[JOINT COMMITTEE PRINT]

DESCRIPTION OF S. 1822 (RELATING TO TRUSTS FOR INVESTMENTS IN MORTGAGES)

SCHEDULED FOR A HEARING

BEFORE THE

SENATE COMMITTEE ON FINANCE

ON NOVEMBER 4, 1983

PREPARED BY THE STAFF

OF THE

JOINT COMMITTEE ON TAXATION

NOVEMBER 3, 1983

U.S. GOVERNMENT PRINTING OFFICE

26-679 O WASHINGTON : 1983 JCS-55-83

Congress of the United States
JOINT COMMITTEE ON TAXATION
Washington, D.C. 20515

ERRATA SHEET FOR JCS-55-83
(November 3, 1983)

(1) On page 3, the first sentence of the paragraph headed, "Rules for classifying entities as corporations," should read as follows:

"Under the Internal Revenue Code, an unincorporated entity is generally classified as an "association," which is taxable as a corporation if it more nearly resembles a corporation than an unincorporated entity." (The underlined word is the corrected word.)

(2) On page 4, in the third paragraph headed "Partnerships", the first sentence should read as follows:

"A form of indirect ownership is through ownership of an interest in a partnership." (The underlined word is the corrected word.)

(3) On page 5, the second phrase in the last sentence in the first paragraph headed "Real estate investment trusts," should read as follows:

"; income that is not currently distributed to shareholders is taxed at the REIT level as in the case of normal corporations." (The word "also" should be deleted.

(4) On page 7, the last sentence in the first paragraph headed, "**Corporate obligations**," should read as follows:

"Interest income and expense are lower in earlier years under the constant interest rate method compared to the straight-line method." (The word underlined is the corrected word.

(5) On page 7, the last sentence in the second paragraph headed "**Obligations issued by natural persons**," should read as follows:

"Discount on debt obligations issued by natural persons is taken into income by cash basis taxpayers proportionately as principal is paid." (The word "not" should be deleted.)

CONTENTS

INTRODUCTION

This pamphlet provides a description of S. 1822 (introduced by Senators Garn and Tower) relating to "trusts for investments in mortgages," which is scheduled for a public hearing on November 4, 1983, by the Senate Committee on Finance.

The first part of the pamphlet provides an overview of present law. The second part contains a brief discussion of the issues raised by S. 1822. The third part provides a description of S. 1822.

I. PRESENT LAW

Overview

Taxation of alternative methods of owning income-producing assets.—Under present law, income-producing assets (such as mortgages on residential property) can be owned directly, or they can be owned indirectly by means of an equity interest in an intermediary entity. Income generated by property that is owned directly is generally taxed to the owner of the property and, thus, is subject to only one level of taxation. Income from property owned indirectly is subject to one or two levels of taxation depending on whether the intermediary entity is treated for tax purposes (1) as a separate taxable entity (such as a corporation or an association taxable as a corporation), (2) as a complete conduit entity (such as a partnership or S corporation), or (3) as a partial conduit entity (such as a trust or real estate investment trust) under which income is not taxed to the entity to the extent it is currently distributed to the entity's owners.

Also, under present law, interest on debt used to finance the acquisition of income-producing assets generally is deductible to the person incurring the debt. To the extent that a person providing capital in the form of debt (i.e., a debt holder) can be viewed as an owner of the income-producing assets, the deduction for interest insures that there is only one level of taxation on any income from those assets that is paid to that debt holder.

Rules for classifying entities as corporations.—Under the Internal Revenue Code, an unincorporated entity is generally classified as an "association," which is taxable as a corporation if it more nearly resembles a corporation or an unincorporated entity. For these purposes, an unincorporated entity is not classified as an association and treated as a corporation for tax purposes unless such organization has more corporate characteristics than noncorporate characteristics not taking into account characteristics common to both corporations and the unincorporated entity.[1] The standards for determining the classification of an entity are set forth in Treasury Regulations under section 7701. Under these regulations, there are a number of principal characteristics which generally distinguish corporations from other entities. These characteristics are: (1) associates, (2) an objective to carry on business, (3) continuity of life, (4) centralization of management, (5) limited liability, and (6) free transferability of interests (Treas. Reg. sec. 301.7701-2(a)(1)).

