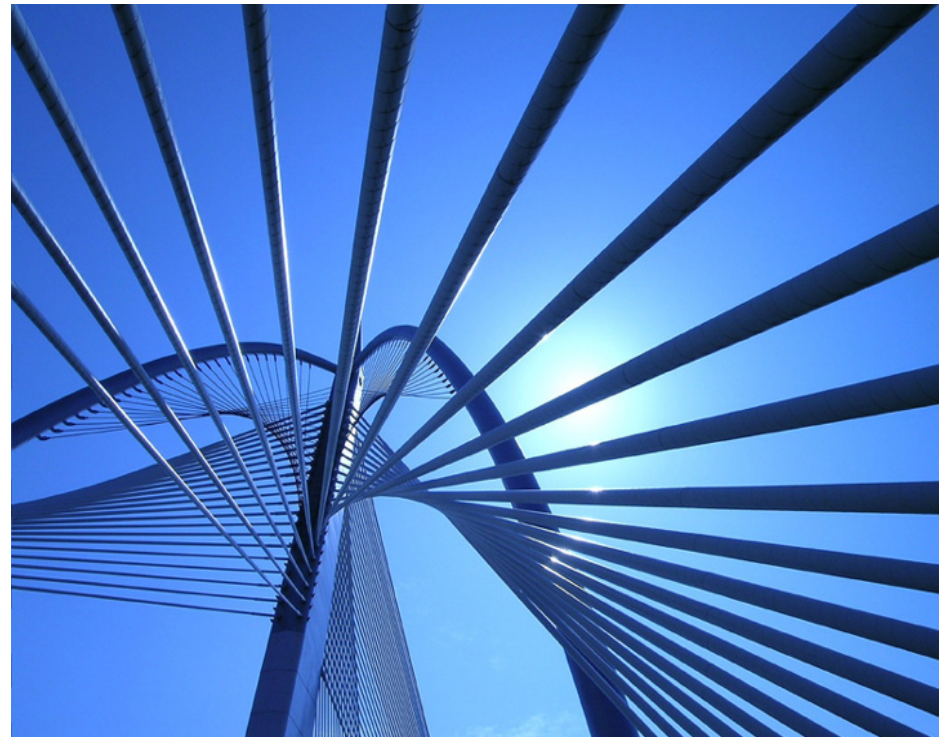
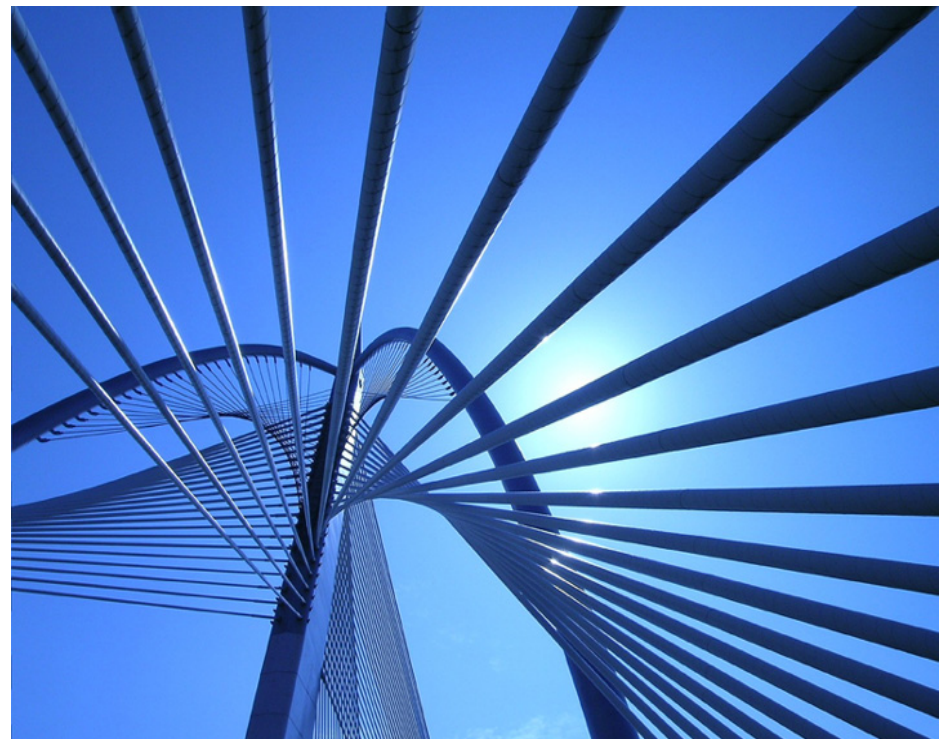


