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Will the SEC's Proposed Credit Risk Retention Rules Fuel Interest in Mortgage REITs? A Summary of the Proposed Rules and Tax Concerns for Mortgage REIT Securitizations*

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William P. Cejudo, Charles A. Sweet, James A. Gouwar and John Arnholz summarize the proposed risk retention rules applicable to mortgage securitizations, compare aspects of mortgage securitizations using the REMIC and mortgage REIT alternatives, and discuss federal income tax concerns for mortgage securitization transactions undertaken by REITs.

The Securities and Exchange Commission (the "SEC" or the "Commission") and various federal banking and housing agencies have proposed broad rules for retention of credit risk in securitizations. The proposed rules would provide several methods of retaining the required risk exposure, as well as limited exceptions for pools of assets that satisfy specified credit criteria. The proposed regulations would be effective one year after publication of final rules in the Federal Register with respect to ABS backed by residential mortgage loans, and two years after publication of final rules for all other securitizations.

The proposed rules would apply to sponsors of virtually all securitizations (other than "synthetic" structures), whether the asset-backed securities ("ABS," as more fully defined below) are publicly or privately offered, and would permit only limited circumstances in which the required risk retention could be held by an originator or other party rather than the sponsor. The required risk could be retained in one of several forms, including vertical, horizontal, L-shaped and representative sample methods, as well as other methods that would apply only to specific types of assets or transactions. The proposed regulations would set strict standards for "qualified residential mortgages" (QRMs) that would be exempt from the risk retention requirements, including a 20-percent down payment for purchase financing and a requirement that the loan documents mandate loss mitigation actions that could include loan modifications. They also would exempt several other classes of qualified assets that meet stringent requirements. The proposed rules would discourage the issuance of interest-only securities or other ABS that are sold at a premium by requiring capture of that premium in a "premium capture cash reserve account." Retained

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credit risk exposure could generally not be transferred or hedged.

Although the final outcome of the proposed rules remains to be seen, real estate investment trusts (REITs) may be inherently well-suited for complying with the risk-retention rules, at least in their proposed form, with respect to mortgage securitizations. Historically, REITs have retained the "first loss" positions in mortgage securitizations by retaining tax ownership of all securities issued in the securitizations that do not constitute debt for federal income tax purposes. As a result, REITs may offer not only tax advantages but also a vehicle for complying with the risk retention rules.

Despite a REIT's combination of tax benefits with its potential as a vehicle for compliance with the risk retention rules, market interest in mortgage REITs will no doubt be tempered by the SEC's recent concept release in which it announced a review of interpretive issues relating to the status of mortgage-related pools under the Investment Company Act (the "Concept Release").[1] The Concept Release does not propose any rules. Instead, it gives notice that the SEC is reviewing various interpretative issues as to whether certain mortgage-related pools, including mortgage REITs, should continue to be exempt from registration under the Investment Company Act. If REITs holding primarily mortgage loans (as opposed to real estate) are required to register as investment companies, they will become substantially more expensive to operate and their flexibility in terms of financing the acquisition of mortgage loans will be radically reduced. Thus, as a practical matter, whether mortgage REITs actually become a viable vehicle for compliance with the risk retention rules may not be known until the SEC not only finalizes the risk retention rules themselves but also resolves the issues raised in the Concept Release.

Pending resolution of the outcome of the Concept Release, consideration should nonetheless be given to mortgage REITs as a possible means for complying with the risk retention rules. Seeking to integrate a discussion of the proposed risk retention rules with the tax considerations applicable to REITs, this article summarizes the principal terms of the proposed risk retention rules applicable to mortgage securitizations,[2] compares certain aspects of mortgage securitizations using the REMIC and mortgage REIT alternatives, and discusses federal income tax concerns for mortgage securitization transactions undertaken by REITs (including the application of the excess inclusion rules). Appendix A provides an overview of the tax rules for REITS and additional detail regarding the excess inclusion rules.

Background on the Proposed Risk Retention Rules

The credit risk retention rules were proposed in a Notice of Proposed Rulemaking (the "NPR") by the SEC along with the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System and the Federal Deposit Insurance Corporation (the "Banking Agencies"), as well as the Federal Housing Finance Agency and the Department of Housing and Urban Development (together with the SEC and the Banking Agencies, the "Agencies") to implement the mandate of Section 941(b) of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act").[3] Section 941(b) of the Dodd-Frank Act has been codified as Section 15G of the Securities Exchange Act of 1934, as amended (the "Exchange Act").

Under Section 15G of the Exchange Act, the SEC and the Banking Agencies were directed to jointly prescribe regulations that require securitizers to retain, generally, not less than five percent of the credit risk of any asset that the securitizer, through the issuance of ABS, transfers, sells or conveys to a third party, subject to certain exceptions. Section 15G provides that securitizers will not be required to retain credit risk for securitized assets if all of the pooled assets are QRMs, as defined by the Agencies. The statute also provides that the regulations must permit securitizers to retain less than five percent of the credit risk of securitized commercial loans, commercial real estate loans and consumer automobile loans if the loans meet underwriting standards established by the Banking Agencies. Finally, Section 15G permits allocation of retained credit risk to originators under the regulations where appropriate.

The risk retention requirements of Section 15G and the proposed rules are intended to address perceived problems in the securitization markets by requiring that securitizers, as a general matter, retain an economic interest in the credit risk of the assets they securitize. "[W]hen incentives are not properly aligned and there is a lack of discipline in the origination process," the Agencies state in the joint notice of proposed rulemaking, "securitization can result in harm to investors, consumers, financial institutions, and the financial system. During the financial crisis, securitization displayed significant vulnerabilities to informational and incentive problems among various parties involved in the process."[4] However, "[w]hen securitizers retain a material amount of risk, they have 'skin in the game,' aligning their economic interest with those of investors in asset-backed securities."[5] By requiring that the securitizer retain a portion of the credit risk of the assets being securitized, Section 15G and the proposed rules are intended to provide securitizers an incentive to monitor and ensure the quality of the assets underlying a securitization transaction, and thereby help to align the interests of the securitizer with the interests of investors in ABS.

Multiple alternative forms of risk retention were considered, according to the Agencies, to take into account "the diversity of assets that are securitized, the structures historically used in securitizations, and the manner in which securitizers may have retained exposure to the credit risk of the assets they securitize."[6]

Who Would Be Required to Retain Credit Risk

Sponsors

Section 15G of the Exchange Act imposes risk retention requirements on any "securitizer" of ABS. As defined, a "securitizer" includes the "person who organizes and initiates an asset-backed securities transaction by selling or transferring assets, either directly or indirectly, including through an affiliate, to the issuer,[7] a phrase which is substantially identical to the definition of "sponsor" under Regulation AB.[8] The proposed rules define "sponsor" in a manner consistent with Regulation AB—except that the definition would be applicable to all securitizations, whether or not subject to the Regulation AB disclosure rules.[9]

The proposed rules generally would require the sponsor, except as described below, to retain the required economic interest in the credit risk of the securitized assets. If there is more than one sponsor, at least one of them would have to retain the required credit risk (except where retention by a third party would satisfy the requirement), though each sponsor would be responsible for ensuring compliance with the risk retention requirement by at least one sponsor.[10]

The definition of "securitizer" in Section 15G also includes an issuer of ABS. For purposes of the federal securities laws, an "issuer" of ABS generally means the depositor (*i.e.*, the entity that deposits the pool assets with the issuing entity).[11] However, the Agencies have chosen to apply the risk retention requirements to the sponsor rather than the depositor.

Originators

The proposed rules do not require that any originator retain credit risk associated with securitized assets.[12] However, the proposed rules permit a sponsor (with the agreement of the affected originators) to allocate some or all of its risk retention obligations to one or more originators of the securitized assets. "Originator" is defined in Section 15G of the Exchange Act as any entity that "creates" a securitized financial asset and sells that asset directly or indirectly to a securitizer. Under the Agencies' interpretation, only the original creditor under the financial asset is an originator for this purpose, so the required risk retention could not be allocated to any subsequent purchaser or transferee.[13] The sponsor's risk retention requirements would be offset by any amount allocated to an originator.

The sponsor would only be permitted to allocate risk retention to an originator that contributes at least 20 percent of the assets to the pool in question, and the originator would be required to hold a percentage of the retention interest of at least 20 percent, but no more than the percentage of the pool assets it originated. An originator to which any risk retention is allocated would be subject to the same restrictions as the sponsor with respect to transferring, hedging and financing its retained interest, as described below.

This risk allocation option would be available only if the vertical or horizontal risk retention methods are used. Each party that retains risk in a transaction would be required to use the same retention method, and the originator would be required to acquire the economic interests either for cash or by virtue of a reduction in the price paid by the sponsor or depositor for the related assets.

Sponsors that allocate risk retention to originators would remain responsible for compliance with the rules regarding retained credit risk, would be required to monitor the compliance by each originator, and would be required to notify securityholders upon discovery of any noncompliance by originators.

CMBS B-Piece Buyers

As described below, in a commercial mortgage-backed securities (CMBS) transaction, the proposed rules would permit the sponsor of a CMBS transaction to meet its risk retention requirements if a third-party buyer acquires the B-piece,[14] provided that a variety of conditions are met.

Resecuritization Sponsors

Only single-class pass-through resecuritizations of underlying ABS for which the risk retention requirements were satisfied would be exempt from the risk retention requirements of the proposed rules, as discussed below. However, the sponsor of any other type of resecuritization, including a transaction in which sponsors of the underlying ABS have complied with applicable risk retention requirements but more than one class of securities is issued in the resecuritization, would be required to comply with the risk retention requirements.

Permitted Forms of Risk Retention

Base Risk Retention Requirement

The proposed rules would apply to securitizers in issuances of "asset-backed securities" as newly defined in the Exchange Act, as amended by the Dodd-Frank Act.[15] This new category of ABS encompasses a much broader range of instruments than asset-backed securities as defined in Regulation AB, including all securities that are collateralized[16] by self-liquidating financial assets that allow securityholders to receive payments based primarily on the cash flows from those assets, whether offered publicly or privately. Among other things, ABS for these purposes include collateralized debt obligations, securities issued or guaranteed by a government sponsored entity such as Fannie Mae or Freddie Mac, municipal ABS and any security that the Commission, by rule, determines to be an asset-backed security.

So-called "synthetic" securitizations, such as transactions effectuated through the use of credit default swaps, total return swaps or other derivatives, would not be covered by the proposed rules, although the scope of this exclusion is unclear.[17]

Section 15G generally requires that a securitizer retain not less than five percent of the credit risk for any asset that the securitizer, through the issuance of ABS, transfers, sells, or conveys to a third party, unless an exemption is available. Therefore, the base risk retention requirement of the proposed rules is that the sponsor retain an economic interest equal to at least five percent of the aggregate credit risk of the pool assets. The base risk retention requirement would be a minimum, and sponsors, originators and other transaction parties could retain additional credit risk exposure.[18]

The proposed rules would permit the risk retention requirement to be satisfied through several methods that attempt to recognize the diversity of asset classes and securitization structures. In general, no particular method is mandated, though the Agencies request comment on whether certain methods should be mandated for particular asset classes or securitization structures.[19] For each method, the proposed rules prescribe disclosure requirements designed to make clear to investors, the SEC and any applicable federal banking agency how credit risk associated with the transaction is retained.

Vertical Retention by Sponsor

A sponsor could satisfy its obligation by retaining at least five percent of each class of "ABS interests" issued as part of the securitization transaction. The vertical risk retention option would give the sponsor an interest in the entire structure of the securitization transaction.

