Mortgage-Backed Securities: Tax, Accounting, and Securities Law Considerations

By

Jerome Christian Muys, Jr.

B.A. June 1976 University of North Carolina
J.D. May 1979 George Washington University

A Thesis submitted to
The Faculty of
The National Law Center
of the George Washington University
in partial satisfaction of the requirements
for the degree of Master of Laws

May 18, 1986

Thesis directed by
Professor Lewis D. Solomon
I. Introduction. .................................................. 1
   A. Overview .................................................. 1
   B. The Role of the Federal Government ................. 3
      1. The Government National Mortgage Association .... 6
      2. The Federal Home Loan Mortgage Corporation ....... 7
      3. The Federal National Mortgage Association ......... 9
   C. Types of Instruments ................................. 10
      1. Mortgage Pass-Throughs ............................. 10
         a. "Ginnie-Maes" ................................... 10
         b. FHLMC Mortgage Participation Certificates .... 13
      2. Mortgage-Backed Bonds ............................. 13
         a. Serial Zero-Coupon Mortgage-Backed Bonds .... 14
         b. Collateralized Mortgage Obligations ............ 15
         c. Builder Bonds ..................................... 16
      3. Mortgage-Backed Stock ............................. 18

II. Federal Income Tax Treatment of Mortgage-Backed Securities ..................... 18
   A. Tax Aspects of Pass-Through Certificates ... 18
      1. General Principles - The Grantor Trust Rules .... 18
      2. Operation of the Grantor Trust Rules ............ 23
      3. Multiple Class Grantor Trusts .................... 26
      4. Reserve Funds ........................................ 32
III. Tax Consequences of Characterization as Grantor trust.

a. Recharacterization as Debt

b. Relevance to Other IRC Provisions

B. Tax Treatment of Mortgage-Backed Bonds

1. Collateralized Mortgage Obligations

2. Builder Bonds

C. Other Tax Considerations

1. Original Issue Discount

2. Market Discounts and Premiums

3. Debt v. Equity

III. Federal Securities Law

A. Applicability

1. Howey Test Applied to Mortgage-Backed Securities

a. Investment of Money

b. Common Enterprise

c. Profits Solely from the Efforts of Others

2. Relevant Administrative and Judicial Determinations

B. Substantive and Procedural Requirements of Federal Securities Laws

1. Registration

a. Liability for False Registration Statement

b. Exemptions

(i) Securities Issued or Guaranteed by Governmental Entities
(ii) Securities Issued or Guaranteed by Banks... 66

(iii) Transactional Exemptions from Registration... 67

1. Private Placement Exemption... 68

2. Certain Real Estate Transactions... 69

2. Anti-Fraud Provisions and Other Requirements... 70

3. Trust Indenture Act of 1939... 70

4. Investment Company Act of 1940... 72

5. Secondary Mortgage Market Enhancement Act... 76

IV. Accounting Issues... 77

A. Financial Accounting Standards Board Determinations... 79

1. Financial Accounting Standard No. 76... 79

2. Financial Accounting Standard No. 77... 80

3. FASB Technical Bulletin No. 85-2... 81

V. Statutory and Regulatory Initiatives... 82

A. Trust for Investment in Mortgages Act... 82

B. Secondary Mortgage Market Enhancement Act of 1984... 83

C. Tax Reform Act of 1985... 88

VI. Conclusion... 91
I. Introduction

A. Overview

This paper will consider various aspects of Federal income tax, securities law, and accounting treatment of "mortgage-backed securities." The term "mortgage-backed security" will be used herein to refer generically to the various investment instruments which are backed by pools of residential (and, recently, commercial) mortgages. These instruments include, among others, mortgage pass-through certificates, mortgage-backed bonds, and mortgage pay-through certificates.

Mortgage-backed securities are created when savings institutions and other lenders sell mortgage loans in the secondary market, generally to quasi-governmental corporations or large mortgage bankers. The buyers then package the mortgages and sell securities backed by "pools" of mortgage loans.

The most common mortgage-backed security is the Government National Mortgage Association-guaranteed pass-through certificate.¹ A mortgage pass-through certificate represents a share in a pool of home mortgages and entitles

¹Monthly payments of principal and interest are "passed-through" to investors.
the holder to a share of the mortgagors’ monthly payments.

Mortgage pass-throughs and other mortgage-backed securities instruments are different from traditional fixed-income investments, which return principal at maturity. Holders of mortgage-backed securities generally receive varying monthly payments which reflect both principal and interest.

The pooling of residential mortgages to create mortgage-backed securities began in the early 1970’s. Mortgage pass-throughs guaranteed by the Government National Mortgage Association were introduced in the capital market in 1970. Since that time, roughly $300 billion of residential loans have been pooled for various types of mortgage pass-throughs.²/

Although the vast majority of mortgage securities issued have been “mortgage pass-throughs”, a small portion have been mortgage-backed bonds and “pay-throughs.” The primary distinction between these instruments is that pass-throughs are issued as sales of assets by the issuer, while mortgage-backed bonds and pay-through certificates are carried on the issuer’s books as debt.

Various of the instruments referred to generically as "mortgage-backed securities" may be subject to federal securities laws, depending on a number of factors. Potentially applicable statutes include the Securities Act of 1933,\textsuperscript{3} the Securities Exchange Act of 1934,\textsuperscript{4} the Trust Indenture Act of 1939,\textsuperscript{5} and the Investment Company Act of 1940.\textsuperscript{6}

B. The Role of the Federal Government

The vast majority of mortgage-backed securities are issued by, or created through the activities of, the Government National Mortgage Association, the Federal Home Loan Mortgage Corporation, and the Federal National Mortgage Association. Historically, each of these quasi-governmental institutions has performed a separate function in the secondary mortgage market. Of late, the distinctions in functions among these entities have diminished.

The rationale for governmental promotion of a secondary mortgage market is to provide additional funds to the primary mortgage market. This is accomplished through the

\textsuperscript{3} 15 U.S.C. § 77a \textit{et seq.}
\textsuperscript{4} 15 U.S.C. § 78a \textit{et seq.}
\textsuperscript{5} 15 U.S.C. § 77aaa-77bbb \textit{et seq.}
\textsuperscript{6} 15 U.S.C. § 80a-1 \textit{et seq.}
purchase of home mortgage loans from lending institutions, which serves to replenish the funds available to such institutions for additional lending.

The quasi-governmental corporations acquire the funds to purchase the home mortgage loans through the sale of mortgage-backed securities to capital market investors who otherwise would probably not invest in mortgages. This serves to expand the total amount of funds available for housing, and to redistribute mortgage funds from capital-surplus to capital-deficient areas.

The activities of the quasi-governmental corporations are conducted through trust agreements, pursuant to which the corporations create mortgage pools and serve as trustees of the pools. Generally, the pools consist of residential mortgages provided by a single mortgage lender in exchange for mortgage certificates, with the lender paying the corporation a processing fee for pooling the mortgages. The trust certificates are then sold to investors.

In its capacity as pool trustee, the corporation collects principal and interest payments on each mortgage and makes monthly distributions to the certificate-holders. The corporation receives a fee for its services as trustee consisting of a monthly service charge, retained from the
interest collected on the mortgages and from other
compensation, including late payment charges, assumption
fees, and prepayment penalties collected by the corporation.

Under the trust agreement, pool proceeds are held in
non-interest bearing accounts and cannot be reinvested.
Neither the trustee corporation nor the lender has the power
to substitute a new mortgage for an original mortgage in the
pool, except that the trustee corporation may require the
lender to replace defective mortgages in the pool. The pool
terminates when all mortgages are liquidated and all
proceeds are distributed. The trustee corporation generally
reserves the right to terminate the pool by purchasing all
trust certificates when the aggregate outstanding principal
amount of mortgages in the pool falls below a certain level.

The certificate holders are generally guaranteed that
they will receive timely payment of interest and collection
of principal. If a mortgage is in default or if there is a
foreclosure on mortgaged property, the corporation generally
reserves the right to withdraw the mortgage from the pool
and deem the mortgage prepaid. The trust certificates,
which are in registered form, generally state that they
represent fractional undivided interests in the mortgage
loans, pool proceeds, mortgaged property acquired by
foreclosure that has not been withdrawn from the pool, and
the corporation's obligation to supplement the pool proceeds
to the extent necessary to make distributions.\(^7\)\\

1. The Government National Mortgage Association

The Government National Mortgage Association ("GNMA")
is a wholly-owned corporate instrumentality of the United
States within the Department of Housing and Urban
Development. Section 306(g) of Title III of the National
Housing Act of 1934, as amended (the "Housing Act")\(^8\),
authorizes GNMA to guarantee the timely payment of the
principal of, and interest on, certificates that are based
on and backed by pools of mortgage loans insured by the
Farmers Home Administration ("FHA") or guaranteed by the
Veterans Administration ("VA").

\(^7\) For a fuller discussion of the various mortgage pooling
arrangements, see Rev. Rul. 71-399, 1971-2 C.B. 433,
80-96, 1980-1 C.B. 317, Rev. Rul. 74-300, 1974-1 C.B. 169,
Rev. Rul. 74-221, 1974-1 C.B. 365, and Rev. Rul. 72-376,
1972-2 C.B. 647 (concerning mortgage pools established by
the Federal Home Loan Mortgage Corporation); Rev. Rul. 70-
both modified by Rev. Rul. 74-169, 1974-1 C.B. 147
(concerning mortgage pools guaranteed by the Government
National Mortgage Association); and Rev. Rul. 77-349, 1977-2
C.B. 20 (concerning a mortgage pool created by a commercial
bank).

\(^8\) 12 U.S.C. § 1716 et seq.
Section 306(g) of the Housing Act provides that "the full faith and credit of the United States is pledged to the payment of all amounts which may be required to be paid under any guaranty under this subsection." In order to meet its obligations under such guarantees, GNMA is authorized, under § 306(d) of the Housing Act, to borrow from the United States Treasury with no limitation as to amount.

GNMA pass-through certificates (commonly known as "GNMAs" or Ginnie Maes), as most securities, are fully transferable from one investor to another. Institutional investors in particular have been attracted to GNMA pass-through certificates because of their favorable yields, good liquidity, and high degree of safety. However, although regular payments of principal and interest are guaranteed, payments are fixed for the life of the pooled mortgages. Thus, certificate-holders bear the risk that mortgage interest rates may fluctuate, making the instruments more or less valuable.

2. The Federal Home Loan Mortgage Corporation

The Federal Home Loan Mortgage Corporation ("FHLMC") is a corporate instrumentality of the United States created

9/ 12 U.S.C. § 1721(g).

10/ 12 U.S.C. § 1721(d).
pursuant to Title III of the Emergency Home Finance Act of 1970 (the "FHLMC Act").11/ FHLMC (also known as "Freddie Mac") was established primarily for the purpose of increasing the availability of mortgage credit for the financing of housing. It has historically acted as a conduit for creating securities backed by conventional (as opposed to FHA or VA) mortgages originated by savings and loan associations. The primary activity of FHLMC currently consists of the purchase of first lien conventional mortgage loans or participation interests in such mortgage loans and the resale of the mortgage loans in the form of FHLMC "participation certificates."

In 1981, FHLMC expanded its secondary market functions through the initiation of its Guarantor Program. The program was designed to assist savings institutions to restructure and improve the liquidity and marketability of their portfolios of conventional mortgages. Under the program, savings institutions may exchange their holdings of mortgage loans for FHLMC participation certificates. In 1983, FHA/VA loans and newly-originated loans were included in the program.

All mortgage loans purchased by FHLMC must meet certain standards set forth in the FHLMC Act. FHLMC is generally restricted to purchasing mortgage loans of such quality, type and class as to meet purchase standards imposed by private institutional mortgage investors.

