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# Beneficial Ownership and The REMIC Classification Rules

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REMICs are securitized pools of mortgages that qualify for special flow-through taxation. [1] To qualify for flow-through tax treatment, the pool must satisfy several requirements. [2] An intended REMIC that fails to satisfy those requirements will likely be taxed as a corporation and payments made to holders of interests in a failed REMIC will likely be nondeductible dividend payments, [3] subjecting the REMIC to significant tax and penalties. [4] Such tax and penalties will cause beneficial interests in the pool to lose value and frustrate investors who relied upon REMIC classification as an incentive to purchase interests. Thus, tax classification is critical to REMICs and their investors. Nonetheless, recent litigation and various media reports suggest that many mortgage pools may not qualify for REMIC classification.

[1] *See* §860A(a) ("[Generally], a REMIC shall not be subject to taxation ...."); §860A(b) ("The income of any REMIC shall be taxable to the holders of interests in such REMIC as provided in this part."); Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1986*, 412 (H.R. 3838, 99th Cong; P.L. 99-514) (hereinafter "1986 Bluebook") ("In general, if the specified requirements are met, the REMIC is not treated as a separate taxable entity. Rather, the income of the REMIC is allocated to, and taken into account by, the holders of the interests therein, under specified rules.").

[2] *See* §860D (defining REMIC as any entity that makes a REMIC election, offers only regular and residual interests, has a single class of residual interest, and substantially all of its assets are qualified mortgages or permitted investments three months after the startup day); 1986 Bluebook at 411 ("[T]he Congress believed that the provisions of the Act should apply to any multiple class entity used for packaging interests in mortgages, regardless of the legal form used, *provided that the interests satisfy the specified substantive requirements*." (emphasis added)).

[3] *See* Lee A. Sheppard, "The Crazy Train of Mortgage Securitization," *Tax Notes* 639, 640 (11/8/10) ("A REMIC that failed to qualify would be a taxable mortgage pool—that is, a taxable corporation, in which case regular interests could be treated as equity, payments on which would be nondeductible .... [*See* §7701(i)]"). Even though a failed REMIC may not meet the taxable mortgage pool requirement that more than 50% of the pool's assets must be real estate mortgages, see §7701(i)(2)(A)(i), it will likely be taxed as a publicly traded partnership subject to corporate taxation. *See* §7704(a).

[4] *See* 1986 Bluebook at 427 ("The Congress intended that REMICs are to be the exclusive means of issuing multiple-class real estate mortgage-backed securities without the imposition of two levels of taxation."); Consolidated Complaint at 20–22, *HSH Nordbank AG v. Barclays Bank PLC*, No. 652678/2011 (County of New York 4/2/12); Bradley T. Borden & David Reiss, "Wall Street Rules Applied to REMIC Classification," *Thomson Reuters News & Insight* (9/13/12), *available at* http://newsandinsight.thomsonreuters.com/Securities/Insight/2012/09_-_September/Wall_Street_Rules_Applied_to_REMIC_Classification/.

REMICs are a central feature of residential real estate finance. To create REMICs, banks and other financial

institutions originate loans and sell them to REMIC sponsors. The sponsors pool mortgages into REMIC trusts and sell interests in the trusts to investors, [5] including financial institutions, insurance companies, retirement plans, and institutional and individual investors. Securitizing mortgages in this manner infused capital into the real estate market and created unprecedented growth of the real estate market during the early part of this millennium. Some commentators also blame REMICs in part for causing the financial crisis. [6] The losses sustained by REMIC investors are significant, and their claims against REMIC organizers are serious. REMIC investors, state governments, and borrowers claim that loan originators and REMIC organizers failed to transfer mortgage notes to REMICs or transferred poor-quality notes. [7] Consequently, REMICs and parties who put them together are under serious legal and public attack, and their practices raise questions about the tax classification of purported REMIC trusts. [8]

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[5] *See* Amended Complaint at 32–33, *Federal Housing Finance Agency v. JPMorgan Chase & Co.*, No. 11 Civ. 6188 (DLC) (S.D.N.Y. 6/13/12).

[6] *See* Roy D. Oppenheim & Jacquelyn K. Trask-Rahn, "Deconstructing the Black Magic of Securitized Trusts: How the Mortgage-Backed Securitization Process Is Hurting the Banking Industry's Ability to Foreclose and Proving the Best Offense for a Foreclosure Defense," 41 *Stetson L. Rev.* 745, 745–46 (Spring 2012).

[7] *See, e.g.,* Complaint, *New York v. J.P. Morgan Securities LLC*, No. 451556/2012 (County of New York 10/10/12); Consolidated Complaint, *HSH Nordbank AG v. Barclays Bank PLC*, note 4 above; Amended Complaint, *Federal Housing Finance Agency v. JPMorgan Chase & Co.*, note 5 above; *Western and Southern Life Ins. Co. v. Residential Funding Co.*, No. A1105042 (Hamilton County Ohio 6/6/12) (denying motions to dismiss claims against organizers of residential mortgage-backed securities (RMBS)); Borden & Reis, note 4 above; Tracy Alloway, "Taxing Times for MBS," *Financial Times*, Oct. 13, 2010, at http://ftalphaville.ft.com/blog/2010/10/13/369061/taxing-times-for-mbs/; Blog, "The REMICs Have Failed! The REMICs Have Failed," *Deadly Clear* (11/4/11), available at http://deadlyclear.wordpress.com/2011/11/04/the-remics-have-failed-the-remics-have-failed/. *See also Western and Southern Life Ins. Co. v. Countrywide Financial Corp.*, No. 2:11-cv-07166-MRP (MANx) (C.D. Cal. 6/29/12) (dismissing suits against RMBS organizers). Parties who put REMICs together (i.e., REMIC participants) include the banks that originated loans, banks and others that entered into pooling and servicing agreements, parties who marketed and sold interests in REMICs, and professionals who advised them.

