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US federal income tax consequences of investing in distressed MBS and mortgage assets

Donald Gray Carden and Zey Nasser
Clifford Chance US LLP

With credit markets in turmoil, many questions have arisen as to the US federal income tax consequences of investments in distressed mortgage-backed securities (MBS) and mortgage assets. Often US federal income tax consequences can affect the expected return on such investments. This chapter summarises the basic tax characteristics associated with such assets and points out some common issues.

Generally, an investor may be exposed to distressed mortgage assets if:

- it holds a loan obligation secured by distressed real estate and/or mortgage loans (a 'loan obligation');
- it holds a debt security collateralised by distressed real estate and/or mortgage loans or MBS (a 'debt security'); or
- it holds an equity interest in a collateralised debt obligation (CDO) vehicle that holds distressed mortgage loans or MBS (a 'CDO equity security').

Considerations for US taxable investors

Accrual of interest and OID

A loan obligation or debt security is generally issued in the form of debt and is treated as such for US federal income tax purposes. However, such debt instrument often will either not pay interest on a current basis or will be in danger of having its current cash flow cut off.

The first US federal income tax issue that a prospective investor in such paper must face is whether it is necessary to continue to accrue interest

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income and original issue discount (OID) with respect to such investment.

Generally, US taxpayers are required to continue to accrue non-OID interest with respect to a loan obligation or debt security if there is a "reasonable expectation" that such interest will ultimately be collected. The mere prospect of a significant delay in payment is not enough to prevent accrual (see *Koehring Co. v. U.S.*, F.2d 715 (Ct. Cl. 1970)).

However, some courts have deemed it futile to require taxpayers to accrue amounts that are seemingly uncollectible (see *Electric Controls & Service Co. v. Com.* T.C. Memo 1996-486). In addition, the Internal Revenue Service (IRS) has held that uncollectible interest need not be accrued even if the underlying obligation to which it relates has not been written off (see Technical Advice Memorandum 8137004).

In sum, and as a general matter, if a US taxpayer has a reasonable expectation that it will ultimately collect the interest due with respect to a loan obligation or debt security, it should continue to accrue such interest.

Logically, this common law 'reasonable expectation of collectibility' test should be equally applicable to OID, which economically represents a substitute for interest. Unfortunately, the IRS took the opposite view when it ruled privately that a holder of a debt security with OID must include the OID in income as it accrues, even when there is no reasonable expectation of payment (see Technical Advice Memorandum 9538007). The IRS's ruling stemmed from its concern that the issuer of a distressed security would continue deducting accrued OID while the holder of such security would stop taking such OID into income.

Given the economic similarity of OID to interest, the IRS's ruling seems incorrect. Nevertheless, in light of the ruling it remains unclear whether a US taxpayer that has no reasonable expectation that it will ultimately collect the OID due with respect to a loan obligation or debt security should continue to accrue such OID.

Market discount

The code contains detailed rules addressing the US federal income tax treatment of debt instruments purchased at a discount. Under these rules, unless a special election is made a taxpayer is not required to accrue the discount on a yield to maturity basis as interest or OID. However, upon a disposition of the instrument, a portion of any gain realised is recharacterised for US federal income tax purposes as ordinary income, up to the amount of market discount (Section 1276(a)(1) of the Internal Revenue Code). (All section references are to the Internal Revenue Code of 1986, as amended, and all Treas Reg § references are to the Treasury Regulations promulgated thereunder.) In addition, any partial payment of principal with respect to a debt instrument issued with market discount must be included as ordinary income to the extent that such payment does not exceed the accrued market discount on such instrument (Section 1276(a)(3)).

For an individual investor (as well as for a hedge fund or other fiscally transparent investment vehicle that reports its income to its investors), ordinary income is less attractive than capital gain, since it may be taxable at a higher rate. Moreover, for both individuals and corporate investors with capital losses, ordinary income is less attractive than capital gain since ordinary income generally may not be offset by capital losses. Hence, the market discount rules make investment in distressed debt a less attractive investment opportunity than investment in distressed equity, where all gain ultimately realised on the investment would generally qualify as capital gain.

Timing and character of losses: bad debt deduction versus worthless security loss

One question that often arises with respect to distressed investments is the timing of tax losses available to the investor. The availability of a deduction for a bad debt is determined under Section 166, whereas the availability of a deduction for losses, including any loss attributable to a worthless security, is determined under Section 165.

One important distinction between a bad deduction and a worthless security loss is that a bad deduction is allowable during a taxable year in which the debt at issue becomes either completely or partially worthless, whereas a worthless security loss is available only when the security becomes completely worthless.

