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Chapman Client Alert

April 16, 2020 Current Issues Relevant to Our Clients

Impact on REMICs and Investment Trusts of COVID-19 Forbearances on Certain Mortgage Loans

Background. The Coronavirus Aid, Relief, and Economic Security Act (the “CARES Act”), which was enacted to support individuals and businesses affected by the COVID-19 pandemic and was signed into law on March 27, 2020, provides, among other things, that borrowers with federally backed mortgage loans experiencing a financial hardship due, directly or indirectly, to the national emergency declared by the President on March 13, 2020 (the “COVID-19 emergency”), may request and obtain forbearance on their loans. The CARES Act requires lenders to acquiesce to a borrower’s forbearance request within the requisite covered period with respect to certain federally backed 1-4 family mortgage loans—(“federally backed 1-4 family mortgage loans” and “federally backed multifamily mortgage loans”).[1] The modifications of such loans pursuant to the CARES Act could adversely affect the tax status and tax treatment of, among others, REMICs, fixed investment (or “grantor”) trusts, and entities seeking to avoid being characterized as taxable mortgage pools. Such potentially adverse impacts could chill the very offers of forbearances that the CARES Act was endeavoring to encourage.

Overview of Guidance. On April 13, 2020 the Internal Revenue Service (the “IRS”) released Revenue Procedure 2020-26, which provides that forbearances and related modifications of certain mortgage loans will not be treated as replacing the unmodified loan with a newly issued loan for purposes of the REMIC and grantor trust qualification tests (and related REMIC-related taxes). The guidance applies to three categories of mortgage loans—federally backed 1-4 family mortgage loans, federally backed multifamily mortgage loans (generally loans securing property designed for 5 or more families), and mortgage loans offered forbearance either voluntarily or through a State-mandated loan forbearance program. The Revenue Procedure does not address the status of entities as taxable mortgage pools or modifications of loans other than mortgages.

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Types of Loans Covered by Guidance

Revenue Procedure 2020-26 addresses the modifications of three types of mortgage loans, each discussed below. The first two categories of mortgage loans, federally backed 1-4 family mortgage loans, and federally backed multifamily mortgage loans are referred to herein as “CARES Act mortgage loans.”

Federally Backed 1-4 family Mortgage Loans. *Federally backed* 1-4 family mortgage loans are loans secured by a first or subordinate lien on residential real property designed principally for the occupancy of 1-to 4 families (including individual units of condominiums and cooperatives) and that are issued, insured or guaranteed by any of a plethora of select federal entities, including the FHA, the National Housing Act, the Housing and Community Development Act, the Department of Veteran Affairs, the Department of Agriculture, as well as mortgage loans purchased or securitized by the FHLMC or the FNMA.

The only requirement for a borrower to receive forbearance during the covered period on such loans is to affirm that it is experiencing a financial hardship during the COVID–19 emergency. The forbearance for federally backed 1-4 family mortgage loans shall be for up to 180 days, which generally may be unilaterally extended for an additional 180 days at the request of the borrower. During the period of forbearance of federally backed 1-4 family mortgage loans, no fees, penalties, or interest related to the forbearance shall accrue on the borrower’s account.

Federally Backed Multifamily Mortgage Loans. The second type of mortgage loan covered under the CARES Act forbearance rules are federally backed multifamily mortgage loans, which generally include a residential mortgage loan (other than temporary financing such as a construction loan) that is secured by a first or subordinate lien on residential multifamily real property designed principally for the occupancy of 5 or more families and that is made, insured or guaranteed

by any agency of the federal government or in connection with housing or urban development programs administered by the Secretary of Housing and Urban Development, as well as mortgage loans purchased or securitized by the FHLMC or the FNMA.