3. The Federal National Mortgage Association

The Federal National Mortgage Association ("FNMA") is a federally-chartered and privately-owned corporation organized and existing under the Federal National Mortgage Association Charter Act.\(^\text{12}^\) The FNMA was originally established in 1938 to provide assistance to the secondary market for residential mortgage loans, and was transformed into a stockholder-owned and privately managed corporation in 1968. It is now the largest supplier of residential mortgage funds in the country.\(^\text{13}^\)

The FNMA historically has provided a secondary market outlet for mortgage bankers or originators of both conventional and FHA/VA mortgages. It is the most recent

\(^\text{12}^\) 12 U.S.C. § 1716 et seq.

\(^\text{13}^\) In the roughly fifty years that the FNMA has been in the business of buying home mortgages from lenders, it has purchased one in thirteen of such loans. Its portfolio holds more than 537,000 mortgages and is worth roughly $85 billion. Since 1981, when it began issuing mortgage-backed securities, it has raised more than $38 billion from investors. Why Fannie Mae Isn't Hammering Out Profits in Mortgages, 11 Bus. Week 146-7, N. 19 (1984).
quasi-government agency to issue mortgage-backed securities. The FNMA issues its own securities and insures timely payment of both principal and interest.

C. Types of Instruments

1. Mortgage Pass-Throughs

Mortgage pass-through certificates represent an ownership interest in a mortgage "pool". A mortgage pass-through is created when a lender sells mortgages to investors, through their trustee, for the establishment of a mortgage pool and the issuance of certificates reflecting an ownership interest in the mortgages. Principal and interest are "passed through" to the certificate-holders on a monthly basis without any reinvestment of the monthly payments.

Under the "grantor trust" arrangement (discussed below), the trustee collects funds from the servicer of the mortgages (generally the original lender) and makes payments directly to the certificate-holders. Prepayments of the mortgages are also passed-through.

a. "Ginnie-Maes"

As noted above, Ginnie Maes are investments representing an undivided interest in a pool of mortgages. Holders of the securities receive pass-through payments of principal and interest. GNMA serves as guarantor of the payments. The securities bear a fixed income rate, which is
somewhat less than the rate on the underlying mortgages because of the GNMA guarantee fee and the issuer’s servicing fee. The issuer makes monthly payments of principal and interest to holders (or remits such payments to GNMA which, in turn, pays the holders).

Ginnie Maes are issued by savings and loan associations or other financial institutions. Although these institutions are generally referred to as "issuers", that term is misleading to the extent that it suggests that the issuing institution incurs a debt in connection with the issuance of the certificates. The certificates provide explicitly that they do not constitute a liability of, nor evidence of recourse against, the issuer. The function of the issuer after the certificates have been sold is solely to service the mortgages in the pool. Legal title to the mortgages is in the GNMA and the actual mortgage documents are held by an independent custodian.

The "straight pass-through" type of Ginnie Mae provides for payments by the issuer of specified monthly installments based on the amortization schedules of each of the mortgages in the underlying pool. If a default or late payment on any mortgage occurs, the issuer will normally advance funds to keep up the payments until the deficiency is corrected by the mortgagor or foreclosure occurs. The issuer makes such
advances because the servicing arrangement is an important source of income. The issuer is generally allowed to retain any late charges which are collected from the mortgagors.

In addition to the scheduled payments, the certificates generally provide for payment to each of the certificate holders a proportionate share of any prepayments or other early recoveries of principal, including foreclosure proceeds. An amount equal to a percentage of the outstanding principal amount on the mortgages is withheld by the issuer each month, which amount is used by the issuer to discharge the certificate holders' obligations to pay the servicing fee to the issuer, the custodian fee, and the GNMA guarantee fee. With respect to the "straight pass-through" Ginnie Maes, GNMA generally guarantees that the issuer will faithfully perform its obligations as a servicing agent.

The "fully modified pass-through" Ginnie Maes differ from the "straight pass through" type in that the GNMA guarantee is expanded to encompass the scheduled payments of principal and interest. If default occurs on any of the underlying mortgages, GNMA guarantees that the certificate holders will receive the scheduled payments even if the issuer is unable or unwilling to make the necessary advances.
b. **FHLMC Mortgage Participation Certificates**

Mortgage Participation Certificates ("PCs"), issued by the FHLMC, are pass-through certificates representing undivided interests in fixed rate, first lien, conventional residential mortgages purchased by the FHLMC. FHLMC guarantees the timely payment of interest on the unpaid principal balance of the mortgages and the ultimate collection of principal on the mortgages. As explained below, PCs (and Ginnie Maes) are exempt from the registration requirements of the Securities Act of 1933 and are "exempted securities" within the meaning of the Securities Exchange Act of 1934.

2. **Mortgage-Backed Bonds**

In addition to mortgage pass-throughs, the sale of which is considered a sale of the underlying mortgages, mortgage-backed securities may also take the form of debt instruments. Mortgage-backed bonds represent a security interest in the underlying mortgages or the cash flow therefrom, rather than an ownership interest in the mortgage pool. They are a general obligation of the issuer, payable out of the general funds of the issuer and the collateral pool. Thus, the bonds appear as a liability on the issuer’s balance sheet.
The collateral pool consists of Ginnie Maes or other mortgage-backed certificates, or mortgage loans. In the latter case, the issuer retains ownership of the mortgage loans.

Mortgage-backed bond issuances are structured to provide for multiple classes of interests that have differing maturities, resulting in greater marketability. In addition, the bonds are structured to provide a predetermined repayment schedule. There are several types of mortgage-backed bonds, including serial zero-coupon bonds, collateralized mortgage obligations, and "builder bonds."

a. Serial Zero-Coupon Mortgage-Backed Bonds

These instruments have a fixed number of annual maturities and pay no interest during their term. The principal amount of each bond is paid in a single installment at its stated maturity. The monthly cash flow generated by the underlying mortgages constitutes the only source of payment for the bonds. Since the bonds are paid annually, the issuer reinvests the monthly mortgage cash flows in eligible investments, mostly short term, until it is time to make the scheduled bond payments.
b. **Collateralized Mortgage Obligations**

Collateralized Mortgage Obligations (CMOs) are the most popular type of mortgage-backed bond. CMOs are designed to combine the safety and high yields of mortgage-backed certificates with the scheduled maturities and semi-annual interest payments of bonds. Instead of purchasing mortgage certificates directly, investors purchase bonds that are backed by mortgage securities. Each bond issue is divided into a range of maturities, with investors holding the shortest maturities receiving prepayments on all mortgages. Investors holding the longest maturities receive semi-annual payments, but no principal, until the shorter term issues are paid off.

CMOs were introduced by the FHLMC in 1983 as an alternative to pass-through certificates. They are now issued by private entities as well. At the time they were introduced, CMOs were considered a radical departure from traditional mortgage-backed securities in which loans were pooled and sold in the form of pass-through or participation certificates.
CMOs are generally structured with mandatory semi-annual sinking fund payments to the bondholders. If there is a shortfall of payment from the mortgage collateral for the sinking fund payment, the issuer makes up the difference from its general funds.

CMOs are now collateralized by both GNMA pass-throughs and FHLMC PCs. The difference between FHLMC CMOs and GNMA CMOs is that the latter have no guaranteed sinking fund payments and are nonrecourse to the issuer. The issuer generally holds no assets other than the GNMA pass-throughs, and has little equity.

c. Builder Bonds

Prior to the advent of CMOs, similar securities, known as "cash flow" or "pay-through" bonds, were frequently issued by finance subsidiaries of major home builders to retain installment sales treatment under the federal tax laws for the homes sold by them.

A cash flow bond issue is collateralized by mortgages which are sufficient (under any payment scenario, from immediate prepayment to no prepayments) to retire the issue by its scheduled maturity date. Rather than having a single payment date for principal, these bonds have periodic
principal amortization payments, just as mortgages do. The interest rate may vary substantially from that of the underlying mortgages.

In a builder bond transaction, mortgage notes are pledged by the builder to secure financing. Builder bonds are generally structured as follows. A builder will sell the homes it has constructed on the installment basis and take back promissory notes providing for periodic installment payments over a period of years. The builder will then enter into an agreement with a lending institution or an investment and underwriting firm pledging the mortgages as collateral for the issuance of bonds, the sale of which provide the builder with financing for new construction. The mortgages continue to be serviced by the builder or its agents.

Under current law, builders who back construction bonds with mortgages may defer taxes through installment sale tax treatment on the sale of the homes they construct. Thus, pay-throughs allow builders to lower their cost of financing and increase their tax benefits. The bonds also give construction companies direct access to capital markets, letting them borrow at a reduced rate and avoid bank charges.
3. Mortgage-Backed Stock

Some savings and loan institutions have used separate subsidiaries owning pools of GNMA certificates to issue preferred stock, similar to the technique used in the CMO area. In July, 1984, the Federal Home Loan Bank Board adopted a rule permitting federal savings and loans to transfer up to 30% of their assets to finance subsidiaries. The subsidiaries can issue various types of secured debt, such as CMOs, or can issue preferred stock. Generally, the preferred stock is issued with an adjustable dividend rate. This type of stock is considered to be a risky investment, because of the danger that it could be recharacterized as debt for tax purposes. In that event, the payments made on the preferred stock would constitute interest, rather than dividends, with the resulting tax implications.

II. Federal Income Tax Treatment of Mortgage-Backed Securities

A. Tax Aspects of Pass-Through Certificates

1. General Principles - The Grantor Trust Rules

The establishment of mortgage pools accompanied by the issuance of "pass-through" certificates is an arrangement

which has been characterized as a "grantor trust" for federal income tax purposes. If a mortgage pool qualifies as a grantor trust, its existence is basically disregarded for federal income tax purposes, with the result that the owners of interests in the trust are treated for tax purposes as owners of proportionate interests in the underlying mortgages. Thus, an owner of an interest in a mortgage pool is treated as owning a fractional undivided interest in each mortgage in the pool, and is taxed on its pro rata share of each item of income arising with respect to each underlying mortgage. Similarly, the certificate holder may deduct its pro rata share of servicing and custodial fees, under § 162 or § 212 of the Internal Revenue Code ("IRC").

---


16/ See 26 C.F.R. § 1.671-3(a)(3). Items of income could include mortgage interest, prepayment penalties, assumption fees, and late payment charges, as well as other related items of income derived from a mortgage pool. See also Private Ruling 8402044 (October 11, 1983).

To qualify as a grantor trust, the mortgage pool must be organized under almost totally passive management. Generally, the pool must be fixed at the outset, self-liquidating with minimal reinvestment, and remain effectively unaltered after formation.

The basic provisions of the grantor trust rules\(^{18/}\) are largely derived from the decision of the Supreme Court in *Helvering v. Clifford*.\(^{19/}\) That case involved a trust established by the taxpayer (Clifford), the net income from which was to be held for the "exclusive benefit" of Clifford's wife. Under the trust agreement, Clifford retained full power to exercise voting power incident to the trusted shares of stock, to "sell, exchange, mortgage, or pledge" any of the securities under the declaration of trust, and to invest "any cash or money in the trust estate or any income therefrom." During the tax year at issue, all income from the trust was distributed to Clifford's wife, who included it in her individual return for that year. The IRS determined a deficiency in Clifford's return for that year on the theory that income from the trust was taxable to

\(^{18/}\) Subpart E of Subchapter J, Section 671 et. seq. of the Internal Revenue Code.

\(^{19/}\) 309 U.S. 331 (1940).
him. The matter was ultimately decided by the Supreme Court, which held that income from the trust was taxable to Clifford.

