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Rare Bird Sightings: Recent Developments Address Distressed Obligation Issues Faced by REMICs

By Russell Nance, Erin Gladney and Mark Leeds

For more than 30 years, tax practitioners working with real estate mortgage investment conduits (REMICs) have had to make some difficult calls based on skeletal statutory language, scant regulations, some legislative history and not much else. One of the toughest areas to address has been the application of the REMIC rules to mortgages that have a high probability of default or credit-based restructuring. After not having any significant guidance at all, within days of each other, two pieces of guidance affecting these issues were released. We guess that rare birds come in pairs.

First, on June 2, 2016, the Second Circuit Court of Appeals confirmed what many tax practitioners had already concluded: a mortgage loan that is "defective" because the mortgage loan is in default, or a default is reasonably foreseeable, or because the mortgage loan does not conform to a customary representation or warranty may still be a "qualified mortgage" capable of being held in a REMIC, even if the defect existed when the mortgage loan was contributed to the REMIC. *State of New York ex rel. Jacobson v. Wells Fargo National Bank, N.A.*, Docket No. 15-1152 (2nd Cir. 2016). Second, on June 6, 2016, the Internal Revenue Service (IRS) issued PLR 201623007. This private letter ruling addresses how a REMIC should treat expenses incurred in the foreclosure of a qualified mortgage.

Background on Subprime Loan and Distressed Debt Issues Faced by REMICs

The Internal Revenue Code (the "Code") specifies that an entity will qualify as a REMIC only if, "as of the close of the 3rd month beginning after the startup day and at all times thereafter, substantially all of the assets … consist of qualified mortgages and permitted investments."[1] A mortgage is treated as a qualified mortgage only if it is "principally secured by an interest in real property."[2] Applicable regulations provide that a mortgage will be treated as principally secured by an interest in real property only if the value of the real property securing the mortgage is at least 80 percent of the adjusted issue price of the mortgage at the time that the mortgage was originated or contributed to the REMIC.[3] Even if the mortgage fails this test, it will be treated as a qualified mortgage if substantially all of the mortgage proceeds were used to acquire an interest in real property and the real property is the only security for the mortgage.[4]

Special rules are provided for defective mortgages.[5] A "defective obligation" is a mortgage that:

(i) Is in default, or a default with respect to the mortgage is reasonably foreseeable;

(ii) Was fraudulently procured by the mortgagor;

(iii) Was not in fact principally secured by an interest in real property within the meaning of the rules above; or

(iv) Does not conform to a customary representation or warranty given by the sponsor or prior owner of the mortgage regarding the characteristics of the mortgage or the pool of which the mortgage is a part.[6]

Defective mortgages may be substituted or sold without adverse federal income tax consequences within the first two years of the REMIC. As discussed below, the *Wells Fargo* decision addressed the interaction of the qualified mortgage rules with the defective mortgage rules.

Foreclosure property is also a permitted asset of a REMIC.[7] Foreclosure property is defined as property acquired in connection with the default or imminent default of a qualified mortgage which would be "foreclosure property under section 865(e)" if acquired by a real estate investment trust (REIT).[8] Property is not foreclosure property if the mortgage with respect to which the default occurs was acquired by the REIT with an intent to foreclose, or the REIT "knew or had reason to know that default would occur."[9] This test is referred to as the "improper knowledge" test.

The IRS issued a number of Private Letter Rulings in the 1990s addressing whether property acquired by a REMIC on the foreclosure of a loan could be treated as "foreclosure property" for purposes of § 860G(a)(8). PLR 1996-30-004; PLR 1997-20-014; PLR 1997-21-005; P.L.R. 1997-42-022. A distinction is drawn between the deliberate acquisition of a mortgage with knowledge that a default was imminent and the inadvertent acquisition of a mortgage which subsequently went into default. The PLRs state that the type of default relevant for the improper knowledge test is one that would lead a reasonable lender to institute foreclosure proceedings against a delinquent borrower. The PLRs describe the "improper knowledge" test as a facts and circumstances test in which no single factor is determinative. In guidance provided by the IRS, a late payment or the breach of a minor loan covenant has not typically resulted in a finding that a REMIC acquired a loan with "improper knowledge."