[8] *See id.*

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Lawsuits accuse REMIC organizers of various forms of wrongdoing, including misrepresentation of the organizers' practices and the quality of mortgages. For example, organizers represented that mortgages included in REMIC pools satisfied high underwriting standards, but lawsuits claim that organizers knew that a significant percentage of the mortgages did not satisfy the standards. [9] Organizers also represented that they performed adequate due diligence to test the mortgages, [10] but lawsuits claim that they did not perform that due diligence and often ignored loan defects that poor due diligence uncovered. [11] Studies also show that the quality of loans transferred to purported REMIC trusts was far below what REMIC sponsors represented in their offering materials. [12] Studies show further that loan originators often did not transfer the mortgage notes to the REMIC trusts. [13] Additionally, a judge in Pennsylvania denied a motion to dismiss a suit against Bank of America for misrepresenting information about REMIC assets in its financial reports. [14] If the accusations in these suits are true, [15] many of the purported REMICs should lose the favorable tax status and be subject to tax liability and penalties, and originators and REMIC organizers face liability to investors.

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[9] *See* Complaint at ¶30, *New York v. J.P. Morgan Securities LLC*, note 7 above.

[10] *See id.* at ¶33.

[11] *See id.* at ¶¶58, 60.

[12] *See* Consolidated Complaint at 23–30, *HSH Nordbank AG v. Barclays Bank PLC*, note 4 above.

[13] *See id.* at 15–20.

[14] *See Pennsylvania Public School Employees' Retirement System v. Bank of America Corporation*, No. 11 Civ. 733 (S.D.N.Y. 7/11/12) (denying Bank of America's motion to dismiss the §10(b) and Rule 10b-5 claim against it because the plaintiff's allegations concerning Bank of America's

"misstatements and omissions concerning its reliance on MERS, vulnerability to repurchase claims, internal controls, and compliance with GAAP and SEC regulations" satisfied the requisite standard to raise a strong inference of the bank's misconduct and scienter regarding the misconduct).

[15] Some REMIC participants deny liability or any wrongdoing. *See, e.g.,* Memorandum of Law in Support of Defendants' Mortion to Dismiss the Complaint, *HSH Nordbank AG v. Barclays Bank PLC*, No. 652678/2011 (County of New York 5/11/12). As pending suits progress and facts are discovered, the public will know better whether the reported actions happened. For the sake of analysis, this Article assumes that reports are accurate. If transactions were executed in accordance with well-crafted pooling and servicing agreements, the arrangements should satisfy the REMIC requirements, and the tax analysis would end there. Interesting tax issues exist only if the claims in the complaints are true or partially true.

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Lawsuits involving borrowers also reveal problems that jeopardize REMIC classification. Several decided cases call into question the legal rights that purported REMICs have in mortgage notes and mortgages they claim to own. A bankruptcy court described the practice of the nation's largest loan originator with respect to pooling arrangements. [16] That court found that the originator generally failed to transfer possession of mortgage notes to REMIC trusts. [17] The court therefore found that a REMIC trust was not the U.C.C. holder of the note and could not enforce it. [18] A significant percentage of U.S. residential mortgages are recorded in the name of Mortgage Electronic Registration Systems, Inc. (MERS) as nominee for the originator and its successors or assignees. [19] Courts split on the legal standing that MERS or its representatives have with respect to MERS-recorded mortgages. [20] Therefore, REMICs are taking steps to acquire notes and mortgages before instigating foreclosure actions. [21] The legal issues that arise from failure to properly transfer mortgage notes and record the mortgages also jeopardize the tax classification of REMICs and expose REMICs to tax liability and penalties. Thus, the tax aspects of a REMIC are becoming an important part of the discussion in REMIC litigation.

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[16] *See In re Kemp*, 440 B.R. 624 (Bankr. D.N.J. 2010).

[17] *See id.* at 628 ("[T]o the best of [Linda DeMartini's (a supervisor and operational team leader for the bank)] knowledge, the original note never left the possession of Countrywide, and that the original note appears to have been transferred to Countrywide's foreclosure unit, as evidenced by internal FedEx tracking numbers…. She testified further that it was customary for Countrywide to maintain possession of the original note and related loan documents.").

[18] *See id.* 631, 634. A Florida appellate court also held that if a bank was not the holder of a note at the time it brought a foreclosure action, it did not have standing to bring the action. *See Cutler v. U.S. Bank National Association*, No. 2D10-5709 (Fla. App. 2d Dist. 9/21/12).

[19] *See Jackson v. Mortgages Electronic Registration Systems, Inc.*, 770 N.W. 2d 487, 490–92 (Minn. 2009) (describing MERS and providing that "MERS asserts that it is currently the nominal mortgagee on approximately two-thirds of all 'newly originated' residential loans nationwide").

