IRS Concedes to REMIC Formation Despite "Economic Substance" Concern

*By William P. Cejudo, David Z. Nirenberg and Sharon Kim**

William P. Cejudo, David Z. Nirenberg and Sharon Kim discuss Technical Advice Memo 201517007, in which the IRS respected a REMIC election despite the taxpayer's clear tax planning objectives. Their article concludes that a taxpayer should be able to rely on a REMIC election even if it achieves tax planning objectives that were not specifically contemplated by the REMIC rules.

In a recently released technical advice memorandum (TAM),[1] the IRS advised that an arrangement that satisfied the statutory requirements for real estate mortgage investment conduit (REMIC) status should be respected as a REMIC despite the audit team's concern about the economic substance of the arrangement. As a result, the tax consequences to the REMIC sponsor and investors were governed exclusively by the REMIC rules. This allowed the sponsor to transfer REMIC regular interests that had lost market value to a newly formed REMIC in exchange for REMIC regular interests in the new REMIC (which it sold) and a relatively large residual interest (which it retained). Under the REMIC rules, the sponsor was able to amortize the portion of the built-in loss allocable

WILLIAM P. CEJUDO is a Partner at Clifford Chance US LLP.

DAVID Z. NIRENBERG is a Partner and **SHARON KIM** is a Counsel, at Ashurst LLP.

to the residual interest as an ordinary deduction (not a capital loss) over a relatively short time period, despite a significant continuing economic investment in the original REMIC regular interests.[2]

By respecting the newly formed REMIC status, the IRS effectively declined to add a nonstatutory requirement that the transfer of assets to a purported REMIC be tested to determine whether there was a transfer of ownership for tax purposes under general tax principles. The conclusion reached in the TAM is consistent with other situations in which the IRS has respected a REMIC election despite tax planning objectives. Thus, the conclusion is both appropriate and unsurprising.

Short-Term REMICs

In the transaction at issue, the REMIC sponsor held residential mortgage-backed securities (RMBS) that were REMIC regular interests whose tax basis exceeded their fair market value. The sponsor could have triggered this built-in loss by selling the RMBS, but in that case it would have recognized an immediate *capital loss*. In addition, a sale would have terminated the sponsor's economic investment in the RMBS and might have required the sponsor to recognize a loss for financial or statutory accounting purposes.

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To achieve a different result, the sponsor chose to re-securitize (or re-REMIC) the RMBS and apply the mechanical rules that determine the tax consequences arising from a transfer to a REMIC. Those rules provide, in general terms, that no gain or loss is recognized upon the transfer of assets to a REMIC in exchange for interests in the REMIC.[3] The rules further provide that the transferor's basis in the assets transferred to the REMIC is allocated among the interests received in the exchange based on their fair market values. If this allocation results in a sponsor holding a residual interest with a basis in excess of its issue price, the excess is "allowable as a deduction ratably over the anticipated period during which the REMIC will be in existence."[4] Treasury Regulations explain that: (1) the loss is to be taken into account "ratably over the anticipated weighted average life of the REMIC,"[5] (2) the weighted average life of a REMIC is the weighted average of the anticipated weighted average lives of all of the classes of interests in the REMIC,[6] and (3) in determining the weighted average lives of the regular and residual interests in the REMIC, one is to take into account, not only a prepayment assumption, but also any required or permitted clean up calls or any required qualified liquidation provided for in the REMIC's organizational documents.[7]

Applying these mechanical rules to the particular interests described in the TAM, the REMIC sponsor was left with a residual interest with a basis exceeding its issue price, which it then deducted over the anticipated life of the REMIC. Presumably, the anticipated life of the REMIC was significantly shorter than the remaining term of the RMBS.

The IRS audit team questioned whether a REMIC was properly formed, asserting that the REMIC sponsor did not transfer the RMBS to the securitization trust for tax purposes. In particular, the IRS audit team focused on the sponsor's right of first refusal to the RMBS upon liquidation of the REMIC, the transferor's parent's various guarantees, and the treatment of the transfer of the RMBS as a secured financing for statutory accounting purposes.[8] The TAM did not adopt the audit team's position. Rather, it held that, because title to the RMBS was transferred and the transaction met all statutory and regulatory requirements for REMIC qualification, the trust qualified as a REMIC.

Similar Positions Taken by the IRS

The conclusion of the TAM is consistent with various Treasury Regulations that acknowledge that the IRS cannot disregard a valid REMIC election, even when the election is used to achieve an additional tax benefit, in many cases having nothing to do with merely avoiding characterization as a "taxable mortgage pool."[9] For instance, Reg. §1.1275-2(c)(4) contains an example intended to illustrate the so-called "OID aggregation rule." In the example, two REMICs, where one REMIC holds all of the regular interests in the other, are formed at the same time. Although not stated in the example, two-tier REMICs are often used to produce regular interests that could not be issued by a single tier REMIC. Significantly, the example does not challenge the separate existence of the two REMICs. Instead, the example recognizes the separate existence of each REMIC, concluding that all of the regular interests issued by one REMIC to the other are aggregated and treated as a single debt instrument for OID purposes.

