Dechert LLP

MEMORANDUM

DATE: July 6, 2018

TO: Fannie Mae

RE: Tax Analysis of Proposed CAS REMIC Structure

This memorandum addresses Fannie Mae’s proposed use of a real estate mortgage investment conduit (a "REMIC") to facilitate Fannie Mae's transfer of mortgage credit risk to third-party investors.[1] This memorandum addresses tax considerations for investors in Fannie Mae guaranteed single-family mortgage-backed securities ("MBS") and provides analysis regarding the proposed CAS REMIC structure. The proposed CAS REMIC structure generally incorporates the payment terms of the recent Connecticut Avenue Securities ("CAS") issuances while addressing certain U.S. federal income tax concerns that have limited (and in certain circumstances, precluded) non-U.S. persons and real estate investment trusts ("REITs") from investing in CAS securities.

I. Summary of Proposed Tax Structure

The proposed CAS REMIC structure will be carried out as follows:

- Fannie Mae will convey mortgage loans to MBS trusts as is done currently.
- In turn, each MBS trust will assign beneficial interests in mortgage loan principal and interest payments (net of servicing fees) to a separate trust established and administered by Fannie Mae (a "Ten Day Trust") in exchange for beneficial interests in the Ten Day Trust representing the right to receive the same mortgage loan principal and interest payments (net of a portion of the guaranty fee).
  - o Fannie Mae will make multiple REMIC elections with respect to the Ten Day Trust, resulting in a tiered REMIC structure.
  - o The upper-tier REMIC in the Ten Day Trust will designate an uncertificated regular interest in respect of each related mortgage loan (each, a "Mirror Interest"). As a result, for U.S. federal income tax purposes, the MBS will

represent beneficial ownership of the Mirror Interests corresponding to the mortgage loans held by the related MBS trust.[2]

- No more than 3 months following the formation of the first Ten Day Trust, the assets of each Ten Day Trust created in the interim will be assigned to a separate trust established and administered by Fannie Mae (a "Quarterly Trust") in exchange for beneficial interests in that Quarterly Trust representing the right to receive the same mortgage loan principal and interest payments.

  - Fannie Mae will make a REMIC election with respect to the assets of the Quarterly Trust (the "Q-REMIC") and will include in such REMIC an "inside reserve fund" funded by Fannie Mae (the "Reserve Fund").

  - With respect to the Q-REMIC, Fannie Mae will designate (i) an uncertificated subordinate regular interest with an initial principal balance equal to the Reserve Fund balance (the "Subordinate Regular Interest") and (ii) an uncertificated interest-only regular interest (the "Interest-Only Regular Interest") that will be paid certain excess interest payable on the mortgage loans (for example, a specified portion of the interest payable on the mortgage loans representing all or a portion of the guaranty fee).

  - The amounts in the Reserve Fund will be available to cover specified losses on the mortgage loans underlying the MBS, and such losses will result in a writedown of the balance of the Subordinate Regular Interest.

  - From time to time, excess amounts held in the Reserve Fund will be released to make payments on the Subordinate Regular Interest.

- The Subordinate Regular Interest and the Interest-Only Regular Interest will be tranched to produce regular interests matching the payment terms of each of the CAS securities (the "CAS REMIC Notes").[3]

The Subordinate Regular Interest created as part of this structure will constitute a REMIC regular interest that will be repaid absent credit losses on the mortgage loans. Because REMIC regular interests are treated as debt for U.S. federal income tax purposes, CAS investors will hold a credit risk transfer security that will be subject to the tax rules applicable to debt (for example, an instrument that generally can be held by non-U.S. investors free of U.S. income and withholding tax). In addition, a REMIC regular interest can qualify as a "real estate asset" for a REIT, counting favorably for purposes of the asset and income tests required for REIT qualification.

II. Tax Considerations for MBS Investors

The proposed CAS REMIC structure is expected to have a very limited impact on the tax treatment for MBS investors. First, for U.S. federal income tax purposes, the MBS will represent ownership of REMIC regular interests as a result of the REMIC election that will be made with respect to the mortgage loans underlying an MBS.[4] Any taxpayer holding a REMIC regular interest must use the accrual method of accounting in determining its income from the regular interest.[5] This likely will affect only individuals holding MBS outside of a tax-favored account, because other investors generally already use the accrual method of accounting in determining income from MBS for U.S. federal income tax purposes.

Second, certain MBS investors rely on the special tax treatment of MBS under the Internal Revenue Code (the "Code"). Specifically, in Revenue Ruling 84-10, the Internal Revenue Service ("IRS") ruled that, subject to certain limitations and qualifications, (i) MBS owned by a REIT are considered as representing real estate assets within the meaning of Section 856(c)(5)(B), and the interest income is considered interest on obligations secured by mortgages on real property within the meaning of Section 856(c)(3)(B) and (ii) MBS owned by a domestic building and loan association are considered as representing loans secured by an interest in real property within the meaning of Section 7701(a)(19)(C)(v), provided the real property underlying each mortgage loan is (or, from the proceeds of the mortgage loans, will become) the type of real property described in that section of the Code.

The proposed CAS REMIC structure will not adversely affect any conclusions under these Code sections, because of the treatment of REMIC regular interests under these Code sections. Under the REIT provisions, a regular or residual interest in a REMIC is generally treated as a real estate asset, and any amount includible in gross income with respect to such a REMIC interest is treated as interest on an obligation secured by a mortgage on real property.[6] However, if less than 95% of the assets of the REMIC are real estate assets (determined as if the REIT held such assets directly) (the "95% REMIC Test"), then the

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REIT is treated as holding directly (and receiving directly) its proportionate share of the assets and income of the REMIC.[7] For purposes of these rules, REMICs that are part of a tiered structure are treated as one REMIC.[8] Analogous provisions are contained in Sections 593(d)(4) (relating to certain banks and savings institutions) and 7701(a)(19)(C)(xi) (relating to domestic building and loan associations).

Under the proposed CAS REMIC structure, the Reserve Fund will be sized and maintained at all times so that the mortgage loans and other assets held in the related tiered REMIC structure comply with the 95% REMIC Test. Accordingly, provided that Fannie Mae complies with these restrictions, the proposed CAS REMIC structure will not adversely affect any conclusions currently reached with respect to the treatment of MBS under Sections 593(d), 856 or 7707(a)(19)(C).