Financial Disclosure and Accounting Meeting
Taxation of Mortgage Back Securities
Mortgage Bankers Association
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CDO Overview and Tax Considerations

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Collateralized Debt Obligations (CDO)

What is it?

A structured finance transaction that repackages various assets (corporate bonds, bank loans, ABS, RMBS, CMBS, etc.) through a special purpose securitization vehicle, which is often an offshore issuer, but occasionally a domestic partnership or limited liability company.

General Characteristics

- Structure can be domestic or offshore (most typical is offshore).
- Can be a physical asset transfer or synthetic structure.
- Usually a securitization of loans (CLO), bonds (CBO) or other debt instruments (CDO).

CDO/CLO vs. REMIC

REMIC

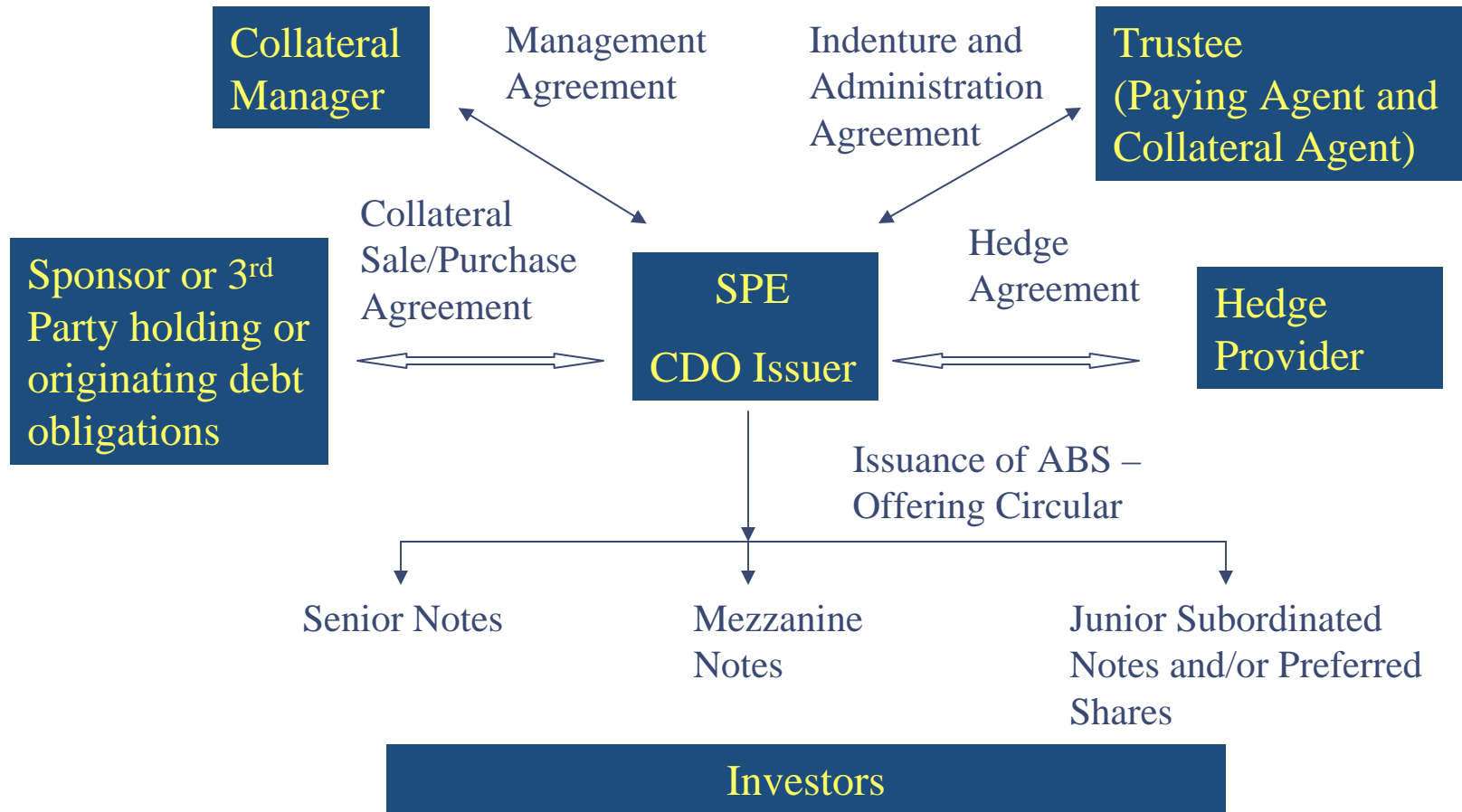
- Materially Static Investments
- Loan Workout Limited (see notice 2007-17)
- Assets Limited to Mortgages

