

Thomas P. Lemke, Esq.
November 12, 1986
Page Eight

(B) provides that interest payments (or other similar amounts), if any, at or before maturity are payable based on a fixed rate (or to the extent provided in regulations, at a variable rate).

An interest shall not fail to meet the requirements of subparagraph (A) merely because the timing (but not the amount) of the principal payments (or other similar amounts) may be contingent on the extent of prepayments on qualified mortgages and the amount of income from permitted investments.

A "REMIC" is any entity:

(1) to which an election to be treated as a REMIC applies for the taxable year and all prior taxable years,

(2) all of the interests in which are regular interests or residual interests,

(3) which has 1 (and only 1) class of residual interests (and all distributions, if any, with respect to such interests are pro rata),

(4) as of the close of the 4th month ending after the startup day and each quarter ending thereafter, substantially all of the assets of which consist of qualified mortgages and permitted investments, and

(5) which has a taxable year which is a calendar year.

REMIC status is governed by an election under new Section 860D(b) of the Code. The REMIC provisions apply to regular and residual interests issued after January 1, 1987. Assuming a proper election, Bonds issued after that time will clearly be regular interests under the Code and the REMIC Qualified Residual Interests associated therewith will clearly be residual interests.

B. REMIC Qualified Residual Interests

Clarification of the real estate-related asset status of residual interests under federal law and thereby REMIC Qualified Residual Interests occurs as the result of a change in Section 856(c)(6)(C) of the Code. Section 856(c)(6)(C) of the Code defines an "interest in real property" for the purposes of Part III, Subchapter M of the Code, regarding real estate investment trusts. To qualify as a real estate investment trust under the Code, an entity must at the close of each quarter of any taxable year have at least 75 percent of the value of its total assets represented by real estate assets (including interests in real property), cash and cash items (including receivables) or government securities. Subject to an exception not here relevant, Section 671(b)(1) of the TRA of 1986 modifies the definition of an interest in real property by inserting subparagraph (D) after said subparagraph (C). New subparagraph (D) states that:

A regular or residual interest in a REMIC shall be treated as an interest in real property, and any amount includible in gross income with respect to such an interest shall be treated as interest . . .

(Emphasis added.) The Conference Agreement for the TRA of 1986 confirms this characterization. It states that "[b]oth regular and residual interests are treated as real estate assets under section 856(c)(6). . . ." For the purposes of applying the asset test stated in Section 856(c)(5)(C) of the Code, the amount of the real estate investment trust's investment in the residual interest is the value allocable to such interest. In that regard, the Conference Agreement likewise states that: "[i]n the case of a residual interest, the fair market value of the residual interest, and not the fair market value of all of the REMIC's assets, is used in applying the asset test of Section 856(c)(5)."*

* As the test under Section 3(c)(5)(C) of the 1940 Act is basically also an asset test, we believe that Qualified Residual Interests should be evaluated under such section on essentially the same basis.

(Footnote continued)

Thomas P. Lemke, Esq.
November 12, 1986
Page Ten

Thus, as a result of the changes effectuated by the TRA of 1986, the Code undoubtedly permits a real estate investment trust to invest solely in residual interests that have qualified as REMICs. We believe that this recent expression of Congressional policy permitting a real estate investment trust to invest in REMIC residual interests is not frustrated by other federal laws, including Section 3(c)(5)(C) of the 1940 Act. Were one to conclude that REMIC residual interests were not "mortgages and other liens on and interests in real estate" (emphasis added), a real estate investment trust would be substantially inhibited in its ability to acquire REMIC residual interests. In such a case, the enactment into law by Congress of this crystallization of its policy regarding real estate related assets would not have the intended effect of decreasing the uncertainty with respect to investment in such assets. For this reason, we believe that REMIC Qualified Residual Interests should clearly be treated as such "interests in real estate" under Section 3(c)(5)(C) of the 1940 Act.

In further support of this proposition, we note that Congress' intent is reflected in at least three other changes to the Code made in the TRA of 1986. Section 671(b)(2) states that REMIC residual interests shall be treated as a "qualifying real property loans" for the purposes of Section 593 of the Code. Section 593 of the Code defines the method by which any mutual savings bank, domestic building and loan association or cooperative bank without capital stock may calculate its reserves for bad debts. Such reserves are used to calculate its bad debt deductions under Section 166 of the Code. Section 671(b)(3) states that REMIC residual interests shall be

(Footnote * continued from previous page)

Since Entities are by their nature fairly highly leveraged, we believe that it would be unfair to credit the REIT with the value of the Mortgage Loans or Mortgage Certificates owned by them rather than the net value of the REIT's investment in them in determining whether the REIT is "principally engaged" in permitted activities under Section 3(c)(5)(C) thereof.

