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

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Craig M. Cohen, Steven L Kopp, and David Z. Nirenberg explore the potential tax issues that could arise from mortgage loan forbearances in the context of REMIC and grantor trust securitizations.

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Background

The Coronavirus Aid, Relief, and Economic Security Act (the "CARES Act"),[1] which was enacted to support individuals and businesses affected by the COVID-19 pandemic and signed into law on March 27, 2020, provides that borrowers experiencing financial hardship due to the national emergency declared by the President on March 13, 2020 (the "COVID-19 emergency") may request and obtain forbearance on certain federally backed mortgage loans.[2] The CARES Act applies to both single-family (one to four units) and multifamily (five or more units) federally backed mortgage loans ("federally backed single-family mortgage loans" and "federally backed multifamily mortgage loans," respectively), and requires lenders to acquiesce to any such forbearance requests made within the requisite covered period.[3] Forbearances and related modifications pursuant to the CARES Act could adversely affect the tax status and tax treatment of certain special purpose entities that hold federally backed mortgage loans, including REMICs (real estate mortgage investment conduits), fixed investment (or "grantor") trusts, and entities seeking to avoid characterization as taxable mortgage pools. These potentially adverse effects could obviate some of the very economic benefits the CARES Act was seeking to encourage.

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Overview of Guidance

On April 13, 2020, the Internal Revenue Service (the "IRS") released Rev. Proc. 2020-26 (the "Revenue Procedure"),[4] which generally provides that forbearances

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and related modifications of mortgage loans between March 27, 2020, and December 31, 2020, inclusive, will not be treated as a replacement of the unmodified loan with a newly issued loan for purposes of REMIC qualification, grantor trust qualification, and the REMIC prohibited transactions tax. The Revenue Procedure does not address the taxable mortgage pool rules or modifications of loans other than mortgage loans.

Mortgage Loan Forbearances Covered by Guidance

The Revenue Procedure addresses forbearances of three types of mortgage loans, each of which must meet the relevant requirements discussed below in order to qualify for relief: federally backed single-family mortgage loans granted forbearance pursuant to the CARES Act, federally backed multifamily mortgage loans granted forbearance pursuant to the CARES Act (together, the "CARES Act mortgage loans"), and mortgage loans offered forbearance after March 26, 2020, and before January 1, 2021, either voluntarily or through a State-mandated loan forbearance program (the "non-CARES Act mortgage loans").[5]

Federally Backed Single-Family Mortgage Loans

Under the CARES Act, federally backed single-family mortgage loans are loans that are secured by residential real property designed principally for the occupancy of one to four families, and that are issued, insured or guaranteed by any of a plethora of select federal entities. Specifically, the term "federally backed mortgage loan" includes any loan which is secured by a first or subordinate lien on residential real property (including individual units of condominiums and cooperatives) designed principally for the occupancy of from one to four families that is: (A) insured by the Federal Housing Administration under title II of the National Housing Act (12 USC 1707 *et seq.*); (B) insured under section 255 of the National Housing Act (12 USC 1715z–20); (C) guaranteed under section 184 or 184A of the Housing and Community Development Act of 1992 (12 USC 1715z–13a, 1715z–4 13b); (D) guaranteed or insured by the Department of Veterans Affairs; (E) guaranteed or insured by the Department of Agriculture; (F) made by the Department of Agriculture; or (G) purchased or securitized by the Federal Home Loan Mortgage Corporation or the Federal National Mortgage Association.[6]

The only requirement for a borrower to receive forbearance during the covered period for such loans is to affirm to the borrower's servicer that it is experiencing a financial hardship caused by the COVID19 emergency.[7] The forbearance period for federally backed single-family mortgage loans extends for up to 180 days, which generally may be unilaterally extended for an additional 180 days at the request of the borrower.[8] During the period of forbearance of federally backed single-family mortgage loans, no fees, penalties, or interest will accrue on the loan, other than amounts scheduled or calculated under the relevant loan documents as if the borrower had made all of the payments required thereunder.[9]

Federally Backed Multifamily Mortgage Loans

The second type of mortgage loan covered under the CARES Act forbearance rules is federally backed multifamily mortgage loans, which includes any loan (other than temporary financing such as construction loans) that (A) is secured by a first or subordinate lien on residential multifamily real property designed principally for the occupancy of five or more families, including any such secured loan, the proceeds of which are used to prepay or pay off an existing loan secured by the same property; and (B) is made in whole or in part, or insured, guaranteed, supplemented, or assisted in any way, by any officer or agency of the Federal Government or under or in connection with a housing or urban development program administered by the Secretary of Housing and Urban Development or a housing or related program administered by any other such officer or agency, or is purchased or securitized by the Federal Home Loan Mortgage Corporation or the Federal National Mortgage Association.[10] Unlike federally backed single-family mortgage loans, however, a federally backed multifamily mortgage loan will only qualify for forbearance under the CARES Act if the borrower was current on payments as of February 1, 2020.[11]