[20] *See, e.g., Fowler v. Recontrust Companay, N.A.*, 2011 WL 939863 (D. Utah 3/10/11) (holding that MERS is the beneficial owner under Utah law); *Jackson v. Mortgages Electronic Registration Systems, Inc.*, 770 N.W. 2d 487 (Minn. 2009) (holding that MERS, as nominee, could institute a foreclosure by advertisement, i.e., a nonjudicial foreclosure, based upon Minnesota "MERS statute" that allows nominee foreclosure); *Gomes v. Countrywide Home Loans, Inc.*, 192 Cal. App. 4th 1149 (Cal. App. 2011) (finding that MERS had authority to foreclose on behalf of the note holder because of the authority granted to it under the deed of trust); *Bain v. Metropolitan Mortgage Group, Inc.*, 285 P.3d 34 (Wash. 2012) (holding that MERS was not a beneficiary under Washington Deed of Trust Act because it did not hold the mortgage note); *Eaton v. Federal National Mortgage Association*, 462 Mass. 569 (Mass. 2012) (holding that mortgagee must hold the note to foreclose or act with the authority of the note holder); *Ralph v. Met Life Home Loans*, No. CV 2010-0200 (5th Dist. Idaho 8/10/11) (holding that MERS was not the beneficial owner of a deed of trust, so its assignment was a nullity and the assignee could not bring a nonjudicial foreclosure against the borrower); *Landmark National Bank v. Kesler*, 289 Kan. 528, 216 P.3d 158 (Kan. 2009) (holding that MERS had no interest in the property and was not entitled to notice of bankruptcy or to intervene to challenge it). Litigation in this area is moving quickly, so even work done a few years ago is not up-to-date. Nonetheless, an early article with a nice overview of cases that consider state-law issues associated with MERS recording is John R. Hooge & Laurie Williams, "Mortgage Electronic Registration Systems, Inc.: A Survey of Cases Discussing MERS' Authority to Act," *Norton Bankruptcy Law Advisor* 1 (Aug. 2010).

[21] *See Trotter v. Bank of New York Mellon*, 275 P.3d 857 (Idaho 2012) (holding that ReconTrust

could initiate a non-judicial foreclosure when the mortgage assignment was recorded, even though the recording occurred on the same day that ReconTrust recorded a Notice of Default); Op Ed, "The 'Robo-Signing' Settlement: Seeds of Recover, Or Chaos?" *Forbes* (2/20/12) (discussing robo-signing, an effort to make mortgages compliant with state recording rules, and the potential effect of the settlement with loan services or robo-signing practices); "Robo-Signing" of Mortgages Still a Problem," *CBS News* (7/18/11), *available at* http://www.cbsnews.com /2100-201_162-20080533.html (discussing robo-signing).

Tax law mandates that REMICs be static pools of mortgage notes. [22] Several technical requirements ensure that a REMIC's pool of assets is static. [23] A fundamental REMIC requirement is that the REMIC trust must own primarily qualified mortgages (or other permitted investments) within three months after its start-up date and at all times after that. [24] The definition of qualified mortgage includes an obligation principally secured by an interest in real property. [25] That definition includes several elements (each of which warrants in-depth examination) [26] that REMICs most likely will not satisfy if the allegations discussed above reflect the actual conduct of REMIC organizers. A central question of those elements is whether purported REMICs hold qualified mortgages for tax purposes. [27] That question raises the additional question of what test applies to determine ownership of mortgage notes.

[22] *See* 1986 Bluebook at 411 ("The Congress believed that there should be some relief from two levels of taxation (i.e., at the entity level and at the shareholder level) where an entity with multiple classes of interests holds only a pool of real estate mortgages and related assets, *has no powers to vary the composition of its mortgage assets*, and has other powers generally consistent with the preservation of trust status, provided that satisfactory rules are prescribed for the taxation of the multiple interests." (emphasis added)), 412 ("In general, a REMIC is *a fixed pool of mortgages* with multiple classes of interests held by investors." (emphasis added)).

[23] *See, e.g.,* §860F(a)(1), (a)(2)(A) and (a)(2)(D) (imposing a 100% tax on gain from a REMIC's disposition of an asset); §860G(d)(1) (taxing the REMIC at 100% of the value of a mortgage contributed after the startup day); §860F(a)(1), (a)(2)(B) (imposing a 100% tax on the income from mortgages that a REMIC purchases more than three months after the startup day).

[24] *See* §860D(a)(4) (requiring that substantially all of a REMIC's assets must be qualified mortgages and permitted investments at the close of the third month following the startup day and all times after that). By definition, as mortgage-backed securities, REMICs own mostly mortgages. Consequently, the focus of this analysis is on whether the assets that a purported REMIC owns are qualified mortgages. Mortgages acquired after the three-month window generally are not qualified mortgages. *See* §860G(a)(3)(A)(i), (ii). *See also* 1986 Bluebook at 413 ("Under the Act, in order to qualify as a REMIC, substantially all of the assets of the entity or segregated pool, as of the close of the third calendar month beginning after the startup day and as of the close of every quarter of each calendar year thereafter, must consist of 'qualified mortgages,' and 'permitted investments.' The Congress intended that the term substantially all should be interpreted to allow the REMIC to hold only de minimis amounts of other assets.").

[25] *See* §860G(a)(3). The definition also includes qualified replacement mortgages and regular interests in other REMICs on the startup day. §860G(a)(3)(B), (C).