The only requirement for a borrower to receive forbearance during the covered period on such loans is to affirm that it is experiencing a financial hardship during the COVID–19 emergency. However, the forbearance rules for federally backed multifamily mortgage loans only apply if the borrower was current on payments as of February 1, 2020.[2] Any forbearance shall be up to 30 days, but subject to certain conditions may be extended for up to 2 additional 30-day periods. Unlike with respect to federally backed 1-4 family mortgage loans discussed above, lenders do not appear to be precluded from charging additional fees, interest, or penalties with respect to such forbearance.

Voluntary and State-sponsored Mortgage Loans. Recognizing that many mortgage loans, including commercial (non-residential) mortgage loans, will not be subsumed under either of the above two categories, Revenue Procedure 2020-26 extends its guidance to cover mortgage loans providing forbearance through voluntary or State-mandated forbearance programs (the "non-CARES Act mortgage loans") to borrowers experiencing a financial hardship directly or indirectly due to the Covid-19 emergency.[3]

Issues with REMICs

A REMIC (real estate mortgage investment conduit) is the name given in the Internal Revenue Code (the "Code") to an issuer of mortgage-backed securities that elects to take advantage of a special tax regime for securitizations of fixed pools of real property mortgages. In very general terms, a REMIC is taxed as a partnership and all interests (called regular interests) issued by a REMIC (other than a single class of a residual interest that may or may not have any economic significance) are treated as debt for all purposes of the Code, even if under general tax principles such interests otherwise would be treated as equity in the issuer. However, in order to be treated as a REMIC, and obtain such favorable tax treatment, the issuer has to satisfy certain rules.[4]

Qualified Mortgages. An entity qualifies as a REMIC only if, among other things, substantially all of its assets consist of qualified mortgages and permitted investments at all times during its existence (except during an initial and final period). With limited exceptions, a mortgage loan is not a qualified mortgage unless it is transferred to the REMIC on the day (the "startup day") it issues all of its interests (or within three months thereof if sold pursuant to a fixed price contract in existence on the startup day).

A mortgage loan is also not a qualified mortgage unless the loan is principally secured by real property. A loan is principally secured by real property only if its security is adequate (as determined under the REMIC rules) as of the date the loan was originated or at the time the sponsor contributes the loan to the REMIC.

In the event that a loan is modified (via forbearance or otherwise) and such modification is considered significant under Treasury Regulation § 1.1001-3(e), the REMIC will be treated as disposing of the pre-modification loan for the new post-modification loan. This could cause the loan to fail to qualify as a qualified mortgage either because the newly issued loan no longer satisfies the principally secured test as of the date of modification (its new issuance date) or because the loan was not transferred to the REMIC on the REMIC's startup day and does not qualify for an exception to such requirement. (Under Treasury Regulation § 1.860G-2(b)(1), certain loan modifications are not treated as reissuances for REMIC purposes, even if treated as reissuances under Treasury Regulation § 1.1001-3(e).) The failure of a mortgage loan to qualify as a qualified mortgage could cause the securitization vehicle to fail to qualify as a REMIC because it could prevent the REMIC from having substantially all of its assets qualify as permitted assets.

Prohibited Transactions. Section 860F(a)(1) of the Code imposes a tax on a REMIC equal to 100% of the net income derived from prohibited transactions. The disposition of a qualified mortgage generally (absent certain exceptions) would qualify as a prohibited transaction and would include, with limited exceptions, a deemed disposition under Treasury Regulation § 1.1001-3(e). A prohibited transaction would also include the income from acquired real estate ("REO") that did not qualify as foreclosure property (described below).

Reissuance of Regular Interests. As indicated above, a REMIC can only have two types of interests, regular interests and a residual interest. All regular interests are required to be issued on the startup day. A regular interest must have fixed terms and must (i) unconditionally entitle the holder to receive a specified principal amount (or other similar amount) and (ii) provide that interest payments, if any, are based on a fixed rate or variable rate.