Bad debt deduction

A US taxpayer will be entitled to a bad debt deduction if it can prove that its loan obligations are worthless in the year that the deduction is claimed. Under Section 166, taxpayers are allowed to deduct the amount of any debt (including any portion of a debt) that becomes worthless during the taxable year (Section 166(a)(1) and (2)). However, no precise test for determining worthlessness exists. Treas Reg § 1.166-2 does not define worthlessness but merely alludes to "evidence of worthlessness". The regulations provide that where circumstances indicate that a debt is worthless and uncollectible, and that legal action to enforce payment would in all probability not result in the satisfaction of execution on a judgment, the facts are sufficient to establish worthlessness (Treas Reg § 1.166-2(b)). A determination as to whether a debt is worthless at a particular time is a question of fact to be determined by the evidence available from all the surrounding circumstances.

Further, a bad debt deduction is allowed for any debt which becomes worthless "within the taxable year" (Sections 166(a)(1)). Therefore, the taxpayer must establish not only that the debt was worthless by the end of the year in which the deduction is claimed, but also that it was not worthless at the end of the immediately preceding year.

The following factors indicate worthlessness:

- a decline in the debtor's business;
- the worthlessness of a judgment against the debtor; and
- the decline in value of the collateral securing the debt.

Evidence that the debtor is having financial difficulties alone does not establish worthlessness. This is because the insolvency or adverse financial condition of the debtor may be temporary, and it may be foreseeable that its financial position will improve in the future.

The burden of proving worthlessness in the correct year it occurs is on the taxpayer. Each year there are a high number of cases where taxpayers fail to sustain such burden. In certain circumstances, even though it is fairly certain that a debt is worthless, it may be advisable to make further (documented) efforts to collect such debt for the purpose of demonstrating worthlessness to the IRS.

If the taxpayer can prove worthlessness, a bad deduction is allowable as an ordinary deduction during a taxable year in which the debt at issue becomes completely or partially worthless (Sections 166(a)(1) and (2)).

Worthless securities

A US taxpayer will be entitled to a worthless securities loss if it can prove that the debt securities are worthless in the year the deduction is claimed. Under Section 165(g)(1), if a security becomes worthless during the taxable year, the resulting loss is deductible. Section 165(g)(2) defines the term 'security' as:

- a share of stock in a corporation;
- a right to subscribe for, or to receive, a share of stock in a corporation; or
- a bond, debenture, note, certificate or other evidence of indebtedness, issued by a corporation or by a government or political subdivision thereof, with interest coupons or in registered form.

In order to obtain a deduction under Section 165(g), the taxpayer has the burden of proving that the security was not worthless in a prior year and that it became worthless in the year claimed. To prove worthlessness, the taxpayer must show:

- balance-sheet insolvency (ie, that the issuer's liabilities exceed its assets) (eg, see *Greenberg v. Comr.*, T.C. Memo 1971-220 (1971)); and
- a complete lack of future potential value as indicated by an identifiable event, such as the adoption of a plan of liquidation (see *Heiss v. Comr.*, 36 B.T.A. 833 (1937)).

A worthless security loss is available only when such security becomes completely worthless. Pursuant to Section 165(g)(1), such deduction will be a capital loss, unless the exception in Section 165(g)(3) for certain worthless securities in a corporation affiliated with the taxpayer applies. This exception is unlikely to apply in the CDO context because it applies only to securities issued by a corporation less than 10 per cent of whose gross receipts are attributable to passive income such as interest (see Treas Reg § 1.165-5(d)(2)(iii)). As noted above, a taxpayer's ability to use capital losses to offset ordinary income is severely restricted.

Abandonment

Until recently, one strategy that was often used to avoid the receipt of capital loss treatment with respect to a worthless security was for a US taxpayer anticipating that a security may become worthless to abandon the security. To abandon a security, the taxpayer would be required to relinquish all rights to future distributions with respect to such a security. Such taxpayers hoped that because abandonment does not, as a technical matter, involve a sale or exchange of the underlying security, any loss recognised as a result of the abandonment would be ordinary rather than capital (and hence more valuable). In order for abandonment to have this desired result, it was necessary to ensure that:

- abandonment occurred prior to the time the security became wholly worthless (since worthlessness triggers a capital loss); and
- the taxpayer had successfully relinquished any right to claim any proceeds that may in the future flow to the holders of the security abandoned.

In 2007 the US Treasury sought to discourage the use of this abandonment technique by promulgating regulations that state that a security that has been abandoned is worthless for US federal income tax purposes, and hence would trigger a capital loss (see REG-101001-05 published in the *Federal Register* on July 30 2007). These regulations were finalised in March 2008 (TD 9386), and as a result it is no longer possible to avoid a capital loss by abandoning a security before it becomes worthless.