Third, pursuant to Revenue Ruling 84-10, a beneficial owner of MBS must report on its federal income tax return its pro rata share of the entire amount of income from each mortgage loan in that particular pool. The items of income from a mortgage loan include interest, original issue discount, prepayment premiums, assumption fees and late payment charges, not reduced by any amount paid for the Fannie Mae guaranty or trust expenses. A beneficial owner can deduct its pro rata share of the Fannie Mae guaranty fee and any other expenses of the MBS trust as provided in Section 162 or 212. Thus, an MBS investor generally will report an amount of income for U.S. federal income tax purposes that is greater than the pass-through rate of the MBS (for example, the amount of the guaranty fee), but may be able to deduct all or a portion of such excess under Section 162 or 212.

Under the proposed CAS REMIC structure, a portion of the amount payable on the mortgage loans in excess of the pass-through rate of the related MBS (for example, some portion of the guaranty fee) will instead be used to fund the interest payments on the Interest-Only Regular Interest and, ultimately, the CAS REMIC Notes. Any such amount will no longer be reported as additional income to MBS investors and will no longer be subject to the limitations on deductions.[9] As a result, the proposed CAS REMIC structure will reduce the amount of the MBS trust expenses that will be reflected in tax information reporting that is made available to MBS investors.

III. MBS Investors Not Reliant on Proposed CAS REMIC Structure

Beyond these three considerations, the existence and operation of the proposed CAS REMIC structure should have no effect on the tax consequences to MBS investors. Further, no changes will be made to the payment terms of the MBS themselves. If, for any reason, the REMIC elections made with respect to the proposed CAS REMIC structure are not respected, the arrangement pursuant to which the MBS are issued and administered would not be treated as a "taxable mortgage pool" (a "TMP") under Section 7701(i).[10] For TMP purposes, the MBS would continue to represent an entitlement to the underlying principal payments and a designated portion of each interest payment, in each case coupled with Fannie Mae's guaranty.[11] Thus, the tax consequences to MBS investors would continue to be as described in Revenue Ruling 84-10.[12] Accordingly, the proposed CAS REMIC structure should not affect MBS investors other than as noted above.

IV. Analysis for CAS Investors

In contrast to MBS investors, the CAS investors will be relying on the validity and operation of the proposed CAS REMIC structure. Thus, the opinion of counsel that will be delivered regarding the CAS REMIC structure will have much more significance for the CAS investors. In this regard, it is important to note that all other Fannie Mae sponsored REMICs and most, if not all, REMIC transactions generally are undertaken by the parties on the basis of an opinion of tax counsel.

The analysis supporting the conclusions reached in the tax opinion for an actual CAS REMIC transaction will need to take into account the following:

1. Election

A REMIC elects REMIC status by timely filing an IRS Form 1066, *U.S. Real Estate Mortgage Investment Conduit Income Tax Return*, for the first taxable year of the REMIC's existence, signed by a person that would be authorized to sign the return for the qualified entity absent the REMIC election.[13] Here it is expected that Fannie Mae will sign the tax return for each REMIC.[14]

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2. Qualified Entity

Treasury Regulation Section 1.860D-1(a) requires that a REMIC be a "qualified entity," which includes any entity and a segregated pool of assets within an entity.[15] In the latter case, the assets identified as part of the segregated pool must be treated for all U.S. federal income tax purposes as assets of the REMIC and interests in the REMIC must be based solely on assets of the REMIC.[16]

Here, each Ten Day Trust or Quarterly Trust will be established as a separate trust and will make one or more REMIC elections (as described below) with respect to specified assets held by such trust. As a result, the trust will be a qualified entity eligible to make a REMIC election.

3. Qualified Mortgages

Substantially all of the assets of a qualified entity intending to qualify as a REMIC must consist of qualified mortgages and other permitted investments (other than during a limited startup period and limited liquidation period).[17] A "qualified mortgage" includes (1) any obligation that is principally secured by an interest in real property that is transferred to a REMIC on the startup day in exchange for regular or residual interests in the REMIC, (2) any regular interest in another REMIC transferred to the REMIC on the startup day in exchange for regular or residual interests in the REMIC and (3) any "qualified replacement mortgage."[18]

Any mortgage loan relating to any MBS trust that will be included in the proposed CAS REMIC structure will be a fully disbursed, unmodified and performing first-lien mortgage loan with a loan-to-value ratio of no greater than 100%. Such mortgage loans themselves would be treated as obligations principally secured by an interest in real property.[19]

Here, it is expected that the beneficial interests in mortgage loans that are pooled into certain MBS trusts over a ten-day period will be aggregated into a Ten Day Trust in which two REMICs will be formed: a lower-tier REMIC and an upper-tier REMIC. This will be done to reduce the number of REMICs that Fannie Mae will need to administer. Treasury Regulation Section 1.860G-2(k) permits the sponsor to contribute property to a REMIC in exchange for regular and residual interests over any period of 10 consecutive days and the REMIC may designate any one of those 10 days as its startup day. Assuming Fannie Mae properly designates the startup day, the beneficial interests in the mortgage loans will be transferred to the lower-tier REMIC within the specified time period. As a result, the beneficial interests in the mortgage loans will constitute "qualified mortgages" to the lower-tier REMIC.[20]

In addition, all of the regular interests issued by the lower-tier REMIC will be transferred to the upper-tier REMIC on the startup day of the upper-tier REMIC. Accordingly, each such lower-tier regular interest will constitute a "qualified mortgage" to the upper-tier REMIC holding such interest.[21]

Finally, it is expected that, at least once every 3 months, a new Quarterly Trust (and a new REMIC) will be formed to aggregate, in effect, the REMICs that have been formed during those 3 months. To do so, it is expected that each of the upper-tier REMICs formed during that period will transfer its assets, which consist of regular interests, to the newly formed REMIC in exchange for regular interests to be issued by the new REMIC that correspond to the assets transferred to the new REMIC. This will occur on the startup day of the new REMIC. Thus, the assets delivered to the new REMIC will constitute "qualified mortgages" to the new REMIC, because they will be regular interests transferred to the new REMIC on its startup day in exchange for interests in the new REMIC.

