

Servicing Real Estate Mortgage Investment Conduits in U.S. Mortgage Securitizations

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The U.S. securitization market is the largest market in the world for issuances of asset securitizations. As of December 31, 2005, over \$1.68 trillion of asset-backed securities were issued in the U.S.¹ The great majority of those asset securitizations involve securities backed by pools of mortgage loans sold via Real Estate Mortgage Investment Conduits (or "REMICs"). The purpose of this article is to (1) describe certain features of REMICs that are generally applicable to pools of mortgage loans in securitizations and (2) highlight certain REMIC-related provisions that are typically found in servicing agreements of securitized mortgage pools. Capitalized terms used in this article and not otherwise defined in the body of the article will have the meanings assigned to them in **Schedule A** attached hereto.

I. What is a REMIC?

A REMIC is a corporation, trust, partnership or a segregated pool of assets that qualifies for special tax treatment under the Internal Revenue Code of 1986, as amended (the "IRC"). The REMIC Provisions were adopted with the passing of the Tax Reform Act of 1986. Recent modifications to the REMIC Provisions made by the American Jobs Creation Act of 2004, which became effective on January 1, 2005, permit new kinds of debt obligations, such as reverse mortgages, home equity lines of credit and government originated loans (i.e., small business administration disaster loans), to be securitized using REMICs. The REMIC Provisions are among the most complex and elaborate sections of the IRC.

II. Why are REMICs Used in Securitizations?

The principal advantage of forming REMICs for the sale of mortgage-backed securities is that REMICs are treated as pass-through vehicles for tax purposes which are not subject to double taxation. For instance, in many mortgage-backed securitizations, the owner of a pool of mortgage loans sells, transfers or contributes such loans to a special purpose entity, which may be a trust, corporation, limited liability company or partnership, that is designed to qualify as a REMIC and, simultaneously, the special purpose entity issues securities that are backed by the cash flows generated from the transferred assets to investors in order to pay for the loans. If the special purpose entity or the assets transferred qualify as a REMIC, then any income of the REMIC is "passed through" and taxable to the holders of the REMIC Regular Interests and Residual Interests.

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1 Asset-Backed Alert, Summary of Worldwide Securitization Volumes 2005 (December 31, 2005).

To qualify for REMIC status, the following criteria must be satisfied:

- The mortgage-backed securities offered to investors must be structured to consist of “Regular Interests” and “Residual Interests.” The mortgage-backed securities that represent Regular Interests of a REMIC are considered debt for tax purposes and the Regular Interest holders are considered creditors of the REMIC. The mortgage-backed securities that represent Residual Interest of a REMIC are considered equity and the Residual Interest holders are treated as partners for tax purposes. Only a single class of Residual Interests may be created to qualify as a REMIC; and
- Substantially all of the assets must be Qualified Mortgages and Permitted Investments as of the third month after a REMIC’s Startup Day. A REMIC may contain a nominal amount (but no greater than 1%) of non-qualified mortgages assets; and
- A REMIC election must be made on the REMIC’s first tax return by the person authorized to sign the REMIC’s tax return (e.g., the sponsor of the REMIC or the trustee) in the first taxable year of the REMIC’s existence, which begins on the Startup Day and ends on December 31st of that same year in order for a legal entity or a segregated pool of mortgage loans to be treated as a REMIC thereafter.

Most securitizations in the U.S. that qualify as REMICs use the statutory trust or common law trust as the legal entity of choice for various reasons including ease of formation and administration and bankruptcy related reasons, none of which are dealt with in this article. However, a legal vehicle that fails to satisfy the criteria listed above cannot be a REMIC (pass-through vehicle) and may be treated as a taxable mortgage pool under IRC § 7701(i), which have less favorable tax considerations and may be subject to double taxation.

III. What is the Impact of Non-Compliance with REMIC Provisions?

Generally, non-compliance with REMIC requirements subjects a REMIC to loss of its tax-free status and to a sizeable tax. This can be catastrophic to the REMIC, the investors and, depending on the contractual arrangement, to whomever causes the REMIC to lose its tax-free status. The IRS has the discretion to reverse a REMIC’s failed status if such termination is inadvertent or steps were taken to reinstate the REMIC status within a reasonable time period.