Thus, a REMIC could be disqualified in two ways by the acquisition of one or more subprime mortgages. First, the mortgage could fail to be treated as a qualified mortgage because the loan-to-value ratio is too high or substantially all of the proceeds were not used to acquire real property. Second, if the mortgage was in danger of imminent default, the foreclosure could result in the REMIC holding property that it is not permitted to hold. In either case, the REMIC could cease to be treated as a REMIC and significant taxes could be imposed.

The *Wells Fargo* Case

PLAINTIFF-APPELLANT ALLEGATIONS

Plaintiff-appellant, a former Wells Fargo loan officer, brought suit against Wells Fargo National Bank, N.A., and Wells Fargo Asset Securities Corporation (together, the "Bank") on behalf of the State and City of New York under the New York False Claims Act (NYFCA).[10] Jacobson alleged that the Bank fraudulently avoided paying New York State and New York City taxes by filing federal tax forms that fraudulently claimed REMIC status on behalf of numerous trusts used to issue mortgage-backed securities. New York State and New York City are exempt from corporation and franchise tax entities that are treated as REMICs for US federal income tax purposes.[11] Jacobson alleged that by fraudulently claiming REMIC status on federal tax returns, the Bank reduced New York State and New York City taxes payable (estimated "very roughly" by the plaintiff-appellant at $1.5 billion) in connection with

$12 billion of subprime and non-conforming mortgage-backed securitization structures.[12]

Jacobson claimed that the Bank fabricated borrowers' income and employment information, which resulted in mortgage loans that the borrowers could not repay. According to Jacobson, a default of these mortgage loans was "reasonably foreseeable," causing the mortgage loans to be "defective" for REMIC purposes. In addition, Jacobson claimed that the mortgage loans were "defective" because the loan applications to FDIC-insured banks contained false information—a federal crime—so the mortgage loans did not conform to customary representations that the mortgage loans complied in all material respects with applicable federal, state and local laws. In the crux of her argument, Jacobson alleged that "defective obligations" cannot be "qualified mortgages." As a result, the REMICs did not meet the REMIC asset test described above.

REASONING OF THE SECOND CIRCUIT

The Second Circuit, in affirming the district court, tersely concluded that it "considered all of Jacobson's arguments on appeal and [had] found in them no merit." In particular, the court found that Jacobson wrongly asserted that a "defective obligation" necessarily fails to be a "qualified mortgage." The court held that the term "defective obligation" is used only to allow certain mortgages to be replaced by qualified mortgages or to be repurchased in lieu of a replacement.[13] The court stated that "nothing in the regulation's definition … purports to alter the Internal Revenue Code definition of qualified mortgage …" and that "only the third category, the defect of 'not in fact [being] principally secured by an interest in real property' has [the] effect [of preventing a mortgage from being a qualified mortgage]."

Finally, the court observed that Jacobson's argument was "clearly refuted" by the Treasury Regulations' provisions for the effect of discovery of a defect: "[i]f the defect is one that does not affect the status of an obligation as a qualified mortgage, then the obligation is always a qualified mortgage regardless of whether the defect is or can be cured."[14] With that, the court concluded that "[n]othing in the Internal Revenue Code or the regulations indicates that these alleged defects affect [the relevant mortgage loans'] status as qualified mortgages." Accordingly, the court concluded that even if the mortgages placed into the REMICs were defective mortgages, such conclusion should not affect REMIC status.

PLR 201623007

PLR 201623007 involves a REMIC that held a portfolio of commercial mortgage loans. One of these loans was secured by a retail shopping mall. The REMIC represented that, at the time of the acquisition of the mortgage loan over the shopping center, the debtor was current on all payments due and that the REMIC had no reason to believe that the mortgage would become nonperforming. This representation allowed the IRS to treat the mall as "foreclosure property" that could be held by the REMIC. Unfortunately, many of the mall tenants became bankrupt, the debtor defaulted on the mortgage and the REMIC foreclosed on the loan. Thereafter, the REMIC became the owner of the shopping center and operated the center while it sought a buyer for the property.