[26] In fact, the authors are preparing an article that will closely examine several of the tax issues that arise from the purported wrongdoing of REMIC organizers.

[27] *See* James M. Peaslee & David Z. Nirenberg, *Federal Income Taxation of Securitization Transactions and Related Topics* 74 (4th ed. 2011) ("For example, in a mortgage securitization, a REMIC election can be made for the trust only if it owns mortgages (loans secured directly by real property as distinguished from loans secured by other mortgage loans).").

At first blush, the general benefits and burdens test for property ownership would appear to apply to determine whether purported REMICs held qualified mortgages. Nonetheless, language in the statute and regulations refer to beneficial ownership, which may cause some commentators or practitioners to speculate that a unique beneficial ownership test applies to REMICs. [28] After examining the statutory and regulatory use of beneficial ownership, this Article concludes that the general test for tax ownership applies to the REMIC classification requirements. [29]

[28] *See* Sheppard, note 3 above, at 645 (quoting Professor Linda A. Beale, who appears to acknowledge that some practitioners believe beneficial ownership is a unique test for REMICs: "So

even accepting that the tax idea of beneficial ownership means that legal title can be held in one entity and merely transferred at the 'end point' when the sponsor or trustee or servicer is ready to foreclose, that transfer apparently won't be legitimate if MERS doesn't have the documents. And that raises another issue for the tax analysis: Is there a point at which failed documentation means that the securitization itself is a sham transaction?").

[29] This conclusion is consistent with the conclusion reached by other commentators. *See, e.g.,* Peaslee & Nirnenberg note 27 above, at 78 ("Whether a transfer of property is considered a sale or financing for tax purposes is fundamentally a question of tax ownership.").

The term "beneficial ownership" appears in the statutory definition of qualified mortgage, which provides, in relevant part, that a qualified mortgage is "any obligation (including any participation or certificate of beneficial ownership therein) which is principally secured by an interest in real property." [30] The obvious qualified mortgage is a properly executed residential mortgage note that is principally secured by an interest in real property through a properly recorded mortgage or deed of trust. [31] An arrangement that owns such mortgage notes for tax purposes would fall within the definition of REMIC.

[30] *See* §860G(a)(3)(A).

[31] The definition also includes regular interests in other REMICs, if the REMIC obtained them in exchange for its own interests on its startup day. *See* §860G(a)(3); Regs. §1.860G-2(a)(6). Including REMIC interests in the definition of qualified mortgage is consistent with the inclusion of interests in other look-through arrangements such as grantor trusts and investment trusts. See text accompanying notes 36–43 (discussing the inclusion of interests in such trusts in the definition of qualified mortgages). For many REMIC failures, the question of whether a REMIC holds an interest in another REMIC will never arise because the originator or other party who may be the tax owner of the mortgage notes will most likely not satisfy the REMIC requirements.

As stated above, any participation or certificate of beneficial ownership in an obligation principally secured by an interest in real property also comes within the definition of qualified mortgage. [32] A plain reading of the statute suggests that a participation or certificate of beneficial ownership means a type of asset that is different from a mortgage note, but it does not appear to mean a type of test for tax ownership. Indeed, an influential REMIC treatise provides that "[t]his language ensures that non-REMIC pass-through certificates (including senior and subordinated pass-through certificates and IO and PO Strips) can be qualified mortgages …." [33] A pass-through certificate is merely an interest in a trust or other arrangement that holds a pool of mortgages notes or other debt instruments. [34] IO and PO Strips in this context are types of stripped bonds and coupons under §1286 that would grant a REMIC holder the rights to identified payments on qualified mortgages. [35] Thus, a participation or certificate of beneficial ownership appears to refer to a type of asset (i.e., an interest in a trust or an IO or PO Strip), not a unique test for determining actual ownership of mortgage notes.

[32] See text accompanying note 30.

[33] *See* James M. Peaslee & David Z. Nirenberg, *Federal Income Taxation of Securitization Transactions and Related Topics* 456 (4th ed. 2011).

[34] *See id.* at 23.

[35] *See id.* at 438. A stripped bond is a bond that separates the ownership of the bond from any coupons or interest that have not yet come due, and stripped coupon is the coupon related to the bond. *See id.* at 701.

Language in the explanation of this provision by the Joint Committee on Taxation similarly suggests that the REMIC rules merely adopted the look-through rules that apply to grantor and investment trusts, [36] which tax law generally disregards. [37] For instance, tax law treats a person who owns an interest in an investment trust as owning an undivided beneficial interest in the assets of the trust. [38] The language in the statute therefore does not appear to add a new test for tax ownership; it merely reiterates that the law will look through certain types of trusts and treat the owners of beneficial interests in those trusts as owners of the trusts' assets.

[36] *See* Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1986*, 413 fn. 67 ("The Congress also intended that interests in grantor trusts would be treated as qualified

mortgages, to the extent that the assets of the trusts that holders of the beneficial interest therein are treated as owning, would be treated as qualifying mortgages. In addition, the Congress intended that interests in qualifying mortgages in the nature of the interests described in Treas. Reg. sec. 301.7701-4(c)(2) (Example 2), and loans principally secured by stock of a tenant-stockholder of a cooperative housing corporation would be treated as qualifying mortgages.”).

[37] *See* §§671–679; Regs. §301.7701-4(c)(1).

[38] *See* Regs. §301.7701-4(c)(1).