The following events will cause a REMIC to lose its tax-free status and potentially become subject to a sizeable tax:

- The occurrence of any Prohibited Transaction and the realization of net income from Prohibited Transactions. Any net income generated from a Prohibited Transaction is subject to a 100% tax. A Prohibited Transaction can also cause the tax-free status of a REMIC to be lost or suspended. A Significantly Modified Obligation that is not a Qualified Replacement Mortgage will be considered a Prohibited Transaction and thus be subject to a 100% tax; or
- The realization of net income from Foreclosure Property. Any net income realized from the operation of Foreclosure Property is subject to IRC §857(b)(4)(B) as if the REMIC were a real estate investment trust, which is then subject to tax at the highest corporate tax rate; or

- The making of unqualified contributions to a REMIC after the Startup Day. Any contributions to a REMIC after its Startup Day is taxed at a rate of 100% unless they are made in cash and are related to: (i) a contribution made to facilitate a Cleanup Call, (ii) a payment in the nature of a guaranty, (iii) a contribution made during the three-month period beginning on the Startup Day, (iv) contribution made to a Qualified Reserve Fund by a Residual Interest holder in the REMIC or (v) a permitted contribution made under the treasury regulations; or
- The transfer of Residual Interests to Disqualified Organizations. Any transfers of Residual Interests to Disqualified Organizations are taxed at the highest corporate tax rate and are taxable to the transferor or its agent.

IV. Applicable REMIC Provisions under a Typical Pooling and Servicing Agreement.

A Pooling and Servicing Agreement would typically provide that the trustee of the trust shall elect to treat the Trust Fund as comprised of a certain number of REMICs. The Trust Fund under a typical Pooling and Servicing Agreement in a mortgage-backed securitization contains, among other things, the pool of mortgage loans sold or transferred by the sellers into the trust, including those loans currently being serviced by the servicer. In addition, a typical Pooling and Servicing Agreement will contain the principal REMIC provisions that apply to the servicer of the pool of mortgage loans, who agrees to perform certain functions, make certain payments and provide certain information to help maintain the status of the REMIC. Some of the typical provisions are described in more detail below:

- A. Furnish Necessary Information. The servicer is required to provide to the trustee upon request any information as the trustee may need with respect to the mortgage loans that the servicer is servicing.
- B. Trustee to Act or Not Act. The servicer may require the trustee to take certain actions or refrain from taking such actions as to the REMIC assets if the servicer furnishes the trustee an opinion of counsel stating that such actions or inactions may or may not result in an adverse REMIC event.
- C. Payment of Prohibited Transaction Taxes. The servicer is required to pay any taxes levied on the trust resulting from a Prohibited Transaction caused by a breach in the servicer's obligations under the applicable Pooling and Servicing Agreement or if the servicer, in its discretion, has determined to indemnify the Trust Fund against the imposing of such taxes.
- D. No Contributions of Assets. The servicer is prohibited from accepting any contributions of assets to the REMIC, except with respect to substitutions for Defective Qualified Mortgages, unless the servicer receives an opinion of counsel from the party seeking to make such contributions stating that such contributions will not cause the REMIC to fail to qualify as a REMIC at any time that the Certificates are outstanding or subject the REMIC to any tax under federal, state or local laws.
- E. No Fees or Income Other Than From Qualified Mortgages or Permitted Investments. The servicer is prohibited from entering into any arrangement by which the REMIC will receive any fees or other compensation and allowing the REMIC to accept any income from assets other than Qualified Mortgages or Permitted Investments.