The holding of the Supreme Court in Clifford turned largely on the taxpayer's continued control over the corpus of the trust:

In this case we cannot conclude as a matter of law that respondent ceased to be the owner of the corpus after the trust was created. Rather, the short duration of the trust, the fact that the wife was the beneficiary, and the retention of control over the corpus by the [taxpayer] all lead irresistibly to the conclusion that [the taxpayer] continued to be the owner for purposes of Section [61].

The principles of the Clifford decision were subsequently embodied in detailed regulations.

A major focus of the grantor trust rules concerns whether the grantor has retained substantial control over the trust assets. Section 675 of the IRC, entitled "Administrative Powers", is a subset of the many provisions dealing with the retention of substantial interests in and powers over a trust. Broadly speaking, it requires that the grantor be treated as an "owner" of a trust when he has

---

²⁰/ 901 U.S. at 335.

²¹/ 26 C.F.R. §§ 1.671-1 through 1.678(d)-1.

power to engage or has engaged in certain transactions with
the trust without providing adequate consideration. This
includes the power to vary the investment of the trust
funds.

It has been held that the power to sell trust assets
does not necessarily give rise to a power to vary the
investment. Rather, it is the ability to substitute new
investments, to reinvest, which gives rise to the power to
vary the investment. More specifically, it is the power
to take advantage of variations in the market to improve the
investment of the investors which violates the passive
management requirement.

Where the trustee in a mortgage-pooling
arrangement has authority to make short-term investments
with the payments of principal and interest received with
respect to the pooled mortgages, but not to purchase new
securities or mortgages or to make any other new
investments, there is no violation of the passive management

24/ Section 675(4) of the IRC; 26 U.S.C. § 675(4).
25/ Pennsylvania Co. for Insurances on Lives and Granting
Annuities v. United States, 146 F.2d 392 (3rd Cir. 1944).
26/ Id.
27/ Commissioner v. North American Bond Trust, 122 F.2d 545
(2d Cir. 1941), cert. denied, 314 U.S. 479 (1942).
Thus, certain limited investment of cash on hand does not, in and of itself, constitute active management. However, where the trustee has the right to reinvest proceeds of obligations which are redeemed prior to maturity, the IRS may find that the trustee possesses the power to vary the investment.\footnote{Rev. Rul. 73-460, 1973-2 C.B. 424.}

A trustee's power to accept an issuer's offer to exchange new obligations for existing obligations of that issuer has been found not to violate the prohibition against active management, where the power was limited to offers made by issuers who were attempting to refinance existing obligations and had already defaulted with respect to them.\footnote{Rev. Rul. 75-192, 1975-1 C.B. 384.} The IRS ruled that this power did not give the trustee the power to take advantage of variations in the market because there was no power to reinvest in additional obligations or to vary the investment of the certificate holders.\footnote{Rev. Rul. 78-149, 1978-1 C.B. 448.}

2. Operation of the Grantor Trust Rules

As noted above, mortgage pooling arrangements are generally considered by the IRS to be analogous to grantor

\footnote{Rev. Rul. 73-460, 1973-2 C.B. 424.}
trusts under § 671 of the I.R.C. Thus, mortgage pools are not taxed on income received and distributed to certificate holders.

Generally, purchasers of mortgage-backed certificates have rights in the mortgage pool which are considered to be within the scope of § 671 because they are entitled to receive all distributions of income and corpus. The purchasers of the certificates are treated as grantors because the nominal creator of the mortgage pool, the issuer, is motivated solely by the expectation of the sale of the certificates. The function of the issuer is essentially that of a broker acting on behalf of the original purchasers who are providing the corpus of the mortgage pool held for their benefit.

The IRS could have taken the position that mortgage pools are not trusts for federal tax purposes, and that certificate holders are simply tenants in common of the mortgages. However, it appears that certificate-holders could not be considered as tenants in common because they lack the power to control the mortgages in the pool. The

34/ See, e.g., 26 C.F.R. § 1.761-1(a)(1).
separation of control from beneficial ownership was seemingly determinate in the characterization of the mortgage pool.

To qualify as a "grantor trust", the mortgage pooling arrangement must first qualify as a "trust" under the relevant regulations. Section 301.7701-2(a)(2) of the regulations\(^{35/}\) provides that, because centralization of management, continuity of life, free transferability of interests, and limited liability are generally common to both trusts and corporations, the determination of whether a trust that has such characteristics is to be treated for tax purposes as a trust or as an association taxable as a corporation depends on whether there are associates and an objective to carry on business and divide the gains therefrom.\(^{36/}\)

In the case of investment trusts created by or for associates, an objective to carry on business and divide the gains therefrom will exist if there is a power under the trust agreement to vary the investment of the certificate holders. If there is no power under the trust agreement to

\(^{35/}\) 26 C.F.R. § 301.7701-2(a)(2).

\(^{36/}\) See 26 C.F.R. § 301.7701-4(b).
37/ 26 C.F.R. § 301.7701-4(c) provides as follows:

which different rights and risks associated with a pool of mortgages are allocated among several classes of certificates. Generally, one class of certificate provides for a priority in distributions from the pool and represents a short-term interest, with other classes of certificates representing interests with longer maturities. The owners of the certificates do not possess the right to receive distributions of principal and interest on any specific mortgage or mortgages, but merely the right to certain distributions from the pool.

On May 2, 1984, the IRS proposed amendments to the definition of the term "trust" for federal tax purposes.\footnote{49 Fed. Reg. 18741 (1984).} In issuing the proposed regulations, the IRS has taken the position that mortgage pooling arrangements involving multiple classes of ownership are taxable as associations. The IRS contends that a multiple class arrangement is not intended solely to protect and conserve property for the beneficiaries, but rather to conduct an active business through shifting to one class of certificate-holders the risk that mortgages in the pool will be prepaid, and to provide the other classes of certificates freedom from premature termination of their interests on account of
prepayments. Thus, IRS takes the position that such an arrangement should be treated as an association or a partnership under § 301.7701-2 of the regulations.

Although the IRS seems to be taking the position in the proposed regulations that all "multiple class" arrangements are inconsistent with the conceptual underpinning of the grantor trust rules, in the past the IRS has issued private rulings holding that an issuer could retain a "junior" class of pass-through certificate and sell a "senior" class to the public. It is not clear whether such an arrangement would be viewed as creating multiple classes of interest under the proposed rule, because both the junior and senior certificates represent undivided interests in the same mortgages and no difference arises until a mortgage default occurs.

General Counsel Memorandum 38311\(^{39/}\) is enlightening in that regard. Under the facts discussed in that Memorandum, a bank, pursuant to a pooling and servicing agreement, intended to form a pool of residential mortgage loans by assigning such loans to Y, an independent party, as trustee. Concurrent with the assignment of the mortgage loans, Y was to deliver to the Bank certificates in registered form representing undivided interests in the pool. The pool was

\(^{39/}\) G.C.M. 38311 (March 18, 1980).
to consist of mortgages selected by the Bank from those originated by the Bank in the ordinary course of its real estate lending practices.

Once the pool had been established, the Bank was not to exchange or substitute mortgages in its portfolio for mortgages in the pool and, except for certain limited circumstances, did not have a repurchase obligation with respect to the mortgages and mortgage notes in the pool. The assignment to Y was without recourse, and the Bank’s obligations with respect to the mortgages were limited to its servicing obligations and its obligation to repurchase mortgages in the event of defective documentation or in the event of breach of the representations and warranties made by the Bank to the trustee with respect to the mortgages.

The certificates representing interests in the pool were to be of two classes, Class A and Class B, and were to be freely transferable. They were to indicate prominently that they were not obligations of the Bank or insured by the Federal Deposit Insurance Corporation. The holders of the Class A certificates were to possess a 93.5 percent interest in the pool and the holders of the Class B certificates were to possess the remainder. The Class A certificates were to be sold to institutional investors, such as domestic building and loan associations, real estate investment
trusts, pension funds, and insurance companies, and to individuals. The Bank stated its intention to retain the Class B certificates, although there was to be no restriction on the right of the Bank to sell at any time all or any of the Class B certificates. The proceeds from the sale of the certificates were to be added to the Bank's general funds and were to be used to originate new conventional residential mortgage loans.

The certificates were to be of a "pass-through" type and bear a pass-through rate of interest equal to the aggregate simple annual interest rate on all the mortgage loans in the pool, less the Bank's service fee. As additional compensation for its services, the Bank was to be entitled to all late payment charges, prepayment charges, and assumption fees paid in connection with mortgage loans in the pool. After payment of the servicing fee to the bank, mortgagor payments of principal and interest (to the extent of the pass-through rate) and prepayment of the principal were to be passed through to certificate holders monthly. The rights of Class A and Class B certificate holders were to be substantially identical except that the rights of the holders of Class B certificates to pass-through payments of principal and interest were to be subordinated to such rights of the holders of Class A
certificates. In addition, a reserve fund was to be established which would be used to make distributions to Class A certificate holders in the event the subordination feature did not provide sufficient funds to make full distributions to the holders of Class A certificates. This arrangement was found not to deviate too far from the traditional formulation, wherein there is a single class of interests in the grantor trust, each with an identical fractional individual interest in the entire pool of mortgages.

Even in the absence of the proposed rule prohibiting multiple class grantor trusts, there are extraordinarily difficult problems in the manner in which holders of interests in multiple class grantor trusts are to be treated for tax purposes. While the tax treatment of a traditional grantor trust is relatively simple because every holder is taxed pro rata on all items arising at the trust level, in the case of a multiple class trust it is necessary to allocate items arising at the trust level among different classes of holders.\(^{40}\)

\(^{40}\) Legislation has been proposed that would allow issuers of mortgage pass-throughs to manage mortgage cash flows actively. See section V.A., below.
4. Reserve Funds

In addition to considering the tax consequences of multiple classes of interests in grantor trust, the IRS has considered specifically whether the use of a reserve fund will be considered to constitute a power to vary the investment such that the trust will be considered an association taxable as a corporation. The issue of the tax consequences of a reserve fund in a fixed investment trust arose in Royalty Participation Trust v. Commissioner.\textsuperscript{41/}

That case concerned certain investment trusts involving oil and gas royalty interests which contained provisions requiring the trustee to establish a reserve fund for purposes of acquiring additional properties for the trust. The Tax Court did not find these provisions to be so expansive as to destroy the fixed investment character of the trust. However, the Court noted that such a trust agreement must specifically prohibit the trustee from reinvesting the money in the fund in a speculative manner.\textsuperscript{42/}

\textsuperscript{41/} 20 T.C. 466 (1953), acq. 1953 C.B. 6.

\textsuperscript{42/} It is the power given by the trust instrument that determines the investment discretion given to the trustee for tax purposes. Helvering v. Coleman-Gilbert Associates, 296 U.S. 369, 374 (1935).
5. **Tax Consequences of Characterization as Grantor Trust**

As noted above, the IRS currently requires taxation at the issuer level with respect to any mortgage pool involving active management, including reinvestments by the trust. Failure to qualify as a grantor trust results in double taxation -- once at the pool level and once at the certificate-holder level. This can be contrasted with the single tax treatment accorded a regulated investment company, which status is available for other kinds of securities.

The initial transfer of mortgages to a trustee for the establishment of a mortgage pool is not treated as a taxable exchange.\(^{43}\) Thus, the transferors of the mortgages do not recognize gain or loss at the time of the transfer of the mortgages to the trust, but only at the time when the transaction becomes a closed transaction through the sale of certificates to investors.\(^{44}\)

The sale of mortgage-backed certificates effects a transfer of the equitable ownership of the mortgages in the pool to the certificate-holders, and the issuer recognizes ordinary income or loss upon its sale of each of the

---

\(^{43}\) Private Ruling 8402044 (October 11, 1983).

