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REMIC Relief for COVID-19 Related Modifications and Forbearance

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The Coronavirus Aid, Relief and Economic Security (CARES) Act allows certain borrowers with federally backed mortgage loans and certain multifamily borrowers with federally backed mortgage loans that are experiencing a financial hardship due to the COVID-19 emergency to request and obtain forbearance on their loans. In addition, the expectation is that holders and servicers of non-federally backed mortgage loans will either voluntarily, or through state-mandated loan forbearance programs, provide forbearances for a period of three to six months to borrowers experiencing financial hardships due to the COVID-19 emergency (COVID-19 forbearance program). (For a summary of the CARES Act, see "Coronavirus Aid, Relief, and Economic Security (CARES) Act Signed into Law.")

Forbearances and workouts of mortgage loans create tax issues for real estate mortgage investment conduits (REMIC) and investment trusts. To address certain tax issues potentially raised by forbearances mandated by the CARES Act and other similar COVID-19 forbearance programs, and in response to comments received by the IRS from members of the securitization industry, the IRS issued Revenue Procedure 2020-26 (2020-26 Safe Harbor), which provides safe harbor relief for REMICs with mortgages for which borrowers are granted forbearance (and related modifications) in connection with financial hardships due to the COVID-19 emergency.

Potential Tax Consequences of Various Forbearance Programs - REMIC Qualification and Tax Issues Raised by Forbearance and Modification of Mortgage Loans

Many of the tax issues for REMICs raised by forbearance and modification of a mortgage loan emanate from the fact that such forbearance or modification may produce a deemed exchange of the original mortgage loan for a new mortgage loan for federal income tax purposes. Not every modification of a loan results in a deemed exchange; only a "significant modification" (within the meaning of the regulations) of a loan does. Such a deemed exchange can jeopardize REMIC qualification and subject a REMIC to a 100% prohibited transaction tax.

Qualified Mortgage Loans?

An entity qualifies as a REMIC only if (among other technical requirements) "substantially all" of its assets consist of qualified mortgages and certain permitted investments, including foreclosure property. The REMIC asset test must be satisfied as of the close of the third month beginning after the REMIC's startup day and at all times thereafter. The asset test is satisfied if the entity owns no more than a *de minimis* amount of other assets. Thus, a REMIC can lose its REMIC status if at any time beginning three months after the REMIC's startup day, more than a *de minimis* amount of its assets are nonqualifying assets. Maintaining REMIC status is important because otherwise the entity will likely be subject to an entity-level tax as a corporation, in addition to the tax paid at the investor level.

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To be a qualified mortgage, a mortgage loan generally (subject to certain exceptions) must be (1) transferred to the REMIC on the startup day in exchange for regular or residual interests in the REMIC, and (2) principally secured by an interest in real property (which means the value of the underlying real property constitutes at least 80% of the mortgage's adjusted issue price (in other words, the mortgage's loan-to-value (LTV) ratio must be less than 125%. This is generally evaluated either at the time the loan was originated or at the time the sponsor contributes the loan to the REMIC. After the startup day, the regulations do not require ongoing satisfaction of this test.

However, under current regulations, a "significant modification" of a mortgage loan is treated for tax purposes as a taxable exchange of the original mortgage loan for a new mortgage loan. Accordingly, if a mortgage loan held by a REMIC is "significantly modified," the REMIC would be treated as though it had disposed of the original mortgage loan for a new modified mortgage loan. The new mortgage loan would then have to be tested to determine whether it is a qualified mortgage as of the date of the modification. The modified mortgage loan could fail to qualify as a qualified mortgage because of an inadequate LTV ratio or because it is not considered to have been transferred to the REMIC on its startup day (and does not otherwise qualify for an exception). Thus, a critical issue for REMICs raised by forbearance of a mortgage loan under the CARES Act and other similar COVID-19 forbearance programs is whether it will result in the loan failing to be a qualified mortgage. The consequences would be disastrous for a REMIC if it resulted in less than substantially all of the REMIC's assets (including unmodified mortgage loans) being permitted (or "good") assets for purposes of the REMIC asset test.

Acquisitions By REMICs of Loans Already Provided COVID-19 Forbearance - Eligible to be Qualifying Foreclosure Property?

As noted above, foreclosure or REO property (real property acquired in foreclosure) generally qualifies as a permitted investment and thus is a "good" asset for purposes of the REMIC asset test. However, real property acquired in foreclosure is not a "good" asset if, when the REMIC acquired the underlying mortgage loan, the REMIC knew or had reason to know that the loan would default. Borrowers seeking forbearance are likely experiencing financial hardship, and so, another issue raised by forbearance under the CARES Act and other similar COVID-19 forbearance programs is whether a REMIC would be treated as having "improper knowledge" of an imminent or anticipated default with respect to a mortgage loan that is already under forbearance at the time it is acquired by the REMIC. If so, a REMIC could be prevented from foreclosing on such loans and taking indirect ownership of REO property because doing so could jeopardize REMIC status if, as a result, substantially all of its assets were not "good" assets.

Still a Regular Interest?

In order for an entity to qualify as a REMIC, all of the interests in the entity must consist of more than one class of regular interests and a single class of residual interests. The terms of a regular interest are required to be fixed on the REMIC's startup day. A regular interest must also unconditionally entitle the holder to receive a specified principal amount (or other similar amount) and the principal amount of a regular interest generally cannot be contingent. Certain contingencies affecting the payment of principal and interest, however, do not prevent an interest in a REMIC from being a regular interest. An additional issue raised by the CARES Act and other similar COVID-19 forbearance programs is whether delays and shortfalls in payments resulting from such forbearances will cause an interest in a REMIC to fail to qualify as a regular interest.