- F. No Disposition of Assets. The servicer is prohibited from selling, disposing of or substituting for any of the mortgage loans it services, except in connection with the (i) default, imminent default or foreclosure of a mortgage loan, including but not limited to properties acquired or sold by deed in lieu of foreclosure, (ii) bankruptcy of the REMIC, (iii) termination of the REMIC pursuant to the applicable Pooling and Servicing Agreement and (iv) purchase or repurchase of mortgage loans pursuant to the applicable Pooling and Servicing Agreement. Similarly, the servicer is prohibited from acquiring any assets for the REMIC, selling or disposing of any investments in the collection accounts for gain and accepting any contributions to the REMIC after the closing date, unless the servicer receives an opinion of counsel that such, disposition, substitution or acquisition will not adversely affect the status of the REMIC or unless the servicer has determined, in its discretion, to indemnify the Trust Fund against any taxes imposed on the REMIC as a result thereof.
- G. No Modifications, Waivers or Amendments. The servicer agrees to protect the interests of the Trust Fund as it would protect its interests in its own mortgage portfolio and agreed not to make or permit any modification, waiver or amendment of any applicable mortgage loan which would cause the REMIC to fail to qualify as a REMIC or result in the imposition of any tax under Section 860F(a) or Section 860G(d) of the IRC.
- H. Management of Foreclosure Property. The servicer is required to dispose of any mortgage property acquired by the Trust Fund with respect to a default or imminent default prior to three years after the end of the calendar year of such acquisition unless an opinion of counsel is furnished by the servicer to the trustee to the effect that the holding by the Trust Fund of such mortgage property subsequent to such 3-year period will not result in the imposition of taxes on Prohibited Transactions or cause the REMIC to fail to qualify as a REMIC at any time that any Certificates are outstanding or unless the servicer applied for, prior to the expiration of such three-year period, an extension of such 3-year period in accordance with IRC §856(e)(3). In addition, the servicer is restricted from renting (or allowing to continue to be rented) any mortgage property acquired by foreclosure or otherwise using such property for the production of income in such a manner or pursuant to any terms that would (i) cause such property to fail to qualify as Foreclosure Property or (ii) subject the REMIC to the imposition of any federal, state or local income taxes on the income earned from such property unless the servicer agrees to indemnify the Trust Fund with respect to the imposition of any such taxes.

In general, a breach by the servicer of any of the relevant REMIC provisions, as those stated above, that results in a loss of the REMIC's status or imposition of taxes on the REMIC would be the responsibility of the servicer, which can be a significant risk to a servicer depending on the severity of such breach and the results thereof.

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V. Conclusions.

REMICs have made it relatively easy for sponsors of mortgage-backed securitizations and the investors of securities issued by legal vehicles qualifying as REMICs to benefit from the tax advantages afforded by the IRC. As the U.S. mortgage market continues to grow, REMICs will continue to play a significant role in the securitization of pools of mortgage loans in the U.S. However, strict compliance with the REMIC Provisions is required to take advantage of the tax benefits afforded by such rules. Non-compliance can be fatal and costly for the REMIC, the servicer and the investors of the related mortgage-backed securities.

Schedule A

DEFINITIONS

"Cash Flow Investments" means any investment of amounts received under Qualified Mortgages for a temporary period not to exceed 13 months before distributing the holders of interests in the REMIC.

"Certificate" means the mortgage-backed pass-through certificates purchased by investors under a Pooling and Servicing Agreement.

"Clean-up Call" means the redemption of a class of Regular Interests when, by reason of prior payments with respect to those interests, the administrative costs associated with servicing that class outweigh the benefits of maintaining the class. Factors to consider in making this determination include the number of holders of that class of Regular Interests, the frequency of payments to holders of that class, the effect the redemption will have on the yield of that class of Regular Interests, the outstanding principal balance of that class, and the percentage of the original principal balance of that class still outstanding. The notion being that the cash flows produced by the mortgage pool are insufficient to cover the expenses of the continued administration of the trust. A Clean-up Call is not a Prohibited Transaction.

"Defective Qualified Mortgage" means a Qualified Mortgage that (i) is in default or in imminent default, (ii) was fraudulently obtained, (iii) breached a seller representation or warranty as to the characteristics of the mortgage or (iv) does not fall within the "Principally Secured" definition. Defective Qualified Mortgages must be disposed of from a REMIC within 90 days of discovering its defect.

"Disqualified Organizations" means the U.S., any state or its political subdivisions, foreign governments, international organizations, agency or instrumentality of the foregoing, any tax-exempt organization unless it is subject to unrelated business tax, and any energy or telephone cooperatives.

"Foreclosure Property" means any real property (including interests in real property) and any personal property incident to real property acquired as a result of a foreclosure sale or having otherwise reduced such property to ownership or possession by agreement or process of law after there was a default or imminent default of a Qualified Mortgage held by the REMIC or on an indebtedness which such property secured, in each case, subject to a 3-year grace period which period can be extended further with special approval of the Secretary of the Treasury.

