

The Deloitte logo is positioned in the top left corner. It features the word "Deloitte" in a white, bold, sans-serif font. To the right of the text are three small green circles of varying sizes, arranged in a slightly curved line. The background of the entire page is a photograph of a modern glass skyscraper with a curved facade, reflecting a vibrant sunset sky with orange, yellow, and blue hues. Overlaid on the left side of the image is a stylized line graph with several green circular data points of different sizes, connected by thin lines, suggesting growth and data analysis.

Deloitte

Chapter 11

How will taxes impact
my transaction?

[View full handbook](#)

Securitization Accounting 12th edition | May 2026

Tax Rules versus GAAP

The current US income tax rules (Tax Rules)¹ for securitization transactions can be quite different from applicable US GAAP. Understanding the tax implications of each class of ownership allows issuers and investors to properly assess the after-tax return—clearly vital to all involved. When considering taxes, it is essential to understand the timing, character, and source of taxable income or loss that may result from the transaction:

- **Timing:** Determination of the proper tax reporting period including the application of the correct tax accounting methodology, such as cash versus accrual method, or the application of mark-to-market principles
- **Character:** Categorization of income as ordinary versus capital, determination of any special tax rates, limitations, or other rules that may apply
- **Source:** Jurisdictional and related issues, such as where income should be subject to tax, taxation of non-US investors, ability to utilize foreign tax credits, and state and local apportionment

Of course, a key tax consideration for most issuers is whether their transaction is considered a sale or financing under the Tax Rules. The term “sale” includes a sale, exchange, or other transaction that results in a realization of gain or loss for US income tax purposes.

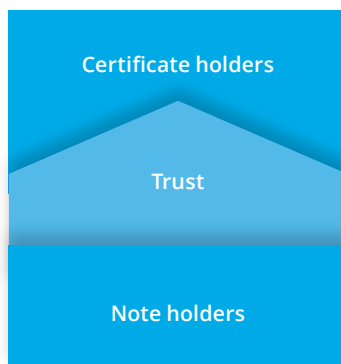
Taxation of a securitization structure is determined by the entity type/jurisdiction chosen and accounting methods utilized.

What is the tax impact of choosing an entity type?

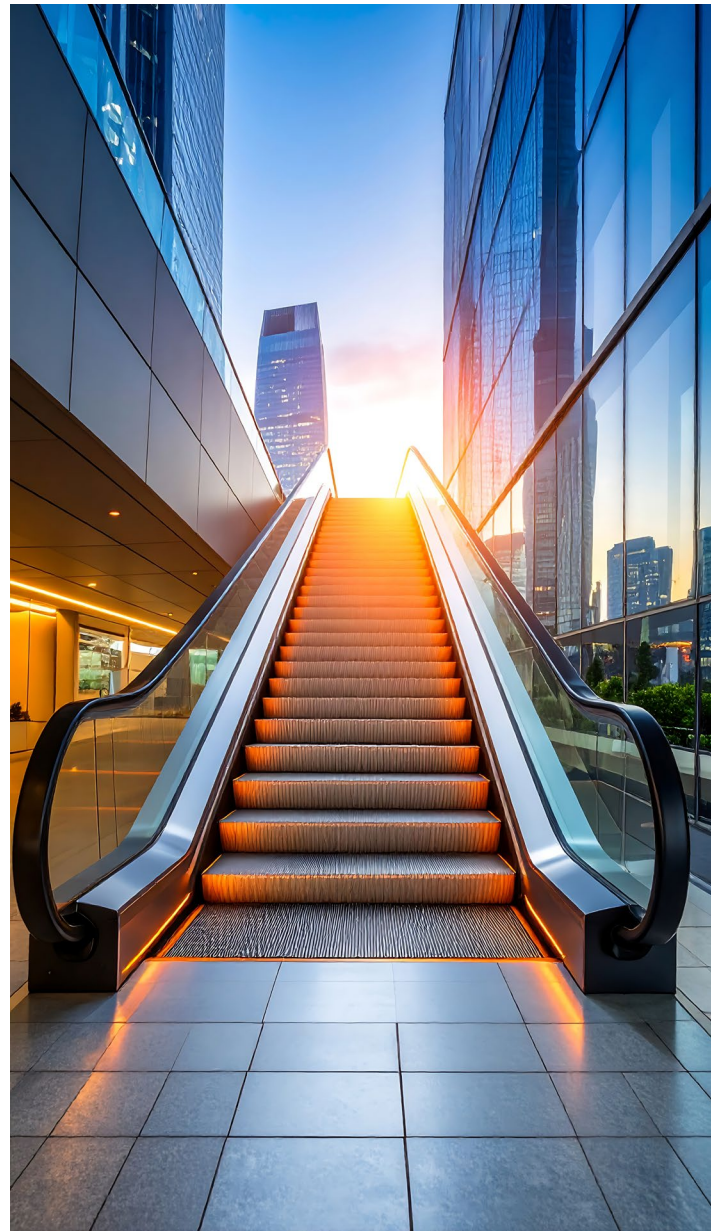
From a tax perspective, the type of entity used in a securitization transaction can be an important consideration. For an issuing entity that is not otherwise a corporation² and does not qualify as an investment trust, a limited liability company, or a partnership, the so-called check-

the-box rules provide added flexibility in determining the tax treatment of the entity. Absent an election by the taxpayer to the contrary, these rules provide that a domestic entity is considered a partnership if it has two or more members or is disregarded as an entity separate from its owner if it has a single owner.