\(^{44}\) Id.
mortgages in the pool. The certificate-holders are required to report the entire interest income and repayment of principal attributable to their pro rata share of the mortgages, and may deduct their ratable portion of the servicing, custodian and guarantee fees under § 162 or § 212 of the IRC.

a. Recharacterization as Debt

While pass-through transactions are generally treated as sales of the underlying mortgages, the continued involvement of the issuer, in its role as servicer of the mortgages, creates some risks to the certificate-holders that such a transaction may be recharacterized as debt in the event that the issuer becomes insolvent. There is precedent for such recharacterization. Prior to the advent of pass-throughs, investments in mortgages generally took the form of purchases of participation interests in packages of mortgages. Problems with recharacterization as debt in the event of the issuer's insolvency arose because the issuer frequently retained all mortgage documents, did not

45/ As to the characterization of the gain or loss on the sale of the mortgages, see Rev. Rul. 60-346, C.B. 1960-2, 217. As to mortgages originated by the issuer, see Burbank Liquidating Corp., 39 T.C. 999, 1009 (1963), Acq. C.B. 1965-1, 5 (sub. nom. United Associates, Inc.).

segregate collections on the mortgages sold by it from its other assets, and retained a subordinated interest in the mortgages.

Similarly, the high servicing fee generally charged by issuers raises the risk that the fee may not be treated for tax purposes as a true servicing fee, but instead be deemed a retained economic interest in the mortgage loans. The retention of such an economic interest might violate the proposed tax regulations, discussed above, that would preclude the creation of mortgage pass-through pools and other similar entities having more than one class of beneficial ownership in the underlying assets.

b. Relevance to Other IRC Provisions

A taxpayer who is treated under Subpart E as the owner of an entire trust or of an individual interest in an entire trust is considered to be the owner of his proportionate share of the assets of the trust. Thus, a real estate investment trust that owns a mortgage pass-through certificate will be considered to own "real estate assets" within the meaning of § 856(c)(5)(A) of the IRC, and interest income will be considered "interest on obligations secured by mortgages on real property" within the meaning of § 856(c)(3)(B).

§ 856(c)(3)(B).\textsuperscript{48/} This is consistent with the established rules with respect to Subpart E trusts. Section 1.671-3(a)(1) of the Treasury regulations provides that:

If a grantor or another person is treated as the owner of an entire trust (corpus as well as ordinary income), he takes into account in computing his income tax liability all items of income, deduction, and credit (including capital gains and losses) to which he would have been entitled had the trust not been in existence during the period he is treated as owner.\textsuperscript{49/}

A certificate owned by a domestic building and loan association will be considered as representing "loans secured by an interest in real property" within the meaning of § 7701(a)(19)(C)(6) of the IRC,\textsuperscript{50/} provided the real property is (or from the proceeds of the mortgage loan will become) the type of real property described in that section.\textsuperscript{51/} Similarly, a certificate owned by a domestic building and loan will be considered as representing "qualified real property loans" within the meaning of

\textsuperscript{48/} Private Ruling 8417078 (January 25, 1984).

\textsuperscript{49/} 26 C.F.R. 1.671-3(a)(1). Similar conclusions were reached where the taxpayer owned a fractional share of an entire trust. See Rev. Rul. 61-175, C.B. 1961-2, 128 and Rev. Rul. 63-228, C.B. 1963-2, 229.


\textsuperscript{51/} Private Ruling 8417078 (January 25, 1984).
§ 593(d),\textsuperscript{52} provided the real property underlying the mortgage loans is (or, from the proceeds of the mortgage loan, will become) the type of real property described in § 593(d).\textsuperscript{53}

Although the IRS has concluded that the certificate holders should be treated as owners of their proportionate shares of the assets and income of the pool, the pool is a reporting entity and must file Form 1041 as an information return in accordance with the provisions of Section 1.671-4 of the regulations.\textsuperscript{54} In addition, a trust of which the grantor is treated as the owner under Subpart E is nonetheless a trust for purposes of Section 1491 of the Code\textsuperscript{55}, which imposes an excise tax upon certain transfers of stock or securities to foreign corporations, trusts, and partnerships.\textsuperscript{56}

\textsuperscript{52} Id.
\textsuperscript{53} Id.
\textsuperscript{54} See Rev. Rul. 61-102, C.B. 1961-1, 245; G.C.M. 31690, dated June 20, 1960, holding that a taxpayer who has the power to sell property in which he has a life estate, but who is required to reinvest and conserve the sale proceeds for future distribution to remaindermen, must report the gain from the sale on Form 1041 and pay the tax due on such gain.
\textsuperscript{55} G.C.M. 33867 (July 1, 1969).
\textsuperscript{56} Id.
B. **Tax Treatment of Mortgage-Backed Bonds**

1. **Collateralized Mortgage Obligations**

As noted above, the CMO\(^{57/}\) is a debt instrument, the payment of which is secured by mortgages (and the cash flow on the mortgages) pledged as collateral for the debt\(^{58/}\). The tax theory of a CMO is that it is simply a debt obligation of the issuing corporation. Holders of CMOs are considered creditors of the issuing corporation, rather than owners of an interest in the underlying mortgages.

Because a corporation is a taxable entity, the corporation which acquires a pool of mortgages and issues CMOs is taxed on the interest, discount, and reinvestment income in the same manner as any other holder of the underlying mortgages. In addition, as the issuer of the CMO

---

\(^{57/}\) The term CMO, which stands for Collateralized Mortgage Obligation, was first used by the FHLMC as the name of an issue of debt securities offered by it in 1983. The term CMO has now become a generic description for securities of that type.

\(^{58/}\) Although "pass-throughs" are currently issued under a "grantor trust" structure that prohibits active management of cash flow generated from the mortgage pool, mortgage-backed bonds, or CMOs, enable bond issuers to actively manage the cash flows generated from the collateralized mortgages to match the maturity terms of bond liabilities.
debt, the corporation is entitled to deductions for interest, original issue discount, and reinvestment premium, as any other issuer of corporate debt.59/

CMOs have both tax advantages and disadvantages to holders, as compared to single or multiple class grantor trusts, arising from the fact that holders are deemed to own corporate debt rather than interests in the underlying mortgages. A disadvantage is that CMOs do not qualify as real estate assets for various tax qualification purposes. An advantage is possible capital gain treatment of at least a portion of income from prepayments on the mortgages. Another advantage, for builders, is that they can retain ownership within a consolidated tax group of mortgages originated to finance the sale of homes built by them and can obtain installment sale treatment and defer profits on the sale of homes for many years.

CMOs may present a recharacterization concern, particularly when the issuing corporation has a high debt/equity ratio. In such a case, CMOs may be considered equity rather than debt of the corporation. If the CMOs were considered equity, payments thereon would constitute

59/ Interest-bearing CMOs are subject to the original issue discount (OID) rules if the issue price is less than the aggregate principal amount payable on the CMO.
nondeductible dividends to the corporation and a double tax would arise. However, debt is normally treated as equity only if a serious risk exists that it will not be repaid.

A parallel concern is presented when the holders of the CMOs are economically in a position so similar to that of an owner of an interest in the underlying mortgages that the holders are treated as owners for tax purposes. If a CMO holder were considered in an economic position equivalent to a holder of an interest in a multiple class grantor trust, a double taxation problem could arise given the uncertain status of multiple class grantor trusts. Therefore, CMOs are generally structured to create economic differences between a CMO and a direct interest in the underlying mortgages, e.g., quarterly or semi-annual payments on a CMO, compared to monthly payments on the underlying mortgages.

To allow certain issuers to record their financing as a sale of assets rather than debt, one broker structured a security offering much like a CMO but issued it through a grantor-trust to free it from corporate taxes. The IRS

---

60/ The consequences to a builder of a recharacterization of his CMO offering as a sale of the underlying mortgages would be immediate recognition of the profit on the homes financed by the mortgages securing the CMO.
ruled that such an investment trust, with multiple classes of ownership, is to be classified for tax purposes as an association taxable as a corporation.\textsuperscript{61/}

2. Builder Bonds

Builder bonds are structured so as to maintain installment sale treatment of the payments received by the builder from the home buyers. IRC § 453 governs the installment method of accounting under which taxpayers may report for federal income tax purposes any profit generated by the sale of real or personal property in the years in which the deferred payments are actually received.\textsuperscript{62/}

A builder may report profits on the sale of a home on an installment sale basis unless he is deemed to have "disposed" of the installment obligation (the purchase money mortgage). Installment sale treatment with respect to the payment received by the builder on the sale of the house is lost if the subsequent pledging of the mortgage note is treated as a disposition by the IRS. The satisfaction,

\textsuperscript{61/} See § II.A.3., above.

\textsuperscript{62/} 26 U.S.C. § 453.
sale, exchange, or other disposition of the installment obligation results in the recognition of gain or loss in the year of such disposition.\textsuperscript{63/}

If the pledging of the mortgage note is treated as a disposition under IRC § 453, recognition of gain will be accelerated under IRC § 453B(a). The gain or loss resulting from the disposition of the installment obligation is considered as arising from the sale or exchange of the property which gave rise to the receipt of the installment obligation.

It has been held that the use of an installment obligation as collateral to borrow money does not, in and of itself, trigger immediate taxation.\textsuperscript{64/} In addition, the Tax Court has held that mere subjection of installment obligations to a lien for the payment of indebtedness does not result in the loss of installment sale treatment.\textsuperscript{65/}

\textsuperscript{63/} 26 U.S.C. § 453B(a).

\textsuperscript{64/} East Coast Equipment Company v. Commissioner of Internal Revenue, 222 F.2d 676 (3rd Cir. 1955).

However, a different result may lie where certain incidents of ownership, such as title to and possession of the obligations, are relinquished.\textsuperscript{66/}

The IRS has identified certain factors which it will consider in determining whether the builder has relinquished substantial incidents of ownership in an installment obligation.\textsuperscript{67/} These factors include whether the transferee of the installment obligation has the power of absolute disposition (i.e., the power to dispose of the underlying mortgage rates); whether the transferee is entitled to the interest accruing on the transferred installment obligations; whether the risk of loss associated with the underlying mortgage notes is assumed by the transferee; whether the transfer was made to a credit subsidiary; whether the transferee pays all the property, excise, sales, or similar taxes with respect to the mortgage notes; and

\textsuperscript{66/} Other incidents of ownership which were identified in Town & Country included whether the taxpayer collects the payments when due, and makes payments to the finance company that are unrelated to payments collected on the obligations.

\textsuperscript{67/} See Private Letter Ruling 8047136 (Aug. 29, 1980); Lore at p. 6-55.
whether the transferor (builder) retains possession and continues to collect the installment obligations at its own expense.\textsuperscript{68/}

C. Other Tax Considerations

1. Original Issue Discount

Section 1273(a)(1) of the IRC defines "original issue discount" to mean the excess of the stated redemption price at maturity over the issue price.\textsuperscript{69/} This discount must be included in the ordinary gross income of the bondholder as it accrues.

Section 1272 of the IRC establishes the method for determining the amount of original issue discount required to be included in a bondholder's income.\textsuperscript{70/} That provision utilizes a constant interest method that takes into account the annual compounding of interest to determine the amount of original issue discount that is deemed to accrue. The holder of the bond is required to include in gross income the total of the calculated daily apportionment of the original issue discount.

\textsuperscript{68/} Id. These factors were expanded on and modified in Private Letter Ruling 8149041 (Sept. 9, 1981).

\textsuperscript{69/} 26 U.S.C. § 1273(a)(1).