The shopping center was required to process its own wastewater. The wastewater system was overburdened and was in need of significant repairs. The local municipality had issued a notice to the prior owner requiring the prior owner to repair and update the wastewater system. In response to this notice, the prior owner had obtained a permit to expand the wastewater treatment apparatus and had begun work. The repair and expansion work appeared to be quite substantial. The work was expected to take at least four years.

The rules on the treatment of property as foreclosure property are limited. Property can be treated as foreclosure property only for three years unless the IRS grants an extension for the orderly liquidation of the property.[15] In addition, only limited improvements can be made to property before it will cease to be treated as foreclosure property.[16] This latter requirement cannot be waived by the IRS.

The IRS agreed to waive the requirement that the property be disposed of within three years, because it was clear that the property would not be readily saleable without a working and approved wastewater treatment system. The IRS allowed the taxpayer to count significant expenditures made by the prior owner as costs incurred prior to the imminent default. Accordingly, when the expenditures were measured in this way, the REMIC did not expend more than the amount permitted by statute for the property to be treated as foreclosure property.

Concluding Comments

The vicissitudes of the real estate market and their effects on the secondary mortgage market make it increasingly likely that REMICs will hold mortgages that default. The dual developments of the *Wells Fargo* case and PLR 201623007 offer favorable guidance on how REMICs can address these situations. The good news is that the courts and the IRS both appear intent upon finding solutions that will not disrupt the REMIC market. Experienced birders can chalk another one off their list.

For more information about this topic, please contact any of the following lawyers.

Hayden D. Brown
+1 704 444 3512
haydenbrown@mayerbrown.com

Jeffrey P. Cantrell
+1 704 444 3513
jcantrell@mayerbrown.com

Erin G. Gladney
+1 212 506 2639
egladney@mayerbrown.com

Mark H. Leeds
+1 212 506 2499
mleeds@mayerbrown.com

Michael K. Marion
+1 212 506 2651
mmarion@mayerbrown.com

Russell E. Nance
+1 212 506 2534
rnance@mayerbrown.com

Endnotes

[1] Code § 860D(a)(4).

[2] Code § 860G(a)(3)(A).

[3] Treas. Reg. § 1.860G-2(a)(1)(i).

[4] Treas. Reg. § 1.860G-2(a)(1)(ii).

[5] See Code §§ 860F(a)(2), 860G(a)(4)(B)(ii)

[6] See Treasury Regulations § 1.860G-2(f)(1).

[7] Code § 860G(a)(5)(B)

[8] Code § 860G(a)(8)(A)-(B).

[9] Treas. Reg. § 1.856-6(b)(3)

[10] N.Y. State Fin. Law § 187 et seq. (McKinney Supp. 2012).

[11] N.Y. Tax Law § 8 (McKinney 2005); N.Y.C. Admin. Code § 11-122 (2012).

[12] As described by the court, the complaint alleged that "[Wells Fargo's] annual filings of 'IRS Form 1066 in order to claim the REMIC tax exemption . . . . were false because the trusts did not qualify as REMICs'. It alleged that Wells Fargo thus violated the NYFCA because it 'knowingly ma[de], use[d], or cause[d] to be made or used, a false record or statement material to an obligation to pay or transmit money or property, i.e., business franchise and corporate taxes, to the State and City of New York', and conspired to commit a violation of . . . § 1891(1)(g)', see N.Y. State Fin. Law § 1891(1)(c)."

[13] See Code §§ 860G(a)(4)(B)(ii) and 860F(a)(2)(A)(i), respectively.

[14] Treasury Regulations § 1.860G-2(f)(2).

[15] Code § 856(e)(3).

[16] Code § 856(e)(4).