Also, the regular interests issued by the new REMIC formed by the Quarterly Trust, which will then be held by an upper-tier REMIC previously formed by a Ten Day Trust, will constitute "qualified replacement mortgages" for that upper-tier REMIC. Section 860G(a)(4) defines a qualified replacement mortgage to mean any obligation that would be a qualified mortgage if transferred on the startup day in exchange for regular or residual interests in the REMIC and that is received for another obligation within the 3-month period beginning on the startup day.[22] Thus, the exchange undertaken by each upper-tier REMIC will meet the statutory requirements for the substitution of a qualified mortgage for a qualified replacement mortgage.

The Code specifically authorizes the Treasury Department to promulgate regulations regarding qualified replacement mortgages.[23] In particular, Section 860G(e)(4) and (5) provides that the Treasury Department "shall prescribe such regulations as may be necessary or appropriate to carry out the purposes of this part, including regulations . . . providing appropriate rules for treatment of transfers of qualified replacement mortgages to the REMIC where the transferor holds any interest in the REMIC, and . . . providing that a mortgage will be treated as a qualified replacement mortgage only if it is part of a bona fide replacement (and not part of a swap of mortgages)." As of yet, no such regulations have been issued.

The legislative history indicates that Congress was concerned that a transferor could effectively move the tax basis of one mortgage loan to another mortgage loan with a similar value. This would allow the transferor to manipulate the timing of gain or loss with respect to those mortgage loans. The legislative history states, "It is intended that these regulations may provide rules for determining the basis of mortgages transferred to, or received from, a REMIC as part of a replacement of qualified mortgages, and also may provide rules for determining or adjusting the basis of qualified mortgages held by the REMIC before or after the replacement."[24] Although unclear, it would seem that any such regulations could affect the basis computations to the REMICs at issue here. Because the upper-tier REMICs will be the transferors of assets to the new REMIC, it would seem that any future regulations Congress may have intended could affect the tax basis of an upper-tier REMIC's assets and thus the income computations of the residual holder but should have no application to MBS or CAS investors.

The legislative history further states:

> In addition, the bill grants authority to the Secretary of the Treasury to provide that a mortgage will be treated as a qualified replacement mortgage only if it is part of a bona fide replacement and is not part of a swap of mortgages. Thus, the Secretary of the Treasury is authorized to issue regulations which prevent a taxpayer from avoiding recognition on the exchange of appreciated mortgages by contributing such mortgages to a REMIC, and then having the REMIC (which will have a fair market value basis in the mortgages), exchange the mortgages for other mortgages.[25]

This aspect of the regulatory authority would not seem to have any application here either. No upper-tier REMIC will exchange regular interests it holds for other regular interests to avoid the recognition of built-in gain. In addition, as part of the exchange, the upper-tier REMIC will receive a regular interest with cash flows from the same underlying mortgage loan. So, this is not an attempt to swap one mortgage loan for another. Finally, and perhaps most significantly, the formation of the resulting REMIC structure in this manner is not being undertaken to achieve a result that could not have been achieved had all the REMICs been formed on the same day.

4. Credit Enhancement Contracts

As discussed above, Fannie Mae will guarantee the payments due on MBS as per its current MBS practice. It is expected that the REMIC operative documents will provide that Fannie Mae will guarantee payments on the Mirror Interests, but this obligation will be tempered by the coverage provided by the Reserve Fund.

The Fannie Mae guaranty is intended to qualify as a "credit enhancement contract." A credit enhancement contract includes any arrangement whereby a person agrees to guarantee full or partial payment of the principal or interest payable on a qualified mortgage or on a pool of such mortgages, or payment on one or more classes of REMIC interests, in the event of defaults or delinquencies on qualified mortgages, unanticipated losses or expenses incurred by the REMIC, or lower than expected returns on cash-flow investments.[26] A credit enhancement contract is not treated as a separate asset of a REMIC, but is treated as part of the pool of mortgages to which it relates.[27] In addition, a guarantee arrangement will not fail to qualify as a credit enhancement contract solely because the guarantor, in the event of default on a qualified mortgage, has the option to immediately pay to the REMIC the full amount of the mortgage principal due or pay principal and interest according to the original payment schedule or according to some other deferred payment schedule.[28] Finally, the REMIC rules permit a guarantor to have subrogation rights.[29]

Further, the REMIC regulations provide that a credit enhancer's right to be reimbursed for amounts advanced to a REMIC pursuant to the terms of a credit enhancement contract is not an interest in the REMIC even if the credit enhancer is can receive interest on the amounts advanced.[30] Thus, the REMIC rules contemplate that a credit enhancer can recover from a REMIC amounts it has advanced under credit enhancement contracts.

5. Qualified Reserve Asset

A REMIC is permitted to hold a "qualified reserve asset." An asset will be treated as a "qualified reserve asset" if it is (i) intangible property, (ii) not a residual interest, (iii) held for investment and (iv) part of a "qualified reserve fund."[31] An asset need not generate any income to be a qualified reserve asset.[32]

Here, the Reserve Funds may not be maintained as separate investment accounts, but rather may be pooled together. The pooled account, which may include, among other things, cash, cash equivalents and U.S. Treasury securities, will constitute intangible property and will not be treated as a residual interest in a REMIC. Thus, two of the four requirements are relatively straight-forward and compliance with those requirements can be easily established.

No authority expressly addresses what is required for an asset to be held for "investment" in this context. In the absence of guidance, we believe the distinction between an investor and a trader in other contexts is meaningful.[33] Here, the assets will be passive in nature with a return reflecting the time value of money. We understand that the activities with respect to the acquisition and disposition of the assets held in the Reserve Fund will not rise to the level of activities conducted by a trader. As a result, the assets of the Reserve Funds should be treated as held for investment.