Further, in Reg. §1.67-3T(a)(2)(ii)(B), the IRS addressed a situation in which a taxpayer that holds an interest in a

pool of mortgage loans makes a REMIC election for the "principal purpose of avoiding" the passthrough of investment expenses that would apply if the pool were treated as an "investment trust." The regulation doesn't disregard the REMIC election, but instead, requires the taxpayer to pass through the expenses nonetheless.

Finally, in proposed regulations under Code Sec. 475, the IRS contemplates that a taxpayer might make a REMIC election and retain all interests in the REMIC.[10] This illustrates that no particular reason is needed for the REMIC election. Further, the proposed regulations would permit a taxpayer to make a REMIC election and identify the resulting regular interests as held for investment even though it had marked the qualified mortgages to market prior to transferring them to the REMIC.[11] Taken together, these proposed regulations would permit a taxpayer to change the method for reporting income from REMIC-eligible assets even though it hasn't changed its economic investment in those assets.

In each of these instances, the IRS has recognized the taxpayer's REMIC election without requiring a nontax business purpose for making the election.[12] Like the TAM, these Treasury Regulations recognize that REMIC formation is elective. Of course, elections appear in numerous places throughout the the Code.[13] These elections may affect the manner in which income is determined (*e.g.,* whether bond premium is to be amortized as a reduction of ordinary income or taken into account as a capital loss upon disposition of the related bond, which affects both the timing and character of income) or how a particular arrangement is to be taxed (*e.g.,* as a real estate investment trust (REIT) or under the entity classification regulations). "Elections require taxpayers to choose from two or more possible tax treatments for a single taxable event and are usually adopted by Congress in an attempt to provide relief and equity through increased flexibility."[14] Denying a taxpayer the benefit of its election requires a conclusion that the taxpayer did not meet the requirements for the election[15] and not merely that the taxpayer achieved a result that is more favorable than the result it would have achieved had it not made the election.

Other Opportunities for REMIC Elections

In addition to short-term REMICs, other transactions may rely on a REMIC election to achieve a desired tax outcome having nothing to do with merely avoiding characterization as a "taxable mortgage pool." For example, a foreign investor holding a pool of mortgage loans that are not otherwise in "registered form" for purposes of the portfolio interest exemption can address this deficiency by making a REMIC election with respect to the pool, as provided in Reg. §1.871-14(d)(2). By doing so, this same foreign investor can also avoid any concerns about Code Sec. 897 relating to the Foreign Investment in Real Property Tax Act of 1980 (FIRPTA) by allowing the REMIC to foreclose on and dispose of any real property securing any mortgage loan in the pool rather than holding any such foreclosure property directly or through a domestic corporation.

Beyond these more apparent uses for a REMIC, there are other opportunities. Although those transactions are beyond the scope of this article, a REMIC can prove useful in situations in which the parties desire that interests in a vehicle be treated as debt for federal income tax purposes[16] despite their economic entitlements and that the activities of the REMIC not be imputed to a holder of interests in the REMIC despite the partial flow-through nature of the REMIC rules.[17]

In instances where those substantive issues are resolved favorably, a taxpayer should be able to rely on a REMIC election even if it achieves other tax planning objectives as a result of an application of the REMIC rules.

Conclusion

In the end, although a REMIC election itself is not subject to judicial anti-abuse doctrines and many of the REMIC rules rely on mere form, there are a number of substantive tax issues in play with any REMIC (for example, whether the terms of the regular interest meet the requirements therefor).[18] In instances where those substantive issues are resolved favorably, a taxpayer should be able to rely on a REMIC election even if it achieves other tax planning objectives as a result of an application of the REMIC rules. Although the TAM cannot be relied upon, the TAM may bolster confidence in the position that the IRS faces a difficult task in attacking a transaction that relies on a REMIC election where the parties have complied with the mechanical rules for REMICs.

ENDNOTES

* Mr. Nirenberg is the co-author of James M. Peaslee & David Z. Nirenberg, Federal Income Taxation of Securitization Transactions and Related Topics (2011 with annual supplements) (hereafter, Peaslee and Nirenberg).

1 TAM 201517007 (Nov. 21, 2014) (the "TAM").

2 *See* Code Sec. 860F(b)(1)(D)(ii) and Reg. §1.860F-2(b)(4)(iv), discussed below in footnotes 4–5 and accompanying text. Unless the context clearly indicates otherwise, all references to "Code Sec." are to the Internal Revenue Code of 1986 (the "Code"), and all references to "Reg. §" are to regulations promulgated thereunder.