Thomas P. Lemke, Esq.
November 12, 1986
Page Eleven

treated as qualifying properties for the purposes of Section 7701(a)(19) of the Code, which defines a domestic building and loan association for the purposes of the Code. Finally, Section 671(b)(4) of the TRA of 1986 amends Section 582(c) of the Code by providing that REMIC residual interests shall be treated as an evidence of indebtedness thereunder. Section 582 of the Code defines certain special rules applicable to banks regarding their deductions for bad debt losses under Section 166 of the Code. Without question, Congress has seen fit to state clearly and emphatically that REMIC residual interests for all purposes of the Code, and by implication for all purposes of federal law, are real estate-related assets.

C. Non-REMIC Qualified Residual Interests

With respect to Non-REMIC Qualified Residual Interests, we believe that such interests should also be treated as "mortgages and other liens on and interests in real estate," because there is no substantial difference between them and REMIC Qualified Residual Interests. In both cases, the pre-tax cash flow of a holder of such interests will be determined on the basis of the differences between principal and interest receipts on the Collateral over the sum of principal and interest payments on the Bonds plus other administrative expenses of the Entities. In both cases, federal income taxes will not be imposed on the Entities so that, all other variables being equal, after-tax cash flows to such holders will not differ.* Furthermore, in both cases, the Entities will be structured identically for state law purposes, although, in the case of Entities which issue Non-REMIC Qualified Residual Interests, certain provisions in their Entity Agreements which permit them to be treated as pass-through entities for federal income tax purposes need not be included in the Entity Agreements of Entities which issue REMIC Qualified Residual Interests. However, these provisions may be included for other reasons, such as for rating agency purposes or to insure prudent administration of the Entities by their "equity" holders. Lastly, in both cases, since the Entities only differ

* See footnote on page seven hereof.

Thomas P. Lemke, Esq.
November 12, 1986
Page Twelve

with respect to their election as to REMIC status under the federal income tax laws, the holders of interests in the Entities will have virtually identical rights in the Collateral held by the Entities and vis-a-vis holders of Bonds.

We believe that it would clearly contradict recent Congressional policy, which has been enacted into law, to conclude that Qualified Residual Interests, which are issued by Entities which have not elected or cannot elect to be REMICs, do not qualify as "mortgages and other liens on and interests in real estate." Quite to the contrary, it is clear that because Non-REMIC Qualified Residual Interests represent virtually the same economic interests as REMIC Qualified Residual Interests, Congress, looking to the substance of the relationship between the holders of such interests and the real estate assets held by the Entities which issued them, intended that such interests should also be treated as "mortgages and other liens on and interests in real estate" for the purposes of Section 3(c)(5)(C) of the 1940 Act.

IV. Conclusion

For the reasons stated above, we believe that the Qualified Residual Interests acquired by the REIT are qualified real estate-related assets under Section 3(c)(5)(C) of the 1940 Act. For your convenience, we have enclosed copies of the applicable provisions of the TRA of 1986 and the applicable sections of the Conference Agreement. If you have any questions concerning the foregoing, please do not hesitate to contact the undersigned at (212) 735-3840 or Richard F. Kadlick at (212) 735-2716, both of this office.

Sincerely,

Geoffrey K. Hurley
Geoffrey K. Hurley

PUBLIC

JAN 05 1987

RESPONSE OF THE OFFICE OF CHIEF COUNSEL
DIVISION OF INVESTMENT MANAGEMENT

Our Ref. No. 86-608-CC
M.D.C. Holdings, Inc.
File No. 132-3

In your letter of November 12, 1986, you request our assurance that we would not recommend any enforcement action to the Commission under the Investment Company Act of 1940 ("Act") if M.D.C. Holdings, Inc.'s subsidiary corporation (the "REIT") invests in various mortgage-related assets, including participations ("Residual Interests") in various partnerships and trusts ("Entities") which invest in real estate-related assets, and treats these Residual Interests as "mortgages and other liens on and interests in real estate" for purposes of Section 3(c)(5)(C).

