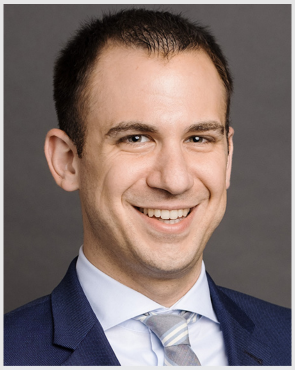
The Taxation of Distressed Mortgage Securitizations

by Jason Schwartz



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In this report, Schwartz examines the tax considerations applicable to two common distressed mortgage securitization structures: the distressed mortgage real estate mortgage investment conduit and the distressed mortgage fund.

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I. Introduction

Distressed debt investors are waiting for the next downturn.[1] By the end of 2018, asset managers reportedly had raised $200 billion in private credit funds that remained uninvested.[2] While it is hard to predict when and how this capital will be deployed, it could pay to reexamine the tax considerations applicable to one of the primary ways that hedge funds and other institutional investors historically have financed their positions in distressed mortgage loans: the distressed mortgage securitization.

Distressed mortgage securitizations are special purpose vehicles that issue securities primarily to institutional investors; invest the proceeds mainly in distressed mortgage loans; and apply the interest, principal, and sale proceeds they receive to pay interest and principal on the securities that they issue. Distressed mortgage securitizations allow hedge funds and other institutional investors to make a leveraged, tax-efficient investment in a pool of distressed mortgage loans, and allow banks, real estate investment trusts, and other mortgage loan originators to finance or sell their distressed mortgage loan portfolios, freeing up capital that they can then use to make or acquire additional mortgage loans. Meanwhile, by issuing multiple classes of securities with different seniorities and

[1] *See* "Distressed Debt Funds Are Waiting for a Downturn," *The Economist*, Nov. 7, 2019.

[2] Julie Segal, "How Dry Powder Could Blow Up Private Credit and Private Equity," *Institutional Investor*, Mar. 6, 2019.

payment characteristics backed by a pool of mortgage loans, distressed mortgage securitizations appeal to investors that may be unwilling or unable to invest directly in distressed mortgage loans.

This report discusses the tax considerations applicable to two common distressed mortgage securitization structures, which it refers to as (1) the distressed mortgage real estate mortgage investment conduit and (2) the distressed mortgage fund.[3]

At the outset, it should be noted that managing a portfolio of distressed mortgage loans is a "high-touch" business that regularly involves negotiated workouts and foreclosures. Each securitization structure represents countless hours spent by collateral managers and tax advisers reconciling business imperatives with tax law. Accordingly, each structure has its own complexities, and the choice between structures may depend in part on how comfortable the parties and their tax advisers are with these complexities.

II. Overarching Tax Considerations

A. Distressed Mortgage REMICs

REMICs are special purpose vehicles that are formed to hold a static (non-traded) pool of mortgage loans and are generally exempt from U.S. entity-level tax.[4] REMICs issue multiple classes of regular interests,[5] which are statutorily treated as debt for U.S. tax purposes[6] and typically are paid down in sequence with principal collections on the REMIC's assets. REMICs also issue one class of residual interests,[7] which is the REMIC's tax equity and is subordinated to the regular interests. A special excess inclusion regime subjects a REMIC's net taxable income to U.S. income tax in the hands of the holder of the REMIC's residual interest.[8]

Under the distressed mortgage REMIC structure, a REMIC uses the proceeds of its issuance of regular interests to acquire a pool of distressed mortgage loans.[9] Hedge funds and institutional investors that want a leveraged return on the distressed mortgage loans acquire the more junior regular interests. Investors seeking a more typically debtlike return acquire the more senior regular interests.

REMICs generally are exempt from entity-level tax.[10] As a result, a tax adviser's primary focus for a distressed mortgage REMIC is ensuring that it retains its REMIC status. Broadly speaking, this requires the tax adviser to confront two main questions.

First, are distressed mortgage loans qualified mortgage loans, even after they are modified? If not, the REMIC would fail to be a REMIC.[11] In this regard, although the REMIC rules generally allow loans to be tested for qualified mortgage loan status retroactively to their origination date (before they became distressed), and accommodate workouts and sales of distressed loans, Congress does not appear to have contemplated the use of REMICs to acquire and work out pools composed entirely of distressed mortgage loans.

Second, do a distressed mortgage REMIC's regular interests entitle holders to principal amounts that are unconditionally payable, even when its assets are unlikely to pay in full? If not, the REMIC would fail to be a REMIC.[12] Read literally, the REMIC rules allow expected defaults on underlying mortgage loans to affect the amount and timing of principal payments on REMIC regular interests. However, again, Congress does not appear to have contemplated

[3] For reasons described in Section II.B, distressed mortgage fund securitizations sometimes are referred to colloquially as debt-for-tax deals.

[4] Section 860A(a).

[5] Section 860D(a)(2).

[6] Section 860B(a).

[7] Section 860D(a)(3).

[8] *See* section 860C.

[9] Because the REMIC's residual interest typically is noneconomic (as described in Section IV.D), the REMIC does not receive any proceeds from issuing the residual interest. Instead, the sponsor typically pays a third party to acquire the residual interest.

[10] *See* section 860A(a) (REMICs not subject to tax except as provided in sections 860A through 860G); section 860F(a) (imposing a 100 percent tax on prohibited transactions); and section 860G(c) (imposing a 21 percent tax on net income from foreclosure property).

[11] *See* section 860D(a)(4) (beginning as of the close of the third month after a REMIC's start-up day, substantially all of its assets must consist of qualified mortgages and permitted investments).

[12] *See* section 860D(a)(2) (REMIC may issue only regular interests or residual interests); and section 860G(a)(1)(A) (regular interests must unconditionally entitle holders to a specified principal amount (or other similar amount)).

the use of REMICs to acquire and work out pools composed entirely of distressed mortgage loans.

Each of these questions is discussed in greater detail in Section IV.