Owner trust structure



A foreign entity is treated as a partnership if it has two or more members and at least one member does not have limited liability; an association (taxable as a corporation) if all members have limited liability; or a disregarded entity (DRE) if it has a single owner that does not have limited liability. The determination of whether an interest constitutes debt or equity for US income tax purposes is a key consideration in applying the check-the-box rules.



1 Unless otherwise noted, all tax-related references are to the income tax rules contained in the Internal Revenue Code of 1986, as amended, and regulations thereunder as of July 4, 2025.

2 The status of certain enumerated foreign entities as corporations is provided in Treasury Regulation Section 301.7701-2(b)(8).

Select US tax considerations for securitization transactions

Consideration	Investment trust	Other entities	Corporations	REMICs
Asset class limitations	No	No	No	Yes
Debt or equity analysis required	N/A	Yes	Yes	No
Time tranching allowed	N/A	Yes ^a	Yes ^a	Yes
Restricted ownership/transfer: ^b				
Debt	N/A	No	No	No
Equity	No	No	No	Yes
Gain or loss recognition:				
Transfer of assets to entity	No	No ^c	No ^c	No
Transfer of interests	Yes	Yes ^d	Yes ^d	Yes
Entity-level taxation	No	No ^a	Yes ^c	No
Equity holder treatment:				
Owner of assets	Yes	No ^e	No	No
Issuer of debt	Yes	No ^e	No	No
Taxable income determination	Holder level	Entity level ^e	Entity level	Entity level
Excess inclusion rules	N/A	N/A ^c	N/A ^c	Yes

^a Subject to the Taxable Mortgage Pool rules

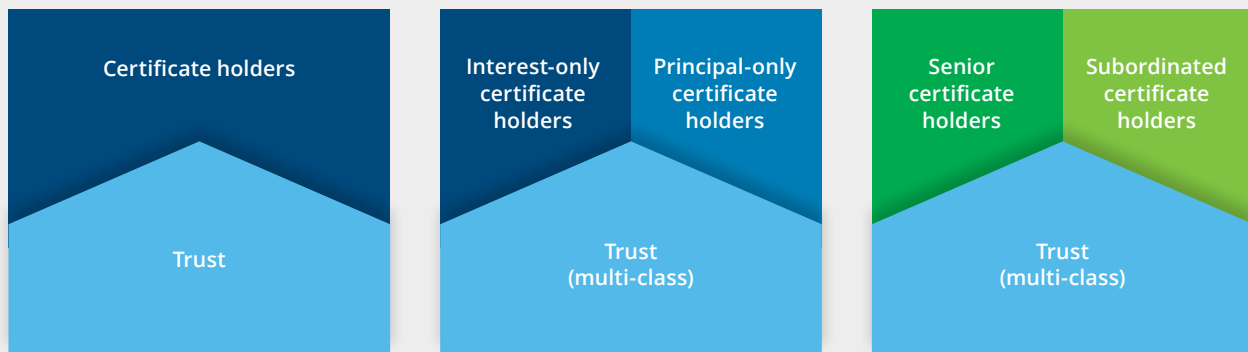
^b Tax withholding rules should be considered

^c Special rules may apply

^d In the case of an equity interest

^e Except in the case of a disregarded entity

Investment trust structures



Investment trust structures

The use of an investment trust (sometimes called a grantor trust) can accomplish several objectives—including no entity-level taxation and exemption from withholding tax. Under the Tax Rules, an investment trust is meant to include a trust that is not a business trust and has either a single class of ownership interests representing an undivided interest or multiple classes that are incidental to facilitating direct investment in the assets of such trust. Such classes could include creation of an IO class or a senior subordinate structure, where principal and interest generally are paid pro rata, but losses are allocated to just one of the classes.

In addition, there must be no power under the trust agreement to vary the investment of the certificate holders. An example of such a “power to vary” generally would include reinvestment of amounts collected on the trust assets (e.g., principal, interest, sales proceeds)—so a revolving structure would not qualify.

Other pass-through structures

If an entity does not qualify as an investment trust, pass-through treatment may still be achieved for tax purposes by utilizing a DRE for entities with only one equity owner or a partnership for entities with two or more equity owners. Owners of DREs are treated as if the entity did

not exist—they are considered the tax owner of all of the assets and the tax issuer of any debt. When assets are first transferred to an SPE—even if the transfer might otherwise qualify as a sale under the Tax Rules—the transfer may not result in a current federal income tax liability, and the assets may obtain carryover basis for tax purposes under rules applicable to an entity classified as a DRE or a partnership.

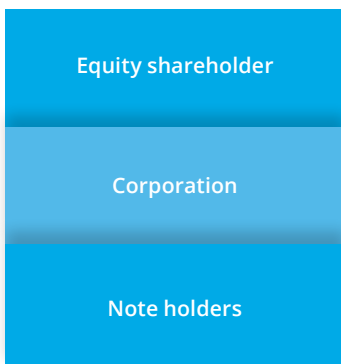
Owners of interests in a partnership are also taxed on their share of all items of income and deduction. However, determination of each partner's share is based on a complex set of rules intended to recognize the economic arrangements between the parties. Accordingly, partnership structures may be useful when the parties have interests that are not strictly pro rata in nature. For example, the "carried interest" arrangements common in private equity partnerships are possible because of the partnership allocation rules.