The only requirement for a borrower to receive forbearance during the covered period on a federally backed multifamily mortgage loan is to provide the borrower's servicer with written or oral affirmation that it is experiencing a financial hardship during the COVID-19 emergency.[12] Unlike federally backed single-family mortgage loans, for which the forbearance period can extend for up to 360 days, the forbearance period for a federally backed multifamily mortgage loan is up to 30 days and only may be extended for up to two additional 30-day periods.[13]

A borrower under a federally backed multifamily mortgage loan that receives a forbearance under the CARES Act may not, for the duration of the forbearance, (i) evict

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or initiate the eviction of an applicable tenant solely for nonpayment of rent or other fees or charges or (ii) charge any late fees, penalties, or other charges to an applicable tenant for late payment of rent.[14] In addition, a borrower may not issue a notice to a tenant to vacate a dwelling unit located in the applicable property for the duration of the forbearance period, and a borrower cannot require a tenant to vacate the applicable premises until 30 days after the date on which proper notice is provided.[15]

On April 27, 2020, the Federal Housing Finance Agency ("FHFA") clarified that borrowers in forbearance with a Fannie Mae or Freddie Mac backed mortgage are not required to repay the missed payments in one lump sum at the end of a forbearance.[16] There are a variety of repayment options. If the hardship has not been resolved, the forbearance plan can be extended. If the hardship has been resolved, the servicer may, among other things, set up a repayment plan including one where the payments subject to forbearance are added to the end of the mortgage. While the FHFA statement only covers Fannie Mae and Freddie Mac mortgages, it encourages all mortgage lenders to adopt a similar approach.

Other Mortgage Loans

Recognizing that many mortgage loans, including commercial mortgage loans, will not be subsumed under either of the above two categories of federally backed mortgage loans,[17] the Revenue Procedure extends its guidance to forbearances of mortgage loans other than CARES Act mortgage loans, granted either voluntarily or pursuant to State-mandated forbearance programs for borrowers experiencing financial hardship due directly or indirectly to the COVID19 emergency.[18]

REMIC Guidance

The Revenue Procedure guidance described below applies to (i) forbearances (and all related modifications)[19] of CARES Act mortgage loans and non-CARES Act mortgage loans held by a REMIC[20] and (ii) the direct or indirect acquisition after March 26, 2020, of CARES Act mortgage loans and non-CARES Act mortgage loans by a REMIC.[21]

General

A REMIC is an issuer of mortgage-backed securities that elects to take advantage of a special tax regime under the Internal Revenue Code of 1986 (the "Code") for securitizations of fixed pools of real property mortgages.[22] In very general terms, a REMIC is not subject to entity-level taxation and, aside from a single class of interests (the "residual interest") that may or may not have any economic significance, all other interests issued by a REMIC ("regular interests") are treated as debt, even if under general tax principles such interests otherwise would be treated as equity in the REMIC.[23] However, in order to be treated as a REMIC and obtain such favorable tax treatment, the issuer has to satisfy certain organizational and operational rules.[24]

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"[25] at all times during its existence, except during an initial and final period (the "substantially-all test").[26] In order to be classified as a qualified mortgage, a loan generally must be principally secured by real property (including stock in a cooperative) at the time of the loan's origination (the "the principally-secured test").[27] Further, the loan must be acquired by the REMIC either (i) on the day it issues all of its interests (the "startup day"),[28] or (ii) within the three-month period beginning on the startup day, if the loan is either (A) purchased pursuant to a fixed price contract in existence on the startup day or (B) acquired in exchange for an existing qualified mortgage held by the REMIC.[29] In the event that a loan is "significantly modified" (via forbearance or otherwise), the REMIC will be treated as disposing of the pre-modification loan in exchange for the new post-modification loan.[30] This characterization could cause the loan to fail to qualify as a qualified mortgage, either because the post-modification loan does not satisfy the principally-secured test as of the date of the modification—which is when the "new" loan is deemed to have been originated—or because the "new" loan was not acquired by the REMIC on or within three months of the startup day. If a mortgage loan ceases to be treated as a qualified mortgage, the entity could fail to qualify as a REMIC if the substantially-all test is no longer met.