The regulations also use the concept of beneficial ownership in the definition of instruments that qualify as obligations secured by interests in real property. [39] In particular, the regulations provide that the definition includes “investment trust interests that represent undivided beneficial ownership in a pool of obligations principally secured by interests in real property … and related assets that would be considered to be permitted investments if the investment trust were a REMIC, and provided the investment trust is classified as a trust under §301.7701-4(c) ….” [40] This rule in the regulations reflects the rule in the statute—it merely reiterates that tax law looks through some trusts and treats the beneficiaries of the trust as owning the trust assets. To own the property of a trust under this rule, a trust would have to exist, and the person claiming ownership would have to be a beneficiary of the trust.

[39] *See* Regs. §1.860G-2(a)(5).

[40] *See* Regs. §1.860G-2(a)(5). Under Regs. §301.7701-4(c), holders of beneficial interests in an investment trust are treated as owning individual interests in the trust's assets.

The use of beneficial ownership in the REMIC rules represents a fairly common usage of the concept of beneficial ownership. Under general legal usage, beneficial ownership includes interests held in a trust by a beneficiary and certain arrangements of stock ownership. [41] That is the manner in which the specific reference in the REMIC rules uses the concept of beneficial ownership. [42] Tax law also uses beneficial ownership less specifically to refer to tax ownership as defined by the benefits and burdens test. [43] The application of the general concept of beneficial ownership to REMICs would require the purported REMICs to show they hold the benefits and burdens of mortgage notes, interests in trusts, or certain types of strips. Generally, the question is whether the purported REMICs own mortgage notes. [44]

[41] *See Black's Law Dictionary* 1137 (8th ed. 2004) (defining beneficial ownership as “1. One recognized in equity as the owner of something because use and title belong to that person, even though legal title may belong to someone else; esp., one for whom property is held in trust… . 2. A corporate shareholder who has the power to buy or sell the shares, but who is not registered on the corporation's books as the owner.”); 1138 (defining beneficial ownership as “1. A beneficiary's interest in trust property…. 2. A corporate shareholder's power to buy or sell the shares, though the shareholder is not registered on the corporation's books as the owner.”).

[42] *See, e.g., Alpha I L.P. v. U.S.*, 683 F.3d 1009, 1023–24 (Fed. Cir. 2012) (discussing beneficial ownership of corporate stock); *Phal v. Comr.*, 150 F.3d 1124 (9th Cir. 1998) (holding that managing partner and CFO of corporation was a beneficial owner of corporate stock).

[43] *See Scoville v. U.S.*, 250 F.3d 1198,1202 (8th Cir. 2001) (looking for who has “active” or “substantial” control of property to determine beneficial owner); *Lay Est. v. Comr.*, T.C. Memo 2011-208 (2011) (“The status of the legal title to the annuity contracts does not control in determining whether a sale occurred. Beneficial ownership, and not legal title, determines ownership for Federal income tax purposes. *Ragghianti v. Comr.*, 71 T.C. 346 (1978), *aff'd without pub. opin.*, 652 F.2d 65 (9th Cir. 1981); *Pacific Coast Music Jobbers, Inc. v. Comr.*, 55 T.C. 866, 874 (1971), *aff'd*, 457 F.2d 1165 (5th Cir. 1972). The federal income tax consequences of property ownership generally depend upon beneficial ownership, rather than possession of mere legal title. *Speca v. Comr.*, 630 F.2d 554, 556–557 (7th Cir. 1980), *aff'g* T.C. Memo 1979-120; *Beirne v. Comr.*, 61 T.C. 268, 277 (1973). “‘[C]ommand over property or enjoyment of its economic benefits' …, which is the mark of true ownership, is a question of fact to be determined from all of the attendant facts and circumstances.” *Monahan v. Comr.*, 109 T.C. 235, 240 (1997) (quoting *Hang v. Comr.*, 95 T.C. 74, 80 (1990)). This court has stated that “a sale occurs upon the transfer of the benefits and burdens of ownership rather than upon the satisfaction of the technical requirements for the passage of title under State law.” *Houchins v. Comr.*, 79 T.C. 570, 590 (1982). The determination of whether the benefits and burdens of ownership have been transferred is one of fact and is based on the intention of the parties, evidenced by their written agreements and the surrounding facts and circumstances.

*Paccar, Inc. & Subs. v. Comr.*, 85 T.C. 754, 777 (1985), *aff'd*, 849 F.2d 393 (9th Cir. 1988); *Grodt & McKay Realty, Inc. v. Comr.*, 77 T.C. at 1237; *Ragghianti*, 71 T.C. at 349. Beneficial ownership is marked by command over property or enjoyment of its economic benefits. *Yelencsics v. Comr.*, 74 T.C. 1513, 1527 (1980) (stock was sold in accordance with an agreement for the sale, even though the title to the stock was not transferred, in accordance with the agreement of the parties).”); Sheppard, note 3 above, at 642 (“FSA 200130009 shows that the IRS will find a sale based on the substance of the transaction, even when something less than a sale might have occurred as a formal matter. This is consistent with tax law's focus on beneficial, economic ownership when ownership is in question.”).

[44] *See* Peaslee & Nirenberg, note 27 above, at 81 (“In the case of a pool of loans, another related question is whether the relevant item of property to which tax ownership tests are applied is the pool or the individual loans. The answer should be the individual loans.”). This analysis focuses mainly on the ownership of the notes and largely leaves a discussion of ownership in a trust or strips for other venues.