B. Distressed Mortgage Funds

Unlike REMICs, distressed mortgage funds do not have a statutorily prescribed code of conduct. Instead, tax advisers draw upon rules of general application to construct tax-efficient securitization structures. Most commonly, the fund is organized as a Delaware limited liability company that by default is treated as a domestic partnership for U.S. tax purposes. The LLC ensures that it is not engaged in a U.S. trade or business for U.S. tax purposes, so that foreign persons can acquire its equity interests without being subject to U.S. net income tax (and without giving rise to a potential withholding tax liability for the LLC). The LLC also takes measures to ensure that it is not treated as a domestic corporation under the taxable mortgage pool (TMP) rules.

1. Avoiding entity-level tax.

Under section 11(b), domestic entities that are treated as corporations for U.S. tax purposes generally are subject to a 21 percent net income tax.[13]

Under section 882, foreign entities that are treated as corporations for U.S. tax purposes are subject to U.S. federal income tax on any income that is effectively connected with the conduct of a trade or business within the United States.[14]

Finally, under section 1446, entities (both domestic and foreign) that are treated as partnerships for U.S. tax purposes and are engaged in a U.S. trade or business are required to withhold tax at the highest rate (now 21 percent for corporations and 37 percent for individuals[15]) on their foreign partners' distributive share of any income that is effectively connected with that trade or business.[16]

Accordingly, to avoid entity-level tax, a distressed mortgage fund may be structured as (1) a partnership not engaged in a U.S. trade or business, (2) a partnership all of whose equity (and potential equity) is held exclusively by U.S. persons, (3) a disregarded entity, or (4) a foreign corporation not engaged in a U.S. trade or business.

a. Partnership not engaged in a U.S. trade or business.

As noted, distressed mortgage funds most commonly are organized as partnerships that are not engaged in a U.S. trade or business. Usually, the fund is organized as a Delaware LLC, because this is the least expensive option. Alternatively, the fund may be organized as a limited partnership in any jurisdiction or as a foreign entity that elects to be treated as a passthrough entity (that is, a disregarded entity or a partnership) for U.S. tax purposes. The fund is not subject to corporate-level tax and takes measures to ensure that it is not engaged in a U.S. trade or business and thus has no withholding tax liability under section 1446. These measures are discussed in Section V.

The fund issues multiple classes of notes, which it treats as debt for U.S. tax purposes and pays down in sequence with principal collections on the fund's assets. The fund also issues equity interests.

The fund uses the proceeds of the issuance to acquire a pool of distressed mortgage loans. Hedge funds and institutional investors that want a leveraged return on the distressed mortgage loans acquire equity interests in the fund. Investors seeking a more typically debtlike return acquire notes.

b. Partnership with only U.S. partners (and potential partners).

The withholding tax liability under section 1446 applies only to partnerships that are engaged

[13] They may be subject to state and local taxes as well. A discussion of state and local taxes is beyond the scope of this report.

[14] They also are subject to a 30 percent branch profits tax on any "dividend equivalent amounts," which generally are a measure of the corporation's after-tax effectively connected earnings and profits that are not reinvested in the U.S. business and are deemed repatriated offshore. *See* section 884.

[15] Under section 1(j), the highest marginal tax rate applicable to individuals for tax years beginning before January 1, 2026, is 37 percent. The highest marginal tax rate applicable to individuals for tax years beginning after December 31, 2025, is 39.6 percent.

[16] Foreign partners in a partnership that is engaged in a U.S. trade or business are required to file U.S. tax returns and may apply the withholding tax as a credit against their income tax liabilities. *See* section 875.

in a U.S. trade or business and have foreign partners. Accordingly, a distressed mortgage fund that is treated as a partnership for U.S. tax purposes will have no obligation to withhold — even if it is engaged in a U.S. trade or business — if it restricts the ownership of its equity to U.S. persons.

Unlike REMIC regular interests, notes issued by a partnership are not statutorily treated as debt for U.S. tax purposes. Instead, if debt treatment is desirable for tax purposes, the notes must be structured to qualify as debt under common law authorities.[17] (For this reason, distressed mortgage fund securitizations sometimes are alternatively referred to as debt-for-tax deals.) If a distressed mortgage fund is structured as a partnership that is engaged in a U.S. trade or business, and the IRS successfully asserts that one or more classes of its notes are equity for U.S. tax purposes, foreign holders of those notes could be subject to U.S. tax (and the fund could be liable for failing to withhold under section 1446).

Accordingly, distressed mortgage fund partnerships that are or may be engaged in a U.S. trade or business generally prohibit foreign persons from investing in their equity or in any classes of notes for which there is not a high level of confidence that they are treated as debt for U.S. tax purposes. This may make it difficult for a sponsor to find investors for the fund. However, some collateral managers prefer this structure because it permits them to engage in a U.S. trade or business on behalf of the fund.

c. Disregarded entity.

When a securitization vehicle is treated as a passthrough entity for U.S. tax purposes, and only one person owns the vehicle's equity (including any notes that are treated as equity for U.S. tax purposes), the vehicle is treated for U.S. tax purposes as a disregarded entity of that person. For U.S. tax purposes, the sole equity holder is treated as the direct owner of the vehicle's investment portfolio and is treated as pledging the portfolio as collateral for the debt-for-tax notes. Accordingly, the vehicle is not subject to U.S. income tax under section 882 or to withholding tax liability under section 1446.

However, if the sole equity owner is a foreign person, it generally will want the disregarded entity to avoid a U.S. trade or business so that the foreign equity owner is not itself subject to U.S. net income tax. Moreover, disregarded entities become partnerships upon a transfer of the equity to a second holder. Accordingly, unless a disregarded entity requires that all its equity (and any notes that could be treated as equity for U.S. tax purposes) be held by a single U.S. person at all times, the vehicle generally will have to ensure that it is not engaged in a U.S. trade or business.

d. Foreign corporation not engaged in a U.S. trade or business.

Because the Cayman Islands and some other jurisdictions do not impose an income tax on their resident corporations, it is possible to organize an entity there that is treated as a corporation for U.S. tax purposes and is not subject to any entity-level tax, as long as it is not engaged in a U.S. trade or business.

However, in practice, distressed mortgage funds rarely are organized as foreign corporations for U.S. tax purposes. Although foreign investors generally prefer to invest in corporate equity instead of partnership equity,[18] they can achieve this result by buying distressed mortgage fund equity through a foreign feeder fund that is treated as a foreign corporation for U.S. tax purposes.