> ***Revenue Procedure*:** (i) The forbearance (and all related modifications) of a CARES Act mortgage loan or a non-CARES Act mortgage loan held by a REMIC will not be treated as a deemed reissuance and acquisition of such loan by the REMIC under Reg. §1.860G-2(b)(1) for purposes of determining whether such loan is a qualified mortgage principally secured by an interest in real property[31] and (ii) any CARES Act mortgage loan or a non-CARES Act mortgage loan acquired by the REMIC will not need to be retested under the principally-secured test as a result of any such forbearance-related modifications.[32]

Prohibited Transactions

The Code imposes a tax equal to 100% of the REMIC's net income derived from "prohibited transactions."[33] The term prohibited transaction includes any disposition (other than pursuant to a clean-up call or a qualified liquidation) of a qualified mortgage by the REMIC, other than by reason of a foreclosure or default of the mortgage.[34] The deemed exchange resulting from the significant modification of a loan could be treated as the disposition of a qualified mortgage and, therefore, a prohibited transaction.[35]

> ***Revenue Procedure*:** The forbearance (and all related modifications) of a CARES Act mortgage loan or a non-CARES Act mortgage loan held by a REMIC will not be treated as a prohibited transaction under Code Sec. 860F(a)(2).[36]

Foreclosure Property and the Improper-Knowledge Test

As described above, substantially all of the REMIC's assets must consist of qualified mortgages and permitted investments at all times, except during an initial and final period.[37] Permitted investments include certain investments in real property ("foreclosure property") acquired by the REMIC as the result of a foreclosure upon a qualified mortgage. In very general terms, foreclosure property is property that would qualify as foreclosure property if acquired by a REIT (real estate investment trust) and which is acquired in connection with the default or imminent default of a qualified mortgage held by the REMIC.[38] However, a REMIC cannot treat property as foreclosure property if the relevant mortgage loan 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").[39] Accordingly, if a REMIC purchases a loan that has previously been issued forbearance and subsequently forecloses on the property securing the loan, the REMIC could fail the improper-knowledge test if it were determined that the relevant forbearance constituted reason to know that a default would occur or was imminent. In that event, the relevant property would not be treated as a permitted asset, and the entity could fail to qualify as a REMIC if substantially all of its assets no longer consist of qualified mortgages and permitted investments.[40]

> ***Revenue Procedure*:** A REMIC's acquisition of a CARES Act mortgage loan or a non-CARES Act mortgage loan will not cause the REMIC to fail the improper-knowledge test under Reg. §1.856-6(b)(3) solely due to the forbearance.[41]

Reissuance of Regular Interests

As indicated above, a REMIC can only have two types of interests: regular interests and a residual interest.[42] All regular interests must be issued on the startup day.[43] In the event that a REMIC modifies one or more underlying loans pursuant to a forbearance, the payments and return on the regular interests could be affected. Arguably, a change to the payments made on a REMIC's regular interests occasioned by a forbearance of a mortgage loan that was not contemplated at the time of issue of the regular interests might be viewed as a modification of the terms of those regular interests and, thus, the reissuance of such regular interests.[44] If the regular interests were deemed to be reissued, the entity could fail to qualify as a REMIC if such interests were no longer treated as issued on the REMIC's startup day.

> ***Revenue Procedure*:** The forbearance (and all related modifications) of a CARES Act mortgage loan or a non-CARES Act mortgage loan will not result in a deemed reissuance of the REMIC regular interests.[45]

Contingent Payments

A REMIC's regular interests must (i) have fixed terms on the startup day, (ii) unconditionally entitle the holder to receive a specified principal amount (or other similar amount), and (iii) provide that interest payments (if any) are based on a fixed rate or a permitted variable rate (or consist of a specified portion of the interest payments on qualified mortgages).[46] An interest will fail to meet the requirement of an unconditional entitlement to principal if either the principal amount or the latest possible maturity date of the interest is "contingent."[47] An interest will not fail to qualify as a regular interest, however, solely because the amount or timing of payments of principal or interest (or other similar amounts) with respect to a regular interest are affected by certain permitted contingencies, including: (i) defaults on qualified mortgages and permitted investments, (ii) unanticipated expenses incurred by the REMIC, or (iii) lower than expected returns on permitted investments.[48] If forbearances of loans cause the principal amount of a regular interest to be treated as contingent (or the regular interest to fail to have fixed terms) and such contingency is not disregarded, the interest could fail

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to qualify as a regular interest and the entity could fail to qualify as a REMIC.

> ***Revenue Procedure*****:** Delays and shortfalls in payments associated with or caused by the forbearance (and all related modifications) of a CARES Act mortgage loan or a non-CARES Act mortgage loan held by a REMIC are treated as permissible contingencies under Reg. §1.860G-1(b)(3)(ii) (credit losses that are treated as permitted contingencies).[49]

Grantor Trust Guidance

The Revenue Procedure guidance described below applies to forbearances (and all related modifications)[50] of CARES Act mortgage loans and non-CARES Act mortgage loans held by a grantor trust.[51]

General

The entity classification rules distinguish between trusts and business entities.[52] An entity properly classified as trust will be treated as an investment trust if (i) its investments are fixed,[53] (ii) its beneficial owners have identical interests,[54] and (iii) the trust does not act as a device to carry on a profit-making business.[55] Investment trusts fall outside of the check-the-box regime for business entities and are subject to a separate set of tax rules applicable to grantor trusts.[56]