For purposes of the proposed rules, an "ABS interest" includes all types of interests issued by an issuing entity, whether or not certificated, including any security, obligation, beneficial interest or residual interest, the payments on which primarily depend on the cash flows from the pool assets.[20] While the proposed rules do not specify how the amount of each class of ABS interests is to be measured, the NPR states that, regardless of method of measurement, the retained credit risk should equal at least five percent of the par value (if any), fair value, and number of shares or units of each class.[21]

Horizontal Retention by Sponsor

Eligible Horizontal Residual Interest. A sponsor could satisfy its risk retention obligations by retaining an "eligible horizontal residual interest" in the issuing entity in an amount equal to at least five percent of the par value of all ABS interests issued as part of a securitization transaction. The horizontal risk retention option would expose the sponsor to a first loss position with respect to the entire asset pool.

In an effort to ensure that an eligible horizontal residual interest remains in a first loss position, available to absorb losses on the pool assets, the proposed rules impose conditions that are not typical of current transaction structures. An eligible horizontal residual interest:

- must be allocated all losses on the asset pool until its par value is reduced to zero;

- must have the most subordinated claim to payments of both principal and interest by the issuing entity; and
- may receive its *pro rata* share of scheduled principal payments in accordance with the transaction documents, but generally cannot receive any other payments of principal on a pool asset (*i.e.,* unscheduled principal payments) until all other ABS interests in the issuing entity are paid in full, so that unscheduled payments will not accelerate the payoff of the horizontal residual interest before any other ABS interest.[22]

It appears that an excess spread residual interest that is not entitled to distributions of principal would not satisfy these criteria. Distributions of interest on a fully subordinated basis on an eligible horizontal residual interest appear to be permitted without restriction.

Horizontal Cash Reserve Account. The proposed rules also would allow a sponsor to establish and fund a cash reserve account referred to as a "horizontal cash reserve account" in lieu of retaining an eligible horizontal residual interest. Similar to an eligible horizontal residual interest, the amount in the account would have to equal at least five percent of the par value of all the ABS interests issued as part of the transaction. The account would be held by the trustee for the benefit of the issuing entity, and could only be invested in U.S. Treasury bills or FDIC-insured deposits.

The proposed rules impose various conditions on a horizontal cash reserve account in an effort to ensure that such an account would be exposed to the same credit risk as a sponsor holding an eligible horizontal residual interest. A horizontal cash reserve account must:

- be used to satisfy payments on ABS interests when the issuing entity otherwise would have insufficient funds; and
- provide that no amounts may be released or withdrawn from the account until all ABS interests in the issuing entity are paid in full or the issuing entity is dissolved, with only two exceptions:
    1. amounts may be released due to receipt of scheduled principal payments on the pool assets, if the issuing entity distributes them in accordance with the transaction documents and only on a *pro rata* basis; and
    2. the sponsor could receive interest income on the permitted investments in the account.[23]

L-Shaped Retention by Sponsor

A sponsor could satisfy its risk retention obligations by using the "L-shaped" method, meaning an equal combination of vertical and horizontal risk retention. The proposed rules would require that the sponsor retain at least 2.5 percent of each class of ABS interests issued in the securitization transaction, as well as an eligible horizontal residual interest equal to at least 2.564 percent of the par value of all ABS interests issued in the securitization transaction, other than those required to be retained as part of the vertical component (or an equivalent horizontal cash reserve account). The amount of the horizontal component avoids double-counting the portion of an eligible horizontal residual interest that the sponsor must hold as part of the vertical component, and ensures that the combined amount equals five percent of the ABS interests.[24]

Retention by Sponsor of Representative Sample

A sponsor could satisfy its risk retention obligations by retaining a randomly selected representative sample of assets that is materially equivalent to the pool assets. The representative sample option is intended to expose the sponsor to substantially the same type of credit risk as investors in the ABS. Under this option, the unpaid principal balance of all the assets in the representative sample would be required to equal at least five percent of the aggregate unpaid principal balance of all the assets initially identified for inclusion in the pool, including those that end up in the representative sample (or 5.264 percent of the total principal balance of the securitized pool). The requirements that have been proposed in an effort to ensure that the sponsor remains exposed to substantially the same aggregate credit risks as investors in the ABS are numerous and complex, and appear to be designed to accommodate only some asset classes.[25]

The proposed rules prescribe several requirements to satisfy this method of retaining credit risk. The sponsor would be required to:

- designate a pool of at least 1,000 separate assets[26];
- randomly select the representative sample from that designated pool;
- ultimately securitize or retain (as part of the representative sample) all assets in the designated pool[27]; and
- assess the sample to ensure that for each "material characteristic"[28] of the assets the mean of any

quantitative characteristic, and the proportion of any characteristic that is categorical in nature, of the assets in the representative sample is within a "95 percent two-tailed confidence interval"[29] of the mean or proportion of the same characteristic of all the assets in the designated pool.

According to the NPR, if the sample fails this statistical test, the selection process must start over or another risk retention option must be chosen.

The proposed rules require the sponsor to establish and adhere to policies and procedures for:

- identifying and documenting the material characteristics of the assets in the designated pool;
- selecting assets for the random sample;
- testing the assets in the random sample;
- maintaining documentation identifying the assets in the representative sample; and
- prohibiting assets in the representative sample from being included in a designated pool for any other securitization.

Before selling the ABS, the sponsor would be required to obtain an agreed-upon procedures report from an independent public accounting firm addressing whether the sponsor has established these policies and procedures. An acceptable agreed-upon procedures report may be relied upon for subsequent securitizations, unless the sponsor's policies and procedures have changed in any material respect.

Until all ABS interests in the issuing entity have been fully paid or the issuing entity has been dissolved, the assets in the representative sample must be serviced by the same servicer and under the same standards as the securitized assets.[30] The proposed rules also state that the individuals responsible for servicing the assets must not be able to determine whether an asset is held by the sponsor or the issuing entity.[31]

The sponsor would be prohibited from removing any assets from the representative sample and, until all ABS interests are repaid, from permitting the assets in the representative sample to be included in any other designated pool or representative sample for any other securitization.

As further described below, detailed, separate disclosure regarding the securitized assets and the retained assets would be required at the time of the ABS offering and on an ongoing basis.

It is not clear what the consequences would be for a sponsor or its securitizations if the ongoing requirements for servicing and segregation of the representative sample and for investor disclosure were not satisfied.

Horizontal Retention by CMBS B-Piece Buyer

Transfer to Third-Party Buyer. Section 15G authorizes the Agencies to permit the retention of the "B-piece" of a CMBS transaction by a third party "B-piece buyer," rather than the sponsor, to satisfy the Dodd-Frank Act's risk retention requirements. The proposed rules would permit the sponsor of a CMBS transaction[32] to meet its risk retention requirements if a third-party B-piece buyer acquires an eligible horizontal residual interest, provided that several conditions are satisfied:

- The eligible horizontal residual interest must be acquired and retained by the B-piece buyer in the same form, amount and manner as would be required of the sponsor under the horizontal risk retention option.
- The B-piece buyer must pay for the B-piece in cash at closing, without financing received directly or indirectly from any other transaction party other than an investor.
- The B-piece buyer must perform a due diligence review of the credit risk of each asset in the pool, including a review of the underwriting standards, collateral and expected cash flows of each loan.
- Neither the B-piece buyer nor any affiliate generally may have any control rights (including servicing and special servicing) not shared with other investors, except as described below.

Control Rights

As is noted in the NPR, in CMBS transactions the B-piece buyer is often the holder of the "controlling class" and is, or is affiliated with, the special servicer, but control of the special servicing function by the holder of a subordinate interest has the potential to create conflicts of interest with holders of senior securities.[33]

Under the proposed rules, the B-piece buyer could not be affiliated with any other transaction party other than an investor[34] or have any control rights (including servicing or special servicing) not shared by all other investors unless the transaction documents provide for an independent operating advisor that is not affiliated with any other transaction party, does not have any direct or indirect financial interest in the securitization other than its fees, and is required to act in the best interest of all investors.

The B-piece buyer or an affiliate would be permitted to act as servicer or special servicer, or to have control rights related to servicing, if the operating advisor has certain powers and duties, and if the B-piece buyer or any affiliate (when acting as a servicer) consults with the operating advisor before any major servicing decision (such as any material modification or waiver of any provision of a loan agreement, and any foreclosure on or acquisition of property). The transaction documents would be required to make the operating advisor responsible for reviewing the actions of the B-piece buyer or any affiliate (when acting as servicer) and for issuing a periodic report concerning its belief (in its sole discretion, exercised in good faith) as to whether that servicer is in compliance with the applicable servicing standards.

In addition, the transaction documents would be required to provide that the operating advisor has the authority to recommend that the B-piece buyer or any affiliate (when acting as a servicer) be replaced as servicer if the operating advisor determines (in its sole discretion, exercised in good faith) that the B-piece buyer or affiliate failed to comply with any applicable servicing standard and that its replacement would be in the best interest of all investors. If the operating advisor makes such a recommendation the servicer or special servicer must be replaced absent the consent of a majority of each class of certificate holders.

Hedging Prohibition

The B-piece buyer would be subject to the same restrictions as the sponsor with respect to transferring, hedging and financing the retained interest under the horizontal risk retention option.

Duty to Comply

If a B-piece buyer holds the credit risk, the sponsor would remain responsible for compliance with all of the relevant risk retention requirements, and would be required to implement and adhere to policies and procedures to monitor the B-piece buyer's compliance. If the sponsor discovers any noncompliance, it would be required to promptly notify investors.

No Additional Risk Retention for ABS Guaranteed by Fannie Mae or Freddie Mac

The proposed rules contain special provisions regarding credit risk retention requirements for Fannie Mae and Freddie Mac (the "GSEs") while operating under the conservatorship or receivership of the Federal Housing Finance Agency (the "FHFA"), and certain successors to a GSE.

The GSEs fully guarantee the timely payment of principal and interest on their mortgage-backed securities, so they are exposed to the entire credit risk of the underlying mortgage loans. The proposed rules provide that the guarantee of a GSE while operating under the conservatorship or receivership of FHFA with capital support from the United States (and an equivalent guarantee by a successor also operating under the direction and control of FHFA with capital support from the United States) will satisfy the risk retention requirements of Section 15G. Neither the premium capture cash reserve account requirements nor the hedging and financing prohibitions described below would apply to a GSE or its successor.[35]

The NPR notes that the Obama administration and Congress have been considering a variety of proposals to reform the housing finance system and the GSEs, and that the Agencies expect to revisit these provisions after the future of the GSEs becomes clearer. In the short time since publication of the proposed rules by the Agencies, some Republicans and Democrats in Congress have expressed opposition to the exemption of the GSEs from the risk retention requirements of Section 15G.[36]

Premium Capture Cash Reserve Account

Securitizers that already are subject to the base credit risk retention requirement also could be subject to an additional risk retention requirement if they seek to monetize excess spread.