CDO/CLO

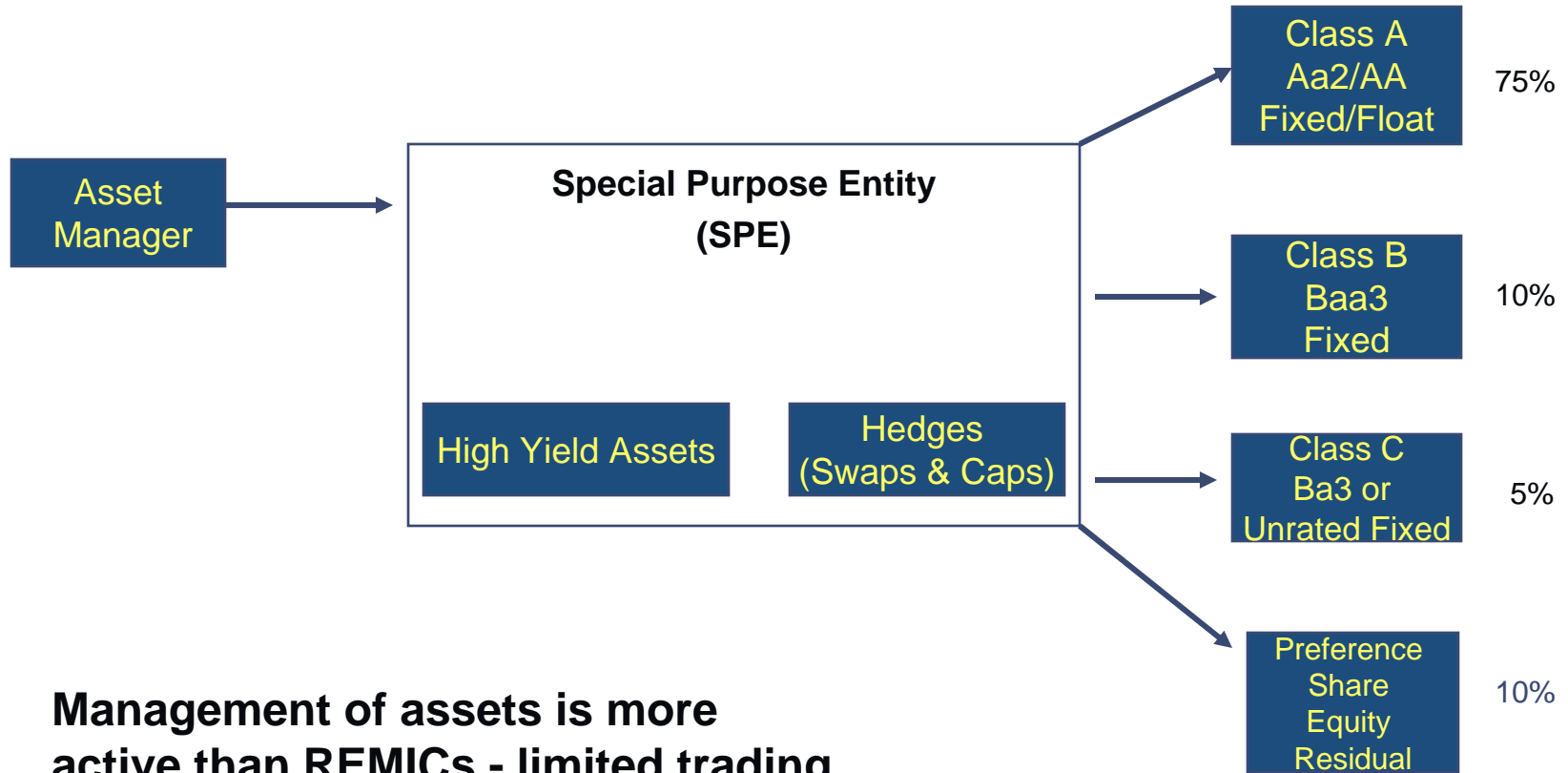
- Managed to a Degree
- Work outs permissible
- No limitation on Assets
- Robust Hedging