Corporate structures

The imposition of entity-level tax on US corporations is one of several tax and non-tax considerations resulting in the infrequent use of these entities for securitization transactions. Foreign corporations (or similarly treated entities) that do not engage in a US trade or business are frequently the issuer in securitization transactions such as CLOs. These non-US entities are typically characterized as passive foreign investment companies (PFICs) for US tax purposes and all income is typically from passive activities (interest, dividends, etc.). Non-US entities may also be Controlled Foreign Corporations (CFCs). As a result, US investors that hold interests in a PFIC or CFC that are not characterized as debt for US income tax purposes are generally subject to special rules. In the case of a PFIC, an investor can choose to include currently its pro rata share of the PFIC's net income (but not losses) in taxable

income by making a qualified electing fund (QEF) election on IRS Form 8621. If the QEF election is not made, the investor may be subject to certain interest charges. A US investor that owns 10 percent or more of the total voting power or value of an entity that is characterized as a CFC is required to currently include its pro rata share of the CFC's net income (but not losses) in taxable income.

Corporate structure



Real estate mortgage investment conduit structures

A specific set of statutory Tax Rules provides for a specialized vehicle that can be used as the issuing entity in the securitization of mortgage loans. This vehicle is called a REMIC. While a number of requirements and special rules apply, the REMIC structure provides tax certainty regarding the treatment of debt and equity classes. A REMIC generally is not subject to an entity-level income tax because its income is taxable to the owners of the interests in the REMIC. However, REMICs are subject to a 100 percent tax on their net income from certain "prohibited transactions." REMICs have significant flexibility in structuring cash flows, unhampered by the need to consider if a class should be treated as debt or equity for tax purposes.

Debt issued by a REMIC, termed a "regular" interest for tax purposes, is subject to the Tax Rules applicable to all debt investments, discussed below. A REMIC is a pass-through entity for tax purposes, and therefore the holder of the tax equity interest, known as the "residual" interest and often designated as an "R" bond, is subject to tax on the net taxable income of the REMIC.

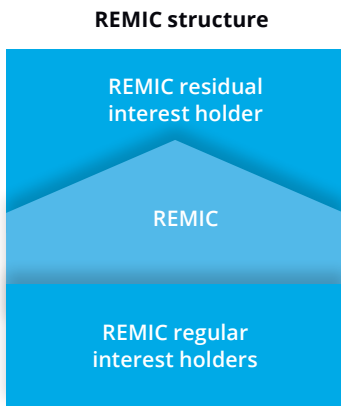
A REMIC generally is required to have a US person as the holder of its tax equity interest. While this interest represents the tax equity, the tax equity interest frequently does not have an economic interest in the cash flows. Accordingly, it is commonly referred to in the marketplace as a noneconomic residual interest (NERD). Ownership of this class may result in negative tax consequences to the holder of this interest, including recognition of phantom income and application of the excess inclusion rules outlined below. These interests are often considered to have negative economic value equal to the net present value of the tax impact of ownership. Due to the negative tax consequences associated with ownership of the NERD, it is common for sponsors of REMICs to pay an inducement fee to the original purchaser of this interest.

In exchange for the greater flexibility and certainty, REMICs are subject to fairly stringent initial and ongoing qualification requirements. In addition, the REMIC sponsor is required to recognize gain or loss upon the sale, exchange, or other taxable disposition of the REMIC's regular and residual interests. Lastly, the taxable income reportable by a REMIC residual interest holder may also be considered "excess inclusion" income. Excess inclusion income cannot be offset by losses from other business operations, net operating losses, or even losses from other REMICs. Excess inclusion income is determined quarterly and equals the excess of REMIC taxable income over an assumed investment return at 120 percent of the applicable federal rate. In the case of a NERD, the amount of excess inclusion income generally equals the taxable income of the REMIC.

Important rule

Absent a REMIC election, when time tranching is desired (i.e., a multi-class issuance with different maturities) in a mortgage securitization, the issuing entity may be characterized as a taxable mortgage pool (TMP) and become subject to an entity-level tax and additional special rules. The Tax Rules treat a TMP as a separate corporation

that is subject to entity-level taxation and not includible in a consolidated tax return. Special exemptions apply for real estate investment trusts (REITs) and certain other entities, allowing REITs to issue mortgage securitizations outside of REMIC form. These “REIT securitizations” are commonly issued by commercial mortgage loan originators.



A REMIC is an entity that has:

1. A valid REMIC election;
2. Only regular interests or residual interests;
3. Only one class of residual interests (and all distributions, if any, with respect to such interests are pro rata);
4. As of the close of the third month beginning after its startup day and at all times thereafter, substantially all of its assets consist of qualified mortgages and permitted investments;
5. A calendar taxable year; and
6. Reasonable arrangements designed to ensure:
 - a) Its residual interests are not held by “disqualified organizations” and
 - b) Information necessary for imposition of tax on any transfer to a disqualified organization will be made available.

How does the concept of “consolidation” apply for tax purposes?

Similar to the accounting concept, consolidation may result in one or more legal entities or business operations joining together in the filing of a single report that consolidates their tax results and generally serves to eliminate the effect of intercompany transactions. Common examples include the filing of a consolidated federal income tax return or state tax filings that are made on a unitary or “combined” basis. Tax consolidation is generally a form-driven

question based on ownership, legal entity form, and any check-the-box elections made, and does not have the nuance of the GAAP rules. For example, foreign corporations are not consolidated for tax purposes and may be classified as a DRE, a partnership, or a corporation.