In the event that a qualified mortgage is exchanged for a modified loan pursuant to the forbearance, the payments and return on some or all of the regular interests may be affected. Arguably, this could cause the terms of the regular interests to

change, thereby effecting a reissuance of the regular interests under Treasury Regulation § 1.1001-3. If a regular interest was deemed to be reissued, the entity would fail to qualify as a REMIC if such interest was no longer treated as issued on the REMIC's startup day. If the regular interest was not deemed to be reissued, but the terms of the regular interest were deemed to have changed, the regular interest may no longer be treated as having been issued with fixed terms. In either case, the securitization vehicle could fail to qualify as a REMIC.

Foreclosure Property. A REMIC is permitted to invest in cash flow investments, certain reserve assets, and foreclosure property. In very general terms, foreclosure property is property that would qualify as foreclosure property if acquired by a REIT and which is acquired in connection with the default or imminent default of a qualified mortgage held by the REMIC. However, a REMIC cannot treat property as foreclosure property if the loan with respect to which the default occurs (or was imminent) was acquired by the REMIC with an intent to evict or foreclose, or when the REMIC knew or had reason to know that the default would occur (the *improper knowledge test*). Accordingly, if the REMIC purchases a loan that has previously been issued forbearance, the REMIC could fail the improper knowledge test if it subsequently were to foreclose on the real property securing the loan. In that event, the securitization vehicle could fail to qualify as a REMIC if substantially all of its assets did not qualify as permitted assets. In addition, even if the REMIC continued to qualify as such, all the income from the real property would be subject to the 100% prohibited transaction tax (discussed above) if such REO failed to qualify as foreclosure property.

Contingent Principal Amount. A regular interest in a REMIC will fail to qualify as such if its principal amount is contingent. However, certain contingencies affecting the payment of principal, including defaults on qualified mortgages and unanticipated expenses incurred by the REMIC, do not prevent the regular interest from being a regular interest. If the delays and shortfalls in payments (or excess fees related to the servicing) associated with or caused by forbearances of loans caused the principal amount of a regular interest to be contingent, the regular interest could fail to qualify as such and the securitization vehicle would fail to qualify as a REMIC.

Issues with Investment Trusts

Any securitization vehicle classified as a trust will be taxed as a grantor trust, meaning that for substantive tax purposes it will be essentially ignored and treated as a co-ownership arrangement among its beneficiaries. A trust that is sufficiently passive to qualify as an investment trust may nonetheless be considered to have a business objective because its investments are not fixed. Specifically, Treasury Regulation § 301.7701-4(c)(1) states that an investment trust will not be classified as a trust "if there is a power under the trust agreement to vary the investment of the certificate holders." This language has been interpreted to preclude any power to reinvest trust assets that may be used to take advantage of market variations to improve the investment of certificate holders. On the other hand, a discretionary power to sell trust assets is allowed if the proceeds of such a sale are not permitted to be reinvested.

If a trust is allowed to permit forbearance of a loan (and the loan is treated as being reissued), it could be deemed to possess the proscribed impermissible power to vary. This would cause the trust to fail to qualify as a grantor trust.

However, actions taken (or permitted to be taken) to preserve the value of a trust's original investment generally will not constitute an impermissible power to vary. For example, the IRS has ruled that a trust can accept an offer by a debtor to exchange old debt for new debt of the debtor (or more generally, to modify the terms of outstanding debt) where the debtor is in default or default will probably occur in the foreseeable future. The IRS also has ruled that a trustee may consent to changes in the credit support for a bond if necessary to preserve the credit rating of the bond, but that a trustee holding leased real property subject to debt cannot renegotiate the terms of the lease or debt absent a lessee default.

In addition, the IRS has ruled that investments changed according to its terms without the exercise of any discretionary rights by a trust should not constitute an impermissible power to vary. Thus, even absent guidance issued under this Revenue Procedure, the granting of forbearance and related modifications should not affect the status of a grantor trust if the modifications are either required under the law or being made to protect the interest of the certificate holders.[5]

Scope of Guidance

Forbearance Offered by REMICs and Investment Trusts. The Revenue Procedure applies to mortgage loans (i) that are subject to forbearance while held by a REMIC or investment trust and (ii) acquired by REMICs on or after March 27, 2020 that were subject to forbearance prior to acquisition by the REMIC.