In short both are financing techniques, but CDOs allow for more flexibility.

Overview of CDOs/CLOs



Overview of CDOs/CLOs



CDO Assets

- High-yield corporate or government bonds (CBO)
- Emerging market debt
- Bank loans and other loans, loan assignments, loan participations and revolving credit facilities (CLO)
- Mortgages and mortgage-backed securities (CMO)
- ABS
- Sale-leaseback or synthetic lease transactions
- Distressed assets
- CDO of CDO's
- Hedge Fund Interests (CFO)

Tax Considerations - Issuers

Issuer Considerations:

- **Organizational Preferences** - The activities and the type of investors determine the organizational structure (partnership v. corporation and offshore v. domestic).
 - If there are foreign equity or mezzanine debt investors or tax-exempt equity investors, the Issuer is generally organized as an offshore corporation.
 - If the assets will produce periodic losses, the Issuer is generally organized as a US partnership (LLC, LP etc.) so that the losses pass-through to investors.

Tax Considerations - Issuers

Offshore Issuers

- Usually no foreign local income tax or foreign withholding tax.
- Not subject to US taxation unless deemed to be engaged in a US trade or business. Although managed by US collateral managers, usually avoid US taxation by means of securities trading safe harbor (IRC §864(b)(2)(A)(ii)) .
- Portfolio interest exemption (IRC §§881(c), 1441(c)(9), 1442).

Tax Considerations

Investors Considerations:

- **Investors In Debt Securities-** The taxation of CDO debt securities is generally the same as with debt securities from domestic securitizations.
 - Generally, OID is not calculated under the 1272(a)(6) methodology on the securities, but 1272(a)(6) is becoming more prevalent

Tax Considerations - Investors Consideration

Investors In Equity Securities – Tax treatment depends on the entity's tax classification.

- **Domestic and Foreign Partnership or LLC** – pass-through treatment.
- **Domestic and Foreign Corporations** - The taxation of equity securities of offshore issuers differs from the taxation of equity securities of domestic securitizations as a result of the application of the anti-deferral rules.

Tax Considerations

Anti-Deferral Rules

- **Passive Foreign Investment Company (PFIC)** - (IRC §§ 1291-1298).
- **Controlled Foreign Corporation (CFC)** - (IRC §§ 951-964).