Prohibited Transaction?

Finally, REMICs are subject to a 100% tax on the net income derived from "prohibited transactions." A disposition of a qualified mortgage is a "prohibited transaction" unless the disposition is pursuant to (1) the substitution of a qualified mortgage for a qualified mortgage, (2) a disposition incident to the foreclosure, default or imminent default of the mortgage loan, (3) the bankruptcy or insolvency of the REMIC or (4) a qualified liquidation. If the

CARES Act and other similar COVID-19 forbearance programs results in a deemed exchange of a qualified mortgage held by a REMIC (and no regulated exception is available), the REMIC could be subject to the prohibited transaction tax.

Safe Harbor Relief for REMICs

The 2020-26 Safe Harbor provides safe harbor relief from the potential tax consequences raised by forbearance and modification of mortgage loans currently held by REMICs due only to the COVID-19 emergency. The 2020-26 Safe Harbor also provides safe harbor relief with respect to mortgage loans under forbearance due to the COVID-19 emergency to enable them to be contributed to a new REMIC.

Mortgage Loans Already held in a REMIC

With respect to mortgage loans already held by REMICs, the 2020-26 Safe Harbor provides a safe harbor, subject to certain conditions, for forbearances (and all related modifications) agreed to by a borrower under: (a) Sections 4022 or 4023 of the CARES Act for any federally backed mortgage loans or federally backed multifamily mortgage loans and (b) another similar COVID-19 forbearance program for any other mortgage loans. Under the 2020-26 Safe Harbor, such forbearances (and related modifications) will not:

1. Be treated as resulting in a newly issued mortgage loan for purposes of Reg. 1.860G-2(b)(1)
2. Constitute a "prohibited transaction" under Code Section 860F(a)(2)
3. Result in a deemed reissuance of the REMIC regular interest

Mortgage Loans to be contributed to a REMIC or Taking Back REO Property

In addition, the 2020-26 Safe Harbor also provides that, if a mortgage loan subject to a forbearance mandated by the CARES Act or another similar COVID-19 forbearance program is acquired by a REMIC, the prior forbearance (and related modifications) of the mortgage loan will not (1) be treated as evidence that the REMIC had improper knowledge of an anticipated default and (2) be taken into account in the determination of the origination date of the mortgage loan for purposes of determining whether it is principally secured by an interest in real property (*i.e.*, whether it satisfies the LTV test mentioned above). Thus, real property acquired by a REMIC through a later foreclosure on the mortgage loan will not fail to be qualifying foreclosure property for purposes of the REMIC asset test even though the mortgage loan was under forbearance at the time the REMIC acquired the loan. In addition, the fact that a mortgage loan is subject to a forbearance mandated by the CARES Act or another similar COVID-19 forbearance program will not cause it to have a different origination date and have to be retested under the LTV test. Accordingly, such loan may be contributed to a REMIC while subject to a forbearance.

Impact on Certificates

Finally, the 2020-26 Safe Harbor provides that, for mortgage loans held by REMICs, delays and shortfalls in payments associated with or caused by forbearances (and any related modifications) are contingencies that can be disregarded. For this purpose, contingencies that can be disregarded 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 interest. Thus, a REMIC regular interest will not fail to qualify as a regular interest because of such contingencies.

2020-26 Safe Harbor Relief for Investment Trusts

In addition to providing relief to REMICs, the 2020-26 Safe Harbor also provides safe harbor relief to investment trusts, which are also used to hold mortgage loans. Investment trusts are generally classified as trusts (and not as business entities) for federal income tax purposes to avoid entity-level taxation. To be classified as a trust for tax purposes, there cannot be power to vary the investment of the certificate holders of the trust. The 2020-26 Safe

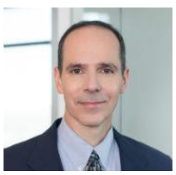
Harbor provides that forbearances and related modifications under the CARES Act and other similar COVID-19 forbearance programs will not be regarded as manifesting a power to vary the investment of the certificate holders and thus will not jeopardize an investment trust's status as a trust for federal income tax purposes.

Conclusion

The 2020-26 Safe Harbor provides welcome relief to REMICs and investment trusts holding mortgage loans. The relief provided is similar in many respects to the relief provided by the IRS during the financial crisis of 2008-2010. At that time, many servicers of mortgage loans developed and implemented foreclosure prevention programs to streamline modifications of troubled mortgage loans. The IRS then provided helpful guidance to REMICs stating that it would not challenge a securitization vehicle's qualification as a REMIC or contend that modifications made to mortgage loans constituted prohibited transactions.

Relief in the form provided by the 2020-26 Safe Harbor continues to be necessary because the REMIC tax rules are not really designed to deal with broad-based mortgage modification plans, such as the forbearance plan in the CARES Act, when the mortgage market is under extreme duress. Many have advocated for the REMIC rules to be amended to deal with these situations instead of needing to rely on the IRS issuing new stop-gap type guidance whenever new mortgage modification plans are adopted to relieve periodic significant stresses in the mortgage loan market. Perhaps this crisis will finally encourage the appropriate changes to the REMIC tax rules. For the time being, the 2020-26 Safe Harbor will have to suffice during the COVID-19 emergency.

CONTACT



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