\textsuperscript{70/} 26 U.S.C. § 1272.
An original holder of a bond would calculate the daily apportionment by allocating to each day in the accrual period the ratable portion of the increase in the adjusted issue price of the bond during the period. The increase in the adjusted issue price for any accrual period is the product of the adjusted issue price of the bond at the beginning of the accrual period and the yield to maturity over the sum of the amounts payable as interest on the bond during the accrual period.

In the event of sale of the bond, the bondholder recognizes gain or loss equal to the difference between the sale price and the adjusted basis of the bond. The adjusted basis of the bond would be calculated by taking the cost of the bond, increasing it by any original issue discount included in the bondholder’s gross income, and reducing it by the portion of the basis of the bond allocable to payments on the bond previously received by the bondholder.

Section 1271(a)(2)(A) of the IRC accords ordinary income treatment to any gain if, on the date of the original issue of the bond, the issuer intended to call all or a portion of the bonds prior to maturity.71/ In addition, gain recognized by a bondholder who purchased a bond at discount from its issue price, plus any original issue discount.

discount that accrued thereon to the purchase price, also
would be taxable as ordinary income in an amount not
exceeding the portion of the market discount that accrued
during the period the bond was held by the bondholder.

2. Market Discounts and Premiums

Mortgage-backed certificates often are acquired for
amounts less than the aggregate unamortized principal
balance of indebtedness represented by the certificate.
This disparity is generally attributable to a pass-through
rate of interest on the certificate that is lower than the
interest rates prevailing on the date of acquisition, and is
typically referred to as "market discount." Similarly,
mortgage-backed certificates may be acquired for amounts
exceeding the outstanding principal balance because the
pass-through rate of interest on the certificate is higher
than the interest rates prevailing on the date of acquisi-
tion. That disparity is typically referred to as "market
premium."

Section 1271 of the IRC\(^72/\) permits investors to report
capital gain rather than ordinary income when retiring,
selling or exchanging corporate or governmental obligations.
Because mortgages are technically individual obligations,

\(^72/\) 26 U.S.C. § 1271.
they are outside the purview of § 1271, and the recovery of market discounts through principal repayments is taxed as ordinary income, not capital gain.

The IRS has ruled that discount income realized on the purchase of mortgages in connection with a mortgage pooling arrangement is ordinary income, and thus certificate holders must report their proportionate share of the discount income as ordinary income.73/ In addition, certificate holders will recognize ordinary income or loss on the sale of their interests in each of the mortgage loans in the pool, measured by the differences between the proportionate amount of the proceeds realized with respect to the sale of each of the mortgages and its adjusted basis in each of the mortgages.74/

Sections 1276-1278 of the IRC75/ set forth the market discount rules applicable to mortgage-backed certificates and other mortgage-backed securities. The amount of market discount that must be included in ordinary income is


74/ Id. See also Shaipfa Realty Corporation, 8 B.T.A. 283 (1927). In Shaipfa, the court concluded that, where notes are given a discounted value at the time of sale, the amount attributable to market discount on the subsequent collections of those notes is ordinary income.

calculated as the lessor of (1) the gain recognized on the sale of the instrument, and (2) the market discount on the instrument multiplied by a fraction, the numerator of which is the number of days the holder held the instrument and the denominator of which is the number of days from the date the holder acquired the instrument until its maturity date.76/

If a mortgage-backed security is bought at a discount, a quicker return of principal at par would mean capital gains and would increase yield. If a premium was paid for the security, prepayments would result in a capital loss, because prepayments are made at par. Also, when a mortgage-backed security is purchased for a premium, the extra charge has to be amortized over the life of the investment (thereby reducing yield).

As with a premium, a discount is amortized over the life of the security. Unlike a premium, a discount is added to the interest earned. The issuer is required to report discount accruing to a holder of its debt to the IRS on Form 1099 in the same manner as interest. The issuer is required by regulation to mark the issue price and the issue date on every obligation.

3. **Debt v. Equity**

An important tax issue to a corporate issuer of debt obligations is whether a mortgage-backed security will be recognized as debt of the issuer or as stock of the issuer.\(^{77/}\) If the obligation were treated as debt of the issuer, the issuer would have a deduction against income in an amount equal to the interest payment. If the obligation were treated as stock, payments by the issuer to the shareholder would be treated as payments of dividends rather than payments of interest.\(^{78/}\) Because a corporation is not permitted a deduction for dividends paid to shareholders, the issuer would be subject to an increased corporate tax.\(^{79/}\) The same income would again be subject to taxation when distributed to shareholders in the form of dividends, because shareholders are taxable on dividends received (assuming they are not corporations eligible for a dividends received deduction).\(^{80/}\)

Section 385 of the IRC sets forth the general rule that the determination of whether an interest in an entity should be characterized as debt or equity should be made by

\(^{77/}\) Lore at 6-28.

\(^{78/}\) Id.

\(^{79/}\) Id.

\(^{80/}\) Lore at 6-29.
analyzing all the facts and circumstances surrounding the transaction.\footnote{Id.} It lists five factors that must be considered in making such a determination:

(1) whether there is a specific unconditional promise to pay on demand or on a specified date a sum certain in money in return for an adequate consideration in money or monies worth, and to pay a fixed rate of interest;

(2) whether there is subordination to or a preference over any indebtedness of the corporation;

(3) the ratio of debt to equity of the corporation;

(4) whether there is convertibility into the stock of the corporation; and

(5) the relationship between holdings of stock in the corporation and holdings of the interest in question.

III. Federal Securities Law

A. Applicability

The Securities Act of 1933 ("Securities Act")\footnote{15 U.S.C. § 77a et seq.} and the Securities Exchange Act of 1934 ("Exchange Act")\footnote{15 U.S.C. § 78a et seq.} provide a broad regulatory scheme governing "securities". These statutes were designed to protect investors by
requiring full and fair disclosure of material facts concerning securities publicly offered, and by preventing misrepresentation and fraud in their sale. Among other things, the Securities Act makes it unlawful to sell a security unless a registration statement is in effect and unless accompanied or preceded by a prospectus.\textsuperscript{84/} The Exchange Act makes it unlawful for any member of an exchange, broker, or dealer to effect any transaction in any nonexempt security on a "national securities exchange" unless a registration statement is in effect.\textsuperscript{85/}

The applicability of the requirements of these statutes to mortgage-backed securities turns on whether such instruments are "securities" within the meaning of section 2(1) of the Securities Act and section 3(a)(10) of the Exchange Act.\textsuperscript{86/} Both statutes provide that "unless the context otherwise requires . . . 'security' means any note, . . . investment contract . . . instrument commonly known as a "security" . . . or any certificate of interest or participation in . . . any of the foregoing."\textsuperscript{87/}

\begin{footnotes}
\item[84/] 15 U.S.C. § 77e.
\item[85/] 15 U.S.C. § 781(a).
\item[86/] 15 U.S.C. §§ 77b(1); 78c(a)(10).
\item[87/] Id.
\end{footnotes}
definition of "security" varies slightly between the two Acts, but the definitions have been held to be virtually identical. 88/

Although the statutory definitions of "security" include "any interest or instrument commonly known as a 'security'", not all investments in the form of securities are necessarily treated as securities. 89/ This is because of the introductory language "unless the context otherwise requires" contained in the definitions. The Supreme Court has held that "[i]n searching for the meaning and scope of the word "security" in the Act[s], form should be disregarded for substance and the emphasis should be on economic reality." 90/ Thus, the courts have generally drawn a distinction between transactions of a purely commercial nature, and investment transactions, with the latter falling within the coverage of the Acts.

The basic test for distinguishing investment transactions from commercial dealings is set forth in S.E.C. v. W.J. Howey Co. 91/ The Howey test makes characterization

90/ Tcherepnin v. Knight, supra, 389 U.S. at 336.
91/ 328 U.S. 293 (1944).
of a transaction as an "investment contract" turn on "whether the scheme involves an investment of money in a common enterprise with profits to come solely from the efforts of others." The Supreme Court "perceive[s] no distinction . . . between an investment contract and an instrument commonly known as a 'security'." Thus, it appears that if a mortgage pooling arrangement or related instrument constitutes an "investment contract", it is within the coverage of the Securities Act and the Exchange Act.


a. Investment of Money

This element of the Howey test requires that the investor commit his assets to an enterprise or venture in such a manner as to subject himself to financial loss. Financial loss is possible in a mortgage-backed securities transaction, notwithstanding the various guarantees provided by GNMA, FHLMC, and FNMA. As a long-term fixed interest

---

92/ S.E.C. v. W.J. Howey, Co., supra, 328 U.S. at 301.
93/ United Housing Foundation, Inc. v. Forman, supra, 421 U.S. 837.
investment, the market value of a mortgage-backed security will generally fall in the event that the prevailing long-term interest rates rise. Thus, it appears that there is an element of financial risk in such an investment.

b. Common Enterprise

A "common enterprise" with respect to an investment of money is one in which the fortunes of the investor are interwoven with and dependent on the efforts and success of those seeking the investment or of third parties. 95/

Although the fortunes of an investor in mortgage-backed securities are in large measure dependent on the external forces of the marketplace, there is also reliance on the managerial efforts of others such as to constitute a common enterprise. 96/

c. Profits Solely from the Efforts of Others

Under the Forman decision, the profits which must be expected for a transaction to qualify as an investment contract may be "either capital appreciation resulting from development of the initial investment . . . or a participation in earnings resulting from the use of


investors' funds.\textsuperscript{97} In Wooldridge Homes, Inc. v. Bronze Tree, Inc.,\textsuperscript{98} involving purchase of a condominium, the defendant asserted that the increase in value of a condominium was inextricably tied to general economic factors and that, therefore, this element of the Howey test was absent. The Court rejected this argument, noting that the term "solely" is not to be given a literal interpretation,\textsuperscript{99} and that the test is whether the efforts made by those other than the investor are the undeniably significant ones, those essential managerial efforts which affect the failure or success of the enterprise.\textsuperscript{100} Reliance of investors on the promoter need not be total.\textsuperscript{101} It appears that, although the determination of what constitutes "essential managerial efforts" can only be determined on a case-by-case basis, this test is probably met in the case of mortgage-backed securities.

\textsuperscript{97} United Housing Foundation v. Forman, supra, 421 U.S. at 852.
\textsuperscript{98} 558 F. Supp. 1085 (D. Colo. 1983).
\textsuperscript{99} S.E.C. v. International Mining Exchange, supra, 515 F. Supp. at 1069.
\textsuperscript{100} Id.
\textsuperscript{101} McCown v. Heidler, 527 F.2d 204 (10th Cir. 1975).
2. Relevant Administrative and Judicial Determinations

In 1958, in Securities Act Release No. 3892, the S.E.C. expressed its view that offerings of whole or fractional interests in mortgages or deeds of trust could constitute the offer of an "investment contract", depending on the arrangement for the providing of services to the investors. The S.E.C. listed services or attributes commonly encountered in such offerings, and stated that "[t]he wider the range of services offered and the more the investor must rely on the promoter or a third party, the clearer it becomes that there is an 'investment contract' and, therefore, a security issued by the promoter."102/

Several courts have "assumed" that GNMA's and similar instruments are "securities" for purposes of the federal securities laws.103/ One court has held squarely that GNMA certificates fall within the definition of "security", being a "note, . . . bond, [or] debenture" with a maturity exceeding nine months.104/

103/ See, e.g., Board of Trade of City of Chicago v. S.E.C., 677 F.2d 1137 (7th Cir. 1982).
In S.E.C. v. G. Weeks Securities, Inc., it was held that "standby with pair-off" arrangements, in which dealers in government securities and their customers simultaneously agree to buy and sell GNMA's at future dates at specified prices, constitute "securities" regulated by the federal securities laws. However, in LTV Federal Credit Union v. UMIC Government Securities, Inc., a "standby commitment" to take delivery of GNMA's (essentially a "put" option in GNMA's between two commercial GNMA traders) was held not to be an "investment contract", and thus not a "security":

The economic realities of this transaction are that there is no "common enterprise" - no common business venture from which both parties can hope to generate profits to be distributed among them. And even if there were a "common enterprise", the profits that each party can hope to derive are derived solely from the movement of a market over which neither has control or the ability to influence. The Standby Committee thus is not an "investment contract" within the meaning of the Securities Act or the Exchange Act.