In the NPR, the Agencies explain that "in many securitization transactions, particularly those involving residential and commercial mortgages, conducted prior to the financial crisis, sponsors sold premium or interest-only tranches in the issuing entity to investors, as well as more traditional obligations that paid both principal and interest received on the underlying assets. By selling premium or interest-only tranches, sponsors could thereby monetize at the inception of a securitization transaction the 'excess spread' that was expected to be generated by the securitized assets over time."[37] "Excess spread" is defined as "the difference between the gross yield on the pool of securitized assets less the cost of financing those assets (weighted average coupon paid on the investor certificates), charge-offs, servicing costs, and any other trust expenses (such as insurance premiums, if any)."[38] By monetizing excess spread before the performance of the securitized assets could be observed and unexpected losses realized, the Agencies say, "sponsors were able to reduce the impact of any economic interest they may have retained in the outcome of the transaction and in the credit quality of the assets they securitized. This created incentives to maximize securitization scale and complexity, and encouraged aggressive underwriting.”[39]

In order to “achieve the goals of risk retention,” the Agencies propose to capture the premium received on the sale of ABS that monetize the excess spread by requiring that this amount be used to fund a “premium capture cash reserve account” that would bear losses before any class of ABS, including an eligible horizontal residual interest. Otherwise, according to the Agencies, “a sponsor could effectively negate or reduce the economic exposure it is required to retain under the proposed rules” through monetization of excess spread.[40] The Agencies state bluntly in the NPR that as a result of the premium capture requirement they “expect that few, if any securitizations would be structured to monetize excess spread at closing.”[41]

The premium capture cash reserve account would be required to be funded at closing in an amount (if any) by which:

- the gross proceeds (net of closing costs paid to unaffiliated parties) from the sale of ABS interests to parties unaffiliated with the sponsor exceed
- 95 percent of the par value of the issuing entity’s ABS interests (if credit risk is retained in vertical, horizontal or L-shaped form or as a seller’s interest in a revolving asset master trust) or 100 percent of the par value of the issuing entity’s ABS interests (if credit risk is retained in the form of a representative sample of securitized assets or by a CMBS B-piece buyer).

The reserve account would be held by the trustee for the issuing entity, and could only be invested in U.S. Treasury bills or FDIC-insured deposits. Other than investment income, amounts in the reserve account could (until all ABS interests have been paid in full or the trust is terminated) be released only to make required payments on ABS interests when the issuing entity has insufficient funds to do so. The determination of whether the issuing entity has sufficient funds must be made before allocation of any losses to an eligible horizontal interest held under the horizontal, L-shaped, or CMBS B-piece options or (if risk retention is satisfied by retention of a vertical slice, seller’s interest or representative sample) before allocation of losses to the class of ABS interests that is in the first loss position or has the most subordinate claim to payment of principal or interest.

An anti-evasion provision would require that gross proceeds be increased by the par value or fair value of any ABS interest transferred to the sponsor, if the sponsor does not intend to hold that ABS interest to maturity or if that ABS interest represents a right to receive “some or all of the interest and no more than a minimal amount of principal payments” and is senior to the most subordinated class. The anti-evasion provision would not apply to required risk retained in the form of a vertical slice (or the vertical portion of L-shaped retention) if the retained interest does not have a par value.

Sponsors would be required to disclose to investors the amount deposited in the premium capture cash reserve account and the material assumptions and methodology used to determine the fair value of any ABS interest not having a par value that was retained by the sponsor.

Qualified Assets

Section 15G of the Exchange Act exempts from the risk retention requirements any ABS collateralized solely by QRMs. Section 15G also directs the Agencies to define jointly what constitutes a QRM, “taking into consideration underwriting and product features that historical loan performance data indicate result in a lower risk of default.” In addition, Section 15G directs the SEC and the Banking Agencies to adopt separate risk retention rules for ABS backed by commercial real estate loans (“CRE loans”), other commercial loans, auto loans, and any other asset class that they deem appropriate, providing for retention of less than five-percent credit risk if the loans satisfy underwriting standards developed by the Banking Agencies that indicate low credit risk. The NPR refers to QRMs and CRE loans that satisfy the criteria for exemption from the credit risk retention requirement as “qualified assets.”

Qualified Residential Mortgages

ABS would be exempt from the risk retention requirement if:

- every loan in the related securitized pool is a QRM—and not a class of ABS backed by QRMs (or other assets);
- every loan in the pool currently is less than 30 days delinquent in payment[42]; and
- the depositor certifies that “it has evaluated the effectiveness of its internal supervisory controls with respect to the process for ensuring that all assets that collateralize the asset-backed security are qualified residential mortgages and has concluded that its internal supervisory controls are effective.”[43]

These "internal supervisory controls" must be evaluated for each issuance of ABS relying on the QRM exemption within 60 days prior to the related cut-off date, and a copy of the depositor's certification must be delivered to prospective investors and, upon request, to the Commission and any applicable banking regulator.

As proposed, the requirements for satisfaction of the definition of "qualified residential mortgage" are extensive and strict, as they are intended to ensure that these loans are "of very high credit quality." As stated in the NPR, "[t]he Agencies recognize that many prudently underwritten residential mortgage loans will not meet the proposed definition of a QRM."[44]

The proposed QRM standards address loan characteristics, credit underwriting, servicing and disclosure. The NPR states that the Agencies have sought to make these standards "transparent" and "verifiable." For example, many definitions and terms have been adapted from those used in underwriting standards applicable to loans insured by the Federal Housing Administration. However, it is not clear that compliance with all of the proposed QRM standards would be readily verifiable by a securitizer.

Definition

The proposed rules would define "QRM" as a closed-end loan made to purchase or refinance a one- to four-family property, if at least one unit is the principal residence of a borrower and the loan:

- is not a loan to finance initial construction;
- is not a reverse mortgage loan;
- is not a temporary or bridge loan with a term of one year or less; or
- is not a timeshare plan; and
- satisfies each of the criteria described below, among others.
    - First lien. The loan must be secured by a perfected first lien on the mortgaged property.
    - Limitations on subordinate liens. For a loan to purchase a property, there must be no other recorded or perfected liens on the mortgaged property, to the creditor's knowledge, at the time of closing of the loan. The proposed rules would not prohibit subordinate liens in connection with the refinancing of a first lien loan, provided that the combined loan-to-value ratio (LTV) does not exceed the applicable thresholds described below.
    - Maximum maturity. The term of the loan must not exceed 30 years.
- Borrower's credit history.[45] The creditor must, within 90 days prior to the closing of the loan transaction, verify that the borrower[46]:
    - is not currently 30 or more days delinquent in payment on any debt;
    - has not been 60 or more days delinquent on any debt in the previous two years; and
    - has not been in bankruptcy or had any property repossessed, foreclosed on or subject to a short sale in the previous three years.[47]
- Payment terms. The loan must not provide for negative amortization, balloon payments, interest-only payments, optional deferral of payments or increases in interest rate or scheduled payments above specified limits,[48] and may not impose a prepayment penalty.
- Points and fees. Total points and fees payable by the borrower may not exceed three percent of the loan amount.
- Borrower debt-to-income ratio. The creditor must verify and document the borrower's income in accordance with specified standards, and determine that as of a date no more than 60 days prior to the closing of the loan transaction the ratio of the borrower's total housing debt[49] (including any other mortgage loans, if the QRM is for refinancing, as well as related taxes, insurance premiums, dues and other assessments) to gross income does not exceed 28 percent, and the ratio of the borrower's total monthly debt to gross income does not exceed 36 percent.
- Loan-to-value ratio. For a loan to purchase a property, the LTV may not exceed 80 percent. The maximum combined LTV is 75 percent for a rate and term refinancing, and 70 percent for a cash-out refinancing. Mortgage insurance could not be considered in calculating the LTV.
- Down payment. The borrower must pay at closing, solely from acceptable sources of "borrower funds":
    - a down payment equal to 20 percent of the lesser of the appraised value of the mortgaged property and, in the case of a purchase financing, the purchase price, plus
    - any closing costs payable by the borrower, plus

- in the case of a purchase financing, any amount by which the purchase price exceeds the appraised value.

- Loss mitigation. The loan documents themselves, not merely any related servicing agreement, must include the creditor's commitment to[50]:
  - undertake within 90 days following an uncured delinquency, loss mitigation activities, such as a loan modification or alternative loss mitigation if the net present value of the proceeds realized by such action would exceed the net present value of a recovery through foreclosure;
  - take into account the borrower's ability to repay and "other appropriate underwriting criteria" in any such loss mitigation activities;
  - implement unspecified servicing compensation arrangements that are consistent with the loss mitigation commitment;
  - implement procedures for "addressing" any loan owned by the creditor and secured by a subordinate lien on the mortgaged property, and disclose these procedures to investors if the QRM is included in a securitized pool; and
  - not transfer servicing rights unless the purchaser or successor servicer agrees to abide by the creditor's loss mitigation commitments.[51]
- Due on sale. QRMs may not be assumable.
- Preservation of exemption. If after the closing of a securitization it is discovered that one or more securitized loans does not satisfy all of the QRM criteria, the sponsor would not lose its exemption from the risk retention requirement if:
  - the depositor complied with the certification requirement described above;
  - within 90 days of discovery of the noncompliance, the sponsor repurchases all affected loans from the trust for a price equal to not less than the unpaid principal balance plus accrued interest; and
  - the sponsor promptly notifies security holders of the noncompliance and the repurchase.

Possible Alternative Approach to the QRM Exemption

The Agencies request comment on an approach to the QRM exemption that would create a broader definition of a QRM that would include mortgage loans of potentially lower credit quality, but would also impose stricter risk retention requirements for securitizations of residential mortgage loans that do not qualify as QRMs, in an effort to incentivize origination of QRMs. Under this alternative, sponsors could be required to retain more than five-percent credit risk on securitized pools of non-QRM residential mortgage loans, or could be limited only to vertical risk retention or another specific retention method. The QRM requirements could be modified, in an example provided by the Agencies, as follows:

- For a purchase transaction or a rate and term refinancing, the combined LTV could not exceed 90 percent, and for a cash-out refinancing, the combined LTV could not exceed 75 percent.
- There would be no restriction on subordinate liens.
- The down payment for a purchase could be as low as 10 percent plus any closing costs payable by the borrower.
- Higher debt-to-income ratios would be permitted.
- Mortgage insurance could be considered in determining whether the applicable LTV requirement has been satisfied.[52]

Other Qualified Assets

The proposed rules include underwriting standards for CRE loans and commercial loans and would completely exempt ABS backed by qualifying assets from the risk retention requirements.[53]

No underwriting standards were proposed for residential mortgage loans other than those that would qualify as QRMs. Although Section 15G authorized the Commission and the Banking Agencies to develop underwriting standards for non-QRM qualified assets that would be subject to a credit risk retention requirement of "less than 5 percent," the Agencies chose only to propose standards consistent with a complete exemption from the risk retention requirement. The Agencies expressed concern that a risk retention level between zero and five percent may not provide sufficient incentive for securitizers to allocate the resources necessary to ensure that the loans would satisfy the required underwriting standards. Section 15G also authorized the identification of additional asset classes that could be subject to a lower credit risk retention requirement, but the Commission and the Banking Agencies chose not to exercise this authority.[54]

Qualifying Commercial Loans

The proposed rules define "commercial loan" to mean any secured or unsecured loan to a company or an individual for business purposes, other than a loan to purchase or refinance a one- to-four family residential property, a loan for the purpose of financing agricultural production, or a loan for which the primary source (*i.e.*, 50 percent or more) of repayment is expected to be derived from rents collected from nonaffiliates of the borrower. A qualifying commercial loan would be required to meet the following requirements:

- The creditor must verify the borrower's ability to repay its obligations by taking specified steps, including verifying and documenting the borrower's financial condition as of the two most recent fiscal years, and analyzing the borrower's ability to service its debts during the next two years, based on compliance with a total liabilities ratio of 50 percent or less, a leverage ratio of 3.0 or less, and a debt service coverage (DSC) ratio of 1.5 or greater.
- The loan payments must be based on straight-line amortization of principal and interest over a term not exceeding five years from origination.
- Payments must be required at least quarterly for a term not exceeding five years.
- If the loan is collateralized, the collateral must be subject to a first lien security interest and the documentation must include a variety of covenants designed to ensure that the collateral is maintained, insured and available to satisfy the borrower's obligations.
- The loan documentation must include several specified covenants that require the provision of financial information and restrict the borrower's ability to incur additional debt or transfer or pledge its assets.[55]

A securitization of qualifying commercial loans could not include a reinvestment period, which would be an impractical limitation for most collateralized loan obligations (CLOs). A relatively small portion of CLOs are "static"—not providing for a reinvestment period. In addition, commercial loans typically included in CLO pools would not satisfy one or more of the proposed criteria.