You argue that, to the extent these Residual Interests comply with new Section 860D of the Internal Revenue Code ("Code"), they should be deemed to be "mortgages and other liens on and interests in real estate" under Section 3(c)(5)(C) of the Act. In addition, you assert that, in amending the Code, Congress did not intend companies investing in these Residual Interests to be subject to regulation under the Act.

We are unable to assure you that we would not recommend any enforcement action to the Commission if the REIT treats Residual Interests as "mortgages and other liens on and interests in real estate" for purposes of Section 3(c)(5)(C). Although the Entities may not be deemed to be investment companies by virtue of exemptive orders under Section 6(c) of the Act or in reliance on Section 3(c)(5)(C) of the Act, 1/ the staff has not viewed interests in similar entities to come within the phrase "mortgages and other liens on and interests in real estate" under Section 3(c)(5)(C). 2/


1/ In the past, the staff has granted no-action requests where an issuer acquired whole-pool Government National Mortgage Association ("GNMA") certificates (i.e., certificates comprising an undivided interest in the entire pool of mortgages backing the certificates), whole-pool Federal National Mortgage Association ("FNMA") certificates, and whole-pool Federal Home Loan Mortgage Corporation ("FHLMC") certificates, to permit these certificates to be treated as "mortgages and other liens on and interests in real estate" for purposes of Section 3(c)(5)(C) of the Act. See, e.g., Landmark Funding Corp. (pub. avail. Sept. 20, 1984); American Home Finance Mortgage Corp. (pub. avail. May 11, 1981). However, the Division has declined to grant no-action with respect to issuers treating partial-pool GNMA, FNMA, or FHLMC certificates as "mortgages and other liens on and interests in real estate" for purposes of Section 3(c)(5)(C). See, e.g., Nottingham Realty Securities, Inc. (pub. avail. Apr. 19, 1984); Arlington Investment Company (pub. avail. Aug. 31, 1974).

2/ See, e.g., Realex Capital Corp. (pub. avail. Mar. 19, 1984) (holding that a limited partnership interest in a partnership relying on Section 3(c)(5)(C) does not come within the phrase); Urban Land Investments, Inc. (pub. avail. Nov. 4, 1971); see also Investment Company Act Rel. No. 3140 (Nov. 29, 1960) (stating that a trust investing to a substantial extent in other real estate investment trusts or in companies engaged in the real estate business might not qualify for the exception set forth in Section 3(c)(5)(C)).

In addition, although Congress amended the Code to provide pass-through tax treatment to entities electing to be taxed as real estate mortgage investment conduits ("REMICs"), neither the legislation nor the legislative history addresses the regulation of REMICs or similar entities under the Act. Thus, although the action of Congress may evidence an intent to facilitate the development of the market in mortgages and mortgage-related assets, we cannot conclude that Congress intended either REMICs to be excepted from the definition of an investment company under the Act or interests in REMICs to be deemed "mortgages and other liens on and interests in real estate" under Section 3(c)(5)(C).

Our position on this question is supported by other recent Congressional action regarding the market in mortgages and mortgage-related assets. In enacting the Secondary Mortgage Market Enhancement Act of 1984, 3/ Congress intended to broaden the market in mortgages and mortgage-related assets. 4/ However, the Senate Committee on Banking, Housing and Urban Affairs rejected a proposed amendment to exclude certain companies investing in real estate-related securities from the Act's coverage, stating that the Act "facilitates development of the private secondary mortgage market adequately" and "contains important protections for investors coming within the definition of the term 'investment company'" 5/ Moreover, the Committee believed that the Commission's power under Section 6(c) of the Act would "permit the Commission to deal with any problems that arise under the Investment Company Act in the area of mortgage-backed securities in a manner that assures adequate investor protection" 6/

Accordingly, we are unable to agree with your conclusion that interests in the Entities would constitute "mortgages and other liens on and interests in real estate" under Section 3(c)(5)(C) of the Act.


Gerald T. Lins
Attorney

3/ Pub. L. No. 98-440, 98 Stat. 1689 (1984).

4/ The report of the Senate Committee on Banking, Housing and Urban Affairs states that "[t]his bill is expressly designed to encourage this broadening of the market for mortgage-backed securities by encouraging more extensive involvement of the private sector in the formation of conduits for the flow of mortgage capital from investors to lenders and homebuyers." S. Rep. No. 293, 98th Cong., 1st Sess. 3 (1983).

5/ Id. at 9.

6/ Id.