In Board of Trade of City of Chicago v. S.E.C., it was held that GNMA option contracts and futures contracts

---


107/ Id. at 830.

108/ Board of Trade of City of Chicago v. S.E.C., 677 F.2d 1137 (7th Cir. 1982).
are not "securities" under the Exchange Act. The Court adopted the analysis employed in the LTV Federal Credit Union decision,\textsuperscript{109} and distinguished S.E.C. v. G. Weeks Securities, Inc.,\textsuperscript{110} by noting that the options program at issue in that case involved on a "book" transfer of GNMA's used to camouflage a loan from the investor to the issuer.\textsuperscript{111}

In Abrams v. Oppenheimer Government Securities, Inc.,\textsuperscript{112} it was held that the purchase of GNMA forward contracts is in connection with the purchase and sale of underlying GNMA securities and, therefore, the anti-fraud provisions of the securities laws apply to the purchase and sale of GNMA forwards. It was successfully argued in Abrams that a GNMA forward contract constitutes the purchase and sale of the underlying GNMA security and, therefore, is regulated by the anti-fraud provisions of the securities laws, even though the GNMA forward contract itself is not a security as defined by the securities laws.

\textsuperscript{109} LTV Federal Credit Union, 523 F. Supp. at 828-833.
\textsuperscript{110} G. Weeks Securities, 483 F. Supp. 1239.
\textsuperscript{111} Board of Trade of City of Chicago, 677 F.2d at 1158.
\textsuperscript{112} Abrams v. Oppenheimer Government Securities, Inc., 737 F.2d 582 (7th Cir. 1984).
The "forward contract" at issue in Abrams was an agreement for the purchase and delivery of GNMA certificates. In such a transaction there is a "trade" date, which is the date the contract is purchased, and a settlement date, which is the date on which the purchaser is to remit the balance of the purchase price in exchange for delivery of the GNMA certificates. Delayed delivery is in part a result of the lead time required by the issuer to effectuate the mortgage loans once the issuer receives assurance of a ready market for the GNMA. To hedge against the possibility of falling interest rates between the date the issuer makes a firm commitment to a home buyer or builder and the date the securities are actually issued, issuers generally sell GNMA forward contracts to broker-dealers who, in turn, enter into contracts for forward delivery with investors.

Both GNMA and GNMA forward contracts are fully transferable from one investor to another, and there is a market for both types of investments. Purchasers of GNMA forward contracts typically speculate that the value of the GNMA certificates will increase. In addition, the purchaser of a forward delivery contract has the option of assigning his rights and obligations by selling the contract before the settlement date.
The Abrams decision noted that a number of factors can influence the market value of GNMA. As a long-term fixed interest security, outstanding GNMA generally become more attractive comparatively and their value rises in the event that the prevailing long-term interest rates fall. In such a situation, the purchaser of the forward contract would take delivery of the GNMA security with a market value exceeding the purchase price. In the event the market value falls, the deflated value is reflected in the price if the purchaser sells before the settlement date. These factors, in their totality, led the Court to find the securities laws applicable.

B. Substantive and Procedural Requirements of Federal Securities Laws

1. Registration

Section 5 of the Securities Act makes it unlawful to sell a security unless a registration statement is in effect and unless the sale is accompanied or preceded by a prospectus. There are civil and criminal sanctions,

113/ The discussion is adapted generally from Herwitz, Business Planning at 197-199 (1966).
as well as administrative enforcement\(^{116}\) subject to judicial review.\(^{117}\) There is also a general anti-fraud section\(^{118}\), which makes unlawful any form of fraud, untruth or omission of a material fact, with respect to the sale of any securities in interstate commerce or by use of the mails.

The three specific civil liability provisions provide a private right of action for violations of the Securities Act. Section 11 provides for civil liability of an issuer and others involved in the preparation of a registration statement, for losses sustained by a purchaser by reason of misstatements or omissions. Section 12(1) provides a remedy when there is an offer or sale of a security in violation of the registration and prospectus requirements of § 5, and § 12(2) imposes liability for sale of a security, whether registered or exempt from registration, by means of material misstatements or omissions of fact.

Section 5 of the Exchange Act\(^{119}\) makes unlawful any exchange trading in any security unless the exchange has
been registered under Section 6. Section 6 gives the S.E.C. power to prescribe the rules for exchange registration. Section 12 gives the S.E.C. power to require registration of securities to be traded on particular exchanges.

a. Liability for False Registration Statement

Section 11(a) of the Securities Act provides that, when a registration statement contains an untrue statement of a material fact, "any person acquiring such security . . . may . . . sue." Section 11(e) provides that:

The suit authorized under subsection (a) may be to recover such damages as shall represent the difference between the amount paid for the security (not exceeding the price at which the security was offered to the public) and (1) the value thereof as of the time such suit was brought, or (2) the price at which such security shall have been disposed of in the market before suit, or (3) the price at which such security shall have been disposed of after suit but before judgment if such damages shall be less than the damages representing the difference between the amount paid for the security (not exceeding the price at which the

security was offered to the public) and the value thereof as of the time such suit was brought. . . .”

It is a prerequisite to liability under § 11 that the fact which is falsely stated in a registration statement, or the fact that is omitted when it should have been stated to avoid misleading, be "material".\textsuperscript{124} Section 11(b) provides what are known as the "due diligence" defenses to liability under § 11(a).\textsuperscript{125} These defenses are not available to the

\textsuperscript{123} 15 U.S.C. § 77k(e).

\textsuperscript{124} See 17 C.F.R. § 230.405(1):

"The term 'material', when used to qualify a requirement for the furnishing of information as to any subject, limits the information required to those matters as to which an average prudent investor ought reasonably to be informed before purchasing the securities in question."

\textsuperscript{125} Section 11(b) provides that:

"... no person, other than the issuer, shall be liable ... who shall sustain the burdens of proof -

* * *

(3) that (A) as regards any part of the registration statement not purporting to be made on the authority of an expert . . . he had, after reasonable investigation, reasonable ground to believe and did believe, at the time such part of the registration statement became effective, that the statements therein were true and that there was no omission to state a material fact required to be stated therein or necessary to make the statements therein not misleading; . . . and (C) as regards any part of the registration statement purporting to be made on authority of an expert (other than himself) . . . he had no reasonable ground to believe and did not believe, at the time such part of the registration statement became

(footnote continued)
issuer. Under § 11(b), a potentially liable party may escape liability by showing, where reliance on an expert is not asserted, that, after reasonable investigation, it had reasonable ground to believe that the statements in the registration statement were true and that there was no omission to state a material fact. Section 11(c) defines "reasonable investigation" as follows:

"In determining . . . what constitutes reasonable investigation and reasonable ground for belief, the standard of reasonableness shall be that required of a prudent man in the management of his own property." 126/

Thus, liability can be escaped only by using that reasonable care to investigate the facts which a prudent man would employ in the management of his own property.

In a typical mortgage-backed security transaction, the primary due diligence centers on an investigation of the adequacy and creditworthiness of the collateral and the structure of the transaction, rather than on the traditional underwriting analysis that emphasizes the accuracy of

(footnote continued from previous page) effective, that the statements therein were untrue or that there was an omission to state a material fact required to be stated therein or necessary to make the statements therein not misleading . . . ."

financial statements or the capability of management. \textsuperscript{127/}

This could involve verification of cash flow models to ensure that the underlying mortgage collateral will generate sufficient funds to meet the required payments to the holders of the securities. \textsuperscript{128/}

b. Exemptions

As noted above, unless an exemption is available, "securities" must be registered with the S.E.C. prior to any offer or sale. However, a number of exemptions under the Securities Act may be available in the case of mortgage-backed securities.

(i) Securities Issued or Guaranteed by Governmental Entities

Section 3(a)(2) of the Securities Act exempts from registration securities issued or guaranteed by certain governmental entities. \textsuperscript{129/} This exemption includes securities issued or guaranteed by GNMA, FHLMC, and FNMA. However, the § 3(a)(2) exemption does not expressly include a certificate of interest or participation in any of the

\textsuperscript{127/} Lore, supra, at 4-34.

\textsuperscript{128/} Id.

\textsuperscript{129/} 15 U.S.C. § 77c(a)(2) provides an exemption from registration for securities "guaranteed by the United States . . . or [issued or guaranteed] by any person controlled or supervised by and acting as an instrumentality of the Government of the United States pursuant to the authority granted by the Congress of the United States. . . ."
securities exempted thereby. Such an interest may also be exempt from registration if the holder of the interest has the same rights as the issuer or guarantor in the underlying exempt security.

(ii) Securities Issued or Guaranteed by Banks

Section 3(a)(2) of the Securities Act also exempts from registration "any security issued or guaranteed by any bank . . . ."\footnote{130} The S.E.C. has traditionally taken the position that § 3(a)(2) was intended to provide an exemption only for a bank's own securities. The S.E.C.'s expressed concern has been that to allow a bank to claim this exemption for any trust or similar entity that it might devise would allow the creation of voting trusts, investment trusts, and a variety of other securities for which the disclosure requirements of the Securities Act could be avoided.

For securities issued or guaranteed by banks to be exempt from registration under § 3(a)(2), the obligations must be with recourse to the bank, either directly or by guarantee. The exemption is unavailable to subsidiaries of banks unless the bank itself guarantees the securities. In addition, the exemption is generally not applicable to

\footnote{130}{15 U.S.C. § 77c(a)(2).}
interests in pools of securities (which are frequently deemed to be "new" securities distinct from the underlying exempt securities).

To come within the exemption, the guarantee must run to the securities themselves, as opposed to any collateral. Thus, pass-through certificates of bank securities would not be exempt unless the pass-through certificate was itself guaranteed in addition to the underlying securities.

It is noteworthy that the original Senate version of what became the Secondary Mortgage Market Enhancement Act of 1984 would have exempted mortgage-related securities from the registration requirements of the Securities Act. That provision was deleted by the House. 131/

(iii) Transactional Exemptions from Registration

Section 4(1) of the Securities Act exempts transactions in securities by any person "other than an issuer, underwriter or dealer." 132/ Section 4(2) exempts transactions by an issuer "not involving any public offering" of securities. 133/ Section 4(5) provides an exemption for certain mortgage transactions and applies to offers or sales of promissory notes (and participation

131/ See § V.B., below.
interests therein) secured by first liens on residential or commercial real estate where (1) such mortgages are originated by a savings and loan association, savings bank, commercial bank or similar institution, and where purchases of the securities are for the account of the purchaser, in a minimum amount of $250,000, and are settled within 60 days, or (2) the mortgages are originated by a mortgagee approved by the Secretary of Housing and Urban Development and are offered and sold under certain conditions to banks, savings and loan institutions, insurance companies and certain governmental bodies or agencies. 134/

(1) **Private Placement Exemption**

Section 4(2) exempts "transactions by an issuer not involving any public offering." 135/ The rules governing this exemption are set forth in Regulation D, comprised of Rules 501 through 506. 136/ Rule 506 exempts offerings sold to not more than thirty-five "non-accredited" purchasers and an unlimited number of "accredited investors". 137/ Each "non-accredited" purchaser must meet a certain standard of sophistication, either individually or jointly, with a

137/ 17 C.F.R. § 230.506.
"purchaser representative".138/ Rule 501 sets forth the net worth, income, and other qualifying standards for an "accredited investor".139/ Rule 506 allows offerings of unlimited dollar amounts to accredited investors without registration.140/

(2) **Certain Real Estate Transactions**

Section 4(5) of the Securities Act provides a limited exemption from the registration requirements of Section 5(a) for certain transactions involving offers or sales of promissory notes "directly secured by a first lien on a single parcel of real estate upon which is located a dwelling or other residential or commercial structure."141/ The exemption also applies to participation interests in such notes. The notes must be originated either by a government-regulated banking institution or an approved mortgage under the National Housing Act, and the aggregate sales price per purchaser must be at least $250,000. The purchaser must pay cash within 60 days of sale and may buy only for his own account.