[1] See also *Morrisey et al v. Commissioner*, 296 U.S. 344 (1935), *Arthur B. Kintner* v. *United States*, 216 F.2d 418 (9th Cir. 1954); and *Glensder Textile Co.*, 46 B.T.A. 176 (1942).

Indirect Ownership Entities

Separate taxable entities

Corporations.—One form of indirect ownership of property is the ownership of stock in a corporation that owns the property. Corporations can be used to hold investment property or to engage in the active conduct of a trade or business.

Corporations are treated for tax purposes as separate taxable entities, apart from their shareholders. Thus, income earned by a corporation is taxed to the corporation. In addition, when the after-tax earnings of a corporation are distributed to the corporation's stockholders as dividends, such earnings are also taxed to the stockholders.[2]

Complete conduit entities

Partnerships.—A form of indirect ownership is through ownership in an interest in a partnership. For tax purposes, a partnership is an unincorporated organization through, or by means of which, any business, financial operation or venture is carried on, and which is not a corporation, a trust or an estate under the Code. For tax purposes, a partnership is generally treated as a complete conduit for tax purposes.[3] Each partner includes in income his "distributive share" of the partnership's taxable income, deduction, and credit. The liability for income tax is that of the partner, and not of the partnership without regard to whether the income of the partnership is actually distributed to the partners. Similarly, partnership losses, deductions, and credits pass through to the partners and can be used to offset other income.

S Corporations.—Another form of indirect ownership of property is ownership of stock in an S corporation. Although S corporations are corporate entities, S corporations are generally treated for tax purposes as complete conduits (i.e., the income of the S corporation is includible in the taxable income of its shareholders).[4]

In order to qualify for S corporation treatment, a corporation must be a "small business corporation." For these purposes the term "small business corporation" is defined as a domestic corporation which is not an "ineligible corporation" and which does not have (1) more than one class of stock, and (2) more than 35 shareholders. In addition, for a corporation to qualify as an S corporation, none of its shareholders can be corporations or nonresident aliens. The term "ineligible corporation" refers to any corporation which is (1) a member of an affiliated group, (2) a financial institution to which section 585 or 593 applies, (3) an insurance company subject to tax under subchapter L, (4) a 936 corporation, or (5) a DISC or former DISC.

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[2] An individual is generally allowed to exclude from taxable income up to $100 of dividends per year (sec. 116). Corporations are entitled to a dividends received deduction for 85 or 100 percent of dividends received each year (secs. 243-245).

[3] A partnership is treated as an entity separate from its partners for purposes of calculating taxable income, deduction, and credit. It also is treated as an entity for purposes of reporting information to the Internal Revenue Service.

[4] An S corporation may be subject to tax at the entity level under certain limited circumstances.

Partial conduit entities

Real estate investment trusts.—Another form of indirect ownership is the ownership of shares or interests in a real estate investment trust ("REIT").[5] Under the provisions of the Code applicable to REITs (secs. 856-859 and sec. 860), REITs generally are treated, in substance, as conduits for tax purposes. Conduit treatment is achieved by allowing the REIT a deduction for earnings distributed on a current basis. Thus, income that is currently distributed to shareholders is not taxed at the REIT level; income that is not currently distributed to shareholders also is taxed at the REIT level as in the case of normal corporations.

A corporation, or an unincorporated trust or association that would be treated as a corporation for tax purposes, can qualify as a REIT if: (1) it is managed by one or more trustees or directors; (2) beneficial ownership is evidenced by transferable shares, or by transferable certificates of beneficial interest, held by 100 or more persons; (3) it is neither a financial institution or an insurance company; (4) it would not be a personal holding company (as defined in sec. 542) if all of its adjusted ordinary gross income (as defined in section 543(b)(2)) were personal holding company income (as defined in sec. 543); (5) it meets certain income and asset tests, described below; and (6) it meets a distribution requirement, described below.