To rely on a specific beneficial ownership claim, REMICs must demonstrate that the tax owner of the mortgage notes (perhaps the originator) holds them in an investment trust. The purported REMIC almost must establish that it is a beneficiary of that trust with an undivided interest in the mortgage notes held in the trust. REMICs acquire their mortgage notes pursuant to a pooling and servicing agreement (PSA) that a loan originator, a loan servicer, a REMIC sponsor, and the REMIC trustee enter into. [45] The PSA provides that the originator will transfer the mortgage notes and that the REMIC trust ultimately will acquire them. [46] The parties do not have other documents that provide the originator will hold the mortgage notes in trust for the purported REMIC. Failure to act in accordance with the PSA does not appear to create an investment trust with the REMIC as beneficiary. Nonetheless, to rely upon the specific concept of beneficial ownership, the REMIC would have to establish that failure to adhere to the PSA somehow created an investment trust and that the REMIC held a beneficial interest in the trust. A purported REMIC probably cannot establish that the originator is the trustee of a trust created pursuant to a PSA.

[45] *See In re Kemp*, 440 B.R. 624, 627 (Bankr. D.N.J. 2010); Amended Complaint at 32–33, *Federal Housing Finance Agency v. JPMorgan Chase*, note 5 above.

[46] *See id.* The PSA generally requires the originator to transfer the note to the sponsor, and the sponsor transfers the note to the REMIC trust, possibly with some other intermediate transfers. *See id.*

To argue that it owned strips, a purported REMIC would have to establish that the PSA was intended to give the purported REMIC a participation interest in qualified mortgages held by a party to the PSA. It would also have to establish that the originator, or other party, transferred strips to the purported REMICs. Purported REMICs likely will be unable to do that because PSAs require transfers of mortgage notes; they do not create participation rights. Furthermore, the mortgages do not appear to satisfy the definition of qualified mortgage, regardless of who holds the note. Thus, REMICs generally will not be able to claim that they own strips, if the PSA provided for the transfer of mortgage notes.

If a purported REMIC does not own qualified mortgages for tax purposes because the REMIC organizers failed to properly transfer the mortgage notes to it, perhaps the purported REMIC holds obligations of the originators or other parties to the PSA. Such obligations might be secured by interests in the mortgages, which in turn may be secured by interests in real property. [47] Such obligations would not satisfy the definition of qualified mortgage. [48] In fact, Congress indicated that an obligation secured by qualified mortgages is not a qualified mortgage unless it is an interest in another REMIC. [49] Thus, a purported REMIC must be the tax owner of qualified mortgages, which generally means mortgage notes, to qualify for REMIC treatment. It cannot satisfy this requirement by owing obligations of an originator or other party to a PSA. REMICs are thus generally left to rely upon the general test of tax ownership to demonstrate that they own qualified mortgages at the time required by statute.

[47] As discussed above, however, many courts have held that the REMIC or MERS does not have standing to foreclose and that only the holder of a mortgage note may enforce the note. See note 20 above. Consequently, notes the originator hold may not be obligations secured by interests in real property.

[48] *See* Regs. §1.860G-2(a)(6) (an obligation secured by another obligation is not principally secured by an interest in real property); Peaslee & Nirenberg, note 27 above, at 466.

[49] *See* 1986 Bluebook at 413 fn. 67 ("Nevertheless, except for regular interests in a REMIC, Congress did not intend that debt obligations that are secured primarily by other debt obligations would be treated as qualified mortgages even where such other debt obligations are secured primarily by interests in real property.").

Although the test for tax ownership may not require REMICs to show that they have legal title to the mortgage notes, [50] it does require them to demonstrate that they hold the benefits and burdens of the notes. [51] The unique nature of mortgage notes under state law may require the REMICs to have possession of the notes to claim that they hold the requisite benefits and burdens for tax purposes. [52] Although the question of tax ownership is complicated, and an in-depth analysis of tax ownership in the REMIC context is the topic for another article, [53] a brief introduction of the concept illustrates fundamental problems that many purported REMICs face. The analysis of tax ownership begins with the benefits and burdens test similar to the one used in *Grodt & McKay Realty, Inc. v. Comr.* [54] Courts use such a test to determine the underlying economics and the attending facts and circumstances that indicate who owns mortgage notes for tax purposes. [55] The IRS has modified the application of *Grodt and McKay* when it analyzes the ownership of notes, but it looks to benefits and burdens to determine ownership. [56] Additionally, two circuit courts have recently applied the benefits and burdens test to determine the nature of transactions involving notes and securities. [57] The benefits and burdens test would similarly apply to determine whether purported REMICs own qualified mortgages.

[50] *See, e.g., Bailey v. Comr.*, 912 F.2d 44, 47 (2d Cir. 1990) ("The determination of ownership of an asset for tax purposes is to be based on an analysis of many different factors indicative of ownership, not always on the bare legal title. In a number of cases involving transfers of assets, courts have disregarded the transfer of formal title where the transferor continues to retain many of the benefits and burdens of ownership.").

[51] *See Geftman v. Comr.*, 154 F.3d 61 (3d Cir. 1998) ("Even if [the parties] had recorded consistent, contemporaneous documents stating that the mortgages had been transferred to the trusts, such documents would be insufficient to establish the trusts' ownership of the mortgages for tax purposes unless the 'objective evidence' as to the 'overt actions' with respect to the mortgages demonstrated that the trusts enjoyed 'actual command' over the mortgages and the right to receive the 'actual benefit' of owning them.").