2. Avoiding TMP status.

The TMP rules are intended to subject any net income recognized by a domestic mortgage loan securitization vehicle — that is, the positive difference between interest accruals on the vehicle's assets on one hand, and interest accruals on the vehicle's notes on the other hand — to U.S. net income tax.[19] Under these rules, a vehicle

[17] For a discussion of factors used to determine whether an instrument is debt or equity for U.S. tax purposes, see Jason Schwartz and David Miller, "Collateralized Loan Obligations," Tax Management Portfolio 6585, at II.A.2.

[18] Unlike foreign shareholders in a corporation that is engaged in a U.S. trade or business, foreign partners in a partnership that is engaged in a U.S. trade or business are required to file U.S. tax returns and may be subject to U.S. income tax.

[19] *See* reg. section 301.7701(i)-1(a) ("The purpose of section 7701(i) is to prevent income generated by a pool of real estate mortgages from escaping Federal income taxation when the pool is used to issue multiple class mortgage-backed securities.").

(other than a REMIC[20]) that securitizes real estate mortgages may be treated as a TMP and taxed as a separate corporation for U.S. tax purposes if (1) substantially all of its assets consist of debt obligations and more than 50 percent of those debt obligations are real estate mortgages (the asset test), (2) it issues two or more classes of debt with different maturities (the maturities test), and (3) the payment characteristics of each debt class bear a relationship to payments on the underlying real estate mortgages (the relationship test).[21] Distressed mortgage funds that are organized as passthrough entities for U.S. tax purposes take measures to ensure that they flunk one or more of these tests, so that they are not TMPs.

III. Nontax Comparison

Although distressed mortgage REMICs and distressed mortgage funds are very different from a tax perspective, the investment activities that they can accommodate are largely the same. This section summarizes two differences that may be significant to a collateral manager.

A. Ability to Trade Collateral

Distressed mortgage REMICs generally may not acquire new mortgage loans over three months after their start-up day.[22] Moreover, distressed mortgage REMICs are subject to a 100 percent tax on prohibited transactions, which include most dispositions other than those in connection with a loan seller's breach of its representations or a foreclosure, default, or imminent default.[23]

By contrast, distressed mortgage funds are not subject to any tax limitations on their ability to acquire additional mortgage loans, as long as their equity owners are U.S. persons or the acquisitions do not cause them to be engaged in a U.S. trade or business (that is, they are not new loan originations).

B. Limitations on Collateral Types

Distressed mortgage REMICs are required to invest almost exclusively in mortgage loans. By contrast, distressed mortgage funds may invest in any assets, as long as the assets do not cause them to be engaged in a U.S. trade or business. Mezzanine loans and preferred equity generally are not treated as good REMIC assets but typically can be acquired by distressed mortgage funds.

IV. Distressed Mortgage REMICs — A Closer Look

A. 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.[24]

A mortgage is a qualified mortgage only if it is principally secured by an interest in real property.[25] The regulations provide that a mortgage is principally secured by real property if the value of the underlying real property is at least 80 percent of the mortgage's adjusted issue price (that is, the mortgage's loan-to-value (LTV) ratio is at least 125 percent).[26]

The 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.[27] Distressed mortgage loans often do not satisfy the LTV test on the date that they are contributed to the REMIC, because the value of the underlying real property has fallen significantly by that time. Accordingly, most distressed mortgage REMICs rely on their mortgages' origination-date LTVs to establish that they are qualified mortgages.

B. Modifications

Under reg. section 1.1001-3, a significant modification of a mortgage loan is treated as a taxable exchange of the loan for a new loan.[28] The

[20]As mentioned earlier, if the vehicle is a REMIC, no entity-level tax is imposed, but holders of a special class of residual interests must pay the tax, and the excess inclusion rules prevent all or a portion of the taxable income from being offset or otherwise eliminated.

[21]*See* section 7701(i).

[22]Section 860D(a)(4).

[23]Section 860F(a).

[24]Section 860D(a). Exceptions to this requirement exist during three-month start-up and liquidation periods.

[25]Section 860G(a)(3)(A).

[26]Reg. section 1.860G-2(a)(1)(i).

[27]*Id.*

[28]Reg. section 1.861G-2(b)(2) incorporates reg. section 1.1001-3 into the REMIC regulations by reference.

new loan generally must be tested to determine whether it is principally secured by real property (and thus whether it is a qualified mortgage) as of the modification date.[29]

However, under reg. section 1.860G-2(b)(3)(i), a modification "occasioned by default or a reasonably foreseeable default" is not treated as a significant modification for purposes of the REMIC rules, even if it is a significant modification under reg. section 1.1001-3.[30] This exception appears to apply even if the modification was reasonably foreseeable when the REMIC acquired the relevant mortgage loan.

Distressed mortgage REMICs typically acquire a large number of loans with the expectation of modifying them in a manner that would be a significant modification under reg. section 1.1001-3 but take the position that the modifications are occasioned by default or a reasonably foreseeable default.

C. Foreclosure Property

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").[31] 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.[32]

Distressed mortgage REMICs typically invest in mortgage loans that are significantly delinquent. To ensure that foreclosures do not cause a distressed mortgage REMIC to lose its REMIC status, distressed mortgage REMICs typically do not foreclose; they instead sell any foreclosure-imminent mortgage loans that they cannot successfully work out.[33] If the REMIC's junior investors want exposure to foreclosure property, the REMIC may sell the foreclosure-imminent mortgage loans to one or more blocker entities that those investors wholly own (outside the REMIC) and that are treated as domestic corporations for U.S. tax purposes.[34]

D. Unconditional Entitlement to Payments

A REMIC is permitted to issue only regular interests and one class of residual interests. Because REMIC regular interests are statutorily treated as debt for U.S. tax purposes, regardless of how little equity supports them, foreign persons generally can hold the regular interests without being subject to any U.S. tax. By contrast, REMIC residual interests generally are held solely by taxable U.S. persons,[35] who pay tax on the REMIC's net income.[36]

Accordingly, virtually all REMIC sponsors prefer to structure the REMIC so that the regular interests represent substantially all of the REMIC's economics, while the residual interest is noneconomic, meaning that it does not receive any cash. (The residual interest's U.S. holder may receive an accommodation payment from the sponsor for agreeing to hold the residual interest.) Under this approach, the aggregate face amount of the regular interests equals the aggregate principal amount of the mortgage loans that the REMIC holds.[37]

However, regular interests must unconditionally entitle the holder to receive a

[29] Reg. section 1.860G-2(b)(1).