Mortgage CLOs

Types

- CRE CLOs (Commercial Mortgage CLOs)
 - REIT CMOs
- Residential Mortgage CMOs

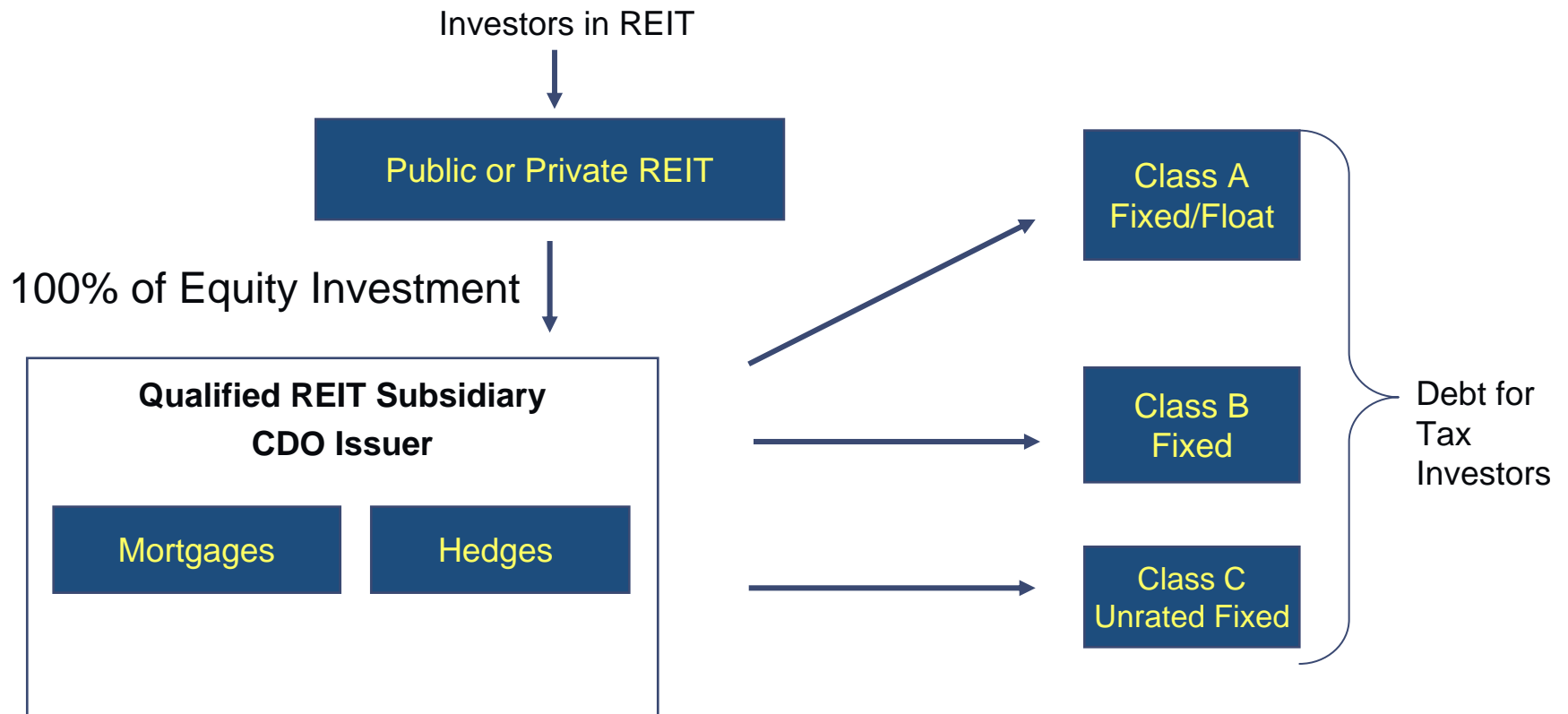
Why Use a CLO Instead of a REMIC?

