Clients&FriendsMemo

COVID-19 Update: Coronavirus-Related REMIC Considerations

March 30, 2020

***Update*: On April 13, the IRS issued a revenue procedure that addresses a number of the concerns discussed in this memo. For more on the revenue procedure, click *here*.**

I. Introduction

The COVID-19 pandemic has created significant headwinds for mortgage loans. Loan forbearances and workouts raise tax complexities for real estate mortgage investment conduits (REMICs), which are the most common vehicles for securitizing mortgage loans. With careful planning, REMICs can continue to be highly useful during these difficult times. This alert explores the feasibility of continuing to use REMICs to securitize mortgage loans subject to forbearance and potential default as a result of the pandemic.[1]

Issues include:

- Whether a distressed mortgage loan is a qualified mortgage;
- Limitations on modifications;
- Limitations on foreclosures; and
- Whether a REMIC's regular interests will qualify as such if distressed loans are contributed to the REMIC.

In summary:

- *Qualified Mortgages.* An increase in a mortgage loan's LTV from its origination date should not, in and of itself, cause the loan to fail to be a good REMIC asset.
- *Modifications.* A servicer's agreement to forbear on a mortgage loan for up to two years (whether before or after the loan is contributed to a REMIC) should not, in and of itself, cause the loan to fail to be a qualified mortgage. Moreover, a REMIC's workout of a distressed loan

[1] This alert draws from Schwartz, *The Taxation of Distressed Mortgage Securitizations*, Tax Notes Federal (Jan. 20, 2020), available at https://www.cadwalader.com/uploads/books/ea64dbe776203131f96877f5a62a7a1c.pdf.

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should not, in and of itself, cause the REMIC to lose its REMIC status, even if the loan was distressed when it was contributed to the REMIC. However, as described below, the REMIC might be prohibited from foreclosing on a distressed loan, and/or might have to reduce the initial principal amount of its regular interests by anticipated shortfalls in respect of the loan.

- *Foreclosure-Restricted Loans.* A REMIC arguably should not be prohibited from foreclosing on a mortgage loan if, at the time the loan is contributed to the REMIC, (1) it is less than 59 days delinquent and (2) the servicer does not intend to foreclose. Although not free from doubt, it would seem that any forbearance required by the Coronavirus Aid, Relief, and Economic Security Act (the **CARES Act**) should not, in and of itself, prohibit the REMIC from foreclosing.
- *Unconditional Entitlement to Payments.* The contribution of a distressed loan to a REMIC should not cause the REMIC's interests to fail to qualify as "regular interests" if, at the time of contribution, (1) the servicer intends to make advances on the loan to cover payments missed by the borrower and (2) the REMIC does not anticipate incurring special servicing fees that would reduce amounts otherwise payable to regular interest holders.

II. Qualified Mortgages

An entity qualifies as a REMIC only if, in general, substantially all of its assets consist of qualified mortgages, foreclosure property, and specified short-term investments and reserves.

A mortgage is a qualified mortgage only if it is principally secured by an interest in real property. Tax regulations provide that a mortgage is principally secured by real property if the value of the underlying real property is at least 80% of the mortgage's adjusted issue price (that is, the mortgage's loan-to-value (**LTV**) ratio is less than 125%).

Tax regulations permit the LTV test to be satisfied on either the date that the loan was contributed to the REMIC or the date that the loan was originated. In the current economic environment, there is a risk that a loan will not satisfy the LTV test on the date that it is contributed to a REMIC. Accordingly, REMICs generally will rely on the loan's origination-date LTV to establish that it is a qualified mortgage.

III. Modifications

A "significant modification" of a mortgage loan is treated as a taxable exchange of the loan for a new loan. The new loan generally must be tested to determine whether it is a qualified mortgage as of the modification date.

Forbearance for up to two years generally is not a significant modification. Accordingly, a servicer's agreement to forbear on a mortgage loan for up to two years should not, in and of itself, cause the

mortgage loan to fail to be a qualified mortgage. However, as described below, the REMIC might be prohibited from foreclosing on a distressed loan, and/or might have to reduce the initial principal amount of its regular interests by anticipated shortfalls in respect of the loan.

