. Section 860G(a)(2).
    - (2) Residual interests, regardless of form, are treated as equity interests in the REMIC. Section 860C.
    - (3) For example, assume the REMIC owns mortgages paying 12 percent and regular interest holders receive 11 percent. The residual interest holders may receive the 1 percent excess interest, plus other gains, less losses.
  - e. The REMIC must make reasonable arrangements to ensure that its residual interests are not held by certain disqualified organizations. Section 860D(a)(6). Treas. Reg. § 1.860D-I (b)(5).
5. Asset requirements
- a. At the close of the 3rd month after the startup day, and at all times thereafter, “substantially all” of the REMIC’s assets must consist of “qualified mortgages” and “permitted investments.” Section 860D(a)(4).
  - b. “Qualified mortgages” are defined as (section 860G(a)(3)):
    - (1) An obligation secured by an interest in real property that is (i) transferred to the REMIC on the startup day in exchange for interests in the REMIC, (ii) purchased by the REMIC within 3 months of the startup day, if such purchase is

pursuant to a fixed-price contract in effect on the startup day, or (iii) represents an increase in the principal amount of an obligation described in (i) or (ii) if such increase is attributable to an advance made to the obligor pursuant to the original terms of the obligation, occurs after the startup day, and is purchased by the REMIC pursuant to a fixed price contract in effect on the startup day.

- (2) A “qualified replacement mortgage” received (i) within 3 months of the startup day, or (ii) to replace a defective mortgage, within 2 years of the startup day.
- (3) A regular interest in another REMIC received on or before the startup day.
- (4) On or after September 1, 1997, a regular interest in a FASIT that is (i) transferred to the REMIC on the startup day in exchange for interests in the REMIC, or (ii) purchased by the REMIC within 3 months of the startup day, but only if 95 percent or more of the assets of such FASIT are attributable to obligations which are principally secured by interests in real property.
- (5) Section 835 of the 2004 Jobs Act expands the definition of “qualified mortgage.”
  - (a) Section 835(b)(5)(B) of the 2004 Jobs Act provides that, beginning January 1, 2005, reverse mortgage loans and certain increases in balances on reverse mortgage loans, are treated as obligations secured by an interest in real property.
  - (b) Section 835(b)(7) of the 2004 Jobs Act provides that, beginning January 1, 2005, if more than 50% of the obligations transferred to or purchased by a REMIC are U.S. or state obligations principally secured by interests in real property, then each obligation transferred to or purchased by the REMIC shall be treated as secured by an interest in real property.
- (6) Modifications to loans
  - (a) Rev. Proc. 2009-23 provides that the IRS will not challenge the tax status of a REMIC if modifications to certain mortgage loans are made pursuant to the Home Affordable Modification Program (also known as “HAMP”).

- (b) Final regulations issued in September 2009 (T.C. 9463) permit certain types of modifications to commercial mortgage loans without jeopardizing REMIC qualification. The regulations provide that the following modifications are permitted so long as the mortgage continues to be principally secured by real property:
  - i) A release of a lien on real property (Treas. Reg. § 1.860G-2(a)(8)),
  - ii) Waiver of a due-on-sale clause or a due-on-encumbrance clause (Treas. Reg. § 1.860G-2(b)(3)(iii)),
  - iii) Conversion of an interest rate by a mortgagor pursuant to the terms of a convertible mortgage (Treas. Reg. § 1.860G-2(b)(3)(iv)),
  - iv) A modification that releases, substitutes, adds, or otherwise alters a substantial amount of the collateral for, a guarantee on, or other form of credit enhancement for, a recourse or nonrecourse obligation (Treas. Reg. § 1.860G-2(b)(3)(v)), and
  - v) Changes in the nature of an obligation from nonrecourse to recourse (Treas. Reg. § 1.860G-2(b)(3)(vi)).
- (c) Due to the financial issues affecting the banking system in 2009, the IRS issued Rev. Proc. 2009-45. The revenue procedure provides that the IRS will not challenge the qualification of a REMIC on grounds that the modifications made to its commercial mortgage loans aren't among those listed in Treas. Reg. § 1.860G-2(b)(3) as long as (1) the pre-modification loan meets certain requirements, (2) payments on loans were overdue by at least 30 days, and (3) based on all the facts and circumstances, holder or servicer reasonably believes there is significant risk of default on maturity or at an earlier date. Rev. Proc. 2009-45.

c. "Permitted investments" are defined as (section 860G(a)(5)):

- (1) Temporary “cash flow investments,” from which the REMIC earns interest.
- (2) “Qualified reserve assets,” which are intangible assets held to enable payments in the event of mortgage defaults.
- (3) “Foreclosure property,” within the section 856(e) definition.