[30] The modification is still treated as a significant modification for purposes of determining the REMIC's taxable income (which, as mentioned earlier, is taxable to the holder of the REMIC's residual interest). *See* preamble to reg. section 1.860G-2(b)(3) (T.D. 9463).

[31] Section 860G(a)(8); reg. section 1.856-6(b)(3). Tax practitioners commonly assume that a REMIC has improper knowledge if the loan is 60 to 90 days delinquent or otherwise satisfies the servicer's standard for pursuing foreclosure. *Cf.* reg. section 301.7701(i)-1(c)(5) (multifamily residential or commercial real estate mortgages are seriously impaired if payments on the mortgages are more than 59 days delinquent; single-family residential mortgages are seriously impaired if payments on the mortgages are more than 89 days delinquent).

[32] Reg. section 1.860D-1(b)(3)(i). Under a safe harbor, bad REMIC assets are de minimis if their aggregate adjusted basis is less than 1 percent of the aggregate adjusted basis of all the REMIC's assets. Reg. section 1.860D-1(b)(3)(i). The adjusted basis of any property contributed to a REMIC is equal to the property's FMV immediately after the contribution. Section 860F(b)(2).

[33] Dispositions of qualified mortgage loans that are incident to a default or imminent default are not prohibited transactions. *See* section 860F(a)(2)(A)(i).

[34] The use of a blocker entity to hold foreclosure property is discussed in Section V, in the context of distressed mortgage funds.

[35] *See* section 860D(a)(6) (REMIC must make "reasonable arrangements" to ensure that its residual interest is not held by a government or tax-exempt organization); and section 860G(b)(2) (REMIC's excess inclusion income is not eligible for any exemption from, or a reduction in the rate of, withholding tax if the owner is a foreign investor).

[36] Section 860C(a); section 860E(c).

[37] Similarly, the aggregate interest payable on the regular interest equals the aggregate weighted average interest payments on the mortgage loans that the REMIC holds.

specified principal amount (or a similar amount).[38] Some tax practitioners have expressed concern that if a REMIC acquires a pool of distressed mortgage loans on which it does not expect principal to be fully repaid, the REMIC cannot issue regular interests that "unconditionally entitle" the holders to a face amount equal to the principal amount on the mortgage loans.

This concern arguably reads too much into the word "entitle." Reg. section 1.860G-1(b)(3)(ii) provides that a REMIC interest "does not fail to qualify as a regular interest solely because the amount or the timing of payments of principal or interest . . . is affected by defaults on qualified mortgages and permitted investments, unanticipated expenses incurred by the REMIC, or lower than expected returns on permitted investments." Read literally, this rule is not limited to situations in which defaults are unexpected or only statistically probable on the REMIC's start-up day. On the contrary, the regulation refers to "unanticipated" expenses and "lower than expected" returns but does not include any similar qualifier for defaults, which suggests that a REMIC interest can qualify as a regular interest even if defaults are *expected* to affect the amount or timing of its principal payments. Similarly, reg. section 1.860G-1(b)(3)(iii) explicitly permits a REMIC to issue a class of regular interests that bears all of the REMIC's credit losses; any such class could have a face amount that far exceeds its expected principal payments.

Moreover, although it is unlikely that Congress contemplated the use of REMICs to acquire and work out pools of distressed loans, the REMIC rules clearly accommodate the acquisition of distressed debt, and the legislative history to the rules suggests that it would be inappropriate to impose extrastatutory glosses on those rules.[39] Government officials have informally raised questions about the use of REMICs as "workout factories," but the IRS has never asserted that distressed loan REMICs in fact violate the REMIC rules.[40]

Sponsors that are nevertheless concerned about the "unconditional entitlement" test might discount the face amount on the REMIC's regular interests to an amount that they project will in fact be paid. Under this approach, if payments on the underlying loans ultimately exceed the REMIC's projections, the excess inures to the benefit of the holder of the residual interest. This typically is not a desirable result, because the accommodation holders that acquire residual interests usually do not pay for the possibility that the residual interests will be economic.

V. Distressed Mortgage Funds — A Closer Look

A. Avoiding TMP Status

Distressed mortgage funds avoid being treated as TMPs by flunking the relationship test, maturities test, or asset test.

1. Flunking the relationship test.

Notes issued by a distressed mortgage fund satisfy the relationship test if the timing and amount of payments on the notes are in large part determined by the timing and amount of payments or projected payments on the fund's assets.[41] For this purpose, payments on the fund's assets include interest and principal payments but do not include settlements at a substantial discount or sale proceeds, unless the settlements or sales were arranged before the fund issued its notes.[42]

The relationship test is met only if there is a relationship between payments on a fund's notes and payments on *the* assets (not only on *some* assets) of the fund. As a result, distressed mortgage funds that conduct significant activities are less likely to be TMPs. Further, distressed mortgage funds that issue notes with "bullet" maturities generally should not be TMPs, because

[38] Section 860G(a)(1).

[39] *See* Senate report on the Tax Reform Act of 1986, S. Rep. No. 99-313, at 791 (1986) (referring to the REMIC rules as "comprehensive"); *see also* H.R. 99-841, at II-230 (1986) (Conf. Rep.) (referring to the REMIC rules as "the exclusive set of rules for the treatment of" REMICs).

[40] *See* Lee A. Sheppard, "Tax Administrator Also Copes With Credit Meltdown," *Tax Notes*, Sept. 22, 2008, p. 1132 (reporting a statement by Diana Imholtz, then an attorney in the IRS Office of Associate Chief Counsel (Financial Institutions and Products), to the effect that "a REMIC is supposed to be a static pool of mortgages, while a workout factory might look more like a business").

[41] Reg. section 301.7701(i)-1(f)(1).

[42] Reg. section 301.7701(i)-1(f)(2).

the timing of principal payments on the notes is independent of the timing of principal collections.