Under the income tests, at least 75 percent of a REIT's income must be derived from (1) rents from real property, (2) interest on obligations secured by real property, (3) gain from the sale or other disposition of real property (or interests therein, including mortgages), (4) distributions from other REITs, (5) gain from the disposition of shares of other REITs, (6) abatements or refunds of taxes on real property, and (7) income and gain on property which qualifies as foreclosure property. Further, at least 95 percent of the REIT's income must be derived from these sources, and from other interest, dividends, or gains from the sale of stock or securities. Finally, under the income tests, income from the sale or other disposition of stock or securities held for less than 1 year, or real property held less than 4 years, must account for less than 30 percent of the REIT's income.[6]

A REIT satisfies the asset tests if, at the close of each quarter of its taxable year, at least 75 percent of the value of its assets is represented by real estate, cash and cash items (including receivables), and government securities. Further, the REIT's investments must meet certain diversification requirements.

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[5] Another form of indirect ownership is the ownership of shares in a regulated investment company ("RIC"). RICs issue shares to investors and invest the proceeds in a diversified portfolio of securities. As in the case of a REIT, RICs are generally treated as conduits for tax purposes. (i.e., RICs are allowed a deduction for earnings distributed to shareholders.) It is understood that RICs cannot be used for pooling mortgages and issuing mortgage-backed securities because the requirements for qualification as a RIC under section 851 cross reference to investment companies registered under the Investment Company Act of 1940, or to common trust funds excluded under section 3(c)(3) of such Act, and mortgage vehicles are exempt from registration pursuant to section 3(a)(5) of that Act.

[6] For purposes of the income test, gross income does not include income from "prohibited transactions," which is subject to a 100-percent tax. Generally, the term "prohibited transaction" means a sale or other disposition of property described in section 1221(1) (other than foreclosure property). However, under certain circumstances, the sale of a real estate asset which has been held for at least 4 years is not a prohibited transaction.

Finally, a REIT satisfies the distribution requirement if it distributes at least 95 percent of its ordinary income on a current basis.[7]

Trusts.—Another form of indirect ownership of property is to own the beneficial interest of property that is held in a trust. A trust is an arrangement whereby trustees take title to property and become responsible for the protection and conservation of such property on behalf of the persons holding the beneficial interest in the property. A trust is treated as a partial conduit for tax purposes. This partial conduit treatment is achieved by allowing trusts a deduction the amounts distributed to its beneficiaries.

A fixed investment trust is a trust used to hold a diversified portfolio of investments for its beneficiaries. Such a trust will be treated as a trust for tax purposes (and not as an association) if the trustee does not have the power to vary the investments of the trust.[8]

Direct ownership entities

Grantor trusts.—A grantor trust is an arrangement under which legal title to property is transferred to a trustee but the transferor retains certain powers over, or interests in, the trust so that the transferors are treated as retaining direct ownership of such property for tax purposes (Code secs. 671-679). Thus, income deductions and credits of the grantor trust are attributed directly to the grantors. In some cases, persons other than the transferor are treated as owners of the trust's assets.

Tax Treatment of Discount

In general

Under present law, different rules apply to the taxation of original issue discount and market discount on debt obligations. Generally, original issue discount ("OID") is the spread between the issue price and the redemption price of a debt obligation that is issued for less than its redemption price. Market discount is the spread between the purchase price paid to a holder of a debt obligation on the sale of the debt obligation and the original issue price of the debt obligation. Generally, market discount arises from increases in the market interest rate over the rate of interest on the debt obligation at the time of issue.

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[7] A deficiency dividend procedure was added to the REIT provisions as part of the Tax Reform Act of 1976 so that a REIT that, acting in good faith, has failed to satisfy the distribution requirement, could avoid disqualification.