Specifically, the Revenue Procedure applies to forbearance offered by REMICs and investment trusts to (i) the CARES Act mortgage loans (which, as indicated in endnote 1, requires forbearance to be made during the covered period) and (ii) the

non-CARES Act mortgage loans for which the borrower either requested or agreed to the forbearance (and all related modifications) between March 27, 2020 and December 31, 2020, inclusive.[6]

Acquisition by REMICs of Forbearance Loans. The Revenue Procedure also applies to the direct or indirect acquisition by a REMIC on or after March 27, 2020 of any (i) CARES Act mortgage loan and (ii) non-CARES Act mortgage loan for which between March 27, 2020 and December 31, 2020, inclusive, the borrower requested or agreed to a forbearance (such loans in (i) and (ii), "Acquisition Forbearance Loans").

Application

Mortgage Loans Held by REMICs. For mortgage loans held by REMICs, forbearances (and all related modifications)[7] agreed to by the REMIC of (i) CARES Act mortgage loans and (ii) non-CARES Act mortgage loans for which the borrower requests or agrees to the forbearance (and all related modifications) between March 27, 2020 and December 31, 2020, inclusive:

a) Are not treated as resulting in a newly issued mortgage loan for purposes of Treasury Regulation § 1.860G-2(b)(1). Thus, the modified obligation does not have to be retested to determine if it is a qualified mortgage and the modification will not be treated as a disposition of the pre-modified obligation subject to the prohibited transaction tax;

b) Will not be subject to the prohibited transaction tax;[8]

c) Will not result in a deemed reissuance of the REMIC regular interests. Thus, the modified obligation will not result in the REMIC failing to qualify as a REMIC due to the regular interests being issued other than on the startup day; and

d) Will not cause the regular interest to fail to qualify as a regular interest as a result of contingencies caused by delays and shortfalls in payments associated with or caused by such forbearances (and any related modifications).

Mortgage Loans Acquired by REMICs. If a REMIC acquires an Acquisition Forbearance Loan, the related prior forbearance (and all related modifications):

(a) Will not cause the REMIC to fail the improper knowledge test. Thus, any foreclosure property derived from such loan will qualify as foreclosure property under the REMIC rules; and

(b) Will not be taken into account in determining when the reference loan was originated. Thus, the determination of whether the loan is principally secured by real property will be made when the loan was originally originated and will not have to be retested as of the date of such prior modification.

Mortgage Loans Held by Investment Trusts. For mortgage loans held by an investment trust, forbearances (and all related modifications) of (i) CARES Act mortgage loans and (ii) non-CARES Act mortgage loans for which the borrower requests or agrees to the forbearance (and all related modifications) between March 27, 2020 and December 31, 2020, inclusive:

will not manifest a power to vary the investment of the certificate holders.

Guidance Not Offered

Although the Revenue Procedure insulated REMICs and grantor trusts from adverse tax consequences resulting from the forbearance of mortgage loans, it failed to address:

a) The forbearance of non-mortgage loans (i.e., loans not principally secured by real property);

b) Any forbearance of mortgage loans that occurred prior to the enactment of the CARES Act on March 27, 2020;

c) The treatment of mortgage loans that were not current prior to the execution of the forbearance (or, with respect to federally backed multifamily mortgage loans, that were not current prior to February 1, 2020);

d) The forbearance of loans after December 31, 2020; and

e) The impact of forbearances on classification of entities as taxable mortgage pools.[9]

The failure to cover these topics is not particularly troubling, and likely is on account of the speed at which the IRS provided the guidance; it is unlikely that any omission was on account of any discomfort with any particular issue. It is noteworthy that the Revenue Procedure provides not only a typical disclaimer:

> No inference should be drawn about whether similar consequences would obtain if a transaction falls outside the limited scope of this revenue procedure,

but also includes the much less typical:

> Furthermore, there should be no inference that, in the absence of this revenue procedure, transactions within its scope would have impaired the Federal tax status of securitization vehicles, would have given rise to prohibited transactions, or would have involved improper knowledge.