Some distressed mortgage funds issue one senior class of notes whose payments are likely to bear a relationship to payments on the fund's assets, and one or more junior classes of notes whose payments do not bear such a relationship (for example, because there will have been sufficient turnover in the fund's assets to break the relationship before the fund begins to pay down principal on the junior classes, or because the fund has the right to redeem the junior classes after the senior class is fully paid down and the likelihood of the fund's failure to exercise the redemption right is remote). If payments on only one class of notes bear a relationship to payments on the fund's assets, the fund will not be a TMP.

2. Flunking the maturities test.

Treasury regulations provide that note classes do not have different maturities solely because they bear different allocations of credit risk (that is, the risk that defaults on the mortgage fund's assets will reduce or delay payments of principal or interest on the notes).[43]

On the basis of these regulations, some distressed mortgage funds issue note classes that initially pay down principal on a *pari passu* basis and begin to pay down principal sequentially once defaults on the underlying mortgage loans reach a specified level in relation to the notes' outstanding principal amount (that is, once a coverage test is breached). The notes return to *pari passu* principal payments when enough principal has been paid down to satisfy the coverage test. Tax practitioners have not reached a consensus on how likely a breach of the coverage test can be. The regulations probably were not intended to encompass notes that pay sequentially in all-but-unlikely scenarios.

Other funds issue notes that never return to *pari passu* principal payments after a coverage test is breached. It is harder to argue that differences in maturities on these notes would be attributable solely to their different allocations of credit risk. Accordingly, these funds typically structure the coverage tests on their notes in a manner such that the risk of a coverage test being breached is remote, and they take the position that they are not TMPs because the notes would have the same maturities in the absence of a remote contingency.[44] Determining remoteness can be an intensive exercise in due diligence and could require an opining tax practitioner to understand the nature of the fund's assets, the likelihood that the assets will be worked out, and the likely outcomes of any workouts.

3. Flunking the asset test.

A distressed mortgage fund may be treated as a TMP only if at least 80 percent of its assets are debt obligations on the date that the fund issues notes to investors.[45] For this purpose, real estate mortgages are not treated as debt obligations if they are "seriously impaired."[46] 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 fund is receiving or anticipates receiving payments on the mortgage loan.[47]

Some distressed mortgage funds select their assets so that more than 20 percent of their assets consist of foreclosure property or are seriously impaired on the date that they issue notes to investors, and they take the position that they are not TMPs because they flunk the asset test. This approach necessarily requires significant due diligence into the nature of the fund's assets. If one of the fund's stated goals is to return mortgage loans to performing status, it may be hard for a tax practitioner to conclude that the fund does not anticipate receiving payments on the mortgage loans (so that the mortgage loans are seriously

[43] *See* reg. section 301.7701(i)-1(e)(2).

[44] *Cf.* reg. section 1.1273-1(h)(2) (generally ignoring any contingency in a debt instrument if the contingency is remote).

[45] *See* reg. section 301.7701(i)-1(c)(2)(ii) (providing a safe harbor under which less than substantially all of an entity's assets are debt obligations if less than 80 percent of its assets are debt obligations).

[46] *See* reg. section 301.7701(i)-1(c)(5).

[47] *See* reg. section 301.7701(i)-1(c)(5)(ii)(A).

impaired within the meaning of the regulatory safe harbor).

B. Avoiding a U.S. Trade or Business

The IRS has asserted that "making loans to the public" within the United States, whether directly or through a U.S. agent, constitutes a U.S. trade or business.[48] As noted earlier, foreign persons that engage in a U.S. trade or business, whether directly or through an entity treated as a disregarded entity or partnership for U.S. tax purposes, are subject to U.S. federal income tax on any income that is effectively connected with that U.S. trade or business.[49]

As discussed in Section II.B.1, distressed mortgage funds typically are treated as disregarded entities or partnerships and take the position that they are not engaged in a U.S. trade or business for U.S. tax purposes. If (contrary to expectations) one of these funds were engaged in a U.S. trade or business, any foreign equity holders would be subject to U.S. net income tax — and potentially to the branch profits tax (for corporate equity holders) — on their allocable share of the fund's effectively connected income, and if the fund were treated as a partnership, it would be liable for failing to withhold on the foreign equity holders. All equity holders (U.S. and foreign) would indirectly bear their share of that liability. This risk could raise concerns among prospective equity holders. The fund's operative documents might (and sometimes do) contain a provision requiring investors to indemnify the fund for their share of any tax liability incurred by the fund. However, in practice it might be difficult or impossible for the fund to locate those investors by the time a tax liability is assessed against the fund, and even if the fund does succeed in locating those investors, there is no assurance that they will have assets sufficient to satisfy their indemnity obligations.

Moreover, unlike REMIC regular interests, notes issued by a distressed mortgage fund are not statutorily treated as debt for U.S. tax purposes. If a distressed mortgage fund is treated as a disregarded entity or partnership and is engaged in a U.S. trade or business, and the IRS successfully asserts that one or more classes of notes issued by the fund are equity for U.S. tax purposes, foreign holders of those notes also could be subject to U.S. net income tax.

The remainder of this subsection summarizes the measures that distressed mortgage funds take to avoid being engaged in a U.S. trade or business.

1. Secondary market acquisitions.

Distressed mortgage funds typically acquire mortgage loans on the secondary market instead of making the loans to borrowers. Purchasing loans on the secondary market constitutes a protected activity under section 864(b)(2), which generally provides that a foreign person is not treated as engaged in a U.S. trade or business solely by reason of trading in stocks or securities for its own account (whether by the foreign person or an agent), as long as the foreign person is not a dealer in stocks or securities.

2. Modifications.

Distressed mortgage funds typically acquire distressed mortgage loans with the expectation of working them out to improve their performance and then either holding the improved loans or selling them. Under reg. section 1.1001-3, a significant modification of a debt instrument is treated as a retirement of the pre-modified loan in exchange for a newly issued loan. The new loan that is deemed to arise upon a significant modification is potentially an origination that could jeopardize a fund's ability to rely on section 864(b)(2), especially if the fund had acquired the loan with the expectation of working it out.[50] Moreover, purchasing loans, improving them, and then selling them may constitute dealer activity that is not protected under section 864(b)(2).

Accordingly, before significantly modifying a loan, distressed mortgage funds first make a tax-

[48] *See* AM 2009-010; *see also* reg. section 1.864-4(c)(5)(i)(b) (a "banking, financing, or similar business" includes "making personal, mortgage, industrial, or other loans to the public").