---

138/ Id.
140/ 17 C.F.R. § 230.506.
2. **Anti-Fraud Provisions and Other Requirements**

Section 17(a) of the Securities Act\[^{142}\] makes it unlawful in connection with the offer or sale of a security, and Section 10(b) of the Exchange Act\[^{143}\] and Rule 10b-5 thereunder makes it unlawful in connection with the purchase or sale of a security, to make misleading statements or to omit the disclosure of material facts, and prohibits other fraudulent or deceptive acts or practices. These provisions apply to all securities, including exempted securities such as GNMA's. The S.E.C. has been actively enforcing the anti-fraud provisions of the Exchange Act in connection with the trading of exempted securities, including over-the-counter trading in GNMA's and optional GNMA standbys.\[^{144}\]

3. **Trust Indenture Act of 1939**

The Trust Indenture Act of 1939\[^{145}\] ("Indenture Act") provides additional requirements with respect to the offering and sale of debt securities. Section 304(a)(1)\[^{146}\] of the Indenture Act makes the Act applicable to:

---


(A) A note, bond, debenture, or evidence of indebtedness, whether or not secured; or

(B) A certificate of interest or participation in any such note, bond, debenture, or evidence of indebtedness; or

(C) A temporary certificate for, or guarantee of, any such note, bond, debenture, evidence of indebtedness, or certificate.

All securities not subject to exceptions must be supported by trust indentures that meet the requirements set forth in the Act. The Act also establishes certain standards for trustees and additional disclosure requirements for a prospectus concerning the trustee and the trust indenture. Section 304(a)(4)(A) of the Indenture Act exempts from the provisions thereof “any security exempted from the provisions of the Securities Act of 1933 by paragraphs (2) to (8) or (11) of section 3(a) thereof.”

In addition, certain debt securities are expressly excluded from the provisions of the Indenture Act. One exemption includes “any certificate of interest or


participation in two or more securities having substantially different rights and privileges, or a temporary certificate of any such certificate. "151/

4. Investment Company Act of 1940

The Investment Company Act of 1940 ("Investment Act")152/ requires all nonexempt investment companies, as defined, to register with the S.E.C. Section 3(a) of the Investment Act defines an investment company to include any issuer that:

(1) or holds itself out as being engaged primarily, or proposes to engage primarily, in the business of investing, reinvesting or trading in securities;

*   *   *

(3) is engaged or proposes to engage in the business of investing, reinvesting, owning, holding, or trading in securities, and owns or proposes to acquire investment securities having a value exceeding 40 per centum of the value of such issuer's total assets (exclusive of Government securities and cash items) on an unconsolidated basis.

"Investment Securities" are defined to include all securities except government securities (as defined), securities issued by employees' securities companies, and


securities issued by majority-owned subsidiaries.\textsuperscript{153} An issuer that holds exclusively government securities would not be deemed an investment company under § 3(a)(3), but may be deemed to be an investment company under § 3(a)(1), because the holding of government securities could be deemed to be "investing" in securities under that section.

Section 3(c)(5)(C) of the Investment Act\textsuperscript{154} exempts from the definition of "investment company" any company that "is not engaged in the business of issuing redeemable securities, face-amount certificates of the installment type or periodic payment plan certificates," and that "is primarily engaged in . . . purchasing or otherwise acquiring mortgages and other liens on and interests in real estate. . . ." Neither the Investment Act nor the regulations thereunder define the term "primarily engaged" for purposes of § 3(c)(5)(C).

Although § 3(c)(5)\textsuperscript{155} does not define the term "primarily engaged", the S.E.C. has taken the position that an issuer is "primarily engaged in purchasing or otherwise acquiring mortgages and other liens on and interests in real estate" if the issuer invests at least 55 percent of its

\textsuperscript{154} 15 U.S.C. § 80a-3(c)(5)(C).
\textsuperscript{155} 15 U.S.C. § 80a-3(c)(5).
assets in mortgages or certificates backed by whole pools of mortgages (e.g., GNMA certificates representing all of the GNMA certificates backed by a particular underlying pool of mortgages). The S.E.C. has also taken the position that GNMA certificates other than whole-pool GNMA's are not interests in real estate but that notes issued by savings and loan associations backed by mortgage loans secured by mortgages may be.

GNMA, FNMA, and FHLMC certificates representing all of the certificates backed by a particular underlying pool of mortgages constitute "mortgages and other liens on and interests in real estate" for purposes of § 3(c)(5)(C). However, the S.E.C. takes the position that the interest represented by a mortgage-backed certificate is an interest in the nature of a security in another person engaged in the real estate business, and not an interest in real estate within the meaning of § 3(c)(5)(C) of the Act. Thus, the engaging primarily in purchasing or otherwise acquiring


mortgage participations, or fractional or undivided interests in pooled mortgages or deeds of trust, does not fall within the § 3(c)(5)(C) exemption. However, it should be noted that, for tax purposes, owners of such certificates may be considered as owning "real estate assets". 159/

The legislative history of § 3(c)(5)(C) of the Investment Act indicates that Congress intended to exempt those companies "which do not come within the generally understood concept of a conventional investment company investing in stocks and bonds of corporate issuers" even though such companies "have portfolios of securities in the form of notes, commercial paper or mortgages and other liens on an interest in real estate." 160/

159/ The IRS has determined that interest income received on GNMA certificates is "interest on obligations secured by mortgages on real property"; that real estate investment trusts which own such certificates are considered to own "real estate assets" and that such a certificate owned by a savings and loan association represents "loans secured by an interest in real property". See Rev. Rul. 70-544, 1970-2; Rev. Rul. 70-545, 1970-2; Rev. Rul. 72-278, 1970 2-1; and Rev. Rul. 74-169, 1974-15.

5. Secondary Mortgage Market Enhancement Act

The Secondary Mortgage Market Enhancement Act ("SMMEA") amended the Exchange Act to provide special treatment in the securities laws for "mortgage-related securities". Mortgage-related securities are defined as securities in one of the two highest rating categories by at least one nationally recognized statistical rating organization, and which meet certain requirements.

Prior to enactment of SMMEA, non-exempt securities were subject to a maximum 35 days delivery requirement under § 11(d)(1) of the 1934 Act. SMMEA amended this section to allow delayed delivery of "mortgage-related securities" against full payment of the entire purchase price or delivery within 180 days of purchase or within a shorter time as may be prescribed by the S.E.C. Subject to such rules as may be adopted by the Governors of the Federal Reserve System, SMMEA provides that it shall not be considered a credit arrangement nor borrowing in the course of business (previously prohibited by §§ 7 and 8(a) of the Exchange Act) when there is delayed delivery of a mortgage-

related security against full payment of the purchase price within 80 days after the purchase (unless the Federal Reserve Board prescribes a shorter period).

The SMMEA was the first comprehensive legislation affecting the secondary mortgage market since 1970. State investment laws and regulations that limit investments in certain specified classes of mortgage-related securities are preempted by law (but states are provided up to seven years to reassert (by state statute) such investment limitations).162/

IV. Accounting Issues

As noted above, the issuance of mortgage-backed securities may be structured by the issuer as a sale of the underlying mortgages or as a debt transaction. Accordingly, accounting treatment will differ from instrument to instrument, depending on the facts and circumstances surrounding issuance of the instrument.

A debate exists within the accounting industry concerning the circumstances under which the issuance of mortgage-backed securities should be accounted for as sales of assets rather than as debt transactions. Sale treatment presents a number of advantages to issuers. Foremost among

162/ The SMMEA is described more fully in § V.B., below.
the advantages of sale treatment is that the securities do not have to be shown as a liability on the books of the issuing corporation. In addition, with such treatment, the issuing institution can recognize immediately any gain or loss on the transaction. Issuing institutions that are insured by the Federal Savings and Loan Insurance Corporation gain additional latitude in that they are authorized to defer and amortize losses from the sale of mortgage loans or mortgage-backed securities under 12 C.F.R. § 563c.14.163/

The debate within the accounting industry on this issue has focused on the accounting treatment to be accorded CMOs. As a general rule, if a CMO transaction is treated as a sale, neither the CMO nor the underlying mortgages appear on the balance sheet of the issuer. Any gain or loss on the transaction is recognized immediately, computed as the difference between the net proceeds of the offering (after issuance costs) and the carrying value of the underlying

163/ The mortgage-backed securities boom was encouraged by a change in accounting rules in 1981 that allowed savings and loan institutions to sell old, low interest mortgages without booking losses on their balance sheet. In 1981, the Federal Home Loan Bank Board issued regulations under 12 C.F.R. § 563c.14 permitting savings and loan institutions insured by the Federal Savings and Loan Insurance Corporation to defer losses or gains under regulatory accounting principles.
mortgages (after providing an accrual for the estimated costs of all future servicing of the bonds, such as trustee fees).

A. **Financial Accounting Standards Board Determinations**

The Financial Accounting Standard Board ("FASB") is an industry standard-setting body that establishes rules governing various aspects of financial accounting. The FASB has established a number of rules bearing on the financial accounting and reporting of mortgage-backed securities transactions. As discussed below, many of these rulings concern whether CMO transactions are to be characterized as asset sales or debt financing.

1. **Financial Accounting Standard No. 76**

   Financial Accounting Standard No. 76 (FAS No. 76) identifies the circumstances under which debt may be considered to be extinguished for accounting purposes. The ruling bears directly on whether, and when, a debtor recognizes gain or loss on an extinguishment of debt. FAS No. 76 provides that a debtor is to consider debt to be extinguished for accounting purposes when:

   
   
   the debtor irrevocably places cash or other assets in a trust to be used solely for satisfying payments of both

164/ Financial Accounting Standard No. 76 is entitled "Extinguishment of Debt" and is dated November, 1983.
165/ Lore, supra, at 7-8, 9.
interest and principal of a specific obligation and the possibility that the debtor will be required to make future payments with respect to that debt is remote. In this circumstance, debt is extinguished for accounting purposes even though the debtor is not legally released from being the primary obligor under the debt obligation.168/

Under this rule, the trust must be restricted to monetary assets which are essentially risk-free as to the amount, timing, and collection of interest and principal, such as obligations guaranteed by the U.S. Government.167/

Thus, it is significant that mortgage-backed securities may not meet the requirement that the instrument be essentially risk-free as to the timing of the collection of interest and principal.168/

2. Financial Accounting Standard No. 77

Financial Accounting Standard No. 77 (FAS No. 77)169/ establishes standards of financial accounting and reporting by transferors for transfer of receivables with recourse that "purport to be sales" of receivables.170/ It

166/ FAS No. 76, Paragraph 3(c).
167/ Lore, supra, at 7-10.
168/ Lore, supra, at 7-11.
169/ "Reporting by transferrers for Transfers of Receivables with Recourse" (December 1983).
170/ Lore, supra, at 7-16.
also applies to participation agreements (transfers of specified interests in a particular receivable or pool of receivables) that provide for recourse. 171/ FAS No. 77 provides that such transfers will be recognized as a sale if certain conditions are met. For the transfer to qualify, the transferor must surrender control of the future economic benefits embodied in the receivables, the transferor's obligations under the recourse provisions must be reasonably estimable, and the transferee must not be authorized to require the transferor to repurchase the receivables except pursuant to the recourse provisions. Although it has been argued that CMOs might fall within FAS No. 77, as discussed below, the FASB has taken the position that FAS No. 77 does not apply to CMOs. 172/

3. FASB Technical Bulletin No. 85-2

FASB Technical Bulletin NO. 85-2 (T.B. No. 85-2) 173/ established methods for accounting for CMO transactions. In essence, it provides that CMO transactions are presumed to be secured borrowings rather than sales of the underlying collateral. If the presumption is overcome, and the

171/ Id.
173/ "Accounting for Collateralized Mortgage Obligations" (March 18, 1985).
transaction is accounted for as a disposition of the underlying collateral, neither the CMO nor the mortgage collateral are to appear on the balance sheet of the issuer. Any gain or loss is recognized, computed as the difference between the net proceeds of the offering (after issuance costs) and the carrying value of the mortgage collateral (after providing an accrual for the estimated costs of all future servicing of the bonds, e.g., trustees fees). Thus, the total cost of the collateral is to be charged against the proceeds in determining gain or loss.