"Issue Price" means the issue price of any Regular Interest or Residual Interest in a REMIC as determined by under Section 1273(b) of the IRC in the same manner as if such interest were a debt instrument; except that if the interests is issued for property, Section 1273(b)(3) of the IRC would apply to whether or not the requirements of such section are met.

"Permitted Investments" means any Cash Flow Investment, Qualified Reserve Asset or Foreclosure Property.

“Pooling and Servicing Agreement” means an agreement entered into by and among the originator and seller of the mortgage loans, if applicable, a depositor that acquires the mortgage loans from the originator/seller and then sells them to a trust that qualifies as a REMIC and issues mortgage-backed securities, the trustee of the trust and the servicer of the mortgage loans as agent of the trust.

“Principally Secured” means an interest in real property means that the fair market value of the property securing the obligation either: (i) was equal to or more than 80% of the adjusted issue price of the obligation at its origination date or at the time such property was contributed to the REMIC or (ii) substantially all of the obligation proceeds were used to purchase or improve or protect the property securing the obligation at origination. In the case of any obligation originated by the United States or any state (or any political subdivision, agency, or instrumentality of the United States or any state), such obligations will be Principally Secured by an interest in real property if more than fifty percent (50%) of such obligations which are transferred to, or purchased by, the REMIC are Principally Secured by an interest in real property (determined without regard hereto).

“Prohibited Transaction” means the disposition of a Qualified Mortgage, not related to any of the following:

- i. A potential default on the regular interest where the threatened default resulted from a default on one or more Qualified Mortgage;
- ii. To facilitate a Clean-up Call;
- iii. Other than: (i) pursuant to a substitution of a Qualified Replacement Mortgage for a Qualified Mortgage or repurchase of a defective obligation in lieu thereof, (ii) incident to a foreclosure, default or imminent default of a mortgage, (iii) a bankruptcy or insolvency of the REMIC or (iv) a qualified liquidation;
- iv. Receipt by a REMIC of income derived from any asset other than a Qualified Mortgage or a Permitted Investment;
- v. Receipt by a REMIC of fees or other compensation; or
- vi. Gain from disposition of a Cash Flow Investment other than related to a qualified liquidation or unless it was necessary to prevent a default on the regular interest where the threatened default resulted from a default on one or more Qualified Mortgage.

“Qualified Mortgage” means (A) any obligations (including any participation or certificate of beneficial interest therein) that are Principally Secured by an interest in real property (e.g., including stock of real property cooperatives and Qualified Replacement Mortgages) and which is (i) transferred to the REMIC on the Startup Day in exchange for Regular Interests or Residual Interests in the REMIC, (ii) is purchased by the REMIC within the 3-month period beginning on the Startup Day if related to a fixed price contract in effect on such Startup Day, or (iii) represents an increase in the principal amount under the original terms of an obligation described in clause (i) or (ii) if such increase (I) is attributable to an advance made to the obligor pursuant to the original terms of a reverse mortgage loan or other obligations, (II) occurs after the Startup Day, and (III) is purchased by the REMIC pursuant to a fixed price contract in effect on the Startup Day, (B) any Qualified Replacement Mortgage, and (C) any regular interest in another REMIC transferred to the REMIC on the Startup Day in exchange for Regular Interests or Residual Interests of the REMIC. Qualified Replacement Mortgages or defeased

mortgages can also be Qualified Mortgages as long as: (i) the lien over the real property is lifted, (ii) the substitute collateral are government securities, (iii) defeasance is done pursuant to the terms of the mortgage and (iv) the defeasance is entered into after 2 years from the Startup Day. In addition, Regular Interests in other REMICs fall within the purview of the definition of a Qualified Mortgage if transferred to the REMIC on the Startup Day in exchange for the Regular Interests and Residual Interests of the REMIC. Further, Qualified Mortgages shall also include any obligations originated by the United States or any state (or any political subdivision, agency, or instrumentality of the United States or any state) if more than fifty percent (50%) of such obligations which are transferred to, or purchased by, the REMIC are Principally Secured by an interest in real property (determined without regard to this sentence).