[8] The determination of whether an organization 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. If the trustees have the exclusive responsibility for the protection and conservation of the property, and the persons with the beneficial interest in the property cannot share in the discharge of that responsibility, there are no associates in a joint enterprise for the conduct of business for profit, and the organization will generally be treated as a trust. (Because centralization of management, continuity of life, free transferability of interests, and limited liability are common to both trusts and corporations, these characteristics are generally not taken into account). An arrangement is not treated as a trust for Federal income purposes if the role of the trustee is not limited to the protection and conservation of the trust corpus. Thus, if a trust is used for carrying on a profit-making business that would ordinarily be carried on through a business organization such as a corporation or partnership, it will not be treated as a trust. However, a trust that is used to hold income-producing assets may be treated as a trust if there is no power under the trust agreement to vary the investment (Treas. Reg. sec. 301.7701–4).

Corporate obligations

Under the code, OID on a corporate obligation, or on an obligation issued by a unincorporated issuer other than a natural person, is included in income by the holder of the obligation, and deducted by the issuer, using a constant instant rate method. Under this method, the interest income and expense are not recognized ratably over the term of the debt obligation, but instead are recognized when earned or incurred. Interest income and expense are higher in earlier years under the constant interest rate method [9] compared to the straight-line method.

Obligations issued by natural persons

To the extent that discount on debt obligations issued by natural persons is accrued by accrual basis taxpayers, it is accrued proportionately as principal is paid or is due. Discount on debt obligations issued by natural persons is not taken into income by cash basis taxpayers proportionately as principal is paid.

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[9] Under the constant interest rate formula, the OID is allocated over the life of the debt obligation through a series of adjustments to the issue price for each period of the debt obligation. The adjustment to the issue price for any period of the debt obligation is determined by multiplying the adjusted issue price (i.e., the issue price as increased by adjustments prior to the beginning of the period of the debt obligation) by the obligation's yield to maturity, and then by subtracting the interest payable during the period of the debt obligation. The adjustment to the issue price for any period of the debt obligation is the amount of the OID allocated to that period of the debt obligation.

II. ISSUES

The bill would create an additional type of entity for the indirect ownership of residential mortgages and interests in residential mortgages, to be known as a trust for investment in mortgages ("TIM"). Under present law, corporations, S corporations, partnerships, REITs, unit investment trusts, and grantor trusts can be used as vehicles for indirect investments in mortgages. Each of these, however, have the following disadvantages:

(1) Use of a corporation to pool mortgages would result in an entity level tax.[1]

(2) Prior to the recent revision of the Code provisions relating to such corporations, S corporations (referred to under prior law as subchapter S corporations) could not have passive investment income. Further, under present law, only individuals can acquire shares of S corporation stock and the maximum number of shareholders is limited to 35.

(3) State laws may restrict the acquistion by institutional investors of interests in limited partnerships.

(4) A REIT must have at least 100 shareholders.

(5) Interests in fixed investment trusts are not attractive investments because of the requirement that the trustee not have the power to vary investments. In addition, the character of the underlying assets as derived from real property may not flow through a trust (unless the trust is a grantor trust) which is important for certain tax benefits of REITs and thrift institutions.[2]

(6) The grantor trust format is subject to certain limitations. First, there can be no active management of the mortgages in the trust, and no reinvestment of regular installments of interest or early recoveries of principal or interest. Second, it is unclear whether beneficial interests in a trust can differ as to amount and as to kind. As a result, only one class of mortgage-backed securities can be issued by a pool using the grantor trust format.

The stated purpose of the TIM is to provide an indirect investment entity which does not have these disadvantages. However, the proposal raises a number of issues—

First, is it appropriate to create another conduit for investments in mortgages under the tax laws.

Second, is it appropriate to permit conduit treatment for a entity even though the managers of the assets held by the entity will

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[1] The corporate form has been used in a number of transactions where current corporate level tax has apparently been avoided by structuring the mortgage-backed securities as debt instruments for tax purposes and using the interest deduction to offset income at the corporate level.

[2] Interests in unit investment trusts would not be attractive investments for these institutions because (i) the interest income would not be considered "interest on obligations secured by mortgages on real property" for purposes of section 856(c)(3)(B); (ii) the certificates would not be considered "real estate assets" for purposes of section 856(c)(5)(A); and (iii) the certificates would not be considered as representing "loans secured by an interest in real property" within the meaning of section 7701(a)(19).

have investment discretion? Similarly, should conduit treatment be provided for a entity that can issue several classes of securities?