[49] *See* section 882 (corporate income tax on ECI); section 884 (branch profits tax on deemed dividends attributable to ECI); section 875 (attributing activities of a partnership that is engaged in a U.S. trade or business to its partners); and section 1446 (enforcing partner-level income tax on ECI through partnership-level withholding obligation).

[50] *See* FSA 5501 (1995) ("The debt received in the 'exchange' . . . would be reevaluated at the time of the exchange to determine if it gives rise to" income effectively connected with a U.S. trade or business.).

free contribution of the loan to a U.S. subsidiary that is treated as a domestic corporation for U.S. tax purposes. The subsidiary, commonly referred to as a modco, pays corporate-level U.S. taxes on its net income and gain but blocks that income and gain from potentially subjecting foreign equity holders in the fund to U.S. net income tax as a result of the modification.

A modco should be respected as an entity separate from the distressed mortgage fund and should not be treated as the fund's agent, even though the fund owns all the equity interests of the modco.[51]

3. Foreclosures.

Under section 897, foreign persons are subject to U.S. net income tax on gain from a sale of specified U.S. real property interests, including gain that they realize indirectly through an entity treated as a partnership for U.S. tax purposes (such as a distressed mortgage fund).

Mortgage loans that lack "equity kickers" are not U.S. real property interests;[52] however, U.S. real property received on a foreclosure of a loan is. It is highly likely that at some point one or more loans that a distressed mortgage fund holds will default and the fund will have the right to foreclose on the underlying real property. If the fund has foreign equity holders (either directly or indirectly through other passthrough entities) and sells U.S. real property, those holders will be subject to U.S. net income tax on their share of any gain that the fund recognizes on a subsequent sale of that property.[53]

Accordingly, either before or after foreclosing on a mortgage loan, distressed mortgage funds make a tax-free contribution of the loan or of the real property to a U.S. subsidiary that is treated as a domestic corporation for U.S. tax purposes. Like a modco, this subsidiary, commonly referred to as an REOco,[54] pays corporate-level U.S. taxes on its net income and gain but blocks gain from the sale of real property from subjecting foreign equity holders in the fund to U.S. net income tax.

C. Liquidation of Modcos

Nonliquidating distributions by a domestic corporation are treated as dividends and generally are subject to 30 percent withholding tax when paid to foreign investors, to the extent of the corporation's earnings and profits.[55] The amount of a dividend of property is deemed to be the property's fair market value.[56] Accordingly, if a modco distributes a loan after modifying it, the modco generally must remit to the IRS an amount of withholding tax equal to 30 percent of the FMV of the loan to the extent that the distressed mortgage fund's beneficial owners are foreign.[57]

By contrast, liquidating distributions are not treated as dividends and are not subject to withholding tax.[58] Accordingly, modcos generally avoid making nonliquidating distributions. Instead, the distressed mortgage fund forms a new modco periodically (typically monthly or quarterly). After all loans that a modco holds have been modified, the modco distributes the loans back to the fund in liquidation.

D. The Installment Method for Modcos

When a modco significantly modifies a loan, the modco is treated as having exchanged the loan for a new loan that is issued at its issue price.[59] Assuming (as is usually the case) that a mortgage

[51] *See, e.g.*, *Moline Properties Inc. v. Commissioner*, 319 U.S. 436, 438-439 (1943) (a corporation generally is a separate taxable entity even if it has only one shareholder who exercises total control over its affairs); and *Commissioner v. Bollinger*, 485 U.S. 340 (1988) (a corporation's actions would be attributed to its parent only if (1) the corporation agrees to serve as its parent's agent under a written agreement; (2) the corporation in fact functions as agent and not as principal; and (3) the corporation is held out to third parties as agent). The IRS has issued several private letter rulings respecting the separate existence of blocker subsidiaries in the hedge fund context. *See, e.g.*, LTR 199952086; LTR 200251016; LTR 200251017; LTR 200251018; and LTR 200315028.

[52] *See* section 897(c) (interests "solely as a creditor" are not U.S. real property interests).

[53] The ownership and operation of commercial real estate (*e.g.*, a hotel) also could constitute a U.S. trade or business.

[54] REO stands for "real estate owned."

[55] *See* section 316 (defining dividend); section 1441(a) (dividend withholding on foreign individuals); and section 1442(a) (dividend withholding on foreign corporations).

[56] Reg. section 1.1441-3(e)(1).

[57] E&P generally is determined without regard to the installment method. *See* section 312(n)(5). Accordingly, even if a modco reports its modification gain under the installment method as described in Section V.D, its E&P should increase immediately by the full amount of the gain, making it more likely that a nonliquidating distribution by the modco would be treated as a dividend and subject to withholding tax to the extent allocable to foreign persons.

[58] *See* section 331 (liquidating distributions to shareholders generally are treated as gain from the shareholders' disposition of stock); and section 865(a) (gain on a sale of personal property (such as stock) is sourced to seller's residence).

[59] *See* section 108(e)(10).

loan is not publicly traded and requires all interest to be unconditionally payable at least annually, the mortgage loan's issue price generally will be its face amount.[60] As a result, the modco stands to recognize gain equal to the difference between the modified loan's face amount and the modco's tax basis in the loan, even if the loan's face amount substantially exceeds its FMV (for example, because the modco does not actually expect to be able to collect on the entire principal amount).

The modco may be able to avoid recognizing this full amount of gain if it reports the gain under the installment method.[61] The installment method permits a taxpayer that is not a dealer to report gain on a sale of property in exchange for an installment note (such as a mortgage loan) ratably as the taxpayer receives principal payments on the installment note. Under the installment method, the amount of each payment under the modified loan that a modco would treat as gain each year would be the principal payment made under the loan in that year, multiplied by a fraction equal to the total gain realized on the modification divided by the total principal payable under the loan. However, as described below, an interest charge on some deferred gains could limit this benefit.