The key takeaway here is that GAAP and the Tax Rules do not apply the concept of consolidation in a similar fashion. Also important, the answer for federal income tax purposes may not be the same for state tax purposes.

When is a securitization vehicle subject to entity-level taxation?

Because any imposition of tax on the issuer will reduce the amount of funds otherwise available to pay investors, thereby increasing the overall cost of borrowing for the transferor, a primary objective is the selection of a vehicle that will not be subject to an entity-level tax. In the absence of a REMIC election, the commonly preferred characterization would be either a partnership or a DRE, because neither is subject to a separate entity-level income tax. The check-the-box regulations contained in Treasury Regulation §301.7701-3 have made structuring to achieve either characterization a reasonably simple process for transferors. For REMICs, the tax answer is simple, regardless of the entity’s legal form: a REMIC essentially is treated as a pass-through vehicle and is generally not subject to an entity-level income tax. Foreign corporations will not generally be subject to tax (other than certain withholding taxes) if they do not engage in a US trade or business. In order to reduce the risk of US taxation, foreign entities often follow certain self-imposed trading and operational restrictions determined through consultation with their tax advisers.

When is a securitization treated as a sale for tax?

Generally, the income tax results of a transaction are decided based upon its substance, rather than its form, and—importantly—a “sale” is not always required for gain or loss recognition to occur. For example, certain assumptions of liabilities by the transferee made in connection with the transfer of assets may result in gain recognition.

Typically, the determination of whether a transaction is properly characterized as a sale for tax purposes, rather than a mere pledge of the assets as security for a financing, requires an analysis of the specific facts and circumstances of the transaction. The result will depend on the answer to several questions, outlined in the “Sale or financing?” graphic that follows.

The determination of whether a transaction is considered a sale or a financing for tax purposes is often directly linked to the tax characterization of the interest(s) that are being transferred. Consequently, the “debt or equity” question can be an important consideration for both sponsors and investors.

If the transaction is characterized as the transfer of an ownership or equity interest in the assets, for tax purposes, the sponsor typically recognizes gain or loss to the extent of such transfer. It is important to note that because the sponsor generally receives cash in addition to any debt or equity interests retained, common tax non-recognition provisions for transfers to controlled entities may be limited or unavailable. If the transaction is characterized as a financing for tax purposes, the sponsor typically recognizes no gain or loss for US income tax purposes. The investor is similarly interested in the characterization because it can be an important consideration when determining their tax reporting and withholding tax requirements.

Sale or financing?

Benefits and burdens of ownership

- Who bears the risk of loss?
- Who has the opportunity for gain?
- Who possesses power to dispose of the assets?
- Does the agreement provide for a fixed price?
- Are the payment terms of the receivables and the certificates significantly different?

Servicing arrangement

- Who controls servicing of the assets?
- Who is obligated to collect receivables?
- Who bears the cost of collection?
- Is the transferee held harmless for acts of collection agent?

Form of transaction

- Are borrowers notified of a change in receivable ownership?
- Who is liable for property, excise, sales or similar taxes?
- Does the transferor have the right to inspect the books and records of the transferee?
- Is the transferee a shell subsidiary?

How is tax gain or loss determined?

Once a transaction has been determined to result in a tax sale, the amount of gain or loss recognized generally is determined by comparing the net value received to the allocated tax basis of the interests sold—but special rules can apply to limit or disallow the deductibility of losses where related parties participate. Tax basis typically differs from GAAP carrying value for various reasons that can stem from differences in accounting methodology. For example, the allowance for loan losses, while reducing carrying value, typically

would not reduce tax basis. Differences can also result from the use of lower of cost or fair value accounting for GAAP and mark-to-market (applicable to dealers in securities, including loan originator/sellers and certain traders) or non-mark-to-market for tax. Another common example is the recognition of a servicing asset for GAAP that is not recorded as an asset for tax purposes.

Special rules for REMICs

Additional rules apply to the sponsor of a REMIC. A REMIC sponsor is defined as any person who directly or indirectly transfers qualified mortgages and related assets to a REMIC in exchange for its regular and residual interests. The Tax Rules provide that no gain or loss is recognized as a result of the initial transfer of assets to a REMIC, with the sponsor's tax basis in the assets transferred to the REMIC simply being allocated among the regular and residual interests issued by the REMIC in proportion to their fair market value. Gain or loss is recognized upon the subsequent sale of the REMIC interests (including the sale of the REMIC regular interests). The amount of such gain or loss would equal the difference between the sponsor's net proceeds (i.e., proceeds received less selling expenses) and the allocated tax basis of the REMIC interest sold.

Generally, gain or loss attributable to REMIC interests that are retained by the sponsor is deferred and recognized over time. The amount of such unrecognized gain or loss is equal to the difference between the fair market value of the retained REMIC interest at the startup date of the REMIC and its allocated tax basis.

What determines whether an interest is debt or equity?

Once the securitization has been completed, the sponsor and investors must begin to report their ongoing taxable income from the related interests that they have either acquired or retained. The tax accounting will depend to some degree on whether the interest held constitutes debt or equity for tax purposes. The tax characterization of an interest ultimately depends upon the nature and degree of participation that the investor has in the activities/success of the issuing entity or the assets underlying the transaction. For example, interests issued by the securitization trust that represent a passive investment to its holder, based on a limited risk of loss, stable return, and a fixed maturity would be more consistent with debt issued in a lending arrangement than an equity interest.

