# Clients&FriendsMemo

## COVID-19 Update: IRS Issues Securitization Guidance on Coronavirus-Related Forbearances

**April 13, 2020**

On April 13, 2020, the Internal Revenue Service issued a helpful revenue procedure that permits loans that are subject to certain forbearances and related modifications as a result of the COVID-19 pandemic to be contributed to, and held in, real estate mortgage investment conduits (**REMICs**) and grantor trusts without jeopardizing these vehicles' U.S. tax status.

More specifically, under the revenue procedure:

- *LTV test*. A mortgage loan's LTV does not have to be retested as a result of a qualified forbearance to determine whether the loan is REMIC-eligible;
- *Deemed reissuance.* A qualified forbearance of a loan that is held by a REMIC or grantor trust does not jeopardize the tax status of the REMIC or grantor trust;
- *Foreclosure-restriction.* A qualified forbearance before a loan is contributed to a REMIC does not restrict the REMIC from later foreclosing on the loan; and
- *Unconditional entitlement to payments*. Interest shortfalls and special servicing fees incurred as a result of a qualified forbearance do not cause a REMIC's regular interests to fail to qualify as such.

For these purposes, qualified forbearances are:

- Forbearances under certain federally backed residential and multifamily mortgage loans that are granted under the Coronavirus Aid, Relief, and Economic Security Act (the **CARES Act**);[1] and

[1] For a discussion of the CARES Act, see our recent Clients & Friends Memo.

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- Similar forbearances of up to six months that are provided to borrowers experiencing a financial hardship due, directly or indirectly, to the COVID-19 emergency and are requested or agreed to between March 27, 2020, and December 31, 2020,

in each case together with any related modifications. The revenue procedure does not define related modifications, but gives as examples (1) the capitalization of deferred interest and (2) the re-amortization of a loan to preserve its original maturity date.

The remainder of this memo describes the relief provided by the revenue procedure in greater detail.

**Qualified Mortgages**

An entity qualifies as a REMIC only if, in general, substantially all of its assets consist of qualified mortgages, foreclosure property, and specified short-term investments and reserves.

A mortgage loan is a qualified mortgage only if it is principally secured by an interest in real property and is contributed to the REMIC on its startup day. Tax regulations provide that a mortgage loan is principally secured by real property if the value of the underlying real property is at least 80% of the mortgage loan's adjusted issue price (that is, the mortgage loan's loan-to-value (**LTV**) ratio is less than 125%).

Tax regulations permit the LTV test to be satisfied on either the date that the loan was contributed to the REMIC or the date that the loan was originated. In the current economic environment, there is a risk that a loan will not satisfy the LTV test on the date that it is contributed to a REMIC. Accordingly, REMICs may have to rely on the loan's origination-date LTV to establish that it is a qualified mortgage.

The revenue procedure provides that a loan's LTV will not have to be retested after its origination as a result of a qualified forbearance.

**Modifications**

A "significant modification" of a mortgage loan is treated as a taxable exchange of the loan for a new loan. If a REMIC holds the loan, then, unless an exception applies, this deemed exchange would be an impermissible acquisition of a newly issued non-qualified mortgage. If a grantor trust holds the loan, then the deemed exchange could be an impermissible exercise of a "power to vary." In either case, the deemed exchange could jeopardize the entity's U.S. tax status.

The revenue procedure provides that a qualified forbearance does not jeopardize a REMIC's or grantor trust's U.S. tax status.

**Foreclosure-Restricted Loans**

Real property acquired in foreclosure does not constitute a good REMIC asset if, when the REMIC acquired the related loan, the REMIC knew or had reason to know that the loan would default (that is, the REMIC had **improper knowledge**). A REMIC can lose its REMIC status if at any time beginning three months after the REMIC's start-up day, more than a *de minimis* amount of its assets are bad REMIC assets. Accordingly, if a REMIC has improper knowledge with respect to a loan, then it must sell the loan before foreclosure.

The revenue procedure provides that a qualified forbearance does not cause a REMIC to have improper knowledge.

**Unconditional Entitlement to Payment**

The "regular interests" that a REMIC issues to investors must unconditionally entitle the investors to receive a specified principal amount (or a similar amount). Some market participants have expressed concern that if a REMIC acquires a pool of mortgage loans on which it does not expect principal to be fully repaid (because some of the loans are distressed), the REMIC cannot issue regular interests that "unconditionally entitle" the holders to a face amount equal to the principal amount on the mortgage loans.

Similarly, a servicer may be unable to advance interest on loans or a special servicer might charge additional fees to the REMIC in connection with workout and foreclosure activities; the servicer's inability to advance or the imposition of these fees also would delay and/or reduce amounts that otherwise would be payable on the REMIC's regular interests. Finally, payments under a forbearance may not accrue compound interest, resulting in shortfalls on the REMIC's regular interests.

The revenue procedure provides that these potential shortfalls do not cause an interest to fail to qualify as a REMIC regular interest.

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If you have any questions, please feel free to contact any of the following Cadwalader attorneys.


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