Qualifying CRE Loans

The proposed rules would define a "CRE loan" to mean a loan secured by a property with five or more single-family units, or by nonfarm, nonresidential real property, the primary source (50 percent or more) of repayment for which is expected to be derived from the proceeds of the sale or financing of the property, or from rental income derived from nonaffiliates of the borrower. A CRE loan would not include a land development and construction loan, a loan on raw or unimproved land, a loan to a real estate investment trust, or an unsecured loan to a developer.

A qualifying CRE loan would be required to meet the following requirements, among others:

- The creditor must verify the borrower's ability to repay its obligations by taking specified steps, including analyzing the borrower's ability to service all outstanding debt obligations during the next two years, and documenting and verifying that the borrower has satisfied all debt obligations over a look-back period of at least two years.
- The DSC ratio must be 1.7 or greater (which may be reduced to 1.5 or greater on certain properties with a demonstrated history of stable net operating income (NOI)), consistent with a focus on both the sufficiency of the mortgaged property's NOI less replacement reserves to support the payment of principal and interest over the full term of the CRE loan, as well as the financial condition of the borrower (independent of the property's NOI less replacement reserves) to repay other outstanding debt obligations.
- The CRE loan must have a fixed interest rate, though an adjustable rate may be allowed if the borrower obtains a derivative that effectively results in the payment of a fixed rate.
- The loan payments must be based on straight-line amortization of principal and interest over a term not exceeding 20 years from origination, with payments required at least monthly over a term of at least 10 years.
- The combined LTV must be 65 percent or less, though in certain cases where very low capitalization rates are used, the maximum ratio is limited to 60 percent.
- The creditor must obtain an appraisal prepared no more than six months before the origination date and must conduct an environmental risk assessment of the property.
- The property must be subject to a first lien security interest.
- The documentation must include a variety of covenants designed to ensure that the collateral is maintained and available to satisfy the borrower's

obligations, including a covenant to comply with all legal obligations with respect to the property.
- The documentation must include covenants that require the provision of financial information (including leasing and rent-roll activity) and restrict the borrower's ability to incur additional debt secured by the mortgaged property (even on a subordinated basis) or transfer or pledge the property, other than loans to finance the purchase of machinery and equipment that is pledged as additional collateral for the CRE loan.[56]

Depositor Certification; Preservation of Exemption

For a securitizer to qualify for zero percent risk retention for qualified commercial loans or CRE loans, the depositor would be required to certify that "it has evaluated the effectiveness of its internal supervisory controls with respect to the process for ensuring that all assets that collateralize the asset-backed security" meet the applicable underwriting standards.

If after the closing of a securitization it is discovered that one or more securitized loans does not satisfy all of the applicable criteria, the sponsor would not lose its exemption from the risk retention requirement if:

- the depositor complied with the certification requirement described above;
- within 90 days of discovery of the noncompliance, the sponsor repurchases all affected loans from the trust for a price equal to not less than the unpaid principal balance plus accrued interest; and
- the sponsor promptly notifies security holders of the noncompliance and the repurchase.

Other Exemptions

Various portions of Section 15G require or permit the Agencies to adopt other exemptions from the risk retention requirements for certain types of ABS transactions. The exemptions proposed by the Agencies include:

- any securitization transaction collateralized solely (other than cash or cash equivalents) by residential, multifamily, or health care facility mortgage loan assets that are insured or guaranteed as to payment of principal and interest by the United States or an agency of the United States[57];
- any securitization transaction in which the ABS are insured or guaranteed as to payment of principal and interest by the United States or an agency of the United States and collateralized solely (excluding cash and cash equivalents) by residential, multifamily or health care facility mortgage loan assets or interests in such assets[58];
- any securitization transaction in which the ABS are collateralized solely (excluding cash and cash equivalents) by obligations issued by the United States or an agency of the United States, collateralized solely (excluding cash and cash equivalents) by assets that are fully insured or guaranteed as to the payment of principal and interest by the United States or an agency of the United States, or fully guaranteed as to the timely payment of principal and interest by the United States or any agency of the United States;
- any securitization transaction that is collateralized solely (excluding cash and cash equivalents) by loans or other assets made, insured, guaranteed, or purchased by any institution that is supervised by the Farm Credit Administration, including the Federal Agricultural Mortgage Corporation; and
- ABS that are issued or guaranteed by any state of the United States, or by any political subdivision of a state or territory, or by any public instrumentality of a state or territory that is exempt from the registration requirements of the Securities Act under Section 3(a)(2).[59]

Resecuritizations

Most resecuritizations would be subject to the risk retention requirements, even if the sponsors of the underlying securities had already complied with the risk retention rules in the securitization of the underlying assets. Repackagings of corporate debt would also be subject to risk retention.

The proposed rules would provide a narrow exemption from the risk retention requirements for resecuritizations under two conditions:

- The transaction must be collateralized solely by existing ABS issued in a securitization for which credit risk was retained as required under the rule or which was exempted from the credit risk retention requirements of the rule ("15G-compliant").
- The transaction must involve the issuance of only a single class of ABS interests and provide for the pass-through of all principal and interest payments received on the underlying ABS (net of the issuing entity's expenses).

Sponsors of resecuritizations that are not structured purely as single-class pass-through securities would be required to meet the credit risk retention requirements with respect to those resecuritizations unless another exemption is available, regardless of whether the sponsor of the underlying ABS retained the required credit risk or qualified for an exemption. Therefore, resecuritizations that re-tranche the credit risk or the prepayment risk of the underlying ABS, or that are structured to achieve a sequential paydown of tranches, would not be exempted. Also, private-label ABS issued before the effective date of the final rules typically will not be 15G-compliant, so resecuritizations of these securities would not be eligible for the limited exemption even if they are structured as single-class pass-through securities.[60]

Limitations on Hedging, Financing and Transfer of Retained Interests

In general, a sponsor would be prohibited from transferring or hedging an interest that it is required to retain under the proposed rules, or financing the retained interest on other than a full recourse basis. Third parties that retain any required risk as described above would generally be subject to similar requirements.

A sponsor would be permitted to transfer a retained interest to an affiliate whose financial statements are consolidated with those of the sponsor.[61]

Hedging of Retained Interests

Neither a sponsor nor its consolidated affiliate would be permitted to enter into any transaction or agreement if payments on a related financial instrument, derivative or other position are materially related to the credit risk of any ABS interests that the sponsor or affiliate is required to retain, and the position would in any way limit the financial exposure of the sponsor to the credit risk of interests it was required to retain.

Permitted hedging would include:

- hedges related to interest rates, currency exchange rates or home prices, or tied to other sponsors' securities; and
- credit hedges involving instruments tied to an index that includes ABS, provided that:
  - any class of ABS interests in an issuing entity as to which the sponsor was required to retain risk represents no more than 10 percent of the dollar-weighted average of all instruments in the index; and
  - all classes of ABS interests in all issuing entities as to which the sponsor was required to retain risk represent no more than 20 percent of the dollar-weighted average of all instruments in the index.[62]

Issuing entities' hedging activities would be similarly limited.[63] Any credit protection or hedge obtained by an issuing entity could not limit the financial exposure of the sponsor on any interest required to be retained. For example, a credit insurance policy to cover losses on ABS interests or on a pool of securitized assets could not benefit the retained interest. However, it appears that asset-level insurance or guarantees generally would be permitted.[64]

Financing of Retained Interests

Neither a sponsor nor its consolidated affiliate could pledge an interest it is required to retain as collateral for any financing (including a transaction structured as a repurchase agreement)[65] unless the financing is full recourse to the borrower. The Agencies note in the NPR that if a sponsor or consolidated affiliate were to default under such a financing or otherwise permitted a pledged retained interest to be taken by the lender, the borrower would have violated the prohibitions on transfer of retained interests.[66]

Disclosure Requirements

The proposed rules require that a variety of disclosures be provided to prospective investors "a reasonable period of time prior to the sale" of the ABS and, upon request, be provided to the applicable regulators.

For sponsors electing the horizontal, vertical or L-shaped risk retention options, sponsors would be required to provide information regarding the form of risk retention, the amount of the interest retained by the sponsor or any other party, the material assumptions and methodology used in determining the aggregate amount of ABS interests issued, including those relating to estimated cash flows and the discount rate used,[67] and (for the horizontal option and the horizontal component of the L-shaped option) the material terms of the interest retained.

If vertical or horizontal risk is allocated to an originator, the sponsor would be required, in addition to providing the other applicable information described above, to identify the originator and the amount and form of risk it retains.

If the risk retention requirement is satisfied through retention of a representative sample of the designated pool, disclosure would be required regarding the amount of assets in both the designated pool and the representative sample, material characteristics of the designated pool, the policies and procedures used by the sponsor to ensure compliance with the applicable requirements described above, confirmation of receipt of the required agreed-upon procedures report, and the material assumptions and methodology used in determining the aggregate amount of ABS interests issued. Detailed disclosure would be required with respect to the representative sample pool "in the same form, level and manner" as is provided regarding the securitized assets. For each distribution date, sponsors would be required to provide to investors a comparison of the performance of the retained sample with the performance of the pool assets.

For CMBS with respect to which the risk retention requirement is satisfied through retention of an eligible horizontal residual interest by a third party, the sponsor would be required to identify the B-piece buyer, describe the amount of the interest retained by that party, the price paid, the material terms of the retained interest, and the B-piece buyer's experience in investing in CMBS, and provide any other information about the B-piece buyer "that is material to investors in light of the circumstances of the particular securitization transaction." Disclosure also would be required regarding loan-level representations and warranties, whether any of the securitized loans do not comply with those representations and warranties, and what factors were used in determining that the affected loans should be included in the securitized pool notwithstanding such noncompliance.[68]

For securities guaranteed by Fannie Mae or Freddie Mac as to which the risk retention requirement is satisfied by that guarantee, the sponsor would be required to describe the manner in which it met its credit risk retention requirement.

Safe Harbor for Foreign Transactions

The proposed rules include a safe harbor for certain foreign transactions. Under the safe harbor, the risk retention requirements would not apply to a securitization transaction if:

- the securities are not required to be and are not registered under the Securities Act;
- no more than 10 percent of the dollar value by proceeds (or equivalent if sold in a foreign currency) of all classes of ABS interests are sold to U.S. persons[69] or for the account or benefit of U.S. persons;
- neither the sponsor nor the issuing entity is organized under the laws of the United States or a U.S. state or territory, or is an unincorporated branch or office located in the United States of an entity not organized under the laws of the United States or a U.S. state or territory (a "U.S.-located entity"); and
- no more than 25 percent of the assets were acquired by the sponsor, directly or indirectly, from any consolidated affiliate of the sponsor or issuing entity that is a U.S.-located entity.

The safe harbor would not be available for any transaction or series of transactions that technically complies with the safe harbor but is part of a plan or scheme to evade the risk retention requirements of Section 15G and the proposed rules.[70]

REITs As a Vehicle for Risk Retention

The requirements of the proposed risk retention rules have re-focused market interest on REITs. From a tax standpoint, the principal benefit of a REIT is that it can originate or purchase mortgage loans, finance the loans and avoid any federal income taxation. With respect to risk retention, REITs have historically retained the "first loss" positions in mortgage securitization transactions by retaining tax ownership of all securities issued in the securitization that do not constitute debt for federal income tax purposes. As a result, the historical practice of REITs may be tweaked to comply with the requirements for horizontal retention with few economic consequences to the transaction participants.