Alternatively, if the interest is more closely tied to the overall performance and success of the issuing entity (or underlying assets), it suggests that the interest is more akin to an equity investment. Invariably, the tax characterization of the interest will fall somewhere along the continuum between pure debt and pure equity due to the blending of the risks, rewards, and related contingencies negotiated by the parties. Subject to much debate over the years, the Tax Rules for analyzing whether an interest represents debt or equity are the product of a variety of income tax rulings and court decisions.

Debt or equity?

The factors determining whether a security will be considered debt or equity for US federal income tax purposes include:

- 1) Whether there is an unconditional promise on the part of the issuer to pay a sum certain on demand;
- 2) Whether holders possess the right to enforce the payment of principal and interest;
- 3) Whether the rights of the holders of the instrument are subordinate to rights of general creditors;
- 4) Whether the instruments give the holders the right to participate in the management of the issuer;
- 5) Whether the issuer is thinly capitalized;
- 6) Whether there is identity between holders of the instruments and stockholder of the issuer;
- 7) The label placed upon the instrument by the parties; and
- 8) Whether the instrument is intended to be treated as debt or equity for non-tax purposes, including regulatory, rating agency, or financial accounting purposes.

How is periodic income for debt instruments determined?

The Tax Rules provide special rules for interest, discount, and premium and distinguish between debt instruments acquired at the issue date and those purchased in the secondary market. While discount or premium that results from an investor's purchase of a debt instrument in the secondary market (i.e., after the issue date) does not affect the issuer's taxable income calculation, it must be considered in determining the ongoing income of the investor. Typically investors must account for each of the following items separately, based upon the applicable Tax Rules. However, the Tax Rules provide an election that allows for all interest, discount, and premium of a debt instrument to be accounted for in aggregate.

Special rules for amortization of discount or premium are prescribed for debt instruments where principal can be accelerated due to prepayments on the underlying collateral (prepayable debt instruments [PDI securities]) or for contingent payment debt instruments (CPDI securities). Common examples of PDI securities include REMIC regular interests, other MBS and ABS, and mortgage and consumer loan pools. Examples of CPDI securities include debt instruments that provide for a payment based upon the gross receipts of the issuer or that pay based upon the fluctuations in the price of a publicly-traded stock. The mere possibility of impairment due to insolvency, default, or similar circumstances does not cause a debt instrument to provide for contingent payments. Because PDI securities are the more common type of debt instrument

encountered in securitization transactions, discussion is limited to the Tax Rules that generally apply to them. Similarly, for ease of illustration, there will be no discussion of the effects of the mark-to-market method of tax accounting that generally can apply in the case of dealers in securities and electing traders in securities.

Interest

For tax purposes, interest falls into two general categories: qualified stated interest (QSI) and nonqualified stated interest (non-QSI). Generally, QSI includes all interest that is unconditionally payable at least annually (i.e., typical coupon interest from loans that may not be paid in kind). QSI is considered to be interest income for tax purposes. While standard tax accounting methods generally apply to its recognition, QSI earned with respect to a REMIC regular interest must be recognized using the accrual method, regardless of the general tax accounting method of the holder. All payments other than QSI and principal are non-QSI payments and typically are accounted for as part of original issue discount (OID).

Original issue discount

Subject to certain de minimis rules, a debt instrument with an issue price that is less than its stated redemption price (SRP) at maturity is generally considered to have OID. The SRP of a debt instrument equals the sum of all payments expected to be made with respect to the debt instrument other than QSI (i.e., the sum of principal and non-QSI payments).



OID accrues and is recognized currently based upon the debt instrument's yield to maturity (the tax yield). There are two methods that can apply for purposes of determining the amount to be accrued. The standard method IRC 1272(a)(3) applies to debt instruments that are not CPDI and not otherwise subject to the prepayment assumption catch-up (PAC) method IRC 1272(a)(6). Note: The PAC method was used to amortize discount and premium in the simplified tax example below.

The methods differ both in their determination of tax yield and in the amount of OID that must be recognized each period. Under the PAC method, the determination of tax yield allows for the use of a prepayment assumption (the tax prepayment assumption) while the standard method does not. Regardless of the method employed, the Tax Rules do not allow a loss assumption to be used when determining the tax yield. See further discussion of tax loss below.

In addition, the legislative history to the PAC method clarifies that a negative OID accrual is not permitted. Instead, the amount of OID is treated as zero for the period, and the computation of OID for the next period would be made as though that period and the preceding period were a single period (i.e., OID would not be accrued until the cumulative result produces a positive amount).

Premium

There are two types of premium under the Tax Rules: (1) market premium and (2) acquisition premium. Market premium occurs when a debt instrument is acquired at a price that is greater than its SRP. If the debt instrument was issued with OID, only the market premium is accounted for by the holder, because the holder is not required to account for the OID. While holders are not required to amortize market premium for taxable debt instruments, they may elect to amortize it based upon the debt instrument's yield to maturity (i.e., its tax yield). In the case of debt instruments that are subject to

the PAC method, the legislative history suggests that holders may apply rules for amortizing premium similar to those provided for the accrual of market discount (discussed below).