- Commercial Mortgage CLOs allow far greater servicing discretion (loan modification) than REMIC transactions.
- Management and Reinvestment: CLOs allow varying degrees of management and reinvestment. Revolving periods allow principal to be reinvested for a period of three to five years.
- Asset composition: Allows for loans that might not qualify as real estate mortgages for REMIC purposes

Why CLOs are Offshore Instead of Onshore?

- CDOs provide for sequential pay structures. If a domestic structure were used for mortgage CLOs and such structure was not structured as a REMIC, other tax rules would apply that could result in tax assessed at the entity level.

REIT CLOs/CMOs



Public or Private REIT may do multiple Transactions

REIT CLOs

- REITs use CDO technology to add leverage
- Differences of REIT CLO and Typical CLO Transactions
 1. REIT is domestic
 2. Equity investment is at REIT level rather than CDO level
 3. Excess Inclusion Rules
- REITs can originate mortgages. Foreign CLOs or funds cannot originate without certain tax implications that could give rise to concerns.

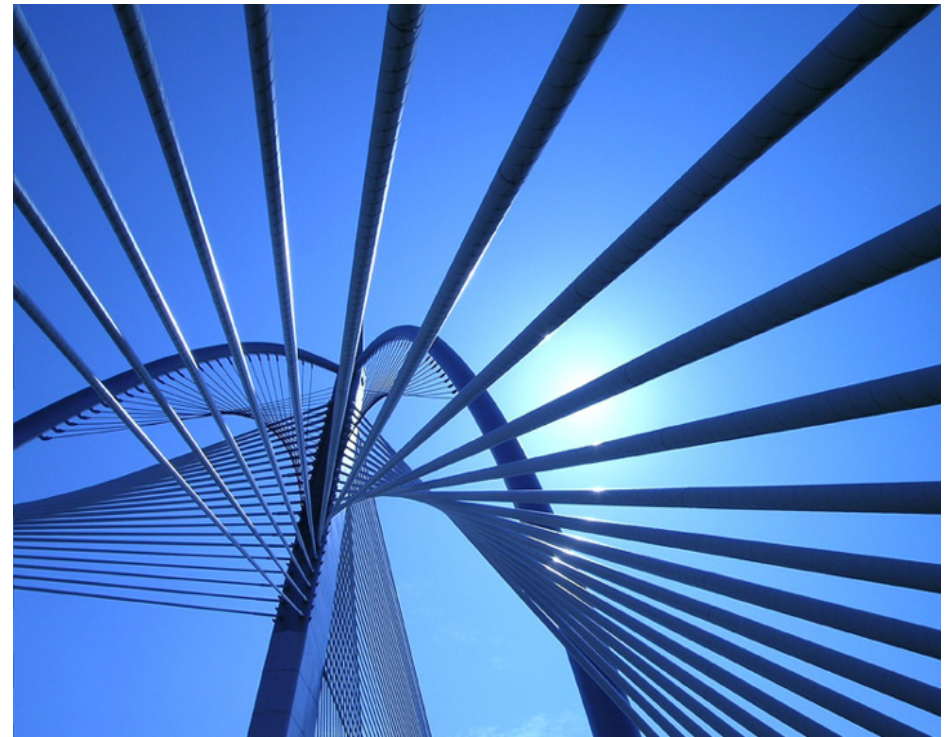
REIT CLOs

Why REITs typically do not engage in REMIC Transactions:

- REITs can own REMIC interests and mortgages.
- REITs can originate mortgages.
- REITs are often precluded from directly engaging in REMIC transactions due to certain types of activities that can give rise to taxation concern.
- On the commercial mortgage side, in addition to the dealer concerns, loan workouts, and mortgage characterization can cause REITs to avoid REMIC transactions.
- If REITs do engage in REMICs they typically do so through taxable REIT subsidiaries.