Work-outs: material modification rules

Gain or loss may be triggered to the holder of a loan obligation or debt security if the terms of such instruments are materially modified as a result of a work-out proceeding. Treasury regulations contain detailed rules that govern whether a material modification has occurred. The rules differ depending on whether the debt instrument in question is recourse or non-recourse. Under a recourse debt instrument, a lender, in addition to being secured by specific assets, has recourse against the general assets of the debtor. Under a non-recourse debt instrument, a lender has no recourse to the assets of the debtor beyond those securing the loan.

The substitution of a new obligor of a recourse obligation is deemed to be a material or significant modification, but a change in the collateral securing such obligation is generally not unless it results in a change in payment expectations (Treas Reg §§ 1.1001-3(e)(4)(i) and (iv)(A)).

A change in payment expectations occurs if there is either:

- a substantial enhancement of the obligor's capacity (including guarantees, third-party collateral and other sources of payment or credit enhancement) to meet the payment obligations, where that capacity was primarily speculative before the modification and is adequate after the modification; or
- a substantial impairment of the obligor's capacity to meet the payment obligations, where that

capacity was adequate before the modification and is primarily speculative after the modification (Treas Reg § 1.1001-3(e)(4)(vi)).

With respect to a non-recourse obligation, understandably the regulations focus less on the identity and creditworthiness of the borrower (as that is essentially irrelevant to the question of whether the debt will be repaid), and more on the nature of the collateral. A modification that releases, substitutes, adds or otherwise alters a substantial amount of the collateral for, a guarantee on or other form of credit enhancement for a non-recourse debt instrument is a significant modification (Treas Reg § 1.1001-3(e)(4)(iv)(B)).

In MBS transactions it can be difficult to determine whether a debt instrument is properly viewed as recourse or non-recourse. This is because borrowers in such transactions are often special purpose vehicles whose assets consist solely of the collateral securing the notes they issue. For these borrowers, whether a note is non-recourse (ie, recourse only to the collateral securing it) or recourse to the borrower (ie, recourse to all the borrower's assets) makes little or no difference because the borrower's assets consist solely of the collateral securing such note. Arguably, under current law taxpayers can choose which set of rules apply by (rather formalistically) drafting documents that are recourse or non-recourse as a technical matter without significantly affecting the rights and obligations of the parties.

Distressed CDO equity securities

As used herein, the term 'CDO' refers to an arrangement whereby a special purpose vehicle has been established to invest in loan obligations, MBS and similar securities. In most instances, CDOs are established as corporations in tax-haven jurisdictions, such as the Cayman Islands. A CDO typically issues several tranches of securities that comprise its capital structure. The more senior tranches of securities issued by the CDO are treated as indebtedness for US tax purposes and, in the event that they become worthless, are subject to the rules described above with respect to worthless securities. The most junior tranche of securities in the capital structure (or in some cases the two or three most junior tranches) are treated as equity of the CDO vehicle for US federal income tax purposes. In many cases securities issued by CDOs are now trading for a fraction of their initial issue price.

An investment in a CDO equity security, while potentially attractive from an economic perspective due to the low current price and tremendous upside potential, carries with it potentially negative tax consequences. Specifically, if the CDO is characterised as a controlled foreign corporation for US tax purposes (which will depend upon the level of US ownership and certain other factors), a US taxable investor in a CDO equity security will be required to recognise its proportionate share of the net earnings of the CDO as such earnings accrue, regardless of whether payments are being made with respect to the security on a current basis. In the current environment, current payments with respect to a CDO equity security are rare.

Moreover, if earnings that are required to be recognised on a current basis do not eventually translate into cash returns, the US investor will be left with a capital loss, use of which is subject to the restrictions described above. Careful planning may be required to avoid any risk that a CDO may be classified as a controlled foreign corporation. This planning may include, for example, acquiring exposure to the CDO equity via a properly structured derivative, rather than via outright purchase.

US federal income tax considerations for non-US investors

US trade or business considerations

A non-US investor seeking to invest in distressed ABS and mortgage assets must consider the risk that in doing so it may be considered to be engaged in a trade or business in the United States. If a non-US investor is so engaged, it will be subject to US tax on the net income effectively connected with such trade or business, and potentially to a branch profits tax as well.