Third, should the amount of debt that a TIM can issue be limited?

Fourth, is the treatment of discount on residential mortgages proper under present law?

Fifth, should foreign investors in TIMs be treated as being engaged in a domestic trade or business?

Sixth, is it appropriate to exclude the Federal National Mortgage Association and the Federal Home Loan Mortgage Corporation from being eligible trustees of a TIM?

III. DESCRIPTION OF THE BILL

Explanation of Provisions

Qualification as a TIM

In general.—Under the bill, a TIM would be a corporation or trust the ownership of which is evidenced by one or more classes of transferable shares, which is not a bank, thrift institution, or insurance company, which elects to be treated as a TIM, and which meets gross income tests, an asset test, and certain stock ownership rules.

Gross income tests.—Under the bill, at least 75 percent of the TIM's gross income must be derived from qualified obligations; 95 percent must be derived from such obligations, cash, cash items (including receivables), and Government securities. For these purposes, gross income does not include income from certain transactions called prohibited transactions (described below). Also, under the income test, no more than 20 percent the amount of gross income can be derived from the disposition of stocks or securities held for less than 1 year or from prohibited transactions. No amount of gross income can be derived from the active conduct of a trade or business. Commitment fees and points in connection with any qualified obligation would not be treated as income from the active conduct of a trade or business unless such income is for services performed by the TIM. Special rules apply to newly formed TIMs and to TIMs in the process of liquidation.

Prohibited transactions.—Under the bill, prohibited transactions are transactions involving the disposition by a TIM of (1) any qualified obligation that it has held for less than 3 years, or (2) any qualified obligation which, in the hands of the trust, is property described in section 1221(1) (subject to exceptions for certain limited dispositions, and certain dispositions in connection with a liquidation of a TIM which has been a TIM for at least 3 taxable years prior to the disposition). Dispositions in connection with the prepayment, retirement, or renegotiation of a qualified obligation, or of defective obligations, foreclosure property or qualified short-term investments would not be prohibited transactions. Similarly, a disposition in connection with the involuntary liquidation or dissolution of a TIM would not be a prohibited transaction.

Asset test.—Under the asset test, at the close of each quarter of the taxable year, at least 85 percent of the TIM's total assets must consist of qualified obligations, cash, cash items (including receivables), and Government securities. Qualified obligations would include qualified first or second mortgages, qualified participations in such loans, cash flow mortgage-backed bonds secured by any qualified first or second mortgage, qualified repurchase agreements collaterized by such loans, shares of other TIMs, and qualified income investments.

A qualified first or second mortgage would be any first or second mortgage, whether or not insured, which is secured by a single-family residence which is the principal residence of the mortgagor, and is used to acquire, or to make a home improvement in connection with, such residence. The amount of any qualified mortgage is limited by reference to the fair market value of the residence. Construction loans would not be qualified first or second mortgages. Further, except as provided in Treasury Regulations, mortgages issued at a discount would not be qualified first or second mortgages.

Any participation in a mortgage or pool of mortgages would be a qualified participation if (1) the mortgages would be qualified first or second mortgages if held directly by the TIM, and (2) the mortgagees of the mortgages remain the primary obligors. A qualified repurchase obligation would be a first or second mortgage that is subject to a repurchase agreement with respect to which (1) the TIM purchases the mortgage for not more than fair market value, (2) any amount payable to the TIM does not exceed the payments due on the mortgage, and (3) the amount payable is fixed at the time of the agreement.

Qualified income investments would include any security, letter of credit, certificate of deposit, surety bond, or other similar instrument or device which (1) is acquired during the 18-month period beginning on the date the TIM is incorporated or formed and (2) is acquired to provide cash to meet fixed obligations of the TIM which cannot be met from investments in other qualified investments, or to provide income to the TIM to offset income which is lost by reason of the prepayment or liquidation of any qualified obligation prior to maturity. Qualified income investments do not include any investment after the earlier of (1) the date which is 7 years after a TIM is incorporated or formed or (2) in the case of a TIM with a fixed term, the date on which the first one-third of such term has expired.