T.B. No. 85-2 establishes a number of criteria for determining whether the presumption of debt treatment is overcome. Consideration is given to whether the CMOs are issued on a non-recourse basis, whether the residual value of the issuer after payment of the CMOs is expected to be nominal, whether the CMOs contain optional redemption provisions, and whether the estimated net present value of the residual value can be recorded.

V. Statutory and Regulatory Initiatives

A. Trust for Investment in Mortgages Act

In 1983, legislation was introduced which was intended to remedy the relative inflexibility of the "grantor trust" structure of mortgage-backed securities. The legislation,
known as the Trust for Investment in Mortgages ("TIMs")\textsuperscript{174/}
would have amended federal tax and securities laws to promote the pooling of mortgages and their sale in the secondary mortgage market. Under TIMs, mortgage pooling arrangements could have been undertaken through the creation of a tax-exempt entity whose trustee would have been permitted to actively manage the trust assets. This would have included the power to reinvest and alter cash flows from the underlying mortgages so as to create multiple classes of securities with varying yields and maturities. The TIM and its shareholders would have been a partnership for tax purposes, with only the shareholders, and not the TIM, subject to federal taxation. However, to qualify as a TIM, the entity could not have had income from the active conduct of a trade or business and would have had to meet specified income and asset tests.

B. Secondary Mortgage Market Enhancement Act of 1984

As noted above, the SMMEA\textsuperscript{175/} was enacted in 1984 to reduce the requirements of federal (and state) securities laws applicable to "mortgage-related securities." The legislation amended certain provisions of the federal


securities laws with respect to "mortgage-related securities." These amendments were designed to encourage private sector activity by changing or preempting certain federal and state securities regulations.\footnote{H.R. Rep. No. 98-994 Part 1, 98th Cong., 2nd Sess. (1983).}

The statute amends the Securities Exchange Act of 1934 to add a definition of the term "mortgage related security" and to change the margin requirements of the Act as they apply to mortgage related securities to reflect the need for delayed delivery in transactions involving such securities. The statute also authorizes depository institutions to invest in private mortgage related securities. In addition, the statute preempts State law with respect to limitations on investments in these instruments and exempts them from registration under State securities law unless a State reimposes investment limitations or registration requirements, or both, within seven years.

The SMMEA has served to reduce the regulatory barriers and requirements at the Federal and State levels that inhibited the private secondary mortgage market. Prior to the SMMEA, federally regulated depository institutions were not authorized to invest in private mortgage backed securities. Such investments were often not included in
lists of permissible investments for pension funds, insurance companies, and other financial institutions chartered and regulated under State laws. In the great majority of these cases, the limiting State legislation was enacted before these instruments came into being.

Another impediment to marketing mortgage backed securities that the SMMEA sought to address were State registration requirements. These laws, as well as laws governing investment authority, were generally enacted before mortgage-backed securities evolved. Thus, they failed to anticipate and provide for the special needs of the mortgage related securities markets, such as those that result from the forward nature of that market, which requires that securities be sold in advance of the formation of mortgage pools and of payment.

Early versions of the SMMEA would also have exempted mortgage related securities from registration requirements under the Securities Act of 1933. This exemption was dropped because of concern that it would significantly erode investor protection. As noted above, the Securities Act requires that, unless securities are exempted under section 3 or 4 of the Act (e.g., securities issued or guaranteed by the Federal Government or government related agencies, such as GNMA, FNMA, and FHLMC), a registration statement
describing those securities and the investment risks must be filed with the S.E.C. before the securities are sold to the public.

The early versions of the statute would have significantly expanded the securities covered by the exemption from registration provided by section 4(5) of the Securities Act. The exemption would have included intermediate securities collateralized by first mortgages and second mortgages and loans on cooperative housing and manufactured homes. In addition, the exemption would have been expanded to add credit unions and insurance companies regulated by Federal or State authorities and HUD-approved mortgages to the list of institutions that could originate mortgages used as collateral for securities not subject to the registration requirements. These changes were promoted as a means of allowing private issues to better compete with securities issued or guaranteed by GNMA, FNMA, and FHLMC.177/

The State defines a "mortgage related security" as one that is rated in one of the two highest rating categories by at least one nationally recognized statistical organization,

177/ Because of their government status, these agency securities are already exempted from State and Federal securities laws, and they are also permitted as legal investments for State pension funds and insurance companies in many states.
and that either (a) represents ownership of one or more promissory notes or other instruments that are secured by a first lien on property on which is located a residential or mixed residential and commercial structure, or on a residential manufactured home, and that were originated by an institution supervised and examined by a Federal or State authority or by a mortgage lender approved by the Secretary of HUD; or (b) is secured by one or more instruments meeting the requirements set forth above that, by its terms, provides for payments of principal in relation to payments or reasonable projection of payments. 178/

The definition is designed to broaden the market for mortgage backed securities by encouraging the formation of new conduits for the flow of mortgage capital. In addition to traditional securities backed by whole loans which give investors direct recourse to underlying mortgages, the SMMEA includes the sale to investors of intermediate securities, such as participation or units of interest in other securities, or collateralized by pools of mortgage backed securities, or collateralized by participation interests in such pools or securities, and mortgage backed payment securities such as CMOs. It further provides that such

intermediate securities will have some relationship to the underlying obligations, but not necessarily a direct relationship, since investors are concerned more with predictability of cash flow than mortgage instruments typically provide.\footnote{179/}

C. Tax Reform Act of 1985

The Tax Reform Act of 1985 ("TRA")\footnote{180/}, passed by the House of Representatives in December of last year, would alter in several major respects the federal income tax treatment of trusts and estates. Section 1211 of the TRA would amend a number of IRC sections, including 641-44, 651-52, and 661-64. In addition, it would create new sections 645-46, 653, 665-66, and new Chapter 99 of the IRC.

The impact of the proposed legislation on "grantor trusts" is discussed in House Report No. 99-426 ("House Report").\footnote{181/} The House Report includes a statement of the intent of the proposed changes:

While the committee believes that there are many nontax reasons for the creation of trusts, the committee is concerned about the inherent tax benefits arising under the present rules governing the taxation of trusts. The committee also is concerned about the overall level of

\footnote{179/} Id.
complexity in the present rules
governing the taxation of trusts, estates, and their beneficiaries.\textsuperscript{182/}

To remedy these perceived problems, the income of most non-grantor trusts would be taxed during the lifetime of the grantor at the marginal tax rate of the grantor without a deduction for distributions to beneficiaries. The distributions from such trusts would not be taxed to the beneficiaries. However, with respect to grantor trusts, the House Report expressly provides that "a grantor should continue to be treated as the owner of the trust if, in effect, the grantor or his spouse can benefit currently from the assets of the trust."\textsuperscript{183/}

As discussed above, under the existing grantor trust provisions, where the grantor transfers property to a trust and retains certain powers or interests over the trust, the grantor is treated as the owner of that trust for Federal income tax purposes, and the income and deductions attributable to that trust are included directly in the grantor’s taxable income. In addition, a beneficiary is treated as the owner of a trust where the beneficiary has given up a power to revoke the trust but retains any of such powers or interests in the trust. Under the TRA, a grantor

\textsuperscript{182/} Id. at 811. 
\textsuperscript{183/} Id. at 812.
of a trust is treated as the owner of the trust if the
grantor retains a power to revoke the trust, if the grantor
(or grantor’s spouse) retains the right to receive the trust
income or the power to use the trust income, and if the
grantor retains certain administrative powers over the
trust.

Thus, the taxation of grantor trusts would not be
significantly changed, but the number of cases subject to
those rules would be reduced. Under the bill, the grantor
would be treated as an owner of the trust and, therefore,
taxed directly on the income of the trust in the following
three circumstances (all of which are consistent with the
treatment under present law):

(1) If the grantor or the grantor’s spouse
retains the power to deal with the trust
for less than adequate and full
consideration, where the grantor or the
grantor’s spouse retains the power to
borrow without adequate interest or
security, or where the grantor or the
grantor’s spouse has borrowed from the
trust and not repaid that amount before
the beginning of the taxable year;

(2) If the trust is subject to a power to
revoke which enables the grantor or the
grantor’s spouse to invest part or all
of the trust in the grantor or the
grantor’s spouse; or

(3) If any portion of the income of the
trust is required to be or may, in the
discretion of the grantor or the
grantor’s spouse, be distributed to the
grantor or the grantor’s spouse, held
for future distributions to the grantor or grantor’s spouse, or applied to the payment of premiums on life insurance policies on the grantor or grantor’s spouse.

A person other than the grantor is treated as the owner of the trust when that person had the power to revoke and retained one of the powers listed above. The legislative history of the bill makes clear that, if a trust is treated as a grantor trust, the grantor (or beneficiary, where appropriate) is treated as the owner of the property for all Federal income tax purposes.\footnote{184/}

VI. Conclusion

The secondary mortgage market has emerged as a primary source of housing credit. Recent legislative and regulatory initiatives have helped transform mortgage-backed securities into widely accepted investments that are competitive with other more traditional securities. As a result, other types of assets, such as automobile loans, are now targeted for use as collateral backing securities.

In the short run, the major players in the secondary mortgage market will continue to be the three quasi-governmental agencies - GNMA, FNMA, and FHLMC. However,

\footnote{184/ Id. at 818.}
with the enactment of the SMMEA, it appears that future growth in the secondary mortgage market will be concentrated in the private sector.

Although the focus of federal policy in recent years has been to encourage the development of the secondary mortgage market, there is a continuing need to reform the federal tax laws to provide greater flexibility in the structuring of mortgage-backed securities issuances. In addition, other regulatory incumbrances, resulting from state regulation of real estate and securities, need to be removed to reduce complexity and expense of issuing mortgage-backed securities.

It seems likely that the increasing demand for mortgage credit will foster efforts to further reduce the regulatory burdens on issuers and holders of mortgage-backed securities. Less likely is further expansion of the federal role in the secondary mortgage market. The present trend is to reduce the advantages held by the quasi-governmental corporations and to place them on more equal footing with private issuers of mortgage backed securities. However, no one is predicting an end to the federal presence in the secondary mortgage market.