For federal income tax purposes, a REIT is treated as a corporation, except that it can deduct the dividends it pays it shareholders.[71] To qualify for this treatment, a REIT must meet a variety of organizational and operational requirements, which are discussed in Appendix A. A REIT that distributes all of its taxable income as dividends will not pay an entity level federal income tax unless it engages in certain prohibited transactions. Thus, unlike a trust or partnership, which itself does not have an entity level tax, a REIT is subject to a corporate level of taxation but can conduct its activities such that it pays no tax.

Despite the current focus on mortgage REITs, REITs have been around for five decades. In drafting the REIT provisions, Congress sought to provide a tax-favored vehicle through which investors, particularly small ones, could pool resources for investment in real estate and real estate mortgage loans. Because the REIT provisions address both REITs holding principally real estate (so-called "equity REITs") and REITs holding principally real estate mortgages (so-called "mortgage REITs"), certain of the statutory and regulatory provisions may have little or no application to one type of REIT or the other. In addition, authorities applying the REIT provisions in the context of one type of REIT must be analyzed for their application to REITs having a different investment focus.

Typical Structure for a REIT Securitization of Mortgage Loans

In its simplest form, a REIT securitization typically involves the following transactions:

- The REIT acquires or originates mortgage loans.
- The REIT sells those loans to a depositor.[72]
- The depositor transfers the loans to a Delaware statutory trust in exchange for the sole class of equity interest in the trust and one or more classes of notes secured by the loans.
- The depositor sells the notes to investors.

At the end of this series of transactions, the REIT holds, directly or indirectly, the proceeds of the note offering and the sole class of equity in the trust.

Although this series of transactions shares many similarities with a traditional, securitizations utilizing a real estate mortgage investment conduit (REMIC), a REIT securitization has a number of contrasts with a REMIC securitization, the principal contrasts being as follows:

- Notes rather than Certificates. REITs will typically issue securities in the form of notes rather than certificates. Notes are consistent with the intended tax treatment that the securities be treated as debt rather than ownership interests in the issuer. To address non-tax concerns, the issuance mechanics generally will require issuing the notes pursuant to an indenture, administered by an indenture trustee. The indenture may contain events of default that are not typically found in trust agreements for REMIC transactions in which certificates of beneficial ownership are issued.
- "Debt-for-tax" opinions. To obtain greater comfort that the REIT has not sold an ownership interest in the mortgage loans or in the REIT itself, a REIT will typically seek an opinion of tax counsel that the securities sold by the REIT (or its depositor) constitute debt for federal income tax purposes. To do so, tax counsel will analyze the debt or equity characteristics of various features of the issuance. In contrast, no such "debt/equity" analysis is necessary for a REMIC transaction. By statute, all regular interests in a REMIC are treated as debt for federal income tax purposes. For example, an interest-only regular interest in a REMIC is treated as debt; a REIT typically does not issue an interest-only security given its lack of traditional debt features.
- Retention of equity classes. REITs typically have at least two tax reasons to retain any classes that could be treated as "equity" in any securitization transaction it undertakes. First, selling equity could require the REIT to recognize gain and possibly pay a prohibited transaction tax on any such gain. Second, the REIT may be required to retain all the equity (including any class of security for which no "debt-for-tax" opinion has been obtained and accordingly may be equity for federal income tax purposes) if transferring equity would result in the issuer being a taxable mortgage pool that is not wholly owned by a REIT or a qualified REIT subsidiary.[73]
- Additional re-purchase obligations for retained securities. Consistent with retaining tax ownership of any equity (including any class of security for which no "debt-for-tax" opinion has been obtained), a REIT seeking to repo out any such equity (or class of security) generally should do so only if it can be done in a way that does not result in the issuer becoming subject to an entity level of tax if the repo counterparty forecloses on the repo-ed security.
- Internalizing phantom income normally associated with a REMIC residual interest. Unlike a REMIC, a REIT cannot transfer the tax consequences of the securitization while retaining the economics of the securitization. In a REMIC, this is done by transferring a noneconomic residual interest (commonly referred to as a "NERD") to a third party. Because a REIT generally will retain all the equity in a mortgage securitization, it will suffer any related tax burdens associated with

holding such equity. In addition, in light of the requirement that REITs typically distribute their income, the accrual of any income becomes of particular concern. For example, if a REIT receives interest payments on loans and uses it to pay principal on securities it has issued, the REIT will have taxable income (in respect of the interest received) but may not have current cash flow from the securitization available for the REIT to satisfy its distribution requirements.[74]

- Additional concerns with the "income test" if the REIT acquires distressed loans. As explained in greater detail below, REITs must comply with asset tests and income tests. In general, each of these tests seeks to determine the portion of the REIT's assets and income attributable to real estate and real estate mortgage loans. These tests can pose issues for a REIT acquiring an "underwater" loan—that is, a mortgage loan having a stated principal balance greater than the value of the real estate securing the loan.
  - If a mortgage covers both real property and other property, a REIT is required to apportion the interest between these two amounts to determine the amount attributable to the real property for purposes of the income test. Seemingly, if the mortgage does not cover other property, no apportionment is necessary. However, REITs should proceed cautiously in determining that no other property is covered by a mortgage.
  - If the value of the real property equals or exceeds the loan amount, all of the interest is apportioned to the real property. On the other hand, if the loan amount exceeds the value of the real property, the interest is multiplied by a fraction to determine the apportionment. The numerator of the fraction is the value of the real property (determined as of the date the REIT commits to buy or make the loan) and the denominator of which is the amount of the loan.
  - In the case of distressed debt, the apportionment rule can provide particularly harsh results where property other than real estate is covered by the mortgage. This results from the fact that the numerator will take into account the distressed value of the real estate but the denominator reflects the full principal amount of the loan rather than only the value of the property securing the loan.
- Additional concerns with the "asset test" if the REIT acquires distressed loans. The REIT's asset test is generally based on the fair value of the asset. Given that distressed mortgage loans generally have a value determined by reference to the value of the real property securing the loan, the value of the loan itself would not be expected to be materially greater than the value of the underlying real property.
  - In Rev. Proc. 2011-16,[75] the IRS sought to provide relief to REITs acquiring distressed mortgage loans where the property values were declining. In general, the relief allows a REIT to use as the value of the mortgage loan for purposes of the asset test an amount equal to the lesser of the fair value of the loan and the fair market value of the real property securing the loan determined as of the date the REIT commits to the buy the loan. Although this relief may assist a REIT if real estate values continue to decline, it may also preclude a REIT from translating any increases in real property values into greater values for the asset test, as the Revenue Procedure imposes a "lesser of" test tied to the fair market value of the real property securing the loan determined as of the date the REIT commits to the buy the loan. Thus, even if the value of the real estate increases in the future, the value of the loan for purposes of the asset test will be frozen in time.
  - In contrast, REMICs typically have not faced hurdles with declines in real property values. For example, for purposes of determining whether a loan is a "qualified mortgage" under the REMIC provisions, a sponsor may rely on the loan-to-value ratio of the loan determined at the time of origination of the loan or at the time the loan is transferred to the REMIC and the loan, at most, only has to be 80 percent secured by real property at the more favorable of either time.[76] Of course, in the context of declining real estate values, the LTV at the time of origination would be expected to provide a more favorable answer.
- Hedging transactions. A REIT has two annual gross income tests that it must satisfy. In general, on an annual basis 75 percent of its gross income must come from real estate sources (the "75-percent income test") and 95 percent of its gross income must come from real estate sources,

dividends interest, and gains from the sale of stock or securities (the "95-percent income test"). Any income a REIT earns from a hedging transaction that it entered into to hedge its indebtedness incurred or to be incurred to acquire or carry real estate assets, is excluded from its gross income for purposes of applying the 75-percent income test and the 95-percent income test. This income is, however, included for purposes of determining its taxable income and the amount it needs to distribute. In addition, a REIT is allowed to exclude from its gross income for purposes of applying the 75-percent income test and the 95-percent income test any income from a transaction entered into primarily to manage foreign currency risk. Again, note that such income is not excluded for purposes of determining its taxable income and the amount it needs to distribute. In addition, it is also important to note that if a REIT is entering a hedging transaction that is not either to hedge debt related to real estate assets or foreign currency risk, such hedging income is not excluded from either the 75-percent income test or the 95-percent income test.

Time-Tranched REIT Securitizations

Perhaps the most significant structuring issue in a REIT securitization is whether to issue multiple classes of notes in a sequential pay structure (that is, a transaction in which one class of notes is entitled to receive principal before another classes of notes, regardless of any credit losses). Such a sequential pay, or time-tranched, structure is typical for mortgage securitizations effected as REMICs. If such a structure is used in a non-REMIC transaction and notes of different classes are sold to investors, the securitization would be classified as a "taxable mortgage pool" for federal income tax purposes (a "TMP").

Generally, if a securitization is structured in a manner that constitutes a TMP,[77] the issuing trust is treated as a corporation for federal income tax purposes. An entity-level tax can be avoided, however, if the sponsor of the trust is a REIT.

If a REIT held all of the equity in the issuing trust, directly or indirectly through a "qualified REIT subsidiary" (a "QRS"), the issuing trust itself would also be a QRS.[78] For federal income tax purposes, a QRS is ignored as an entity separate from the parent REIT, and all of the assets, income and expenses of the QRS are treated as those of the REIT. As a result, an issuing trust that constitutes a TMP but that also satisfies the requirement to be a QRS is treated as an entity whose separate existence from the REIT is disregarded, and the REIT is treated as the owner of its assets and the issuer of the outstanding notes. Thus, even though the securitization transaction might give rise to an entity level tax obligation, that obligation is much the same as the tax obligation of any other REIT—that is, it can be eliminated as long as the REIT continues to qualify as a REIT and distributes its taxable income to its shareholders.

In the case of a time-tranched securitization, however, additional tax consequences arise for both the REIT and its shareholders. In calculating its income, the REIT will be treated as if it owns a residual interest in a REMIC. As a result, a portion of the REIT's income generally will be "tainted" as excess inclusion income. (Additional background on excess inclusion income is contained in Appendix A.)

To the extent that a REIT's excess inclusion income for any year exceeds its REIT taxable income (that is the income the REIT retains and pays a corporate level tax on), the excess inclusion is to be apportioned among its shareholders in proportion to the dividends they receive from the REIT.[79] To the extent that a dividend is thus characterized as excess inclusion, a REIT shareholder must treat the dividend as though it were excess inclusion income attributable to a REMIC residual interest. Thus, a shareholder's taxable income could not be less than the excess inclusion income portion of its dividends (meaning that a taxable shareholder cannot use net operating losses or current deductions to offset excess inclusion income), a tax-exempt shareholder (including a pension plan or individual IRA) would have to treat that portion of its dividends as unrelated business taxable income, and a foreign person would be subject to U.S. income and withholding tax on that portion of the dividend without any reduction in rate otherwise allowable by treaty. In addition, if the REIT has any government entity that is a shareholder, the REIT will have to pay tax on that portion of income allocable to that shareholder.[80]

At this time, there are no regulations explaining exactly how a REIT is to make the required adjustments mentioned in the TMP rules. Moreover, there are no information reporting rules explaining how a REIT is to inform its shareholders of the portion of their dividend that is or could be excess inclusion income. Although the IRS has not issued regulations, it has stated in a published notice that a REIT must ascertain whether it or any QRS that it owns is a TMP, and, if so, the REIT must calculate the amount of excess inclusion income for the TMP using a reasonable method and must allocate the excess inclusion to its shareholders in proportion to the dividends paid to such shareholders.[81]

If a REIT undertakes time-tranched owner trust transactions, it potentially will have large amounts of excess inclusion. Although there are no reporting rules in place, a REIT should notify its shareholders about the portion of each dividend it pays that should be treated as excess inclusion income. In addition, the offering documents for the REIT should advise potential investors of the fact that the REIT may recognize significant amounts of excess inclusion and that it may affect the tax treatment of dividends paid by the REIT.