Power to Vary

As described above, a trust's investments must be fixed in order for the trust to be classified as an investment trust taxable as a grantor trust. A trust's investments will not be treated as fixed—and therefore the trust will be classified as a business entity—if there is a power under the trust agreement to vary (an "impermissible power to vary") the investments of the trust.[57] This requirement precludes any power to reinvest trust assets, except with respect to certain temporary investments in high-quality debt instruments that mature no later than the anticipated distribution date and are held to maturity.[58] If a trust permits forbearance of a mortgage loan and, as a result, such loan is deemed to have been retired and the proceeds reinvested in a "new" mortgage loan, this modification could be viewed as the exercise of an impermissible power to vary that would cause the trust to fail to qualify as a grantor trust.[59]

> ***Revenue Procedure*****:** Forbearances (and all related modifications) of CARES Act mortgage loans and non-CARES Act mortgage loans will not manifest an impermissible power to vary.[60]

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:

1) The forbearance of non-mortgage loans (*i.e.*, loans not principally secured by real property);
2) Any forbearance of mortgage loans that occurred prior to the enactment of the CARES Act on March 27, 2020;
3) The forbearance of loans after December 31, 2020;
4) The impact of forbearances on the classification of entities as taxable mortgage pools[61];
5) The impact of forbearances on REITs holding mortgage loans[62]; and
6) Whether the forbearance of a mortgage loan could be treated as a significant modification and, thus, a reissuance under general tax principles, which (for example) could give rise to taxable gain or loss for the holders of REMIC residual interests or the holders of the equity interests in grantor trusts.

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. The Revenue Procedure provides two disclaimers:

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

Depending on the facts, many forbearances would not be treated as reissuances under general tax principles or, if treated as reissuances, would not cause a REMIC or grantor trust to need to rely on the relief provided by the Revenue Procedure. Thus, even absent the protections of the Revenue Procedure, many forbearances would not be treated as reissuances of the mortgages. A temporary forbearance agreed to between parties to a mortgage loan generally is not considered a significant modification and, thus, not a reissuance, unless the forbearance period extends for more than two years (plus an additional period of time for negotiation or during which the borrower is in

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bankruptcy) following the borrower's initial failure to perform.[63] Nevertheless, modifications are not automatically disregarded simply because they arise within the context of a forbearance. Depending on the facts, a forbearance may be treated as other than temporary. For example, the Treasury Regulations governing modifications of debt instruments may not insulate a forbearance that lasted for just 18 months if the holder, in addition to staying collection, also agreed to permit a lump sum payment of the forgone interest at the maturity of the loan.[64] And as discussed above, many forbearances will permit the forgone interest to be paid as a lump sum at the maturity of the loan.[65] Further, a forbearance may be part of a package of modifications, of which only the temporary forbearance itself (and not any related modifications) is protected by the safe harbor for temporary forbearances.[66]

In addition, the Revenue Procedure does not address the effect of a forbearance on the mortgagor of the loan, including whether the mortgagor recognizes cancellation of indebtedness income.

ENDNOTES

* Mr. Nirenberg is the co-author of Peaslee & Nirenberg, FEDERAL INCOME TAXATION OF SECURITIZATION TRANSACTIONS AND RELATED TOPICS (5th Edition 2018).

1 The Coronavirus Aid, Relief, and Economic Security Act, P.L. 116-136, 134 Stat. 281 (March 27, 2020).

2 CARES Act §§4022, 4023.

3 The covered period is after March 26, 2020, and before the earlier of (x) January 1, 2021, and (y) the termination of the COVID-19 emergency. CARES Act §4023(f)(5). Federally backed single-family mortgage loans and federally backed multifamily mortgage loans are addressed in sections 4022 and 4023, respectively, of the CARES Act. Although both sections obligate the lenders to offer forbearance upon request during the "covered period," only section 4023 actually defines *covered period*, and technically such definition only applies to federally backed multifamily mortgage loans under such section. For obvious reasons, we believe the failure to apply such definition to section 4022 was an oversight.

4 Rev. Proc. 2020-26, 2020-18 IRB 753.

5 Section 5.01. Except as indicated or if the context otherwise requires, references to sections herein are to sections of Rev. Proc. 2020-26.