“Qualified Reserve Asset” means any intangible property held for investment and as part of a Qualified Reserve Fund.

“Qualified Reserve Fund” means any reasonable required reserve to (i) provide for full payment of expenses of the REMIC or amounts due on regular interests in the event of defaults on Qualified Mortgages or lower than expected returns on Cash Flow Investments, or (ii) provide a source of funds for the purchase of obligations described in clauses (A)(ii) or (iii) of the definition of Qualified Mortgages. The aggregate fair market value of the assets held in any Qualified Reserve Fund may not exceed fifty percent (50%) of the aggregate fair market value of all of the assets of the REMIC on the Startup Day, and the amount of any such Qualified Reserve Fund shall be promptly and appropriately reduced to the extent the amount held in such Qualified Reserve Fund is no longer reasonably required for purposes specified in the foregoing clauses (i) or (ii). A reserve will not be treated as a Qualified Reserve Fund for any taxable year (and all subsequent taxable years) if more than 30 percent (30%) of the gross income from the assets in such fund for the taxable year is derived from the sale or other disposition of property held for less than three (3) months. Gain on the disposition of a Qualified Reserve Asset shall not be taken into account if the disposition giving rise to such gain is required to prevent default on a Regular Interest where the threatened default resulted from a default on 1 or more Qualified Mortgages.

“Qualified Replacement Mortgages” means Qualified Mortgages received either in exchange for other Qualified Mortgages within 3 months after a REMIC’s Startup Day or in exchange for a Defective Qualified Mortgage within 2 years after a REMIC’s Startup Day.

“Qualified Reserve Fund Payment” means any payment made to a Qualified Reserve Fund.

“Regular Interest” means any interest in a REMIC which is issued at the Issue Price on the Startup Day with fixed terms and which is designated as a regular interest if: (A) such interest unconditionally entitles the holder to receive a specified principal amount (or other similar amount), and (B) interest payments (or other similar amount), if any, with respect to such interest at or before maturity (i) are payable based on a fixed rate (or to the extent provided in treasury regulations, at a variable rate), or (ii) consist of a specified portion of the interest payments on Qualified Mortgages and such portion does not vary during the period such interest is outstanding. The interest shall not fail to meet the requirements of the foregoing clause (A) merely because the timing (but not the amount) of the principal payments (or other similar amounts) may be contingent on the extent of prepayments on qualified mortgages and the amount of income from permitted investments. An interest in the REMIC

shall not fail to qualify as a Regular Interest solely because the specified principal amount of the Regular Interest solely because the specified principal amount of the Regular Interest (or the amount of interest accrued on the Regular Interest) can be reduced as a result of the non-occurrence of 1 or more contingent payments with respect to any reverse mortgage loan held by the REMIC if, on the Startup Day for the REMIC, the sponsor of the REMIC reasonably believes that all principal and interest due under the Regular Interest will be paid at or the liquidation of the REMIC.

“REMIC” means a Real Estate Mortgage Investment Conduit as further defined in the REMIC Provisions.

“REMIC Provisions” means the enabling provisions of the IRC applicable to REMICs found under Sections 860A through 860G and Treasury Regulations §1.860A through §1.860G.

“Residual Interest” means an interest in a REMIC which is issued at the Issue Price on the Startup Day, which is not a Regular Interest, and which is designated as a residual interest.

“Significantly Modified Obligation” means an obligation subject to changes in its terms such that it is treated as an exchange other than (i) changes in the terms of the obligation occasioned by a default or imminent default, (ii) assumptions of the obligation, (iii) waivers of a due-on-sale clause or a due-on-encumbrance clause, and (iv) conversion of interest rates pursuant to the terms of a convertible mortgage.

“Startup Day” means generally the day on which a REMIC issues all of its Regular Interests and Residual Interests. A sponsor of the REMIC may contribute property to a REMIC in exchange for Regular Interests and Residual Interests over any period of ten (10) consecutive days and the REMIC may designate any one of those 10 days as the REMIC’s Startup Day.

“Trust Fund” means as it is defined in the applicable Pooling and Servicing Agreement which would include, among other things, a pool of mortgage loans.