REMIC Tax Concerns Surrounding Foreclosures

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A Real Estate Mortgage Investment Conduit (REMIC) is an entity employed to securitize loans secured by real property and that has been granted tax-favored status. In the current economic environment, due to the fact that they hold primarily commercial or residential mortgages, REMICs are commonly faced with workouts of troubled loans. The tax rules[1] that apply to REMICs place restrictions on the activities of a REMIC and the assets a REMIC can hold without risking its tax-favored status. These rules apply to performing and nonperforming loans alike, and therefore restrict when, how and what a REMIC can hold when it forecloses on a loan. The tax rules relating to foreclosure property held by a REMIC are intended to prevent a REMIC from engaging in activities that are the equivalent of operating a business.

What Property Can a REMIC Hold upon Foreclosure?

In order to maintain its preferred tax status, a trust formed as a REMIC is permitted to hold only "qualified mortgages" and "permitted investments." The tax rules define the term "permitted investments" to include "foreclosure property" as that concept is set forth in the rules applicable to Real Estate Investment Trusts. Generally speaking, foreclosure property is any real property (including interests in real property), as well as personal property incident to such real property, that is acquired by the REMIC via a foreclosure as a result of a default on the loan that such property secured. The REMIC can acquire the property through foreclosure or a similar process, such as the acceptance of a deed in lieu of foreclosure. Foreclosure property would include real property and personal property incident to such real property, but would not include equity interests in an entity that owns such real or personal property. A REMIC cannot, therefore, foreclose on a pledge of equity in a entity.

If a REMIC holds more than a *de minimis* amount of nonpermitted assets (such as property that does

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1 The term "tax rules" as used herein shall refer to Section 860D et seq. of the Internal Revenue Code of 1986, as amended, and Treasury Regulations Section 1.860A-1 et seq.

not qualify as foreclosure property), its tax-favored status as a REMIC is terminated. If the REMIC holds only a *de minimis* amount of nonpermitted assets (less than 1 percent of the aggregate tax basis of all of the REMIC's assets), the REMIC will not lose its status as a REMIC, but will still be subject to a 100 percent tax on any net income attributable to such nonpermitted assets. If, when the loan was transferred to the REMIC, the REMIC or its agents knew the loan was troubled and would likely result in a foreclosure, it cannot foreclose on the collateral and hold the property without paying the 100 percent tax.

How Long Can a REMIC Hold Foreclosure Property?

Importantly, foreclosure property can only be held by the REMIC until the end of the third taxable year following the taxable year in which the trust acquired the property, unless an extension is granted by the IRS. An extension will only be available if the REMIC can prove to the IRS that it is necessary for the orderly liquidation of the REMIC's interest in the foreclosure property.

What Limitations Are Placed on a REMIC in Owning Foreclosure Property?

A REMIC will be subject to a 100 percent tax if it engages in certain prohibited activities with respect to foreclosure property. These prohibited activities include:

- **Leasing** – the REMIC can't enter into a lease under which it receives income other than "rents from real property" and other types of permitted income;
- **Construction** – the REMIC can't engage in construction on the foreclosure property other than completing a building or improvements that were begun pre-foreclosure and only so long as more than 10 percent of the construction was begun pre-foreclosure; and
- **Engaging in a Business** – the REMIC can't operate the property in a trade or business after an initial 90-day grace period other than through an independent contractor.

In order to avoid violating the prohibition against operating the property in a trade or business, the REMIC must employ the services of an independent contractor to manage the property after the initial 90-day grace period. Such manager must be truly independent and cannot exceed certain ownership levels in the REMIC.

If a REMIC engages in one of the prohibited activities with regard to the foreclosure property, it will be subject to a 100 percent tax on the income it receives from the foreclosure property, as well as any gain on the disposition of the property.

What Income from Foreclosure Property Is Taxable?

While the benefit of REMIC status is that it is not generally taxed on its income, there is an exception for "net income from foreclosure property." To the extent a REMIC receives net income from foreclosure property, it will be taxed on such income at the highest corporate tax rates. Generally, the type of income on which a REMIC would be taxed is income from foreclosure property that does not qualify as "rents from real property."

So long as income from foreclosure property qualifies as rents from real property, such income will not be taxed. Rental income does not qualify as rents from real property, and therefore will be subject to the tax on net income from foreclosure property, if (i) the amount of the rent is tied to the amount of income generated by such property, (ii) the rent is received from a party related to the REMIC, or (iii) the REMIC provides services to the lessee of the property that are not customary for the rental of real property. Services provided to tenants are considered customarily rendered in connection with the rental of real property based on comparisons to buildings of a similar class in the same geographic market. For example, providing utilities, general maintenance, parking facilities, swimming pool maintenance and security services will be considered customarily rendered if those services are provided to tenants of buildings of a similar class in the same geographic market. Further, such services must be provided by an independent contractor.

Assets such as shopping centers and office buildings typically generate income that qualifies as rents from real property because the services provided to tenants of such properties, such as utilities, general maintenance and janitorial services, are customarily provided in connection with the rental of real property. Such services, however, must be provided by an independent contractor.

Certain types of assets, such as a hotel or nursing home, typically produce income that is taxable. These types of assets commonly generate income that cannot be characterized as charges for services customarily rendered in connection with the rental of real property, such as a dry cleaning service offered by a hotel or a hair salon operated in a nursing home. Gross income from such assets is first reduced by any deductions or expenses directly connected to such gross income before the amount of tax is determined. The REMIC can, therefore, deduct from its gross taxable income items such as interest, depreciation and management fees associated with the property.

If an asset will generate taxable income, the REMIC may choose to enter into a master lease of the property. If a master lease structure is employed, the master tenant will operate the property and receive all income, and pay only a set amount of rent to the REMIC that is the landlord under the master lease, thereby preventing the REMIC from receiving any taxable income. In this situation, while the REMIC may escape the burden of paying tax on net income from foreclosure property, the master tenant will not likely be willing to pay as much rent as a tenant under a standard lease due to the increased responsibility and risk involved in operating the property itself.

Considerations for Servicers

The time periods in which property can be held, the type of collateral for a loan (real property vs. equity in an entity owning the real property) and the limited activities relating to the property in which the REMIC can engage while it holds the property are relevant factors to consider in its long-term approach to the workout of a troubled asset. A key decision for a servicer that has decided to foreclose is whether to operate the property through an independent contractor or to enter into a master lease of the property. If an independent contractor is engaged to operate the property and the property generates income other than rents from real property, such income will be taxable (less certain deductions as discussed above). While a master lease structure prevents the REMIC from receiving such taxable income, the REMIC will also receive less rent from a master tenant than it would a tenant under a standard lease.

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