6 CARES Act §4022(a)(2).

7 CARES Act §4022(b)(1). Although section 4022(b)(1)(B) only requires the borrower to affirm that it is experiencing a financial hardship *during* the COVID19 emergency, section 4022(c)(1) instructs servicers to provide forbearance upon receipt of the borrower's attestation to a financial hardship *caused by* the COVID19 emergency. Further, the general eligibility requirement under section 4022(b)(1) provides that the hardship must be *due, directly or indirectly*, to the COVID19 emergency. Thus, it is unclear to what extent the borrower's request for forbearance must attest to a link between the borrower's financial hardship and the COVID19 emergency. From a practical perspective, however, servicers likely will require that borrowers at least comply with section 4022(c)(1) and, thus, insist that borrowers certify (at a minimum) that their financial hardship was *caused by* the COVID19 emergency. *Cf. infra* note 12. In addition, section 4022 does not specify the acceptable form of such affirmation, whereas section 4023 is explicit that, in the context of federally backed multifamily mortgage loans, a forbearance request and affirmation may be made orally or in writing. CARES Act §4023(b).

8 CARES Act §4022(b)(2).

9 CARES Act §4022(b)(3). In addition, during the 60-day period that began on March 18, 2020, mortgage servicers of federally backed mortgage loans (other than loans with respect to a vacant or abandoned property) are not permitted to initiate any foreclosure process, move for a foreclosure judgment or order of sale, or execute a foreclosure-related eviction or foreclosure sale. CARES Act §4022(c)(2).

10 CARES Act §4023(f)(2).

11 CARES Act §4023(b).

12 CARES Act §4023(b). Although section 4023(b) merely requires the borrower to submit a request for forbearance to the borrower's servicer affirming that the borrower is experiencing a financial hardship *during* the COVID-19 emergency, and section 4023(c)(1) instructs servicers to provide forbearance upon receipt of a request without specifying the content thereof, the general eligibility requirement under section 4023(a) provides that a borrower must be experiencing a financial hardship *due, directly or indirectly, to* the COVID-19 emergency. Thus, it is unclear whether the borrower's request for forbearance must attest to a link between the borrower's financial hardship and the COVID-19 emergency. *Cf. supra* note 7.

13 CARES Act §4023(c)(1)(B)–(C). The borrower's request for extension must be made during the covered period and at least 15 days prior to the end of the initial forbearance period. CARES Act §4023(c)(1)(C).

14 CARES Act §4023(d). Because the prohibition on fees and penalties only applies with respect to late payments of rent (whereas the prohibition on eviction applies to nonpayment of rent *or other fees or charges*), a borrower under a federally backed multifamily mortgage loan subject to mandatory forbearance arguably can charge fees and penalties during the covered period with respect to the late payment of any non-rent associated outstanding fees or charges otherwise owed by the tenant.

15 CARES Act §4023(e). Section 4024 of the CARES Act imposes more stringent restrictions on a lessor's legal actions to recover possession of dwellings from tenants for nonpayment of rent or other charges, and such restrictions would apply to certain federally backed single-family mortgage loans and federally backed multifamily mortgage loans subject to forbearance under sections 4022 and 4023, respectively.

16 Federal Housing Finance Agency, *"No Lump Sum Required at the End of Forbearance" Says FHFA's Calabria* (April 27, 2020), citing publications from Fannie Mae and Freddie Mac. *See www.fhfa.gov/Media/PublicAffairs/Pages/No-Lump-Sum-Required-at-the-End-of-Forbearance-says-FHFAs-Calabria.aspx*.

17 Section 2.07 notes that the Treasury and the IRS received comments that many holders and servicers of mortgage loans that are not CARES Act mortgage loans intend, either voluntarily or through State-mandated loan forbearance programs, to provide forbearances "for the next three to six months" on such loans. The operative provisions of the Revenue Procedure, in turn, generally apply the relief thereunder to forbearances identical or similar to those described in section 2.07. Sections 5.01(2), 5.02(2), 6.02(2). It appears, however, that the description in section 2.07 of anticipated forbearances in the next three to six months was gratuitous language and that the Revenue Procedure does not limit its application to non-CARES Act mortgage loans that are offered forbearance within six months of their issuance.

18 As indicated in note 3, above, the CARES Act mandates forbearances for CARES Act mortgage loans after March 26, 2020, and before the earlier of (x) January 1, 2021, and (y) 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 a forbearance after March 26, 2020, and before January 1, 2021. Sections 5.01(2), 5.02(2)(a), 6.02(2). In the event that the President terminates the COVID-19 emergency before January 1, 2021, non-CARES Act mortgage loans would still be covered by the Revenue Procedure after such date, provided that the borrower is still experiencing a financial

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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 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) would no longer be eligible for mandatory forbearance.

[19] Wherever the Revenue Procedure permits modifications related to forbearance, it is likely that any modifications of the type typically made in the market in conjunction with the forbearance would qualify as a related modification. However, we note that the two examples of related modifications provided in the Revenue Procedure are fairly narrow: "[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 … [or] at the end of the forbearance period, an amortizing loan will be re-amortized 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.

[20] Section 5.01.