Acquisition premium occurs when a debt instrument is purchased at a premium to its adjusted issue price (AIP), but at a price that is less than its SRP. The AIP is the issue price of the debt instrument increased for previous accruals of OID and decreased for payments of principal and non-QSI. In this case, the holder must continue to account for OID from the debt instrument. The amortization of acquisition premium is mandatory, and the amount amortized each period equals the product of the OID accrual for the period and the fixed ratio of acquisition premium to the OID remaining at the holder's date of acquisition.

Market discount

A debt instrument has market discount when it is acquired subsequent to its date of issuance for a price that is less than its SRP (or, in the case of a debt instrument issued with OID, for a price less than its AIP). Market discount is very important to many investors, as these rules serve to recharacterize all or part of the holders' gain to ordinary income that is not eligible for the beneficial capital gains rates. In short, the Tax Rules require that any gain upon sale is ordinary income to the extent of market discount accrued prior to the sale date. Additionally, any payments on the instrument are recognized as ordinary income to the extent of market discount accrued prior to the payment date. Alternatively, holders may elect to recognize market discount as it accrues, which may be beneficial to holders seeking to increase taxable income or decrease differences between amounts calculated pursuant to GAAP and those determined under the Tax Rules.

The default calculation of market discount is ratable amortization over the period between the purchase date and maturity date, based upon the number of days held during the period. Alternatively, the holder can elect to accrue market discount based upon a constant interest rate determined in a manner similar to the standard method used for calculating the tax yield. It should be noted that the constant yield method would generally result in a more beneficial calculation for taxpayers seeking to limit market discount amortization.

For debt instruments that provide for two or more principal payments, a special rule applies that requires market discount to be accrued based upon a method provided in regulations. Although these regulations have not yet been issued at publication date of this book, the legislative history for the rule provides that a holder may not use the ratable method for these instruments. The history provides that a holder may accrue market discount based upon either a constant interest method or an applicable ratio method, the

Debt instruments subject to the PAC method

- 1) Any regular interest in a REMIC or qualified mortgage held by a REMIC;
- 2) Any other debt instrument if payments under such debt instrument may be accelerated by reason of prepayments of other obligations securing such debt instrument (or, to the extent provided in regulations, by reason of other events); or
- 3) Any pool of debt instruments, the yield on which may be affected by reason of prepayments (or to the extent provided in regulations, by reason of other events).



market discount accrual ratio (MDAR). The MDAR that applies will vary depending upon whether the debt instrument was issued with OID. The stated interest ratio method applies to debt instruments issued without OID, and the OID ratio method applies to debt instruments issued with OID.

The amount of a holder's deductible net direct interest expense may be limited where market discount has accrued but has not been recognized.

In January 2021, the Treasury Department issued Treas Reg §1.451-3(a)(13) to provide that accrued market discount does not fall under IRC Section 451(b). As such, rules for the timing of market discount accretion are unchanged.

Tax accounting methods

Constant interest methods for accrual of OID

- IRC 1272(a)(3) – The standard method $[a \times b - c]$
The amount of OID accrued generally equals the product of (a) the debt instrument's AIP at the beginning of the period and (b) the tax yield of the debt instrument less (c) the amount of QSI for the period.
- IRC 1272(a)(6) – The PAC method $[a + b - c]$
The amount of OID accrued generally equals the sum of (a) the present value of cash flows remaining at the end of the period (based upon the tax prepayment assumption) and (b) any principal and non-QSI payments during the period less (c) the debt instrument's AIP at the beginning of the period.

The market discount accrual ratio method $[a \times b]$

The amount of market discount accrual equals the product of (a) the MDAR for the period and (b) the amount of market discount remaining (i.e., not previously accrued) at the beginning of the accrual period. Use tax prepayment for instruments that would have been subject to the PAC method if issued with OID. The MDAR that applies will vary depending upon whether the debt instrument was issued with OID. The stated interest ratio applies to debt instruments issued without OID, and the OID ratio applies to debt instruments issued with OID.

Market discount accrual ratios $[a/b]$

- Stated interest ratio equals (a) the interest (other than OID) for the accrual period divided by (b) the sum of such interest and the interest (other than OID) remaining at the end of the period, using the tax prepayment assumption for instruments that would have been subject to the PAC method if issued with OID.
- OID ratio equals (a) the OID for the accrual period divided by (b) the total OID remaining at the beginning of the period using the tax prepayment assumption for instruments that would have been subject to the PAC method if issued with OID.

Acquisition premium $[a \times b]$

The amount of amortization equals the product of (a) the OID accrual for the period and (b) the fixed ratio of acquisition premium to the OID remaining at the holder's date of acquisition.

An investor example

Assume Much Pursued Investment Fund (MPIF) purchased \$100,000 par of REMIC regular interest Class O for a price of \$65 on the first day of the January accrual period. The Class O has OID and no QSI, and has made no principal or interest payments since Investor's purchase. At the end of the quarter, MPIF contacted the REMIC and obtained a statement containing the following information for the calendar quarter:

Period	QSI	OID	Beginning AIP	MDAR
January 2024	\$0	\$2,000	\$80,000	0.10000
February 2024	0	5,000	82,000	0.27778
March 2024	0	3,200	87,000	0.24615

Based upon this information, MPIF determined that its taxable income for the calendar quarter was as follows:

Period	Market discount	MDAR	Market discount accrued
January 2024	\$15,000	0.10000	\$1,500
February 2024	13,500	0.27778	3,750
March 2024	9,750	0.24615	2,400

However, because no principal payments have been made during the accrual periods, if MPIF has not otherwise elected to currently recognize market discount, the total amount of income to be reported by MPIF for the first calendar quarter would be \$10,200—the amount of OID.