The final requirement will be met if the Reserve Fund is a "qualified reserve fund." A "qualified reserve fund" is any reasonably required reserve to provide for full payment of REMIC expenses, amounts due on regular or residual interests in the event of defaults on qualified mortgages, prepayment interest shortfalls, lower than expected returns on cash-flow investments or any other contingency that could be provided for under a credit enhancement contract.[34] A reserve must be promptly and appropriately reduced to the extent that such reserve exceeds a reasonably required amount.[35] In determining whether the amount of a reserve is "reasonably required," one is required to consider: (i) the credit quality of the qualified mortgages within the REMIC, (ii) the extent and nature of any guarantees relating to either the qualified mortgages or the regular and residual interests of the REMIC, (iii) the expected amount of expenses of the REMIC, and (iv) the expected availability of proceeds from qualified mortgages to pay the expenses.[36] There is no published authority that addresses any of these requirements and standards in the REMIC rules.[37]

Here, amounts in a Reserve Fund will be used to provide for (or to reimburse Fannie Mae for advances of) amounts due on the Mirror Interests in the event of a default or delinquency with respect to certain loans. In addition, the balance of a Reserve Fund will be reduced from time to time such that it will not exceed prescribed size limitations, including a limitation based on historical losses. Thus, the purpose of the Reserve Fund and its reduction over time should satisfy the applicable requirements, leaving the question of the reasonableness of the size of the Reserve Fund as the principal concern.

Justifications for the reasonableness of the size of the Reserve Funds can be found from three different sources. First, we understand that Fannie Mae believes that each Reserve Fund will be sized to a reasonable amount in relation to historical losses. In addition, Fannie Mae should lack the incentive to overfund the Reserve Funds because the average interest return on the assets held in the Reserve Funds is expected to be significantly less than the yield of the CAS REMIC Notes.

Second, the payment terms of the CAS REMIC Notes will generally have the same payment terms as the recent CAS securities, providing market proof that the size of the Reserve Funds is not a function of the REMIC structure. Also, the credit ratings of the CAS securities indicate that the credit enhancement provided by a Reserve Fund will be protecting against meaningful credit risk. In more recent CAS issuances, the Class M1 Notes generally receive a credit rating of at least "BBB-", the M2 Notes generally receive a "B" rating, and the B Notes receive no rating. In these circumstances, the rating agencies have identified meaningful credit risk with respect to the underlying loans that has been isolated in the Class M1 Notes, M2 Notes and B Notes. Further, we understand that, if rated, the B Notes would receive ratings lower than "B" given that these Notes will be allocated losses prior to the Class M2 Notes. We would expect that the credit rating agencies would provide similar ratings to the CAS REMIC Notes.

Third, as part of the goals agreed to by the Federal Housing Finance Agency ("FHFA") and Fannie Mae, Fannie Mae expects to enter into credit risk transfer transactions only to the extent they are "economically sensible." In an August 2015 report, the FHFA stated that the Enterprise (presumably meaning either of Fannie Mae or Freddie Mac) is presently using credit risk transfer transactions to obtain the "equivalent of insurance to cover its potential credit losses (after taking into account credit enhancements such as [mortgage insurance]) up to about the first three to six percent of the outstanding balance on the pool of mortgage loans covered by the credit risk transfer."[38] The FHFA Report points out that this level of protection focuses on covering "expected" and "unexpected" losses.[39] Although the FHFA Report notes that CAS detachment points exceed historical loss rates if the historical data is adjusted to include only loans with comparable loan-level risk characteristics, which suggests that the CAS transactions might be acquiring too much protection, the FHFA Report also states that unexpected losses are "plausible." In particular, the FHFA Report states, "Unexpected loss is the loss to the Enterprise over and above expected losses should there be a stressful, yet plausible, macroeconomic event, such as a severe downturn in house price levels as might accompany a recession (similar to what was experienced during the recent housing crisis)." By providing that CAS issuances have not provided unreasonable amounts of protection, the FHFA Report supports the reasonableness of the size of the Reserve Funds.

Each of these three sources could together provide a basis to establish the reasonableness of the size of the Reserve Funds.

6. Foreclosure Property

A REMIC is also permitted to hold "foreclosure property." Foreclosure property generally includes any real property (and any personal property incident thereto) acquired by a REMIC as a result of having bid on such property at foreclosure or having otherwise reduced the property to ownership or possession in connection with the default or imminent default of a qualified mortgage held by such REMIC.[40] Foreclosure property will cease to be so treated as of the close of the third taxable year following the taxable year in which such property is acquired, unless an extension is obtained from the IRS.[41]

Foreclosure property will generally cease to be so treated for purposes of Section 860F, and therefore income from such property would be subject to a 100% prohibited transactions tax, if (i) the REMIC enters into a lease that by its terms generates certain active income, (ii) certain construction takes place on the property following acquisition of the foreclosure property by the REMIC, or (iii) after a 90-day grace period starting with the day the REMIC acquires the property, such property is used in a trade or business (other than a real estate rental business) that the REMIC conducts.[42] Importantly, the disqualification of such property as foreclosure property for one of these reasons will not be taken into account for purposes of a REMIC satisfying the asset test.[43]

Finally, property acquired upon the default of a loan will not constitute "foreclosure property" if the REMIC acquired the loan with an intent to evict or foreclose or where the REMIC knew or had reason to know that default would occur.[44] A REMIC will generally be deemed to have such knowledge if the expected default was of a type that ordinarily leads to foreclosure.[45]

Here, all of the mortgage loans transferred to a REMIC will be performing loans at the time they are transferred and the REMICs will not know or have reason to know that a default with respect to any particular loan will occur. Although some level of defaults on a pool-wide basis will be anticipated, there will be no such knowledge as to any specific loan. Further, Fannie Mae’s existing management practices for any real estate ("REO") acquired in respect of a defaulted mortgage loan are consistent with the applicable REMIC provisions. As a result, any REO acquired in respect of a defaulted mortgage loan should qualify as "foreclosure property" for purposes of the REMIC asset test of Section 860D(a)(4).

7. Regular Interests

An interest in a REMIC will qualify as a regular interest if (i) the interest is designated as a regular interest, (ii) the interest is issued on the REMIC's startup day and with fixed terms, (iii) the holder of such interest is unconditionally entitled to a specified principal amount (or similar amount), and (iv) interest payments on the REMIC interest, if any, at or before maturity (a) are either payable based on a fixed rate, or to the extent permitted by the REMIC rules, a variable rate,[46] or (b) consist of a specified portion of the interest payments on qualified mortgages held by the REMIC and such portion does not vary during the period the REMIC interest is outstanding.[47]

(i) Designation

A REMIC designates an interest as a regular interest by attaching to the IRS Form 1066 it files for its first taxable year certain information concerning the terms and conditions of the regular interest.[48] Here, each Mirror Interest, Subordinate Regular Interest and Interest-Only Regular Interest will be designated as a regular interest by the issuing REMIC.