[21] Section 5.02. With respect to non-CARES Act mortgages *held* by a REMIC, the Revenue Procedure applies if, among other things, the forbearance was issued to borrowers experiencing financial hardship "due, directly or indirectly, to the COVID-19 emergency." In contrast, with respect to non-CARES Act mortgages *acquired* by a REMIC, the Revenue Procedure applies to forbearances offered to borrowers experiencing financial hardship "due to the COVID-19 emergency." It is unclear why in the latter case the words "directly or indirectly" are omitted and whether that omission is meant to carve out borrowers experiencing financial hardship indirectly due to the COVID-19 emergency.

[22] Code Secs. 860A to 860G. Unless otherwise noted, all Code Sec. references are to the Internal Revenue Code of 1986 ("Code").

[23] Code Secs. 860A(a), 860B(a), 860D(a)(2)-(3); Reg. §1.860G1(b)(6).

[24] *See* Code Sec. 860D(a). 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.

[25] Permitted investments consist of temporary investments of amounts received on qualified mortgages prior to distribution ("cash flow investments"), intangible property held as part of a reserve fund to pay certain REMIC expenses ("qualified reserve assets"), or investments in property acquired by the REMIC as the result of a foreclosure upon the default or imminent default of a qualified mortgage ("foreclosure property"). Code Secs. 860G(a)(5)–(8), 856(e)(1).

[26] Code Sec. 860D(a)(4). The REMIC asset test is satisfied if the entity owns no more than a *de minimis* amount of assets other than qualified mortgages and permitted investments. Reg. §1.860D1(b)(3)(i). A safe harbor rule provides that this *de minimis* threshold is satisfied if the aggregate of the adjusted bases of those other assets is less than 1% of the aggregate of the adjusted bases of all of the entity's assets. Reg. §1.860D1(b)(3)(ii). The REMIC's final period for which it doesn't need to satisfy the asset test begins with the adoption of a plan of liquidation in connection with a qualified liquidation and ends, not more than 90 days later, with the liquidation of the REMIC. Code Sec. 860D(a) (last sentence).

[27] Code Sec. 860G(a)(3)(A). An obligation is considered to be "principally secured" by an interest in real property only if (i) the fair market value of the interest in real property securing the obligation was equal to at least 80% of the adjusted issue price of the obligation either at the time of origination or upon the sponsor's contribution of such loan to the REMIC or (ii) substantially all of the proceeds of the obligation were used to acquire, improve, or protect an interest in real property that, at the time of origination, is the only security for the obligation. Reg. §1.860G-2(a)(1). The second part of this definition is intended to cover home improvement and other loans for which property appraisals are not required when the loan is originated, and therefore the borrower cannot readily demonstrate that the 80% test is satisfied. *See* T.D. 8458, 1993-1 CB 147, 148 (preamble to final regulations). The first part of the test (the value-at-origination part of the test) generally avoids the need to revalue real property collateral at any time after the initial underwriting of a loan. Thus, changed circumstances after origination that cause a deterioration in value of the real property and eventually a default (for example, a downgrading of an anchor tenant) would be ignored. In general, a mortgage loan is considered to be "originated" (1) when the loan is made or (2) if there is a "significant modification" of the loan (with an exception for, among other things, modifications occasioned by defaults or reasonably foreseeable defaults), at the time of the modification. Reg. §1.860G-2(b)(1)-(3). Accordingly, if a REMIC offers a borrower forbearance with respect to a loan it is holding, and the forbearance caused the loan to be significantly modified under Reg. §1.1001-3 and Reg. §1.860G-2(b)(1)-(3), the mortgage loan would have to satisfy the principally-secured test at the time of the modification. This could be problematic if the value of the real property securing the mortgage has dropped since the test was first performed. It could also be a burden on the REMIC (and ultimately the holders of the interests in the REMIC), which would have to absorb the added cost of performing this calculation.

[28] If the relevant sponsor contributes property to the REMIC in exchange for residual and regular interests within a consecutive 10-day period, the REMIC may designate any day within that period as the startup day. Code Sec. 860G(a)(9); Reg. §1.860G-2(k).

[29] Code Secs. 860G(a)(3)(A)(i), (ii), 860G(a)(3)(B), 860G(a)(4)(B)(i). A REMIC also can acquire a qualified mortgage to replace a defective loan within the two-year period beginning on the startup day. Code Sec. 860G(a)(4)(B)(ii).

[30] Reg. §1.860G-2(b)(1)(i).

[31] Section 6.01(1).

[32] Section 6.03(2).

[33] Code Sec. 860F(a)(1).

[34] Code Secs. 860F(a)(2)(A), 860F(a)(5); Reg. §1.860G-2(j). A REMIC also can dispose of a qualified mortgage in exchange for another qualified mortgage within the three-month period beginning on the startup day (or, if replacing a defective mortgage, within the two-year period beginning on the startup day) without such disposition being treated as a prohibited transaction. Code Secs. 860G(a)(4), 860F(a)(2)(A)(i).