As noted, modcos typically will not hold loans for a significant period after modifying them and instead will distribute the loans in liquidation once all the loans that they hold are modified. Deferral of gain under the installment method comes to an end when the installment note is disposed of upon a liquidation. However, the gain required to be recognized as a result of the liquidation is the difference between the loan's FMV (not face amount) and the modco's tax basis in the loan.[62] Accordingly, if a loan's FMV is less than its face amount — as is common with distressed assets — using the installment method could allow the modco to avoid recognizing gain that it would otherwise have been required to recognize.

However, if a modco holds modified loans that have a face amount of more than $150,000, and the aggregate face amount of all those loans exceeds $5 million, the modco will be subject to an annual interest charge that generally would eliminate the benefits of using the installment sale method.[63] The interest charge equals (1) the underpayment rate under section 6621(a)(2) in effect for the month in which the tax year ends (now 3 percent), multiplied by (2) a fraction equal to the extent to which the aggregate face amount of all modified loans with a face amount of more than $150,000 exceeds $5 million divided by the aggregate face amount of all those modified loans, multiplied by (3) the modco's deferred tax liability. A modco's deferred tax liability would be the amount of gain not yet recognized under the installment method for the modified loans, multiplied by the corporate tax rate (21 percent). Accordingly, the installment sale is likely to be more helpful for distressed mortgage funds that invest in residential real estate mortgages, which tend to have lower face amounts than commercial real estate mortgages.

E. Timing of Foreclosures

A foreclosure on a loan is treated as a taxable exchange of the loan for the underlying real property.[64] The foreclosing entity recognizes taxable gain or loss equal to the difference between the FMV of the real property and its tax basis in the loan.[65] If an REOco forecloses and recognizes taxable gain, the distressed mortgage fund typically has to contribute cash to the REOco to enable it to pay tax on that gain.

There are potential tax benefits to having the fund foreclose on a loan and then contribute the real property to an REOco instead of having the REOco foreclose on the loan. If the fund's tax basis in the loan exceeds the value of the real property, the loss that the fund recognizes on the foreclosure flows through to its U.S. equity holders. If the value of the underlying real property exceeds the fund's tax basis in the loan, the gain that the fund recognizes on the

[60] *See* section 1273(b)(3) (issue price of a non-publicly traded loan is its stated redemption price at maturity); section 1273(a)(2); and reg. section 1.1273-1(b) (stated redemption price at maturity is the sum of all payments to be received on the loan, other than interest that is unconditionally payable at least annually).

[61] *See* section 453.

[62] Section 336(a).

[63] Section 453A.

[64] Section 1271(a).

[65] Section 1001(a).

foreclosure is not subject to corporate-level tax, and only the fund's U.S. equity holders (and not its foreign equity holders) are taxed on their share of the gain.

Although the fund's transfer of real property to an REOco constitutes a disposition to which the tax under section 897 otherwise would apply, section 897(e) provides that the tax does not apply to nontaxable exchanges if a sale of the property received in the exchange would itself be subject to the tax under section 897. At the time of a transfer of real property to an REOco in exchange for REOco stock, the REOco stock would be subject to tax on a sale because the REOco is a U.S. real property holding corporation.[66] The REOco is cleansed of its U.S. real property holding corporation status only after it sells all its U.S. real property for cash.[67]

F. Recast Risk for Liquidating Distributions

As noted earlier, distressed mortgage funds take the position that any distributions they receive from a modco or an REOco are liquidating distributions on which their foreign equity holders are not subject to withholding tax. Some tax practitioners have expressed concern that the IRS could challenge this position under the liquidation-reincorporation rule of reg. section 1.331-1(c), the tax avoidance acquisition rule of section 269, or the economic substance doctrine.

1. Liquidation-reincorporation.

Under reg. section 1.331-1(c), the IRS may treat a liquidating distribution as a dividend if the liquidation "is followed by a transfer to another corporation of all or part of the assets of the liquidating corporation." Here, the distressed mortgage fund does not transfer all or part of the assets of a modco or an REOco to another corporation, although it may transfer new assets (that is, other pre-modification loans, pre-foreclosure loans, or real property) to a newly formed corporation.

2. Tax avoidance acquisitions.

Under section 269, if the principal purpose of any person's acquisition of control over a corporation is the evasion or avoidance of U.S. tax by securing a deduction, credit, or "other allowance" that the person "would not otherwise enjoy," the IRS may deny that deduction, credit, or other allowance.[68] For purposes of section 269, acquiring control over a corporation includes forming a new corporation.[69] Moreover, regulations provide that "other allowance" means any code or regulatory provision that "has the effect of diminishing tax liability."[70]

Read literally, section 269 applies only if the diminution of tax liability depends on the taxpayer's acquisition of control over the corporation.[71] The treatment of a modco or REOco's liquidating distribution as a transaction that gives rise to capital gain or loss instead of dividend income does not depend on the distressed mortgage fund's acquisition of control over the modco or REOco.

3. Economic substance.

If the economic substance doctrine is "relevant" to a transaction,[72] the IRS may disregard the transaction unless (1) it meaningfully changes the taxpayer's economic position without regard to U.S. tax effects (the objective test) and (2) the taxpayer has a substantial nontax purpose for entering into the transaction (the subjective test).[73] If the IRS successfully applied the economic substance doctrine to disregard the liquidation of a modco and the incorporation of a new modco, each modco's liquidating distribution would be taxed instead as a dividend.

[66] *See* section 897(c)(2); *cf*. reg. section 1.1445-2(d)(2) (a transferee of U.S. real property from a foreign transferor is not required to withhold tax under section 897 if (1) the transfer is entitled to tax-free treatment under the code, (2) the transferor notifies the transferee that the transfer is nontaxable, and (3) within 20 days of the transfer, the transferee forwards the transferor's notice to the IRS).

[67] Section 897(c)(1)(B).

[68] Section 269(a).

[69] *Id*.

[70] Reg. section 1.269-1(a).

[71] Section 269(a) (the denial of a deduction, credit, or other allowance applies when, in the first instance, "any person or persons acquire, directly or indirectly, control of a corporation," and "would not otherwise enjoy" the deduction, credit, or other allowance); *Commodores Point Terminal Corp. v. Commissioner*, 11 T.C. 411, 417 (1948) (IRS could not deny a dividends received credit under predecessor to section 269 because the credit "was in no sense dependent upon petitioner's acquisition of a controlling interest" in the paying corporation).