[52] *See, e.g., Burnet v. Harmel*, 287 U.S. 103, 110 (1932) ("The state law creates legal interests, but the federal statute determines when and how they shall be taxed. We examine [state] law only for the purpose of ascertaining whether the leases conform to the standard which the taxing statute prescribes for giving the favored treatment to capital gains.").

[53] The authors are working on a draft of such an article, which they hope to complete in the next few months. See note 26 above. Other commentators have discussed the rules and identified the applicable authority that applies to note ownership — see Peaslee & Nirenberg, note 27 above, at 90–138 — but to date, no one has applied the rules to facts that are becoming apparent in the various forms of REMIC litigation. *See also* Sheppard, note 3 above, at 641–46 (presenting the argument that close examination of the ownership question is warranted); Scot J. Paltrow, "IRS Weighs Tax Penalties on Mortgage Securities," *Reuters* (4/27/11), *available at* http://www.reuters.com/article/2011/04/27/us-usa-mbs-taxes-idUSTRE73Q7UX20110427 (suggesting that note ownership may be a problem for many purported REMICs).

[54] 77 T.C. 1221 (1981) (relying upon the following factors to hold that the transaction was not a sale: "(1) Whether legal title passes; (2) how the parties treat the transaction; (3) whether an equity was acquired in the property); (4) whether the contract creates a present obligation on the seller to execute and deliver a deed and a present obligation on the purchaser to make payments; (5) whether the right of possession is vested in the purchaser; (6) which party pays the property taxes; (7) which party bears the risk of loss or damage to the property; and (8) which party receives the profits from the operation and sale of the property." (citations omitted)).

[55] *See Helvering v. F.&R. Lazarus & Co.*, 308 U.S. 252, 255 (1939) ("In the field of taxation, administrators of the laws, and the courts, are concerned with substance and realities, and formal written documents are not rigidly binding."); *Gregory v. Helvering*, 293 U.S. 465, 470 (1935) (disregarding the form of a transaction because it was "an elaborate and devious form of conveyance masquerading as a corporate reorganization[,] … the transaction upon its face lies outside the plain intent of the statute[, and to] hold otherwise would be to exalt artifice above reality and to deprive the statutory provision in question of all serious purpose"); *Washington Mut.*

*Inc. v. U.S.*, 636 F.3d 1207, 1218 (9th Cir. 2011) ("As an overarching principle, absent specific provision, the tax consequences of any particular transaction must reflect the economic reality."); *Lazarus v. Comr.*, 513 F.2d 824, 829 n. 9 (9th Cir. 1975) ("'Technical considerations, niceties of the law of trusts or conveyances, or the legal paraphernalia which inventive genius may construct' must not frustrate an examination of the facts in the light of economic realities." Citing the Tax Court's decision quoting from *Helvering v. Clifford*, 309 U.S. 331, 334 (1940)); *Union Planters National Bank of Memphis v. U.S.*, 426 F.2d 115, 118 (6th Cir. 1970) ("In cases where the legal characterization of economic facts is decisive, the principle is well established that the tax consequences should be determined by the economic substance of the transaction, not the labels put on it for property law (or tax avoidance) purposes." *Citing Comr. v. P.G. Lake, Inc.*, 356 U.S. 260, 266–67 (1958); *Gregory v. Helvering*, 293 U.S. 465 (1935)).

[56] *See* FSA 200130009; TAM 9939001 (citing *Grodt & McKay Realty, Inc.* and listing the following factors: "(1) whether the transaction was treated as a sale; (2) whether the obligors on the notes (the transferor's customers) were notified of the transfer of the notes; (3) which party serviced the notes; (4) whether payments to the transferee corresponded to collections on the notes; (5) whether the transferee imposed restrictions on the operations of the transferor that are consistent with a lender-borrower relationship; (6) which party had the power of disposition; (7) which party bore the risk of loss; and (8) which party had the potential for gain" (citations omitted)).

[57] *See Calloway v. Comr.*, 691 F.3d 1315 (11th Cir. 2012) (treating a purported loan of securities as a sale because the purchaser sold them immediately with no obligation to return them to the seller); *Sollberger v. Comr.*, 691 F.3d 1119 (9th Cir. 2012) (holding that a purported loan of securities was a sale).

Applying that authority to REMICs based upon the information in case filings and reported decisions reveals that many REMICs most likely would fail the tax ownership test and lose REMIC status. [58] As the bankruptcty court held in *In re Kemp*, a purported REMIC cannot enforce a mortgage note if the REMIC is not the holder of the note. [59] The ability to enforce an obligation is certainly an important benefit of ownership that many purported REMICs appeared not to obtain within the time frame required by the REMIC rules. [60] The lack of possession also inhibits a purported REMIC's ability to transfer the notes, which is another factor that courts consider in determining tax ownership of notes. [61]

[58] Fact development will help determine whether allegations in the filing are correct. If the allegations are correct, the analysis will inform the proper tax treatment of purported REMICs. If the allegations are not correct, and the REMIC organizers followed the terms of the PSA, then the arrangements will satisfy the REMIC requirements and qualify for REMIC treatment. The analysis is relevant only if the allegations are correct, at least in part, so this article analyzes the arrangements based on the assumption that the allegations are correct.