A non-US investor can invest in US assets without being engaged in a US trade or business by relying on

the so-called 'securities trading safe harbour'. The securities trading safe harbour provides that trading in stocks or securities for a taxpayer's own account, whether by the taxpayer or its employees or through a broker or other agent, does not constitute a trade or business within the United States (Section 864(b)(2)(A)(i)). However, the securities trading safe harbour does not apply to dealers in stocks or securities, even if the trading at issue is unrelated to the dealer activities. In addition, the safe harbour does apply to loan origination activities.

It is unclear whether the securities trading safe harbour applies to non-US investors that purchase distressed assets with a view to profiting from a work-out. It is possible that such investors might be deemed to be engaged in loan origination activities or to be otherwise engaged in activities beyond the scope of mere trading, particularly if the non-US investor is an active participant in the work-out process. This is because in a work-out, creditors of a troubled corporation often exchange their notes for new notes of the corporation. Such new notes are essentially new loans to the corporation that may cause a non-US investor that receives them to be viewed as engaged in loan origination activities that do not qualify for the securities trading safe harbour. However, a non-US investor generally should not be deemed to be engaged in loan origination activities merely as a result of receiving a new debt instrument in a work-out due to the absence of:

- a customer relationship with the borrower;
- an advance of fresh funds; and
- other typical money-lending activities.

Considerations applicable to foreclosure

Non-US investors must be particularly sensitive to the potential tax impact of the receipt of a deed to property in connection with a foreclosure proceeding. The securities trading safe harbour described above with respect to an investment in stock and securities does not apply to an investment in real property, which can cause a non-US investor to be treated as engaged in a US trade or business. However, even if a non-US investor is not treated as so engaged, the investor will be subject to a 30 per cent gross income withholding tax on any rent received from the subject property. In addition, a special tax regime under the Foreign Investment in Real Property Tax Act (FIRPTA) applies to a non-US investor which invests in US real property. Such an investor is subject to US tax on any gain arising from such investment as if such gain were effectively connected with a US trade or business, resulting in tax at generally applicable US rates, plus possibly the imposition of a branch profits tax.

These adverse tax consequences are likely to cause a non-US investor to seek alternative structures to minimise the tax drag associated with these investments. Depending on the type of asset, it may be possible to limit adverse tax consequences by establishing an entity qualified as a real estate investment trust (REIT) to hold the mortgages and/or foreclosed assets. A REIT is a vehicle that is treated as a corporation for US federal income tax purposes, but provided it meets certain requirements it is not subject to an entity-level tax. Moreover, a domestically controlled REIT is not subject to the FIRPTA, meaning that its stock may be sold by a non-US investor without attracting US tax on any gain. A domestically controlled REIT is a REIT in which, at all times during the relevant testing period, less than 50 per cent in value of the stock of such REIT held directly or indirectly by foreign persons (Section 897(h)(4)(B)). However, a distribution by a domestically controlled REIT to a non-US investor will be subject to FIRPTA tax if it is attributable to a disposition of a US real property interest, unless such distribution is with respect to a class of stock that is regularly traded on an established securities market located in the United States and the non-US investor owned 5 per cent or less of that class of stock at all times during the year ending on the date of the distribution (Section 897(c)(3)). A distribution to a non-US investor by a REIT (regardless of whether it is a domestically controlled REIT) that is not attributable to

a disposition of a US real property interest is subject to US withholding tax at a rate of 30 per cent. Such withholding tax may be reduced or eliminated under an applicable income tax treaty.

Alternatively, it may be possible for non-US investors to avoid some of the adverse tax consequences of investing in distressed mortgage assets by investing in, or holding its interests through, a vehicle that qualifies as a real estate mortgage investment conduit (REMIC) for US tax purposes. A REMIC is a specialised vehicle designed to facilitate mortgage securitisation. A REMIC is not subject to an entity-level tax except in certain limited situations and the securities issued by a REMIC are typically characterised as indebtedness for US federal income tax purposes, regardless of whether they would be so treated under common law principles. Moreover, a REMIC may foreclose on mortgages it holds, and hold and operate the underlying foreclosed properties, for a substantial period of time without creating US trade or business or adverse withholding tax consequences for a non-US investor. Most securitised mortgage assets are already in the form of REMIC securities, so these benefits are already available to non-US investors in such assets. Raw mortgage loan assets can be placed in a REMIC structure prior to foreclosure in order to avoid the adverse consequences described above, provided that certain value tests are met. CDO securities are not eligible to be placed in a REMIC; however, many of the assets inside a CDO may already be in the form of REMIC interests.

Conclusion

The recent market turmoil undoubtedly has and will create opportunities for astute investors that can understand and properly value the complex mortgage-related securities created over the last decade. However, it is important that tax consequences be properly modelled to avoid unpleasant surprises.