Note: The Issuer-provided information shown is based upon Investor's specific facts for ease of illustration only; actual information provided by the Issuer is typically on a "per unit of original face amount" or similar basis.

How are MSR's treated for tax purposes?

MSR's are assets that can represent two different types of instruments for tax purposes. "Normal" servicing is the right to reasonable compensation for the services to be performed. "Excess" servicing is the right to receive any amounts greater than the normal amount. There is no specific guidance available with respect to the numeric amounts that should be considered normal versus excess, though an election is available under which a safe harbor may be utilized for one- to four-unit residential loans.

Amounts paid by a servicer for normal servicing are amortized for tax purposes over either nine or 15 years, depending on the circumstance. Amounts paid for excess servicing are treated as paid for an IO strip off the mortgage itself. Accordingly, income from excess MSR's must be recognized as OID income related to an IO strip and requires calculations on the PAC method. Additionally, because excess MSR's are considered to be IO interests in the mortgages, they are qualified assets for REITs.

What is the tax accounting that applies to interests that are classified as equity for tax purposes?

For owners of investment trusts and similarly DREs, the determination of taxable income or loss is made at the investor level. For other entities, the determination of taxable income or loss is made at the entity level. In each case, the rules described above for determining the ongoing income (and expense) from debt instruments continue to apply.

Why is taxable income to the interest holders sometimes more than the cash they received?

Taxable income greater than cash distributions to equity holders is sometimes referred to as "phantom" income. Phantom income can result from differences that exist between the weighted average yield on the debt instruments held by the issuing entity and the weighted average yield on the debt instruments issued by the entity. For example, in a traditional sequential pay structure, if the yield curve is upward sloping on the date of the securitization, the issued debt will have different yields. Specifically, the shorter-term issued debt will have lower yields than the longer-term issued debt. In contrast, the yield on the assets held by the issuing entity will be a fixed, medium-term yield. The weighted average yield (and, therefore, interest/OID expense) on the issued debt will increase over time as the lower yielding classes are retired. This effect creates net taxable income in early periods (phantom income) and net deductions in later periods (phantom deductions).

Phantom income can also result from structural features that result in the utilization of cash for purposes other than distribution to the equity holders. For example, in CLO structures, it is common for

cash from sales of assets to be reinvested in additional assets during the reinvestment period. Any net gain, market discount or OID associated with these positions therefore creates phantom income to the equity investors during this period.

Finally, phantom income can result from straightforward differences between tax accounting methods and cash distributions. For example, accruals of OID will result in taxable income without receipt of corresponding cash amounts. Additionally, taxable items must be reported on an accrual method, while securitization entities make distributions only on specific payment dates.

Example: CLO equity

Investor owns 40 percent of the preference shares of RCLO, Ltd. (RCLO), a Cayman CLO that is in its reinvestment period. Investor has been informed that RCLO is not a CFC. Investor receives a PFIC annual information statement informing him that the earnings and profits (E&P) of RCLO are \$4,125,000. Investor received cash distributions of only \$1,000,000 from RCLO during the taxable year. Upon inquiry, Investor learns from the collateral manager and RCLO’s tax adviser that the E&P of RCLO is calculated as follows:

Interest income	\$12,500,000
OID	250,000
Market discount	587,500
Gain on sale of loans	787,500
Interest expense	(8,750,000)
Management/admin expenses	<u>(1,250,000)</u>
E&P	<u>\$4,125,000</u>

If Investor makes or has made a QEF election with respect to RCLO, it will report \$1,650,000 of taxable income (40 percent of \$4,125,000) with respect to its ownership in RCLO. Its tax basis in RCLO will be increased by this amount and decreased by the cash distributions that it received during the taxable year.

When are losses taken into account for tax purposes?

Generally speaking, the effect of less-than-desirable credit performance may only be taken into account for tax purposes once it can be demonstrated that an actual credit event has occurred. Moreover, the Tax Rules do not permit the use of a loss assumption when projecting the cash flows to be used in determining the tax yield of a debt instrument. Consequently, while a reserve established based upon the general expectation that credit losses will occur in the future is not deductible for tax purposes, the specific write-off of a debt instrument due to a credit loss may result in a properly deductible tax expense (see below).

Non-accrual of interest

The Tax Rules require that interest income continues to be accrued to the point it is no longer collectible. In those circumstances where interest has been properly accrued and is subsequently determined to be uncollectible, the holder may not reverse the accrual but may record a bad debt expense or loss deduction (see below). If, however, it can be demonstrated that the interest income is “uncollectible” at the date it otherwise would be accrued, then the accrual of interest is not required. For this purpose, interest would be considered “uncollectible” where, based upon the surrounding facts and circumstances, no reasonable expectation exists at the time of accrual that the interest will be collected.

Bad debt expense

Typically, a holder is entitled to a deduction for bad debt expense when there is clear evidence that a debt instrument it owns has become wholly or partially worthless. In the case of a deduction for partial worthlessness, the holder must be able to demonstrate that the debt instrument was “charged off” on the holder’s books and records during the same tax year as the deduction is taken. Special rules can apply to require the recognition of gain or loss upon foreclosure of a loan to the extent that the fair market value of property acquired in foreclosure differs from the holder’s tax basis in the loan. In addition, a modification to the terms of a debt instrument that is considered to be “significant” under the Tax Rules can result in the recognition of taxable gain or loss.