(ii) Fixed Terms on Startup Day

A regular interest has fixed terms on the startup day if, on the startup day, the REMIC's organizational documents irrevocably specify: (i) the principal amount (or other similar amount) of the regular interest, (ii) the interest rate or rates used to compute any interest payments (or other similar amounts) on the regular interest and (iii) the latest possible maturity date of the regular interest.

Here, each upper-tier REMIC will issue the Mirror Interests on the startup day with a fixed principal amount equal to the unpaid principal balance ("UPB") of the mortgage loans as of the startup day, an interest rate equal to the pass-through rate of the related MBS (plus, in some cases, a portion of the guaranty fee) and a maturity date no earlier than 3 years following the latest maturity date of any mortgage loan held by the REMIC as of its startup day. In addition, (i) the Subordinate Regular Interest will be issued on the startup day of the issuing REMIC with a fixed principal amount as of the startup day, and an interest payment based on a fixed rate or permitted variable rate of interest on the outstanding balance of the Subordinate Regular Interest and (ii) the Interest-Only Regular Interest will be issued on the startup day of the issuing REMIC and will receive a specified portion of the excess interest on the mortgage loans held by the REMIC.

It is possible that the Subordinate Regular Interests and Interest-Only Regular Interests may not provide enough interest to pay the full coupon on the CAS REMIC Notes. In that event, Fannie Mae may be obligated to pay such excess outside of any REMIC, as is frequently done in private label mortgage securitization transactions that pay basis risk shortfalls.[49]

(iii) Unconditional Entitlement to Specified Principal Amount

A regular interest must *unconditionally* entitle the holder to receive a specified principal amount. Although this requirement generally prohibits contingent principal amounts, the REMIC rules provide an exception for shortfalls of principal payments resulting from defaults on qualified mortgages and permitted investments, *unanticipated* expenses incurred by the REMIC or *lower than expected* returns on permitted investments.[50] The specific mention of *unanticipated* and *lower than expected* to describe the types of expenses and returns on permitted investments that are principal payment contingencies that are allowable under the REMIC rules indicates that credit loss contingencies on qualified mortgages are permitted whether or not they are expected or anticipated. This standard makes sense as it would be nearly impossible to anticipate the exact amount of credit losses that a pool of mortgage loans will incur.

The REMIC regulations further provide that a subordinated interest can "bear[ ] all, or a disproportionate share, of the losses stemming from cash flow shortfalls due to defaults or delinquencies on qualified mortgages . . . before other regular interests or the residual interest bear [such] losses."[51] This portion of the regulations makes at least two points:

first, a subordinated interest can bear a disproportionate share of credit losses; second, the share of credit loss shared by the subordinated loss cannot exceed the actual amount of credit losses.[52]

By way of background, we note that this aspect of the REMIC regulations reflects statements in the legislative history regarding senior/subordinate structures. The Conference Report to the legislation that added the REMIC provisions to the Code states:

> The conferees intend that an interest in a REMIC would not fail to be treated as a regular interest if the payments of principal (or similar) amounts with respect to such interest are subordinated to payments on other regular interest in the REMIC, and are dependent upon the absence of defaults on qualified mortgages. Thus, the conferees intend that regular interests in a REMIC may resemble the types of interests described in Treas. Reg. sec. 301.7701-4(c)(2)(Example 2).[53]

Example 2 of Treas. Reg. § 301.7701-4(c)(2) illustrates an arrangement in which multiple classes of beneficial ownership in a state law trust do not preclude treating the arrangement as a trust for federal income tax purposes. In short, the trust in the example holds a pool of mortgage loans and issues two classes of interests, class C and class D. Holders of class C certificates are entitled to receive 90 percent of the payments of principal and interest on the mortgages; class D certificate holders are entitled to receive the other ten percent. The two classes of certificates are identical except that, in the event of a default on the underlying mortgages, the payment rights of class D certificate holders are subordinated to the rights of class C certificate holders. The example concludes that the existence of multiple classes of ownership interests is incidental to the trust's purpose of facilitating direct investment in the assets of the trust.

In the example, class D suffers the actual amount of any loss, and any allocation of loss to class D does not increase the entitlement to class C. This same result would be required by the REMIC provisions if the trust in the Example were structured as a REMIC, regardless of whether class C or class D is issued as a regular interest or even if both of them are issued as regular interests.

Finally, we note that the REMIC rules contemplate that a REMIC's residual interest might not be entitled to any cash flow, meaning that a REMIC could be fully leveraged. Accordingly, the REMIC rules contemplate REMICs with credit losses on qualified mortgages that leave only the regular interest holder in a non-guaranteed transaction to bear the losses on such qualified mortgages.

Here, the Mirror Interests will have a fixed principal amount equal to the UPB of the mortgage loans as of the startup day. Also, the Subordinate Regular Interest will be issued with a fixed amount of principal. The principal amount of the Subordinate Regular Interest will not be repaid to the extent of covered credit losses, which will result in a write-down of the balance of the Subordinate Regular Interest. However, as discussed above, the REMIC rules permit a REMIC to fail to pay principal on a REMIC interest due to credit losses on the REMIC's qualified mortgages (as long as the amount of principal not paid on the regular interest doesn't exceed the amount of the credit losses on the qualified mortgages) without jeopardizing the status of the interest as a regular interest.

We note that, although the CAS REMIC structure will involve a Mirror Interest being issued in respect of each underlying mortgage loan and a single Subordinate Regular Interest being issued to absorb credit losses, the total losses allocated to the Subordinate Regular Interest are simply an aggregation of the losses that would have been permitted had each mortgage loan been included in a separate REMIC along with its own subordinate interest perfectly sized for the credit risk of that mortgage loan. Thus, as a theoretical matter, the same amount of aggregate losses potentially allocable to the Subordinate Regular Interest could be replicated by the issuance of a separate REMIC for each mortgage loan (that is, a loss allocation structure similar to that of Example 2 of Treas. Reg. § 301.7701-4(c)(2) for each mortgage loan).