Moreover, a modification "occasioned by default or a reasonably foreseeable default" is not treated as a significant modification for purposes of the REMIC rules. This exception appears to apply even if the modification was reasonably foreseeable when the REMIC acquired the relevant mortgage loan. Accordingly, although not free from doubt, a REMIC's workout of a distressed loan arguably should not, in and of itself, cause the REMIC to lose its REMIC status, even if the loan was distressed when it was contributed to the REMIC.

IV. Foreclosure-Restricted Loans

Real property acquired in foreclosure does not constitute a good REMIC asset if, when the REMIC acquired the related loan, the REMIC knew or had reason to know that the loan would default (that is, the REMIC had **improper knowledge**). A REMIC can lose its REMIC status if at any time beginning three months after the REMIC's start-up day, more than a *de minimis* amount of its assets are bad REMIC assets. Accordingly, if a REMIC has improper knowledge, then it must sell any foreclosure-imminent mortgage loans that it cannot successfully work out.

Some market participants have expressed concern that a REMIC could have improper knowledge with respect to loans currently being contributed to the REMIC (and the REMIC may therefore be restricted from ever foreclosing on the loans) if the borrowers have indicated that coronavirus-related market disruptions will prevent them from being able to remain current on their payments.

Although the improper knowledge test ultimately will depend on all facts and circumstances, a loan arguably should not be foreclosure-restricted if, at the time it is contributed to the REMIC, (1) it is less than 59 days delinquent and (2) the servicer does not intend to foreclose.

Under the CARES Act, borrowers under certain federally backed multi-family mortgage loans are entitled to automatic forbearance.[2] Although not free from doubt, it would seem that any forbearance required under the CARES Act should not, in and of itself, cause a loan to be foreclosure-restricted.

Moreover, even if a REMIC determines that a loan is foreclosure-restricted when it is contributed to the REMIC, the loan could become non-foreclosure-restricted if the borrower becomes current on payments before subsequently defaulting.

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[2] For a discussion of the CARES Act, see our recent Clients & Friends Memo.

V. Unconditional Entitlement to Payment

The "regular interests" that a REMIC issues to investors must unconditionally entitle the investors to receive a specified principal amount (or a similar amount). Some market participants have expressed concern that if a REMIC acquires a pool of mortgage loans on which it does not expect principal to be fully repaid (because some of the loans are distressed), the REMIC cannot issue regular interests that "unconditionally entitle" the holders to a face amount equal to the principal amount on the mortgage loans.

Similarly, a special servicer might charge additional fees to the REMIC in connection with workout and foreclosure activities; these fees also would reduce amounts that otherwise would be payable on the REMIC's regular interests.

The contribution of a distressed loan to a REMIC should not cause the REMIC's interests to fail to qualify as "regular interests" if, at the time of contribution, (1) the servicer intends to make advances on the loan to cover payments missed by the borrower and (2) the REMIC does not anticipate incurring special servicing fees that would reduce amounts otherwise payable to regular interest holders. Otherwise, the interests still could qualify as regular interests if their initial principal amount is reduced by anticipated shortfalls.

VI. Non-REMIC Alternatives

In some situations, it may be preferable to use a vehicle other than a REMIC to securitize mortgage loans. However, when a REMIC is not used, care must be taken to ensure that the securitization is not treated as a "taxable mortgage pool" and subject to corporate-level tax. A non-REMIC mortgage loan securitization is particularly useful if: (1) more than 20% of the collateral will consist of REO and seriously impaired loans;[3] or (2) the securitization vehicle intends to issue only one class of debt whose payments bear a relationship to payments on the collateral. Each of these options is discussed in greater detail our article on distressed mortgage loan securitizations, available here.

[3] Although the determination of whether a real estate mortgage is seriously impaired is based on all relevant facts and circumstances, under a safe harbor, a single family residential real estate mortgage loan is treated as seriously impaired if payments on the loan are over 89 days delinquent, and a multifamily residential or commercial real estate mortgage loan is treated as seriously impaired if payments on the loan are over 59 days delinquent, in each case unless the securitization vehicle is receiving or anticipates receiving payments on the mortgage loan. However, in today's uncertain economic environment, it may be difficult to conclude whether payments are or are not anticipated for purposes of this safe harbor.

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If you have any questions, please feel free to contact any of the following Cadwalader attorneys.

Jason Schwartz +1 202 862-2277 jason.schwartz@cwt.com

Gary Silverstein +1 212 504-6858 gary.silverstein@cwt.com

Linda Swartz +1 212 504 6062 linda.swartz@cwt.com