Concerns with REITs Sponsoring REMIC Transactions

In light of the consequences to a REIT's shareholders of issuing time-tranched securities, a REIT might be tempted to consider making a REMIC election with respect to the transaction and transferring the residual to another party. However, REITs typically do not undertake securitization transactions through REMICs due to prohibited transaction concerns that arise under the REIT rules. In short, if a REIT sells property to customers in the ordinary course of business (so-called dealer sales), the REIT can be subject to a prohibited transactions tax at a rate of 100 percent on any net income derived from such sales.[82] If a REIT undertook a REMIC transaction and sold regular interests in an offering, the REIT could be viewed as having sold the regular interests in a prohibited transaction. This would be especially true if the REIT entered into REMIC transactions on a regular and recurring basis.

As an alternative, a REIT could use a "taxable REIT subsidiary" (a "TRS") for a REMIC transaction. A TRS is a corporation in which the REIT holds stock, typically a wholly owned subsidiary, and which joins the REIT in making a TRS election.[83] As the name implies, a TRS is taxable as an ordinary corporation and is not subject to the qualification requirements to which the parent REIT is subject. A TRS allows a REIT to undertake activities, such as dealer sales, that a REIT could not undertake directly without running afoul of the prohibited transaction rules.

If a REIT chooses to securitize mortgage loans in REMIC transactions through its TRS, then the TRS will recognize and pay corporate level tax on any gain realized upon the sale of regular interests. This is true even for classes of regular interests that are purchased by the parent REIT in the offering. In addition, for purposes of applying the REIT quarterly asset tests and annual gross income tests, the REIT will be treated as owning only those classes of regular interests that it purchased from the TRS. This is true even if for financial reporting purposes the transaction is treated as a financing and the REIT and the TRS are consolidated for financial reporting purposes.

Conclusions

Although the final outcome of the proposed risk retention rules remains to be seen, REITs may be inherently well-suited for complying with the credit risk retention rules, at least in their proposed form. Despite the complex nature of the REIT provisions, REITs have been used successfully to acquire mortgage loans (either through origination or purchase) and securitize them. For the future, mortgage REITs can be expected to provide a workable, tax-favored vehicle for leveraged investments in mortgage loans that may also serve as a mechanism for compliance with the risk retention rules.

Endnotes

* Portions of this article were adapted from John Arnholz & Edward E. Gainor, Offerings of Asset Backed Securities (2nd Ed.) (Wolters Kluwer, 2011) and Edward E. Gainor and Charles A. Sweet, "A Guide to the Proposed Credit Risk Retention Rules for Securitizations," 2011, *available online at www.bingham.com/Media.aspx?MediaID=12273.*

1 The Concept Release can be found at *www.sec.gov/rules/concept/2011/ic-29778.pdf.*

2 The proposed rules also include special rules for specific types of non-mortgage securitizations, which are not addressed in this article. Additional detail regarding the portion of the proposed rules applicable to nonmortgage securitizations may be found in the article cited in note * above.

3 76 FR 24090 (Apr. 29, 2011). The complete text of the NPR is available at *www.sec.gov/rules/proposed/2011/34-64148fr.pdf.*

4 NPR, 76 FR, at 24095.

5 *See id.,* at 24096, quoting S. Rep. No. 111-176, at 129 (2010).

6 *Id.,* at 24096.

7 The Agencies interpret "issuer" for this purpose as referring to the issuing entity.

8 *See* Item 1101 of Regulation AB. Regulation AB, published by the SEC in 2005, contains registration, disclosure and reporting rules for publicly registered asset-backed securities.

[9] The NPR states that "in the context of collateralized loan obligations (CLOs), the CLO manager generally acts as the sponsor by selecting the commercial loans to be purchased by an agent bank for inclusion in the CLO collateral pool, and then manages the securitized assets once deposited in the CLO structure." NPR, 76 FR, at 24098, n.42.

[10] While not altogether clear, the proposed rules do not appear to permit the sponsors to allocate the required risk retention among themselves, but would require at least one of them to retain all of the required interest. In the NPR, the Agencies request comment on whether this is the best approach or whether the required retention should be permitted to be allocated among multiple sponsors in some other way.

[11] *See, e.g.*, Rule 191 under the Securities Act of 1933, as amended (the "Securities Act") and Rule 3b-19 under the Exchange Act.

[12] The Agencies expressed concern that requiring originators such as mortgage brokers and small community banks to retain credit risk could adversely impact credit availability because those parties would have difficulty obtaining funding for any such risk retention. The Agencies said risk retention at that level could cause operational and compliance problems because "a loan may be sold or transferred several times between origination and securitization and ... an originator may not know when a loan it has originated is included in a securitization transaction."

[13] Regulation AB uses the term "originator" but does not define it. In a correspondent lending arrangement in which a lender originates loans pursuant to a purchaser's underwriting guidelines and the purchaser has previously committed to purchase loans that satisfy its guidelines, ABS market participants generally have viewed the purchaser, not the correspondent lender, as the originator for purposes of Regulation AB. Under the risk retention rules as proposed, the original creditor would be the originator, but it is not entirely clear whether the SEC and the Banking Agencies intend to prohibit a party that purchases loans from a correspondent lender from sharing a sponsor's risk retention obligation.

[14] In CMBS transactions, the "B-piece" refers to the most subordinate tranche of securities issued.

[15] *See* Section 3(a)(77) of the Exchange Act.

[16] The proposed rules clarify that the term "collateralize," as used in Section 15G and in the proposed rules, does not imply any specific legal structure for a securitization covered by the risk retention requirements. "Assets or other property collateralize an issuance of ABS interests if the assets or property serve as collateral for such issuance." Assets or other property serve as collateral for an ABS issuance if they provide the cash flow (including cash flow from the foreclosure or sale of the assets or property) for the ABS interests irrespective of the legal structure of issuance, including security interests in assets or other property of the issuing entity, fractional undivided property interests in the assets or other property of the issuing entity, or any other property interest in such assets or other property. NPR, 76 FR 24098, n. 33, 24156.

[17] The NPR states that because the term "asset-backed security" for purposes of Section 15G includes only those securities that are collateralized by self-liquidating financial assets, "synthetic" securitizations are not within the scope of the proposed rules. NPR, 76 FR, at 24098, n. 32.

[18] NPR, 76 FR, at 24099-24100.

[19] *Id.*, at 24100.

[20] *Id.,* at 24156. The term excludes common or preferred stock, limited liability interests, partnership interests, trust certificates, or similar interests in an issuing entity that are issued primarily to evidence ownership of the issuing entity and the payments on which are not primarily dependent on the cash flows of the underlying assets.

[21] *Id.,* at 24101. Neither "par value" nor "fair value" is defined in the proposed rules. "Par value" generally refers to the face amount, stated value or nominal dollar value of a security.

[22] *Id.,* at 24102.

[23] *Id.,* at 24102-03.

[24] *Id.,* at 24103-04.

[25] *Id.,* at 24104-06.

[26] It is not clear to what extent the Agencies have considered the implications for securitization of certain asset types, such as residential and small balance commercial mortgage loans, of requiring that at least 1,000 assets be designated. Use of the representative sample method of risk retention would probably not be feasible for some transactions, such as collateralized loan obligations, securitizations of large balance commercial loans or resecuritizations, even in the absence of this requirement.

[27] In other words, if any assets are removed from the designated pool for any reason prior to the securitization, such removal must occur before the final identification of the designated pool.

[28] According to the NPR, the average unpaid principal balance of the assets is always a material characteristic. Other material characteristics may include the location of the properties securing the loan, the debt-to-income ratios of the borrowers, and the interest rates.

[29] This statistical term is not defined in the proposed rules. In general, a "confidence interval" describes the degree of uncertainty associated with a sampling method. The term is used in various federal regulations; the federal banking regulators have referred to confidence intervals in aspects of risk-based capital guidelines for banks and thrifts. In a recent rule proposal, the National Credit Union Administration stated that "[c]onfidence levels and confidence intervals are statistical concepts that relate to the precision of the estimates produced by the sampling approach. Confidence level is the probability that the results of a sampling approach are within the confidence interval of the true answer. Confidence interval specifies the allowable margin of error around the true answer." Sample Income Data To Meet the Low-Income Definition, 75 FR 80,364, at fn. 4 (Dec. 22, 2010).

[30] NPR, 76 FR, at 24106. As a result, this method of risk retention would probably not be feasible if an issuing entity's assets are serviced by multiple servicers.

[31] It is not clear how this requirement could be fulfilled in practice, in view of the typical servicer's responsibility for collecting and remitting payments on the pool assets. It would of course be necessary to ensure that cash flows on the securitized assets are properly remitted to security holders and that cash flows on the retained assets are properly remitted to the sponsor.

[32] At least 95 percent of the total unpaid principal balance of the securitized assets must be commercial real estate loans.

[33] *Id.,* at 24109.

[34] This requirement is subject to a *de minimis* exception permitting affiliation with one or more originators of the securitized assets collectively comprising less than 10 percent of the pool's dollar volume. *Id.,* at 24410, n. 93.

[35] *Id.,* at 24111-12. These requirements would not apply to a GSE or its successor so long as it is operating under the conservatorship or receivership of FHFA with capital support from the United States.

[36] Rep. Scott Garrett (R., N.J.) has introduced the "GSE Credit Risk Equitable Treatment Act," which is intended to "ensure mortgages held or securitized by Fannie Mae and Freddie Mac and asset-backed securities issued by such enterprises are treated similarly as other mortgages and asset-backed securities for purposes of the credit risk retention requirements." The bill, if enacted, would override any final rules exempting the GSEs from the risk retention requirements.

[37] NPR, 76 FR, at 24113.

[38] *Id.,* at 24096, n. 18.

[39] *Id.,* at 24113.

[40] *Id.* The NPR states that prohibiting sponsors from receiving compensation in advance for excess spread income expected to be generated by securitized assets over time "should better align the interests of sponsors and investors and promote more robust monitoring by the sponsor of the credit risk of securitized assets, thereby encouraging the use of sound underwriting in connection

with securitized loans." Further, the Agencies say, this prohibition "should promote simpler and more coherent securitization structures." *Id.*

[41] *Id.*

[42] NPR, 76 FR, at 24120 (definition of "currently performing") and 24165 (terms of exemption). As written, this requirement appears to apply as of the closing date, not the cut-off date.

[43] *Id.,* at 26165.

[44] *Id.,* at 24118.

[45] The Agencies elected not to use a borrower's credit score as a criterion for QRM eligibility because various credit scoring models may be inconsistent and models may change over time. Instead, the Agencies chose to define a set of so-called "derogatory factors" that would disqualify a borrower's mortgage loan from qualifying as a QRM. These factors are "designed to be a reasonable proxy" for credit score thresholds associated with low delinquency rates. The Agencies cite a report by the Board of Governors of the Federal Reserve System showing that the median FICO score is "somewhere between 700 and 749," and that "borrowers with prime fixed-rate mortgages with FICO scores below 700 were substantially more likely" to default than the average of prime fixed rate borrowers. That report concludes that "any major derogatory factor, including being substantially late on any debt payment (not just a mortgage), as well as bankruptcy or foreclosure, would push a borrower's credit score down substantially." *Id.,* at 24121.