As a result, the failure by a REMIC to make principal payments on the Subordinate Regular Interest due to covered credit losses with respect to qualified mortgages held by such REMIC will not cause the Subordinate Regular Interest to fail to unconditionally entitle the holder to receive a specified principal amount, provided the amount of such principal not paid as a result of credit losses doesn't exceed the actual amount of such credit losses. Likewise, the failure of a REMIC to make principal payments on the CAS REMIC Notes due to write-downs of Subordinate Regular Interests (and to the extent of such write-downs) will not cause the CAS REMIC Notes to fail to unconditionally entitle the holders of the CAS REMIC Notes to receive a specified principal amount.

(iv) Interest Payments

Here, the Mirror Interests will receive interest payments at a rate equal to the related MBS pass-through rate (plus, in some cases, a portion of the guaranty fee), the Subordinate Regular Interest will receive interest payments at a rate equal to a fixed or permitted variable rate and the Interest-Only Regular Interest will receive a specified portion of the excess interest payable on the mortgage loans held by the REMIC. As noted above, a portion of the coupon payable to holders of CAS REMIC Notes may be paid outside of the REMIC as a basis risk shortfall.

(a) *Interest-Only Regular Interest*

Interest-only regular interests issued by a REMIC generally must consist of a specified portion of the interest payments on qualified mortgages held by the REMIC.[54] For this purpose, a specified portion of the interest payments on qualified mortgages includes a portion of the interest payable on qualified mortgages if the portion can be expressed as either a fixed number of basis points of the interest payable on some or all of the qualified mortgages or the interest payable at a permitted variable rate on some or all of the qualified mortgages in excess of another permitted variable rate.[55]

Here, the interest payments of the Interest-Only Regular Interest could be expressed as the portion of the interest payable on qualified mortgages at a fixed number of basis points. Alternatively, the interest strip could be expressed as interest payable on the qualified mortgages at a rate equal to (i) the weighted average gross rate of the qualified mortgages over (ii) the weighted average gross rate of the qualified mortgages minus the same fixed number of basis points.[56]

(b) *LIBOR Based Payments*

The CAS REMIC Notes will bear interest based on LIBOR. Permitted variable rates for regular interests include a "qualified floating rate" as defined in Treasury Regulation § 1.1275-5(b)(1) (but without the application of paragraph (b)(2) or (3) of that section) set at a current value, as defined in Treasury Regulation § 1.1275-5(a)(4). The REMIC regulations also permit a constant number of basis points to be added to such a rate. Accordingly, the portions of the interest rates of the CAS REMIC Notes payable from the REMIC will qualify as permitted variable rates.

(v) Certain Other Payment Contingencies

As noted above, the payments on the Subordinate Regular Interests will be made, in part, from amounts in the Reserve Funds and earnings thereon. Accordingly, the payment of principal and interest on the Subordinate Regular Interests, the Interest-Only Regular Interests and the CAS REMIC Notes could be affected by defaults or delinquencies with respect to any investments held in the Reserve Funds.

The REMIC regulations provide that an interest will not fail to qualify as a regular interest solely because the amount or timing of payments of principal or interest (or other similar amounts) with respect to the such interest is subject to a contingency where there is only a remote likelihood that such contingency will occur.[57]

Also, the REMIC rules provide that an interest will not fail to qualify as a REMIC regular interest solely because the amount of payments of principal or interest is affected by defaults on qualified mortgages and *permitted investments*.[58] As a result, so long as the investments held by the Reserve Fund are treated as reserve fund assets or as cash-flow investments (both of which are permitted investments), the failure to pay principal on the Subordinate Regular Interest resulting from a default by the issuer of any such investment would not cause a REMIC to fail to satisfy the requirements applicable to regular interests.

Similarly, if Fannie Mae were unable to invest the amounts in the Reserve Funds in interest-bearing assets earning a rate of interest expected as of date the CAS REMIC Notes are issued, the REMICs should still satisfy the Interests Test even though the Reserve Funds might not produce enough interest to pay the full interest payments on the Subordinate Regular Interests (and in turn on the CAS REMIC Notes). As mentioned above, an interest does not fail to qualify as a regular interest solely because *the amount* or the timing of *payments of principal or interest* (or other similar amounts) with respect to a regular interest is affected by . . . *lower than expected returns on permitted investments*.[59] As a result, if the returns on the investments of the Reserve Fund amounts were less than expected, the REMICs should still satisfy the Interests Test.

8. Residual Interest

A residual interest is an interest in a REMIC that is issued on the startup day, is not a regular interest and is designated as a residual interest.[60] A REMIC designates an interest as a residual interest by attaching to the REMIC's tax return for its first taxable year information concerning certain terms and conditions of the residual interests.[61] A residual interest is not required to have any particular economic characteristics or entitle its holder to any distributions from the REMIC.[62]

Here, an interest in each REMIC will be properly designated as a residual interest. Fannie Mae will hold each residual interest in each REMIC formed under the proposed structure. It will do so in its corporate capacity, separate and apart from any MBS trust. Thus, Fannie Mae's ownership of the residual interests will not have any impact on MBS holders. As holder of the residual interest, Fannie Mae will receive any amount remaining in any related REMIC.

9. Credit Enhancer's Rights

As discussed above, Fannie Mae will guarantee payments due on the Mirror Interests and can recover from a Reserve Fund certain amounts, including advances made by Fannie Mae, in respect of credit losses with respect to qualified mortgages held by the related REMIC. The REMIC regulations provide that a credit enhancer's right to be reimbursed for amounts advanced to a REMIC pursuant to the terms of a credit enhancement contract is not an interest in the REMIC even if the credit enhancer is entitled to receive interest on the amounts advanced.[63] Thus, the REMIC rules contemplate that a credit enhancer can recover amounts it has advanced under credit enhancement contracts from a REMIC.

Also, Fannie Mae may withdraw from any of the REMICs an amount to compensate it for providing its guaranty. The right to receive from the REMIC payments that represent reasonable compensation for services provided to the REMIC in the ordinary course of its operation is not an interest in the REMIC.[64]

Under these circumstances, Fannie Mae's right to be reimbursed for amounts advanced under its guaranty and its right to compensation for providing its guaranty should not be treated as an interest in any REMIC.