3 Code Sec. 860F(b)(1)(D).

4 Code Sec. 860F(b)(1)(D)(ii).

5 *See* Reg. §1.860F-2(b)(4)(iv).

6 *See* Reg. §1.860E-1(a)(3)(iv).

7 *Id.*

8 The TAM addressed only whether the RMBS were transferred to the trust. It did not discuss whether the various parent guarantees were good assets for purposes of the REMIC asset test but that appears to have been assumed, or they may have been designated as held outside the REMIC. The TAM did not elaborate on this point.

9 *See* Code Sec. 7701(i).

10 *See* Proposed Reg. §1.475(b)-3(a).

11 *See* Proposed Reg. §1.475(b)-3(b)(1).

12 In the analogous context of REIT qualification, the IRS has decided it was prohibited from imposing limitations on the activities of a REIT that are not expressly found in the statutes or regulations. *See, e.g.,* GCM 38090 (Sept. 12, 1979) (in holding that a REIT may engage in the business activity of making loans, "[i]f the REIT otherwise qualifies as a REIT by meeting the technical requirements of the REIT provisions ... it should not ... be disqualified on the basis of a qualitative test not expressly provided in the statutory scheme."). *See also* GCM 37708 (Sept. 29, 1978) (in holding that a REIT can operate an insurance business, "[w]e do not favor the adoption of a qualitative nonpassive income source test under Code Sec. 856. In the formulation of the REIT provisions, Congress took 'care to draw a sharp line between passive investments and the active operation of business,' H.R. Rep. No. 2020, 86th Cong., 2d Sess. 4 (1960), by prescribing a detailed set of statutory rules. For this reason, we believe a requirement not expressly provided in the statute should not be lightly inferred."); GCM 38238 (Jan. 9, 1980) (in discussing certain so-called rehypothecation loans, "[t]hat a REIT may generally engage in the active conduct of a trade or business so long as the literal requirements of the Code are satisfied is now an established office position.").

13 Aubree L. Helvey and Beth Stetson, *The Doctrine of Election,* 62 The Tax Lawyer 2 (Winter 2009) at 335, 337 ("For example, taxpayers, including business entities, both foreign and domestic, must choose the type of taxpayer they will be; the type of return they will file; whether to file returns alone or with other taxpayers; who among a potentially eligible group will take a personal exemption deduction for a certain individual; whether to take a deduction or credit for certain expenditures; whether to treat gains from sales of investments as ordinary or capital because of the potential impact thereof on their investment interest deduction; whether to leave stock rights with a zero basis or allocate the related stock's basis among the stock and stock rights; whether to deduct certain administrative expenses or loss of an estate for estate tax purposes or for income tax purposes; and whether estate assets and liabilities will be valued on the date of death or on an alternate valuation date."). Internal citations omitted.

14 *Id.,* at 335.

15 *See id.,* at 338 ("In addition to prescribing when an election may be made, Code provisions often specify other prerequisites for claiming an election.").

16 *See* Reg. §1.860G-1(b)(6) ("In determining the tax under chapter 1 of the Internal Revenue Code, a REMIC regular interest (as defined in Code Sec. 860G(a)(1)) is treated as a debt instrument that is an obligation of the REMIC").

17 For example, a REMIC might be used to address certain tax concerns for foreign investors seeking to acquire nonperforming mortgage loans. For a discussion of this use of a REMIC, *see* Peaslee and Nirenberg, at 561.

18 The technical requirements for a REMIC election are discussed in chapters 6 and 7 of Peaslee and Nirenberg.

While the IRS does not generally apply judicial anti-abuse rules to REMICs, it's not above interpreting the technical rules with a heavy hand. For example, in a recent heavily redacted, results-oriented field attorney advice, the IRS appears to have interpreted a rule regarding how regular interests should be taxed to create an additional requirement for REMIC qualification. FAA 20150601F (Apr. 4, 2014) appears to require that a regular interest be structured so that interest thereon is by virtue of its form subject to current accrual in the same way as a debt instrument. That advice held, in the case of a financial asset securitization investment trust (FASIT) regular interest structured as stock, "[u]nder the FASIT rules, and the REMIC rules by cross-reference, interest on qualifying regular interests must be subject to current accrual by an accrual basis taxpayer, in the same way as a debt instrument, not accrued by the holder that happened to hold the instrument on the date of declaration or liquidation [an apparent reference to increases in liquidation preference for unpaid dividends]." The IRS appears to have created this extra-statutory requirement to further the requirement in Code Sec. 860B(b) that a holder of a regular interest use the accrual method of accounting with respect to the regular interest. A less strained reading of Code Sec. 860B(b) would be: income accrues on a regular interest as if it were a debt instrument regardless of whether income would accrue if the regular interest were taxed according to its form.