[46] The creditor would be deemed to have satisfied these requirements if it obtains at least two credit reports obtained no more than 90 days before the loan closing confirming the above, provided that no subsequent credit report obtained by the creditor before the loan closing contains contrary information. *Id.,* at 24122.

[47] The NPR states that "[t]he Agencies' own analysis, as well as work published in academic journals, indicates that borrower credit history is among the most important predictors of default." *Id.,* at 24121.

[48] Interest rates on adjustable rate mortgage loans could not increase by more than two percent in any 12-month period, or by more than six percent over the life of the loan.

[49] For this purpose, calculation of interest payments on loans would be based on the maximum interest rate that could be charged during the first five years of the loan's term.

[50] The Agencies call attention in the NPR to the fact that that there is currently an interagency effort among certain federal regulatory agencies, including some of the Agencies joining in the proposed rulemaking, to develop national mortgage servicing standards that would apply to all servicers of residential mortgage loans. These standards would apply to residential mortgage loans regardless of whether the mortgage loans are QRMs, are securitized or are held in portfolio by a financial institution. The NPR states that the primary objective of this separate interagency effort is to develop a "comprehensive, consistent, and enforceable set of servicing standards for residential mortgages that servicers would have to meet." *Id.,* at 24127. The Agencies say that they anticipate requesting comment on proposed servicing standards later this year, with the goal of issuing final standards shortly afterward.

[51] Although this provision refers to transfer of "servicing rights," it is not clear whether it is intended to address a transfer of servicing responsibility in which servicing rights are not transferred.

[52] NPR, 76 FR, at 24129.

[53] Separate exemptions are provided for securitizations of CRE loans and commercial loans. *Id.,* at 24169-70.

[54] The NPR states that "many of the other types of ABS issuances are collateralized by assets that exhibit significant heterogeneity, or assets that by their nature exhibit relatively high credit risk. Such factors make it difficult to develop underwriting standards establishing low credit risk that can be, as a practical matter, applicable to an entire class of underlying assets in the manner described under section 15G." *Id.,* at 24130.

[55] *Id.,* at 24131-32.

[56] *Id.,* at 24132-34.

[57] Fannie Mae, Freddie Mac, and the Federal Home Loan Banks are specifically deemed not to be agencies of the United States. *Id.,* at 24136.

[58] *E.g.,* Ginnie Mae securitizations.

[59] *Id.,* at 24136-38.

[60] *Id.,* at 24138-39.

[61] *Id.,* at 24115-16.

[62] *Id.,* at 24116.

[63] Issuing entities, however, would not be considered to be consolidated affiliates of the sponsor for purposes of restrictions applicable to such affiliates.

[64] The NPR notes as an example that the proposed rules would not prohibit loan-level mortgage insurance obtained by a borrower in connection with the origination of a mortgage loan. NPR, 76 FR 24116, n. 111.

[65] Although the proposed rules would prohibit sale of an interest required to be retained, the proposed rules contemplate financings in the form of repurchase agreements.

[66] NPR, 76 FR, at 24116.

[67] Other assumptions that would likely be material, according to the Agencies, include estimated default rate, prepayment rate, the time between default and recoveries on the underlying assets, and interest rate projections for assets with variable interest rates. In the NPR, the Agencies expressed concern that "[d]epending on the circumstances, a sponsor may have an incentive to inflate the value of the underlying collateral and the ABS supported by such collateral (for example, to increase the proceeds from the securitization transaction) or to underestimate the value of such collateral and ABS (for example, to reduce the sponsor's risk retention requirement). *Id.,* at 24102, n. 58.

[68] What the Agencies intended here is unclear. It is possible that this disclosure item was intended to address loan underwriting criteria rather than representations and warranties.

[69] "U.S. person" has substantially the same meaning as under Rule 902(k) of Regulation S.

[70] NPR, 76 FR, at 24139-40.

[71] Code Sec. 857(b)(2)(B). REITs are subject to the preferential dividend rules of Code Sec. 562(c) that prevent it from deducting a dividend paid that is considered "preferential." In general, dividends are preferential if shareholders of the same class receive proportionately different amounts or amounts at different times. The IRS has ruled that dividend reinvestment plans (typically referred to as DRIPs) that provide for a purchase price of at least 95 percent of the stock's value on the distribution date does not create a preferential dividend. *See* Rev. Rul. 83-117, 1983-2 CB 98. "Code Sec." references herein are to the Internal Revenue Code of 1986, as amended.

[72] Typically, the "sale" in this context will be to a depositor that is a disregarded entity of the REIT or to a special purpose subsidiary of the underwriter of the notes. In either such case, the "sale" should not constitute a sale for federal income tax purposes. Accordingly, the "sale" to the depositor should not be a "prohibited transaction" for the REIT.

[73] Under Code Sec. 7701(i), such a taxable mortgage pool would be a separate taxable corporation.

[74] A REIT could satisfy the distribution requirement through the use of a "consent dividend," under Code Sec. 565. Pursuant to these provisions the REIT makes a hypothetical distribution (rather than an actual cash distribution) to shareholders of consent stock (generally common stock rather than preferred stock). Each shareholder of consent stock is required to agree to include in income the amount of the consent dividend as if cash had been distributed. As a result, a consent dividend may be a practical strategy for only certain private REITs.

[75] IRB 2011-5. *See* LeDuc & Wang, *Recent Developments for REITs Owning or Investing in Distressed Mortgages and Related Assets,* J. Tax'n Fin'l Prods., Vol. 9, No. 3, at 27 (Apr. 2011).

[76] There is an alternative test available to REMICs, which applies if real property is the sole security for the loan at the time of its origination and "substantially all" of the loan proceeds were used to acquire, improve or protect the mortgagor's interest in the real property.

[77] Under Code Sec. 7701(i), a securitization that has the following three characteristics will constitute a TMP: (1) substantially all of its collateral assets are debt instruments, more than half of which are principally secured by real estate, (2) two or more classes of debt are issued that will have different maturities for a reason other than credit loss, and (3) payments on the collateral assets "bear a relationship" to payments on the debt issued by the securitization.

[78] A QRS is any corporation in which a REIT holds 100 percent of the equity interests and that has not elected to be a taxable REIT subsidiary. Code Sec. 856(i)(2).

[79] REIT taxable income is the excess of taxable income over the deduction for dividends paid. Almost all REITs distribute as dividends an amount sufficient to reduce their taxable income to zero and thereby avoid being subject to a corporate level tax. Consequently, one would expect that excess inclusion income would always exceed REIT taxable income.

[80] Code Sec. 7701(i) provides authority for the Treasury Department to issue regulations to the effect that, if a REIT or a QRS is a TMP, adjustments similar to the adjustments under Code Sec. 860E(d) of the Code are to apply to the REIT's shareholders. The IRS has provided interim guidance as to how to apply these rules in Notice 2006-97, 2006-2 CB 904. A REIT required to pay tax on income allocable to a government entity shareholder would file Form 8831.

[81] Notice 2006-97.

[82] Code Sec. 857(b)(6).

[83] Code Sec. 856(l).

APPENDIX A: Additional Detail Regarding REIT Qualification and the Excess Inclusion Rules

Requirements for REIT Status

In brief, for a corporation or other entity to qualify as a REIT, it must elect REIT status on its tax return for the first year for which it seeks to qualify and it must satisfy certain organizational tests, quarterly asset tests, and two annual gross income tests set out in Code Sec. 856. In addition, the organization must satisfy annual distribution requirements. These requirements are addressed in this order below.

Organizational Requirements. The following organizational tests must be satisfied if an organization is to qualify as a REIT:

- It must be taxable as a domestic corporation—a corporation, a statutory trust or other unincorporated entity, such as an LLC, that files a federal income tax return as a REIT.
- It cannot be a bank, thrift or insurance company.
- It must be managed by a board of directors or by one or more trustees.[1]
- It must have 100 or more beneficial owners for 335 days of a full year or a proportionate number of days in a short year (no attribution rules apply for purposes of this test, and this test does not apply for the first year for which REIT status is sought).
- It cannot be closely held—five or fewer individuals cannot own more than 50 percent in value of the outstanding beneficial interests in the organization at any time during the last half of any tax year (this test does not apply for the first year for which REIT status is sought):
  - Shares owned by a corporation, partnership or trust are attributed to the shareholders, partners or beneficiaries in applying this test.
  - Certain organizations, such as charitable trusts, are treated as individuals for purposes of this test.
  - Special rules apply to "pension held REITs."[2]
- Its beneficial ownership interests must be represented by transferable shares or certificates.
- It must maintain records showing actual beneficial ownership of its shares (*i.e.,* it must monitor its compliance with the five-or-fewer test).
- It must elect REIT status by filing a tax return (Form 1120 REIT) on which it computes taxable income as a REIT.
- It must have the calendar year as its tax year.

Quarterly Asset Tests. To qualify as a REIT, an organization must satisfy certain asset tests, set out in Code Sec. 856(c)(4), at the end of each calendar quarter.

The "75 percent test." At least 75 percent of a REIT's total assets must consist of real estate assets, cash and cash items, and U.S. government obligations.

The term "real estate assets" includes interests in mortgages on real property. The term includes:

- mortgage pass-though certificates, such as Ginnie Mae, Fannie Mae, and Freddie Mac pass-through certificates, that represent beneficial ownership interest in a pool of mortgage loans;
- REMIC regular and residual interests; and
- certain warehouse lines of credit secured by interests in real property where the warehouse lender has the ability to control the servicing on the loans pledges to secure the warehouse line.

Where a REIT owns directly, or indirectly through a QRS, 100 percent of the equity interests in an owner trust that holds mortgage loans, it is considered to own those loans for tax purposes. The leverage represented by the notes issued by the owner trust is ignored for purposes of the asset test because the test is applied on a gross basis.

Where a REIT owns REMIC interests, however, it is treated as owning mortgage-backed securities and not the underlying pool of loans.

The term "real estate asset" also includes any stock or any debt instrument acquired with new capital (proceeds of stock issuance, either public or private, or proceeds of a public offering of debt securities if the debt securities have a term of more than five years) for the one-year period beginning on the date that the REIT raises the capital.

The "25 percent test." Of the securities in the 25-percent basket:

- no more than 25 perent of the value of the REIT's total assets can be represented by securities of one or more taxable REIT subsidiaries;
- no more than five percent of the REIT's total assets can be invested in the securities of any one issuer;
- the REIT cannot hold more than 10 percent of the voting securities of any one issuer; and
- the REIT cannot hold securities representing more than 10 percent of the value of the securities of any one issuer (an exception exists for certain "straight debt" securities that have no contingent payments).

If a REIT fails any of the tests at the end of a calendar quarter, the REIT has a 30-day period following the close of the quarter in which to cure the failure. In addition, if a REIT fails a quarterly asset test, and such failure is either considered *de minimis* under thresholds set out in the Code, or, if not *de minimis*, attributable to reasonable cause and not willful neglect, it will not lose its REIT status but, in the case of greater than *de minimis* failure, it will be subject to a penalty tax. It must, however, remedy the failure within six months (or other period provided in regulations) of the close of the quarter in which it identifies the failure.

Annual Gross Income Tests. A REIT must comply with two gross income tests. If a REIT fails to meet these tests, a REIT can maintain its status as such if the failure is due to reasonable cause and not attributable to willful neglect of the rules and a penalty tax is paid.