V. Implementation of Proposed REMIC Structure

As illustrated by the foregoing list of topics, the proposed CAS REMIC structure requires analysis of a number of the REMIC provisions, but none is problematic. An actual transaction will require documentation related to the structure that addresses all the applicable REMIC provisions. Preparing this documentation will require addressing issues such as the timing for making a REMIC election, given that MBS are issued much more frequently than CAS notes, the sizing, funding and investment of the Reserve Funds, and expressing the interest rates of the CAS REMIC Notes in a manner that complies with the REMIC provisions. As is the case with most REMIC structures, the flexibility of the REMIC rules will afford the opportunity to consider different approaches to reaching the desired result.

We believe that, in the context of an actual transaction and taking into account the assumptions and expectations described herein, we could deliver an opinion that:

1. Each pool of assets for which a REMIC election will be made will qualify as a REMIC.

2. Each CAS REMIC Note will represent ownership of a REMIC regular interest.

3. Each CAS REMIC Note will represent a "real estate asset" (as defined in Section 856(c)(5)(B)) and the interest income will be considered interest on obligations secured by mortgages on real property within the meaning of Section 856(c)(3)(B), provided that the underlying mortgage loans represent "real estate assets."

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4. No withholding tax will apply to a non-U.S. person that holds a CAS REMIC Note.

5. A non-U.S. person that holds a CAS REMIC Note will not be subject to U.S. income tax solely because it holds such note.

6. A CAS REMIC Note will not be a "United States real property interest," and thus the income and gains thereon will not be taxable pursuant to the provisions of the Foreign Investment in Real Property Tax Act ("FIRPTA").

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[1] The content of this memorandum is intended to be the same as that of the memorandum provided to Fannie Mae on April 29, 2018, by Will Cejudo, then a partner of Clifford Chance US LLP and now a partner at Dechert LLP. Any differences from the earlier memorandum are merely stylistic and do not affect the analysis provided in the earlier memorandum.

[2] In Revenue Ruling 84-10, the IRS ruled that MBS represent beneficial interests in a trust holding mortgage loans and related assets and are taxed under the grantor trust rules as ownership interests in the underlying mortgage loans and related assets.

[3] Note that, although the Subordinate Regular Interest and the Interest-Only Regular Interest will be issued in uncertificated form, it is expected that a register will be maintained and that transfers of the Subordinate Regular Interest and the Interest-Only Regular Interest will be permitted. This will facilitate any REMIC structuring required to form the REMIC regular interests to be evidenced by the CAS REMIC Notes.

[4] Note that Fannie Mae Mega certificates, which represent beneficial ownership interests in a grantor trust, can be backed in whole or in part by Fannie Mae REMIC certificates. Thus, this tax construct already exists, albeit on a smaller scale.

[5] Section 860B.

[6] Section 856(c)(5)(E).

[7] Id.

[8] Id.

[9] An example may help with the understanding of this point. Assume that the Fannie Mae guaranty fee is 50bps. Under the current tax treatment of MBS, a holder would be required to include the 50 bps in income and would be permitted to deduct the same 50 bps to the extent permitted by Section 162 or 212. Now assume that, under the proposed CAS REMIC structure, one half of the 50 bps is used to make payments on the Interest-Only Regular Interest. In this case, the 25 bps payable to the Interest-Only Regular Interest would no longer be reported as an expense of the MBS trust and would no longer be reported as income to the MBS holder.

[10] See Treas. Reg. §§ 301.7701(i)-1(g)(2) and 301.7701(i)-2(b).

[11] See Treas. Reg. § 301.7701-4(c)(2) Example (4) (bond stripping itself will not cause a trust to fail to be an "investment" trust).

[12] However, a failure of the proposed CAS REMIC structure could implicate the information reporting to MBS investors regarding expenses, which likely would affect individuals holding MBS outside of a tax-favored account.

[13] Treas. Reg. §§ 1.860D-1(d)(1) and 1.860F-4(c).

[14] Treas. Reg. § 1.860F-4(c)(1)("Thus, the return of a REMIC that is a corporation or trust under applicable State law must be signed by a corporate officer or a trustee, respectively. The return of a REMIC that consists of a segregated pool of assets must be signed by a person who could sign the return of the entity that owns the assets of the REMIC under applicable State law.").

[15] Treas. Reg. § 1.860D-1(c)(3).

[16] Treas. Reg. § 1.860D-1(c)(1).

[17] Section 860D(a)(4). The asset test must be met by the end of the third month following the startup day.

[18] Section 860G(a)(3).

[19] See Section 860G(a)(3)(A).

[20] See Treas. Reg. § 1.860G-2(a)(5) ("Obligations secured by interests in real property include . . . investment trust interests that represent undivided beneficial ownership in a pool of obligations principally secured by interests in real property and related assets that would be considered to be permitted investments if the investment trust were a REMIC, and provided the investment trust is classified as a trust under § 301.7701-4(c) of this chapter . . . .").

[21] See Section 860G(a)(3)(C).

[22] Note that, under Section 860F(a)(2)(A)(i), the substitution of qualified mortgage for a qualified replacement mortgage does not give rise to a prohibited transaction.

[23] See Sections 860G(e)(4) and (5).

[24] Joint Committee on Taxation, Description of the Technical Correction Act of 1988 (H.R. 4333 and S. 2238), JCS-10-88, at 89 (March 31, 1988).

[25] Id.

[26] See Treas. Reg. § 1.860G-2(c)(2).

[27] Treas. Reg. § 1.860G-2(c)(1).

[28] See Treas. Reg. § 1.860G-2(c)(4).

[29] Treas. Reg. § 1.860G-2(c)(4) ("Any deferred payments are payments pursuant to a credit enhancement contract even if the mortgage is foreclosed upon and the guarantor, *pursuant to subrogation rights set out in the guarantee arrangement*, is entitled to receive immediately the proceeds of the foreclosure.") (emphasis added).

[30] Treas. Reg. § 1.860D-1(b)(2)(iii).

[31] Section 860G(a)(7).

[32] Treas. Reg. § 1.860G-2(g)(3)(i).

[33] In determining whether a taxpayer is a trader or an investor for purposes of determining whether expenses and losses are incurred in a trade or business of trading securities, the Tax Court has developed a two-part test that must be satisfied in order for a taxpayer to be a trader: (1) the taxpayer's trading must be substantial and (2) the taxpayer must seek to catch the swings in the daily market movements, and to profit from short-term changes, rather than profit from long-term holding of investments. See Chen v. Comm'r, 87 T.C.M. (CCH) 1388 (2004); Mayer v. Comm'r, 67 T.C.M. (CCH) 2949 (1994).