For More Information

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1 The covered period is between March 27, 2020 and the earlier of (x) December 31, 2020 and (y) the termination of the COVID-19 emergency. Technically, the CARES Act doesn't define covered period with respect to federally backed 1-4 family mortgage loans, but we suspect this is an oversight.

2 It is unclear why the tax relief for federally backed multifamily mortgage loans is only available if the borrower was current as of February 1, 2020, while the tax relief for the federally backed 1-4 family mortgage loans and non-CARES Act loans (discussed below in text) impose no such requirement.

3 As indicated in endnote 1, above, the CARES Act mandates forbearances for CARES Act mortgage loans on or after March 27, 2020 and prior to the earlier of December 31, 2020 and the termination of the COVID-19 emergency. In contrast, the Revenue Procedure covers non-CARES Act mortgage loans for which the borrower either requested or agreed to the forbearance between March 27, 2020 and December 31, 2020, inclusive. In the event the President terminates the COVID-19 emergency, the non-CARES Act mortgage loans will still be governed by the Revenue Procedure provided that the borrower is experiencing a financial hardship directly or indirectly due to the COVID-19 emergency (which will no longer exist). Although unclear, even after the termination of the COVID-19 emergency, a borrower's financial hardship could still be indirectly related to it. Accordingly, it is possible that the non-CARES Act mortgage loans will be subject to the Revenue Procedure when the CARES Act mortgage loans (which were likely the impetus for the Revenue Procedure in the first place) are no longer eligible for forbearance.

4 For a description of the requirements for qualification as a REMIC, see Peaslee & Nirenberg, FEDERAL INCOME TAXATION OF SECURITIZATION TRANSACTIONS AND RELATED TOPICS (2018), chapter 6, part B.

5 The limitations on an investment trust's power to vary its investments, including in connection with modification of loans, is discussed in Peaslee & Nirenberg, supra note 4, chapter 4, part D.4.

6 As indicated in endnote 3, above, it is unclear whether a non-CARES Act mortgage loan would be covered by this guidance if it was subject to forbearance after the end of the COVID-19 emergency but prior to December 31, 2020.

7 Wherever the Revenue Procedure permits related modifications to forbearance, it is likely that any modifications of the type typically made in the market and made in conjunction with the forbearance would qualify as a related modification. However, we note that the Revenue Procedure describes examples of related modifications with fairly narrow examples – e.g., "[f]or example, loan payments deferred as result of the forbearance may be added to the principal amount of the loan to be paid by the borrower after what would

otherwise be the final payment on the loan. Other programs contemplate that, at the end of the forbearance period, an amortizing loan will be reamortized to preserve the original maturity date." Thus, caution should be exercised in treating other atypical modifications as "related" solely on account of being made contemporaneously with permitted forbearances.

8 The Revenue Procedure provides this holding although the prior holding makes this holding redundant.

9 In order to force issuers of mortgage-backed securities to elect to be taxable as a REMIC, a non-REMIC entity that issues multiple classes of debt will be a taxable mortgage pool (a "TMP"), which generally has unfavorable consequences, if it meets certain tests, one of which is that substantially all of its assets are debt obligations (or interests therein) and more than 50 percent of those obligations (or interests) are real estate mortgages (the asset test). However, for these purposes, real estate mortgages that are seriously impaired are excluded from the definition of debt obligation and real estate mortgage. Thus, treating a mortgage loan as seriously impaired is helpful in avoiding TMP status. Forbearance thus raises, among others, the issue of whether a mortgage loan that would be in default but is not on account of a forbearance is nonetheless "seriously impaired." If not, the loan may not be a suitable investment for a non-REMIC entity that invests in distressed debt and seeks to avoid TMP status, notwithstanding that the mortgage loan may be distressed and seriously impaired in a business sense.

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