[72] Whether the doctrine is relevant to a transaction is determined under common law as if section 7701(o) had not been enacted. *See* section 7701(o)(5)(C).

[73] *See* section 7701(o)(1).

Legislative history provides that the economic substance doctrine is not intended to apply to "certain basic business transactions," such as "the choice to enter a transaction or series of transactions that constitute a corporate organization."[74] Arguably, the liquidation of a modco and the formation of a new modco fall within these basic business transactions.

Even if they do not, some tax practitioners believe that using multiple modcos satisfies the objective and subjective tests. They reason that by segregating assets into multiple modcos, each of which provides a layer of limited liability protection, a distressed mortgage fund reduces the risk that any one creditor could assert a claim over all the assets.[75]

G. Avoiding U.S. Withholding Tax

Under section 882, interest on indebtedness paid by a U.S. person to a foreign person is subject to 30 percent withholding tax unless the interest qualifies as portfolio interest.[76] U.S.-source interest received by a distressed mortgage fund on a mortgage loan generally will qualify as portfolio interest and therefore will not be subject to withholding tax when allocated to the fund's foreign equity holders, if:

- the mortgage loan is in registered form; and
- the amount of the interest is not determined by reference to the obligor's income, profits, receipts, sales, or other cash flows; changes in the value of the obligor's assets; or distributions on the obligor's equity.[77]

A mortgage loan is in registered form if the right to receive payments of principal and stated interest on the loan may be transferred only through a book-entry system maintained by the obligor or its agent.[78]

Mortgage loans sometimes contain an explicit requirement that the servicer, acting as an agent of the borrower, maintain a record of each lender and its assignees. This requirement ensures that the mortgage loans are in registered form.

If a mortgage loan does not contain this requirement, a distressed mortgage fund may nevertheless eliminate the withholding tax by holding the loan through a domestic grantor trust. Under reg. section 1.871-14(d)(1), interest received by a beneficiary from a grantor trust is treated as portfolio interest as long as the trust certificate held by the beneficiary is in registered form, even if the underlying obligations are not themselves in registered form.[79] Accordingly, some distressed mortgage funds establish domestic grantor trusts to hold their mortgage loans.[80] The loans are removed from the grantor trust immediately before being contributed to a modco or REOco (which, as U.S. corporations, are not subject to U.S. withholding tax), and any modified loans that a modco distributes to the fund are immediately thereafter contributed to the grantor trust.

Very generally, a trust to which a person transfers property for the purpose of protecting and conserving the property for the transferor's benefit is treated as a grantor trust only if the trust has no power to vary the transferor's investment.[81] A distressed mortgage fund's ability to trade the assets that it holds through a trust, and to remove assets from and contribute assets into the trust, might be construed as a power of the trust to vary the fund's investment. However, because any transfer of assets into or out of the trust may be carried out only at the fund's direction, funds

[74] H.R. Rep. No. 111-443, at 296 (Mar. 17, 2010); Joint Committee on Taxation, "Technical Explanation of the Revenue Provisions of the 'Reconciliation Act of 2010,'" JCX-18-10, at 97 (Mar. 21, 2010). The House report is based on an earlier proposal to codify the economic substance doctrine, and Congress did not write JCX-18-10. However, because the House report is the most recently published legislative history regarding the doctrine's codification before the enactment of section 7701(o), and the JCT released JCX-18-10 before either chamber of Congress voted on the Healthcare and Education Reconciliation Act of 2010, both sources arguably are helpful in interpreting section 7701(o).

[75] *Cf.* LTR 200251016 (respecting the use of a wholly owned foreign corporation by a tax-exempt organization to avoid unrelated business taxable income when the foreign corporation provided an added layer of limited liability); LTR 200252096 (same); and LTR 200315028 (same). However, it should be cautioned that all of these letter rulings predate the enactment of section 7701(o).

[76] Sections 871(h) and 881(c).

[77] Section 881(c). Distressed mortgage funds generally will satisfy the other conditions in section 881(c) because they are not banks and typically do not acquire equity (and thus are unrelated to any obligors).

[78] *See* reg. section 5f.103-1(c).

[79] *See* reg. section 1.871-14(c); reg. section 1.163-5T(d)(1); and prop. reg. section 1.163-5(a)(5)(iii)(b).

[80] To be treated as a domestic grantor trust, (1) a grantor trust must be organized in the United States, so that a court within the United States is able to exercise primary jurisdiction over its administration; and (2) one or more U.S. persons must have the authority to control all substantial decisions of the grantor trust. *See* section 7701(a)(30)(E).

[81] *See* reg. section 301.7701-4; and Rev. Rul. 2004-86, 2004-2 C.B. 191.

typically treat the transfer for U.S. tax purposes as a liquidating distribution by a grantor trust to the fund, followed immediately by the formation by the fund of a new grantor trust.[82] Thus, the fund's ability to hold a managed pool of assets through a trust should not cause interest payments on those assets to fail to qualify for the portfolio interest exemption.

Alternatively, if the fund is treated as a domestic disregarded entity or domestic partnership for U.S. tax purposes, and its own equity interests are in registered form, it is possible that interest payments allocated to the fund's foreign equity owners will be treated as being in registered form under reg. section 1.871-14(d)(1), regardless of whether the fund holds the mortgage loans through a grantor trust.[83] Proposed regulations, if finalized in their current form, would confirm this interpretation.[84]

VI. Conclusion

After the 2008-2009 financial crisis, hedge funds and other institutional investors seeking distressed credit opportunities used each of the two structures discussed earlier to make leveraged investments in pools of distressed mortgage loans. Although a waning supply of distressed mortgage loans during the succeeding economic recovery diminished the use of these structures, economic indicators and a growing mountain of "dry powder" at private credit funds suggest that it may be time for tax advisers to brush up on these potentially powerful tools. ■

[82] *See* Rev. Rul. 81-238, 1981-2 C.B. 248 (certificate holders' reinvestment of trust distributions in a new grantor trust was not treated as a "power to vary").

[83] *See* reg. section 1.163-5T(d)(1) (defining a passthrough certificate to include, in addition to an interest in a grantor trust holding a pool of mortgages, any "similar evidence of interest in a similar pooled fund").

[84] *See* prop. reg. section 1.163-5(a)(3)(B).