[34] Treas. Reg. § 1.860G-2(g)(3)(ii).

[35] Id.

[36] Treas. Reg. § 1.860G-2(g)(3)(ii)(A). Although there is a presumption that a reserve is reasonably required if it does not exceed the amount required by a third party insurer or guarantor, who does not

own an interest in the REMIC, as a condition of providing credit enhancement, here Fannie Mae will own an interest in the REMIC and therefore this presumption is inapplicable.

37 In the rules relating to arbitrage restrictions applicable to tax-exempt bonds, a state or local bond is not treated as an arbitrage bond solely because part of the proceeds of the issue of which the bond is a part is invested in higher yielding investments if such investment is part of a "reasonably required reserve or replacement fund" of the issuer of the tax-exempt bonds, a concept similar to the reasonably required qualified reserve fund in the REMIC rules. See Section 148(d); Treas. Reg. § 1.148-2(f). Under those rules, to qualify as a "reasonably required reserve or replacement fund" such fund generally cannot exceed 10% of the stated principal amount of the related bonds. Here, the Reserve Funds are expected to be sized in amounts significantly less than the 10% standard set forth in the tax-exempt bond arbitrage rules.

38 Federal Housing Finance Agency, "Overview of Fannie Mae and Freddie Mac Credit Risk Transfer Transactions" (August 21, 2015), p. 4 (hereinafter, the "FHFA Report"). The FHFA Report is available at http://www.fhfa.gov/AboutUs/Reports/Pages/Overview-of-Fannie-Mae-and-Freddie-Mac-Credit-Risk-Transfer-Transactions-8212015.aspx.

39 Id.

40 Section 860G(a)(8) and § 856(e).

41 Section 856(e)(2).

42 Section 860G(a)(8) and Section 856(e)(4).

43 Section 860G(a)(8) (providing that solely for purposes of Section 860D(a), which includes the REMIC asset test, the determination of whether any property is foreclosure property shall be made without regard to Section 856(e)(4)).

44 See Treas. Reg. § 1.856-6(b)(3).

45 See e.g., Priv. Let. Rul. 9630004 (Apr. 11, 1996) ("[T]he type of default that is relevant for purposes of section 1.856-6(b)(3) of the regulations is the type of default that ordinarily leads to foreclosure. The mere fact that a payment is delinquent or a minor covenant to a loan agreement is breached may be insufficient to cause a loan to fail the improper knowledge test.").

46 A qualified variable rate includes a rate based on the weighted average of the net interest rates of the qualified mortgages held by the REMIC, provided that all of the qualified mortgages taken into account in computing such weighted average rate bear interest at either a fixed or qualified variable rate. A weighted average rate includes a rate determined by taking a weighted average of the interest rates on the qualified mortgages held by the REMIC, net of any servicing spread, credit enhancement fees or other expenses of the REMIC. Treas. Reg. § 1.860G-1(a)(3)(ii).

47 Section 860G(a)(1).

[48] See Treas. Reg. §§ 1.860G-1(a)(1); 1.860D-1(d)(2).

[49] See Treas. § 1.860G-2(i).

[50] Treas. Reg. § 1.860G-1(b)(3)(ii) (emphasis added). See Treas. Reg. § 1.860G-1(b)(3) for other types of permitted contingencies.

[51] Treas. Reg. § 1.860G-1(b)(3).

[52] Accordingly, any attempt to allocate to a regular interest an amount greater than such losses would run afoul of this provision, because the regular interest wouldn't simply bear all of the loss or even a disproportionate share of the loss. So, this provision couldn't be used to allocate an amount greater than the amount of losses for the benefit of a residual interest, because this provision applies whether the senior class is a regular interest or a residual interest. Also, if the senior interest were a regular interest, it couldn't benefit from the REMIC having allocated to the subordinate an amount greater than the amount of actual losses (for example, by receiving an amount greater than its stated principal balance when issued), as this would cause the senior interest to have a contingent principal balance. In the end, the REMIC regulations permit the amount of losses to be allocated among regular interests but only to the extent of such losses.

[53] H. Rept. 99-841 at 228 (H.R. 3838, (99th Congress, Public Law 99-514) (September 18, 1986) (herein, the "Conference Report").

[54] See Section 860G(a)(1)(B)(ii).

[55] See Treas. Reg. § 1.860G-1(a)(2)(v).

[56] A rate based on a weighted average of the interest rates on some or all of the qualified mortgages held by a REMIC is a variable rate. Treas. Reg. § 1.860G-1(a)(3)(ii)(A). The qualified mortgages taken into account must, however, bear interest at a fixed rate or at a permitted variable rate. Id. Further, a permitted weighted average rate can be reduced by a fixed number of basis points. Treas. Reg. § 1.860G-1(a)(3)(iii)(B). Note that the calculation of a permitted weighted average interest rate cannot take into account earnings on qualified reserve assets.

[57] Treas. Reg. § 1.860G-1(b)(3)(vi).

[58] Id. Note that by referring to permitted investments, rather than merely cash-flow investments, this regulation indicates that a regular interest can fail to be paid principal if a qualified reserve asset defaults and therefore contemplates that a regular interest can be payable from amounts in a reserve fund.

[59] Treas. Reg. § 1.860G-1(b)(3)(ii). In defining "credit enhancement contracts" and a "qualified reserve fund" the Regulations, in contrast, refer to protecting against "lower than expected returns on *cash flow investments*" indicating that the failure to invest the full amount of the Reserve Fund in interest-bearing assets wouldn't cause the REMIC to fail to meet the Interests Test. See Treas. Reg. §§ 1.860G-2(c)(2)

and (g)(2). However, Fannie Mae could not make up the shortfall under the rules for credit enhancement contracts. See Treas. Reg. § 1.860G-2(c)(2).

60 Section 860G(a)(2); Treas. Reg. § 1.860G-1(c).

61 Treas. Reg. §§ 1.860G-1(c) and 1.860D-1(d)(2).

62 Treas. Reg. § 1.860G-1(c).

63 Treas. Reg. § 1.860D-1(b)(2)(iii).

64 Treas. Reg. § 1.860D-1(b)(2)(i).