[59] *In re Kemp*, 440 B.R. 624, 634 (Bankr. D.N.J. 2010).

[60] *See id.* at 628 (describing that one of the country's largest loan originators (Countrywide Home Loans, Inc.) did not transfer mortgage notes to the REMIC trusts); Peaslee & Nirenberg, note 27 above, at 80 ("The power of control encompasses the right to take any of the actions relating to a debt instrument that may be taken by its owner, including *enforcing* or modifying its terms or disposing of the asset." (emphasis added)); note 24 above and accompanying text (discussing the time during which a REMIC must acquire qualified mortgages).

[61] *See Calloway v. Comr.*, 691 F.3d 1315 (11th Cir. 2012); *Sollberger v. Comr.*, 691 F.3d 1119 (9th Cir. 2012).

*New York v. JPMorgan Chase* suggests that the originator and sponsor, not the purported REMIC, bear the risk of loss on the notes. [62] The New York Attorney General has sued those parties to recover losses due to misrepresentations about the quality of mortgage notes transferred to purported REMICs. [63] If states are successful in this type of suit, the originators and sponsors, not the purported REMICs, will bear the burden of the losses associated with the notes as provided in the PSAs. The outcome of these cases will help establish which party had the legal rights and obligations and which parties bore the benefits and burdens associated with mortgage note ownership for tax purposes. If the claims are correct, purported REMICs will have difficulty demonstrating that they were the tax owners of mortgage notes at the required times.

[62] *See* Complaint, *New York v. J.P. Morgan Securities LLC*, note 7 above.

[63] *See id.*

If the purported REMICs are not the tax owners of mortgage notes, do not have a beneficial interest in a trust that owns the notes, and do not own strips, they will lose REMIC classification. Investors are rightly concerned that the loss of REMIC classification will result in significant tax liability to the REMICs and adversely affect the value of the beneficial interests they purchased. [64] REMIC promoters represented that the pooled mortgages "will" qualify for REMIC classification, so a loss of REMIC classification exposes the promoters to various types of liability to the investors. [65] "Will," in the tax context, is a very high level of confidence. [66] By representing that the arrangements will qualify for REMIC treatment, the offering materials assured investors that the arrangements had around a 90–95% chance of qualifying for REMIC status. [67] Nonetheless, the reported practices of REMIC organizers raise serious questions about the status of many purported REMICs. Many purported REMICs appear to not satisfy the tax ownership requirement and therefore not qualify for REMIC status. In fact, if the claims in filed complaints prove to be true, the likelihood of qualifying for REMIC status appears to be closer to 5%, than 95%. A 95% level of confidence would, therefore, be a gross overstatement of the likelihood that many of these arrangements will qualify for REMIC classification. Consequently, purported REMICs face exposure for tax liability and penalties, and REMIC organizers face exposure for misrepresenting tax certainty of the arrangements.

[64] *See* Consolidated Complaint at ¶¶77–83, 161–62.

[65] *See* Consolidated Complaint at ¶82.

[66] *See* Robert P. Rothman, "Tax Opinion Practice," 64 *Tax Law.* 301, 312 (Winter 2011) ("[A]s a practical matter, the 'will' opinion is as strong as it gets.... [A] 'will' opinion is consistent with a conclusion that there is no material risk of being wrong. Put another way, it represents a level of comfort such that if public disclosure were prepared on the issue, it would not be necessary to disclose the risk of being wrong." (citations omitted)); Jasper L. Cummings, "The Range of Legal Tax Opinions, with Emphasis on the 'Should' Opinion," 98 *Tax Notes* 1125, 1132 (2/17/03) ("The 'will' opinion is the clean or unqualified opinion of near certainty, or as certain as things can be in the tax world.").

[67] *See* Rothman, note 66 above, at 327.

Professionals who helped prepare offering materials also may face liability exposure. In *New York v. JPMorgan Chase*, the New York Attorney General claims that the sponsor's attorney advised it to improve its due diligence. [68] Therefore, the attorney knew that the arrangements probably would not comply with the REMIC rules. If the same attorney assisted with the offering materials and provided opinion letters stating the arrangement will qualify for REMIC classification, the attorney would be exposed to malpractice and potentially other liability for intentionally misleading investors. [69] Therefore, the stakes related to this issue are high for a number of REMIC participants. As the cases continue to be filed and courts begin to hand down decisions, the exposure for tax liability and other forms of liability likely will increase.

[68] *See* Complaint at ¶81, *New York v. J.P. Morgan Securities LLC*, note 7 above (claiming that MBS organizers' attorneys advised the organizers that their practices regarding defective loans were not appropriate, illustrating that the attorneys were aware of the organizers' misconduct).

[69] In fact, if the attorney providing the "will" opinion knew or should have known of the deceptive practices of REMIC organizers and the defective loans, the attorney would be exposed to liability. The apparent widespread wrongdoing in the industry suggests that any attorneys who spent significant time advising REMIC organizers would have known of the bad behavior. If that proves to be the case, the attorneys face potential liability.

As the saying goes, all good things must come to an end. The red hot real estate market appeared to be good for a lot of people. That market ended and hurt a lot of people. The ride banks and other participants took in that market was good for them. Now parties who were injured by apparent wrongdoing of REMIC organizers are seeking redress. The good thing may now be coming to an end for those parties.

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