Stock ownership rules.—A TIM would be permitted to issue multiple classes of stock or other equity interests, but only if (1) the outstanding indebtedness of the TIM is limited to 10 percent or less of the aggregate face amount of its assets and (2) the par value of such stock or other equity interest equals the aggregate of the qualified obligations held by the TIM.

Rules governing election as a TIM.—The bill provides special rules governing how the election to become a TIM is to be made, how the election may terminate or can be revoked, and how a TIM can re-elect after a prior termination or revocation.

Ineligible trustees

Under the bill, the Federal National Mortgage Association[1] and the Federal Home Loan Mortgage Corporation[2] would not be eligible trustees, directors, or shareholders of a TIM.

Tax Treatment of a TIM

Under the bill, the shareholders of the TIM would be taxable on the income of a TIM (under rules described below); the TIM would be exempt from Federal income tax. In order to determine the amount taxable to its shareholders, a TIM would be required to compute its taxable income. For this purpose, all TIMs would be on the cash method of accounting using a calendar year. Under the bill, the basis to a TIM of mortgages contributed for TIM stock would be the fair market value of such mortgages at the time of the transfer.

Under the bill, a penalty tax would be imposed on each prohibited transaction of a TIM. The amount of the tax would be 100 percent of the gain or loss allocable to the transaction.

Taxation of Shareholders

Under the bill, shareholders of a TIM would be treated as if the TIM were a partnership and the shareholders were partners.[3] If the proceeds from the disposition by a TIM of any qualified obligation are distributed to a shareholder, the portion of the distribution which is properly allocable to the principal amount of the obligation would be treated as received in redemption of the shareholder's shares and the character of the gain would pass through to the shareholders. However, any gain allocated to (1) a 20-percent shareholder who is a dealer in qualified obligations, or (2) a bank, thrift institution, or REIT, would be treated as ordinary income. If the proceeds from the disposition by a TIM of a qualified obligation are used by the TIM to acquire qualified obligations, each shareholder would be treated as having (1) received a distribution of the shareholder's pro rata share of such proceeds and (2) contributed such amount to the TIM in exchange for shares having a par value equal to the face amount of the acquired qualified obligations.

Under the bill, gain or loss would be recognized by a person transfering a qualified mortgage to a TIM to the extent such person's basis in such mortgage is greater (or less) than the fair market value of such mortgage. Such gain or loss would be ac-

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[1] The Federal National Mortgage Association (FNMA) is a Federally chartered private corporation that provides a secondary market for residential mortgages. FNMA was organized in 1938 as a corporation wholly owned by the Federal government. In 1954, it became a mixed-ownership corporation owned partly by private shareholders. In 1968, the original corporation was split by Congress into two entities—the Government National Mortgage Association and the Federally chartered private Federal National Mortgage Association. FNMA is subject to Federal income tax. Under the Miscellaneous Revenue Act of 1982 (Pub. L. 97–362), FNMA is allowed a 10-year carryback and a 5-year carryover for net operating losses (other than mortgage disposition losses) for any taxable year beginning after December 31, 1981. Under that legislation, FNMA is allowed a 3-year carryback and 15-year carryover for mortgage disposition losses.

[2] The Federal Home Loan Mortgage Corporation was chartered by the Congress in 1970 to provide a secondary market for residential mortgages originated by thrift institutions. It received its initial capital through the sale of stock to the twelve regional Federal Home Loan Banks, which are owned by privately-held savings and loan institutions. Pursuant to its charter, the Federal Home Loan Mortgage Corporation is exempt from Federal income taxes.

[3] The bill is unclear whether the special allocation rules (and other rules applicable to partnerships) would apply.

counted for ratably over the remaining term of the mortgage. If any loss recognized under this provision is an ordinary loss, subsequent gain from the sale or exchange of the taxpayer's interest in the TIM would be treated as ordinary income to the extent of the ordinary loss.

Effective Date

The bill would be effective on the date of enactment.

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