The "95 percent income test." A REIT must derive at least 95 percent of its gross income from dividends, interest, rents from real property, gains from sales of stock, securities or real property (other than dealer property), and income from foreclosure property. Gains and income from properly identified hedging transactions entered into by the REIT to hedge interest rate risk with respect to indebtedness incurred, or to be incurred in the future, by the REIT to carry real estate assets are not treated as items of gross income for purposes of computing the 95 percent income test.

The "75 percent income test." A REIT must derive at least 75 percent of its gross income from rents; interest on obligations secured by mortgages on real property or interests in real property (including income earned on REMIC regular and residual interests and other mortgage-backed securities; gain from sale of real property (other than dealer property); dividends on shares in other REITs; income from foreclosure property; and amounts that would not otherwise be real estate income, but that are earned on the temporary investment of new capital for the one-year period following the receipt of such new capital. Note that interest from U.S. government obligations is not qualifying income for purposes of this test.

Distribution Requirements. As noted above, a REIT is allowed a deduction, under Code Secs. 857(b)(2)(B) and 561, for dividends paid to its shareholders.[3] To qualify for tax treatment as a REIT, the deduction for dividends paid (determined without regard to capital gain dividends) must equal or exceed the sum of:

- 90 percent of the organization's real estate investment trust taxable income determined without regard to the dividends paid deduction and by excluding any net capital gain; and
- 90 percent of net income from foreclosure property.

For these purposes, a few special rules apply. First, certain items of noncash income (*e.g.*, OID on debt in excess of cash flow from the debt) are not required to be distributed currently, but the REIT must pay tax on those amounts to the extent they are not distributed. Second, a REIT is allowed to satisfy its minimum distribution requirement by electing to treat dividends declared and paid after the close of the year as relating back to the preceding year (so called "spill-back dividends").[4] Finally, certain REITs may be able to satisfy the distribution requirement through the use of a "consent dividend."[5]

An excise tax is imposed on a REIT if it fails to make certain required distributions on a calendar-year basis. (A REIT can use spill-back dividends to satisfy the minimum distribution requirement described above, but not to satisfy this calendar year distribution requirement.[6]) The excise tax equals four percent of the required distribution over the sum of (1) the amount actually or deemed received by shareholders for the calendar year, and (2) any amount the REIT retains and pays tax on.[7] The required distribution is the sum of 85 percent of the REIT's ordinary income and 95 percent of capital gain net income.

Taxation of a REIT and Its Shareholders

Although a REIT generally can avoid paying an entity level tax by distributing all of its income to its shareholders, a REIT will pay a federal income tax in the following cases:

- If a REIT inadvertently fails either of the gross income tests, it will be subject to a tax based on a formula tied to the amount by which it fails the test.
- A REIT is subject to a 100-percent tax on redetermined rents, redetermined deductions, and excess interest. Redetermined rents would not arise with respect to a mortgage REIT. Redetermined deductions means deductions or items of expense that were allocated to a TRS that should have been allocated to the REIT. Excess interest is interest paid or accrued by a TRS at rates that are not commercially reasonable on indebtedness owed to the REIT. A mortgage REIT could have redetermined deductions if expenses allocated to a TRS should have been allocated to the REIT or excess interest if the REIT charged interest on indebtedness owed by the TRS at other than a commercially reasonable rate.
- A REIT is subject to a tax upon the failure to satisfy the quarterly asset test. The tax imposed on a failure that is greater than *de minimis* is the greater of $50,000 or an amount to be determined under regulations to be issued based on the income derived from the assets that caused the failure.
- A REIT can pay a tax for the failure of the REIT to satisfy certain tests other than the gross income or asset tests. The tax imposed for failures attributable to reasonable cause and not willful neglect is $50,000 per occurrence.
- A REIT is subject to tax on net income from foreclosure property. In short, if a REIT acquires real property through foreclosure or deed in lieu of foreclosure, and the property generates income that does not qualify for purposes of the 75-percent test, it is subject to a corporate-level tax at the highest corporate tax rate.
- A tax at the rate of 100 percent is imposed on any net income a REIT derives from a prohibited transaction. A prohibited transaction is any sale or disposition of property held for sale to customers in the ordinary course of a trade or business. An exception exists for certain property acquired through foreclosure. For this purpose, any income that a REIT derives from a "shared appreciation provision" contained in an obligation held by a REIT is treated as gain recognized on the sale of the property to which the shared appreciation provision relates.[8]
- If a REIT finds REMIC execution preferable, it will usually conduct a REMIC securitization through a TRS. The TRS will be taxable on any gain recognized on the REMIC securitization
- A tax is imposed on excess inclusion income earned by a REIT and attributable to shareholders who are disqualified organizations (essentially government organizations not subject to tax on their income).

REIT shareholders recognize dividend income on distributions made by the REIT out of earnings and profits. The dividends are subject to the following rules:

- The dividends do not qualify for the dividends received deduction in the hands of a corporate shareholder.
- The dividends paid to noncorporate taxpayers generally will not be eligible for the preferential rates that apply to dividends paid by an ordinary C corporation. To the extent a REIT itself receives dividends from an ordinary C corporation, such as a TRS, the REIT's shareholders can treat a portion of the REIT dividend as qualifying for the preferential rate. In addition, to the extent a REIT retains and pays tax on a portion of its income from a prior year, it may be able to treat a portion of its dividends as qualifying income in the hands of an individual.
- A REIT is allowed, but is not required, to designate certain distributions as being out of recognized capital gains (capital gain dividends) and such distributions will receive long-term capital gain treatment in the hands of the shareholders.
    - As noted above, if a REIT has excess inclusion income, then, under regulations to be promulgated by the IRS, it has to allocate

that excess inclusion income among the dividends it pays to its shareholders and the shareholders are to treat a portion of their dividends as though they represented excess inclusion income.

- For foreign shareholders, the dividends may have consequences under the Foreign Investment in Real Property Tax Act ("FIRPTA"). Under these provisions typically when non-U.S. investors invest in either real property or corporations that hold substantial real property, gain from this investment is treated as effectively connected to a United States trade or business, and accordingly, subject to net income tax in the United States (the "FIRPTA tax"). Sale at a gain of real property by a REIT can cause a non-U.S. shareholder to be treated as earning income from the sale of real property. However, this treatment does not apply to a shareholder if (1) the class of stock it holds is regularly traded on an established securities market, and (2) the shareholder does not own more than five percent of that class of stock and has not owned more than five percent of that class of stock at any time in the prior year. In addition, sale of REIT stock is not subject to the FIRPTA tax if either (1) the REIT is domestically controlled (less than 50 percent owned by foreign persons at all times during the prior five-year period, or if shorter, since the REIT was created), or (2) the class of stock held by the non-U.S. investor is regularly traded on an established securities market and in the prior five years the non-U.S. investor has not held more than five percent of that class of stock.

Excess Inclusion Income

Background of Rules. Generally, a REMIC residual interest holder must include in computing its taxable income the net income or loss of the REMIC on a quarterly basis. A REMIC's net income or loss is the difference between the income realized by the REMIC on its assets (interest, OID and market discount) and its expenses, which are predominantly represented by interest and OID expense on the REMIC regular interests. A residual interest need not be an interest in any economic sense and REMICs are often created in which all of the cash flows on the REMIC's assets are dedicated to making payments on regular interests. Even in the case of such a noneconomic residual interest, the interest holder could recognize significant amounts of taxable income in the early life of the REMIC followed by taxable losses in later years. These periods of phantom income and phantom loss occur because the weighted average yield on the REMIC's regular interests increases (assuming a rising yield curve) as the shorter maturity classes are paid off, while the yield on the mortgages it holds is treated as staying constant. That is, in the early years of a REMIC, cash flows representing interest and OID on the REMIC's assets are used to make nondeductible principal payments on outstanding regular interests. As the REMIC matures, the lower-yielding faster-paying classes of regular interests are retired and, as a result, the weighted average yield on the remaining outstanding regular interests could exceed the yield on the REMIC's assets. In other words, in the later years, the REMIC makes deductible interest and OID payments with nontaxable principal receipts.

When the REMIC legislation was enacted in 1986, Congress created special rules to ensure that all or at least a portion of the income on a residual interest was included in the holder's income in all events. This income, referred to as "excess inclusion income," cannot be offset with otherwise allowable losses, is taxable as unrelated business taxable income in the hands of a tax exempt entity such as a pension fund, and is subject to full withholding in the hands of a foreign person.

Generally, excess inclusion is the income that is allocated to a residual interest holder for a quarter to the extent that such allocation exceeds the amount that would have been allocated to the interest if it were a bond having an issue price equal to the fair market value of the residual interest on the REMIC start-up day and a yield to maturity equal to 120 percent of the long-term AFR.[9]

More precisely, excess inclusion for any quarter equals the amount of income allocated to the residual interest for the quarter in excess of the daily accruals for the quarter. The daily accruals are determined by multiplying the adjusted issue price of the residual interest at the beginning of the quarter by the long-term AFR that was in effect on the REMIC's startup day. This product is then allocated ratably among the days in the quarter. The adjusted issue price for this purpose is the initial issue price of the residual interest (fair market value on startup day) increased by daily accruals in earlier periods and decreased by any payments made on the residual interest in earlier periods.

Application to REITs. A REIT can realize excess inclusion income not only by holding REMIC residual interests, but also by holding the equity interest in non-REMIC Owner Trust that issues multiple classes of time tranched notes. Although such an Owner Trust would be a taxable mortgage pool, and, therefore, classified as a corporation for tax purposes, as long as a REIT holds 100 percent of the equity in the Owner Trust, it would also be a QRS and ignored as an entity separate from the REIT.

ENDNOTES

1 This requirement can restrict a REIT's ability to enter into a long term management contract (a contract with an initial term longer than three years or renewal terms longer than one year) or a management contract that requires it to pay a prohibitive termination fee.

2 A "pension held REIT" is one in which (1) at least one pension trust owns more than 25 percent, by value, of the beneficial interests in the REIT, and (2) one or more pension trusts (each of which owns more than 10 percent of the beneficial interests in the REIT) own more than 50 percent of the beneficial interests in the REIT. If a REIT is a pension held REIT, then any pension trust owning a greater-than-10-percent interest in the REIT could be required to treat all or a portion of the dividends received from the REIT as unrelated business taxable income.

3 The dividends deducted are not allowed to be "preferential," which requires that all shareholders of the same class received the same dividend. Minor allowances are made for differences related to a dividend reinvestment program as long as the discount is not greater than five percent and differences in dividends due to different load charges between series.

4 The dividends must be declared before the REIT is required to file its tax return for the year (including extensions) and be paid before the earlier of the next regular dividend payment after the declaration and 12 months after the end of the tax year.

5 As noted above, with a consent dividend, a REIT does not actually distribute cash. Each shareholder is required to agree to include in income the amount of the consent dividend as if cash had been distributed. Given that the consent of each shareholder is required, a consent dividend may be a practical strategy for only certain private REITs.

6 This excise tax is designed to essentially offset the benefit shareholders in a REIT could receive from having a REIT defer declaring and paying out its income until the year after such income was earned because shareholders would not be taxed on the income until the subsequent year when they received the dividends.

7 If a REIT declares a divided in October, November or December of a given year that is payable to a shareholder of record in the month declared and actually pays the dividend by the end of January of the next year, both the REIT and the shareholder treat the dividend as paid on December 31 of the year declared.

8 In general, a "shared appreciation provision" with respect to a loan entitles the REIT to a specified portion of any gain realized on the sale or exchange of real property securing the loan or any appreciation in value of that property as of a specified date.

9 AFR or applicable federal rates are rates published monthly by the IRS for use in certain tax calculations. There is a short-term, and mid-term, and a long-term AFR. The rates a based on average yields of Treasury securities.