6. Transfers of property to the REMIC

- a. On a transfer of property to the REMIC, in exchange for an interest, no gain or loss is recognized by the transferor. Section 860F(b)(1)(A). Treas. Reg. § 1.860F-2.
- b. The transferors basis of the interest received in exchange for the transferred property is the basis of the property transferred. Section 860F(b)(1)(B).
- c. If a regular interest is received, any nonrecognized gain is taxed under the (market discount) rules of section 1276; any nonrecognized loss is amortized under the (premium amortization) rules of section 171.
- d. If a residual interest is received, any nonrecognized gain or loss is ratably recognized.
- e. The basis of property received by the REMIC is its fair market value. Section 860F(b)(2).
- f. The holder of the REMIC interests will recognize gain or loss on the sale of those interests.

7. Taxes are imposed with respect to residual interests held by disqualified organizations.

- a. A tax is imposed on the transfer of residual interests to certain non-taxable disqualified organizations. Section 860E(e)(1). Treas. Reg. § 1.860E-2.
- b. Similarly, a tax is imposed on certain pass-through entities in which disqualified organizations hold interests. Section 860E(e)(6).

8. Taxation of REMICs

- a. REMICs, in general, are not taxable entities. Like partnerships, they pass through all of their income. Section 860A(a).

- b. However, in order that the REMIC's income can be taxed to holders of interests in the REMIC (see below), the REMIC's taxable income must be determined. Treas. Reg. § 1.860C-2.
- c. REMICs are subject to a 100 percent tax on net income from prohibited transactions. Section 860F(a).
  - (1) Prohibited transactions include most dispositions of qualified mortgages, receipt of income from nonpermitted assets, receipt of compensation for services, and dispositions of cash flow investments other than pursuant to liquidation. "Cash flow investments" are investments of amounts received under qualified mortgages made for a temporary period before distribution to the owners of the REMIC. Section 860G(a)(6).
  - (2) This tax is designed to ensure that REMICs are passive entities.
- d. REMICs also are subject to tax on net income from foreclosure property. Section 860G(c).
- e. In addition, REMIC's are subject to a 100 percent tax on certain contributions made after the startup day. Section 860G(d). Exceptions are provided for certain cash contributions.

9. Taxation of regular interest holders

- a. Holders of regular interests are taxed as if they held a debt instrument. Section 860B.
- b. Income on the interest must be determined on the accrual basis. Income may include qualified stated interest ("QSI") as well as original issue discount ("OID"). The IRS has proposed regulations prescribing rules relating to the accrual of OID on REMIC regular interests. Notice of Proposed Rulemaking, 2004 Fed (CCH) ¶49,610 (Aug. 25, 2004).
- c. Upon disposition of a regular interest, gain constitutes ordinary income to the extent of a portion of unaccrued OID.

10. Taxation of residual interest holders

- a. Holders of residual interests are taxed, currently, on their share of all of the taxable income of the REMIC not taken into account by regular interest holders. Section 860C. Amounts are taxed as ordinary income or loss. Section 860C(e)(1).

- b. Income taxed to a residual interest holder increases his basis in the interest. REMIC losses decrease basis. Section 860C(d).
- c. Section 860E(a) provides rules for “excess inclusions,” under which a portion of the residual income of most residual interest holders cannot be offset by business deductions or NOLs of the holder. Treas. Reg. § 1.860E-1.
- d. Distributions by a REMIC are income to the holder only if they exceed the holder’s basis in the residual interest. Distributions reduce the holder’s basis in the residual interest. Distributions in excess of such basis are treated as gain from the sale of the interest. Section 860C(c).
- e. Losses are allowable only to the extent of a holder’s basis in his residual interest. Disallowed losses carry forward indefinitely. Section 860C(e)(2).
- f. Certain residual interests are called non-economic residual interests (“NERIs”). These interests are defined in Treas. Reg. § 1.860E-1(c)(2).
  - (1) NERIs generally have a negative value when acquired and, thus, NERI buyers generally receive inducement fees to purchase such interests. The IRS requires that, in order to clearly reflect income, the holder of a NERI interest in a REMIC is required to include the inducement fee in income over a period “reasonably related” to the period during which the applicable REMIC is expected to generate taxable income or net loss allocable to the holder of the NERI. Beginning May 11, 2004, two safe harbor methods of accounting for these fees are available: the “book method” and the “modified REMIC regulatory method.” Treas. Reg. § 1.4466(e). A taxpayer may adopt either of these safe harbor methods under the automatic consent procedures for changing methods of accounting, as modified by Rev. Proc. 2004-30, 2004-21 I.R.B. 950.
  - (2) The IRS has identified certain sales of NERI interests as aggressive tax shelters. See IRS News Release 2004-97, 2004 I.R.B. LEXIS 324 (July 26, 2004).