Accounting Considerations: CRE CDO Entities

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Balance Sheet Presentation for On-balance Sheet vs. Off-balance Sheet Structures

Assume:

- Loans having a carrying value of \$100MM are transferred to a securitization vehicle in exchange for:
 - \$90MM of cash (funded by vehicle issuing notes to third parties)
 - \$10MM retained interest (equity interest in vehicle)

On-balance sheet securitization:

Assets:

\$100MM Loans

\$90MM Cash

Liabilities:

\$90MM Debt

Off-balance sheet securitization:

Assets:

\$90MM Cash

\$10MM Retained Interest

SFAS 140 Sale Accounting (paragraph 9)

- Sale criteria under SFAS 140, Paragraph 9
 - 9(a): The transferred assets have been isolated from the transferor – put presumptively beyond the reach of the transferor and its creditors, even in bankruptcy or other receivership
 - 9(b): Each transferee or each holder of beneficial interests in a QSPE has the right to pledge or exchange the assets or beneficial interests it received, and no condition both constrains the transferee or holder from taking advantage of its right to pledge or exchange and provides more than a trivial benefit to the transferor
 - 9(c): The transferor does not maintain effective control over the transferred assets through either an agreement that both entitles and obligates the transferor to repurchase or redeem them before their maturity or the ability to unilaterally cause the holder to return specific assets

Evaluation of Sale Accounting Criteria

- Requires true sale/substantive non-consolidation legal opinions to determine compliance with criterion 9(a)
- Transfer of assets to a CDO poses unique challenges in meeting other sale criteria:
 - Paragraph 9(b)
 - CDO is unlikely to qualify as a QSPE
 - CDO's assets are invariably pledged / "locked up" to secure the notes issued by the CDO
 - "Free trade basket" arrangement may be sufficient to meet this test
 - Paragraph 9(c)
 - Ability to "unilaterally" reacquire a transferred asset as a consequence of the investment manager's active management of the CDO's portfolio

Consolidation Models

- Three consolidation models:
 - QSPE (SFAS 140)
 - VIE (FIN 46(R))
 - VOE (voting control or by contract, EITF 04-05, 97-2)

CRE CDOs: Can They be a QSPE?

- A CRE CDO is unlikely to qualify as a QSPE per SFAS 140 par. 35:
 - Active management of assets
 - Auction calls
 - Hedging derivatives

Comparison of QSPE and FIN 46R VIE Models

QSPE Model:

- Typically used in CMBS structures
- No consolidation of QSPE by any party
- General characteristics:
 - Limited asset classes
 - Limited servicer flexibility/discretion
 - Static structure – no sales of assets (other than in response to default calls)