[35] Reg. §1.860G-2(b)(1)(i).

[36] Section 6.01(2).

[37] Code Sec. 860D(a)(4).

[38] Code Sec. 860G(a)(5)(C), (a)(8). *See supra* note 25, for a complete definition of permitted investments.

[39] Reg. §1.856-6(b)(3). A REMIC will not be considered to have failed the improper-knowledge test with respect to any loan that was acquired pursuant to a binding commitment entered into by the REMIC at a time when it did not have (or have reason to know) that a default would occur or was imminent. *Id*.

[40] *See supra* note 26, for a description of the *de minimis* safe harbor under the substantially-all test. In addition, because real estate owned ("REO") by a REMIC that does not qualify as "foreclosure property" is not a permitted investment, the receipt of income attributable to that REO would be subject to the 100% tax on income from prohibited transactions. Code Secs. 860F(a)(2)(B), 860F(a)(1).

Net income from property that *is* treated as foreclosure property (and thus *is* a permitted investment) is subject to tax at the corporate income tax rate. Code Sec. 860G(c).

[41] Section 6.03(1). In the event that the applicable mortgage loan was in arrears or otherwise in default prior, or subsequent, to the forbearance, a REMIC would still need to consider whether such attributes affected the improper-knowledge test. In addition, even absent any other such defaults or arrearages, a REMIC may need to consider whether it could fail the improper-knowledge test if other criteria lead it to conclude a default is imminent. For example, if the mortgage was trading at a significant discount (*e.g.*, 75%), a REMIC may need to consider whether such discount itself would be indicative of an imminent default that could cause the REMIC to fail the improper-knowledge test.

Interestingly, the Revenue Procedure does not address whether a forbearance would cause

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a REIT to fail the same improper-knowledge test. (The improper-knowledge test is a REIT test that was incorporated by reference into the REMIC rules.) In very general terms, a REIT is taxed on the net income from foreclosure property at the highest corporate income tax rate, but is taxed at a 100% rate on income from prohibited transactions. *See* Code Secs. 857(b)(4), 857(b)(6). A prohibited transaction includes a sale or other disposition of "dealer property" unless that property qualifies as foreclosure property. Code Sec. 857(b)(6)(B)(iii). Thus, treating REO owned by a REIT as foreclosure property can be very advantageous, and foreclosing on a mortgage that is treated as having been acquired with an intention to foreclose may be very costly, for a REIT.

[42] Code Sec. 860D(a)(2).

[43] Code Sec. 860G(a)(1). *See supra* note 28.

[44] Reg. §1.1001-3(c)(1)(i), (e). In many cases, particularly where regular interests are "pass-through" securities that entitle holders to proportionate distributions from available funds held by the REMIC, changes in economics resulting from an underlying forbearance likely will occur by operation of the terms of the regular interest, and therefore would not be modifications for these purposes. Reg. §1.1001-3(c)(1)(ii). Although the modification of a significant amount of a REMIC's mortgages could alter the yield and payments on a REMIC's regular interest, the risk that such effect would cause the REMIC's regular interests to be deemed reissued seems slight. Notably, the Structured Finance Association did not even request such specific relief in its April 3, 2020, letter to the IRS and the Treasury. *See https://structuredfinance.org/wp-content/uploads/2020/04/SFA-letter-IRS-Treasury-Final.pdf*. Nevertheless, the IRS apparently thought such guidance was necessary to alleviate the market's concern, and therefore addressed this point in the Revenue Procedure.

[45] Section 6.01(3).

[46] Code Sec. 860G(a)(1). A regular interest will be treated as having fixed terms if the REMIC's organizational documents irrevocably specify (i) the principal amount (or other similar amount) of the regular interest, (ii) the interest rate or rates used to compute any interest payments (or other similar amounts) on the regular interest, and (iii) the latest possible maturity date of the interest. Reg. §1.860G-1(a)(4). *See* Reg. §1.860G-1(a)(3), for a description of variable rates permitted for REMIC regular interests.

[47] Reg. §1.860G-1(a)(5). The term "contingent" is undefined.

[48] Reg. §1.860G-1(b)(3)(ii). Timing contingencies related to prepayments of qualified mortgages and the income from permitted investments (and the payment of expenses incurred by the REMIC) are also permitted. Code Sec. 860G(a)(1) (penultimate sentence); Reg. §1.860G-1(b)(3)(i).

[49] Section 6.04. For these purposes, permitted contingencies include excess fees paid for specially serviced loans, an inability of a servicer to advance funds, or payments that are subject to forbearance not accruing compound interest. *Id.*

[50] *See supra* note 19.

[51] Section 5.01.