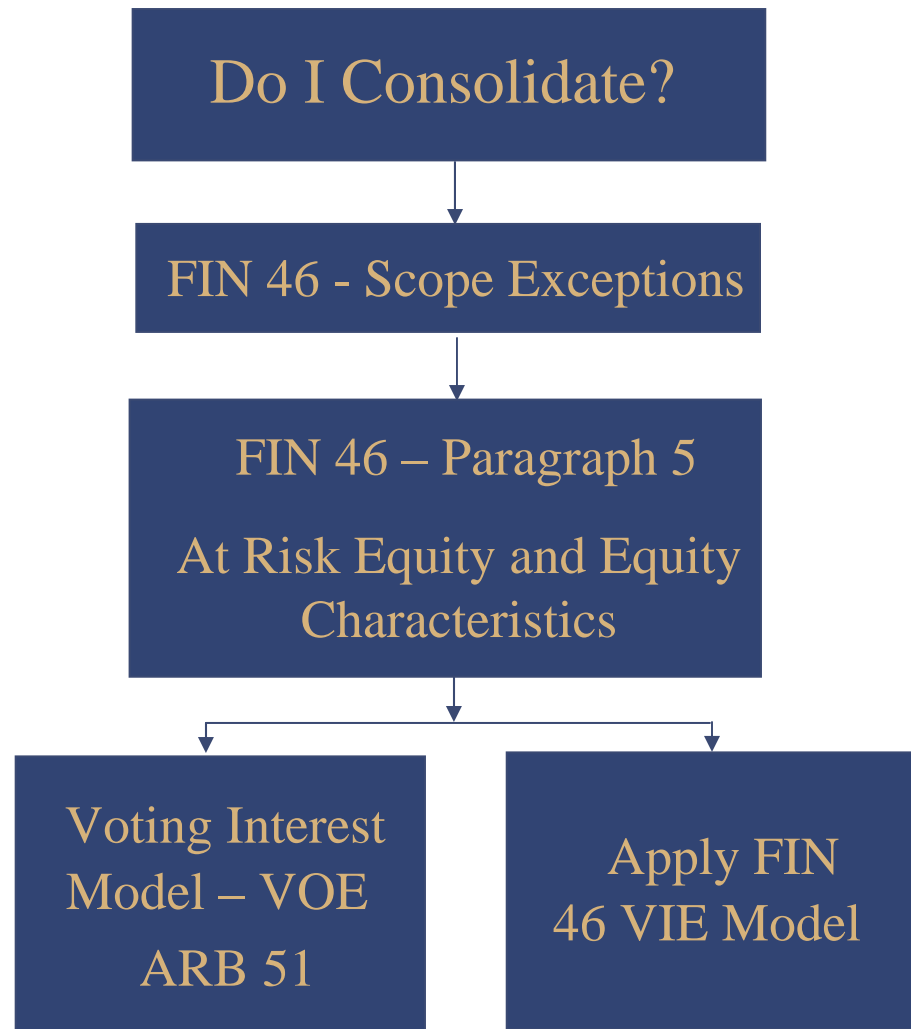
VIE (FIN 46R) Model:

- Typically used in CDOs
- Consolidation by the primary beneficiary (if any)
- General characteristics:
 - Flexibility/discretion in management of portfolio
 - Sales of assets permitted at a gain or loss

FIN 46R - Accounting

Two Models for Consolidation

- Criteria established for determining which of two mutually exclusive consolidation models is to be applied:
 - Voting interest model (ARB 51/FAS 94)
 - Variable interest model (Interpretation 46)



FIN 46-R – Comparison of Two Consolidation Models

FIN 46-R establishes specific criteria for determining which of two mutually exclusive consolidation models is to be applied

Voting interest model

- ARB 51 and SFAS 94
- Generally, based on percentage ownership of voting equity interests

Variable interest model

- FIN 46-R
- If any of the criteria in par. 5 are met, must apply variable interest model
- Generally, more of a risks and rewards approach to consolidation
- Risks and rewards are evaluated as variability from a mean
- Primary beneficiary (receives more than 50% of entity's variability) consolidates

Why are CDO Entities Usually VIEs Under FIN 46R?

- Principal reason:
 - “Decision making” by the collateral manager – as per the collateral management agreement
 - Under par. 5 of FIN 46R, an entity is a VIE if:
 - a) “decision making” (that has a significant effect on an entity’s profitability) is embedded in an instrument (contract) other than the equity of the entity and
 - b) decision-maker cannot be replaced by equity owners through a simple majority kick-out right
 - Typically, the collateral manager of a CDO entity cannot be removed by the equity (pref share) holders except for cause
 - Rarely see an unfettered simple majority kick-out right
- Other reasons:
 - Inadequate equity at risk (infrequently)

CDO Entity: Primary Beneficiary Analysis

- “Variable Interests” in a CDO entity:
 - Notes
 - Equity (pref shares)
 - Collateral management fees
- Primary beneficiary (PB): more than 50% variability threshold
- Collateral manager typically must hold some of the entity’s equity (“skin in the game”) – usually a 20 – 25% equity position
- A 20 – 25% equity position, even when combined with the management fee stream, usually will not expose the collateral manager to more than 50% of the CDO’s variable returns
 - Thus no consolidation risk
- Other investors normally ensure that their positions do not tag them as the PB (e.g., no one equity holder will own a majority of the pref shares)