[52] Reg. §301.7701-2(a).

[53] Reg. §301.7701-4(c)(1).

[54] *Id.* An investment trust is permitted to issue different classes of beneficial ownership if the trust was formed to facilitate direct investment in its assets and the existence of multiple classes of ownership interests is incidental to that purpose. *Id.*

[55] Reg. §301.7701-4(b).

[56] *See* Code Secs. 671–679.

[57] Reg. §301.7701-4(c)(1). In determining whether a power to vary investments is present, a distinction must be drawn between the existence of such power and its actual use. All powers granted under the relevant trust agreement are taken into account, whether or not they are actually used or expected to be used, and whether or not their use is contingent upon the occurrence of events outside of the trust's control. *Helvering v. Coleman-Gilbert Associates*, SCt, 36-1 USTC ¶9022, 296 US 369, 374, 56 SCt 285. *See also* Rev. Rul. 78-149, 1978-1 CB 448 (a right to replace bonds called by the issuer prior to maturity with similar bonds is an impermissible power to vary).

[58] *See, e.g.*, Rev. Rul. 75-192, 1975-1 CB 384.

[59] For a discussion of the limitations on an investment trust's power to vary its investments, including in connection with modification of loans, *see* Peaslee & Nirenberg, FEDERAL INCOME TAXATION OF SECURITIZATION TRANSACTIONS AND RELATED TOPICS (2018), chapter 4, part D.4.

[60] Section 6.02.

[61] A non-REMIC entity that issues multiple classes of debt may be classified as a taxable mortgage pool (a "TMP") and subject to entity-level taxation if, among other requirements, substantially all of its assets are debt obligations (or interests therein) and more than 50% of those obligations or interests are real estate mortgages. Code Sec. 7701(i)(2). However, for these purposes, real estate mortgages that are seriously impaired are excluded from the definitions of debt obligation and real estate mortgage. Reg. §301.7701(i)-1(c)(5). Thus, treating a mortgage loan as seriously impaired is helpful in avoiding TMP status. Among other issues, forbearance thus raises the question as to whether a mortgage loan that would be in default, but is not in default 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 the fact that the mortgage loan may be distressed and seriously impaired in a business sense.

[62] *See supra* note 41.

[63] Reg. §1.1001-3(c)(4)(ii).

[64] *Id.*

[65] *See supra* note 16 and accompanying text.

[66] The exercise of a mandatory forbearance of a mortgage loan pursuant to the CARES Act (or pursuant to a State-mandated mandatory loan forbearance program) may not qualify as a modification since the forbearance is made at the option of the mortgagor. *See* Reg. §1.1001-3(c)(2)(iii) (an alteration that results from the exercise of an option provided to an issuer is not a modification if the option is unilateral (*i.e.*, at the time the option is exercised, or as a result of the exercise, the holder has no right to alter or terminate the instrument)). If such forbearance is not a modification, it will not constitute a significant modification under Reg. §1.1001-3(e) and, accordingly, it will not cause the mortgage loan to be treated as reissued for federal income tax purposes. The fact that the right to the forbearance is not contained within the confines of the mortgage loan documents should not prevent its exercise from being considered a unilateral option. *See* LTR 200321015 (Feb. 14, 2003) (notwithstanding the absence of any right provided in the mortgage loan documents, "the Borrower holds a unilateral option to defease the Loan under applicable law where … the highest court of the State having jurisdiction over the real property and contractual obligations with respect to that property has held that a mortgagor has a right to obtain a release of a mortgagor's lien upon property if a mortgagor provides a mortgagee with the benefit of its bargain"). However, even though the *exercise* of the forbearance option may not be a modification, the alteration of the mortgage loan *to permit* the optional forbearance (even by operation of law) may arguably constitute a modification of the loan (which modification could, on appropriate facts, be significant). Reg. §1.1001-3 appears to contemplate that even modifications occurring by operation of law are taken into account in determining whether a loan has been reissued. *See* Reg. §1.1001-3(a)(1) ("This section applies to any modification of a debt instrument, regardless of the form of the modification").

Further, even if a forbearance with respect to a debt instrument is treated as the reissuance of the debt instrument, the forbearance may not evidence an impermissible power to vary for a grantor trust. The impermissible power to vary is usually thought to require a power to vary under the trust's operative agreement (and related documents), and a requirement thrust upon a trust by a change of law (such as the CARES Act) should not be considered to arise under the trust agreement. Further, a modification undertaken by a trust, not for the purposes of making a profit but solely to preserve the value of an existing investment that may otherwise be impaired, is often not treated as an impermissible power to vary. *See* Peaslee & Nirenberg, Peaslee & Nirenberg, FEDERAL INCOME TAXATION OF SECURITIZATION TRANSACTIONS AND RELATED TOPICS (2018), at chapter 4, part D.4.

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