The ability to deduct bad debt expense does not apply to certain debt instruments considered a “security” for this purpose, such as debt issued by a corporation in registered form. Also, noncorporate holders are entitled to an ordinary deduction only if the debt instrument was created or acquired in connection with the holder’s trade or business. The inability to meet this requirement would cause such a loss to be available only at the time of complete worthlessness, and to be characterized as a short-term capital loss.



Worthless securities

In the case of a security that is a capital asset in the hands of the investor and becomes worthless during the taxable year (i.e., if the investor does not otherwise qualify for a bad debt expense), the loss is treated as resulting from the sale or exchange of a capital asset on the last day of the same taxable year. The term “security” includes a share of stock in a corporation; a right to subscribe for, or to receive, a share of stock in a corporation; or a bond, debenture, note, or certificate, or other evidence of indebtedness, issued by a corporation or by a government or political subdivision thereof, with interest coupons or in registered form.

Possible tax increases with securitizations

Net controlled foreign corporation tested income (NCTI)

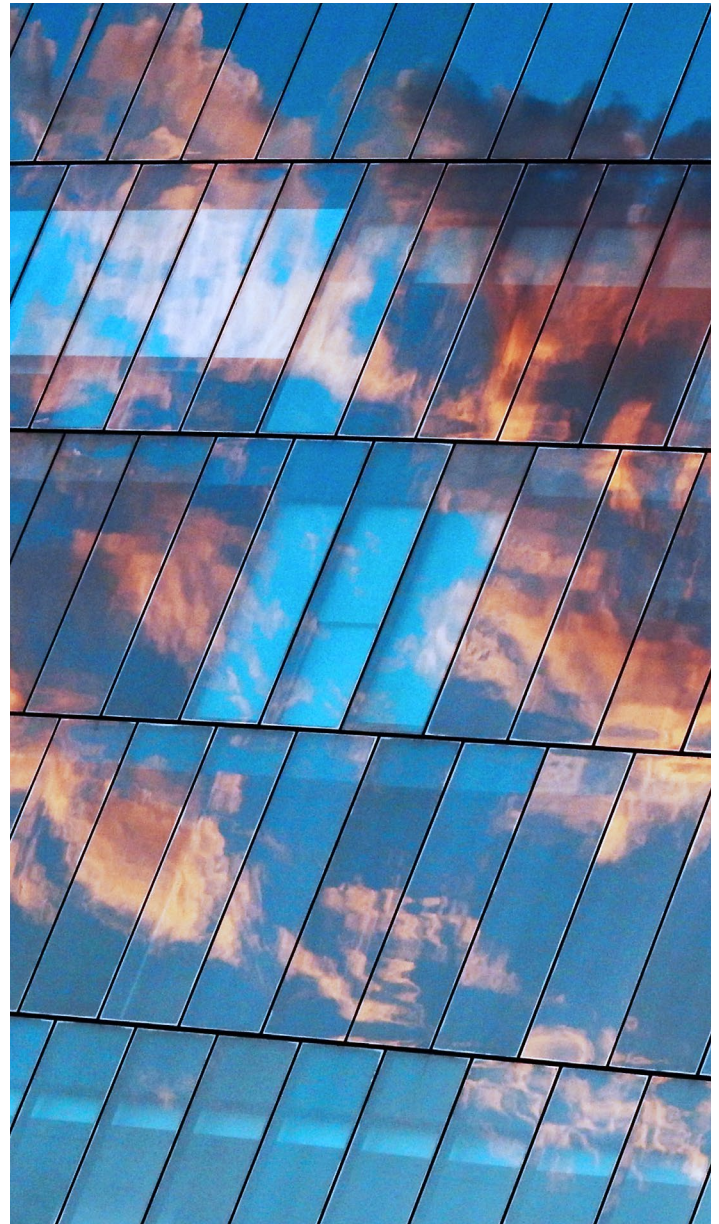
Starting with tax years beginning after December 31, 2025, the Global Intangible Low-Taxed Income (GILTI) tax is renamed to Net Controlled Foreign Corporation Tested Income (NCTI). Foreign securitization entities are often domiciled in low-tax jurisdictions, such as the Cayman Islands, so there may be concern that these entities or their shareholders would be subject to an additional tax under the NCTI rules. The starting point for the NCTI calculation is an aggregate of a shareholder’s “net CFC tested income” from its CFCs. An item that is specifically excluded from the net CFC tested income is gross income taken into account in determining the corporations’ subpart F income (passive income items such as interests, dividends, rents, royalties, or gain from the sale of the assets giving rise to this income). These make up most, if not all, of the income for securitizations. As such, securitizations generally do not have additional tax due to the NCTI regime. However, for a securitization entity structured as a foreign corporation that does generate a portion of its income from non-passive activities, the holders of interest treated as equity could be subject to the additional tax.

Limitations on deductibility of interest expense (IRC Section 163(j))

Section 163(j) potentially limits a taxpayer’s ability to deduct the full amount of its interest expense. Under 163(j), business interest expense is generally limited to the amount of one’s business interest income plus 30 percent of its adjusted taxable income. The limitation is complex and applies differently to different entity types. For tax years beginning after December 31, 2024, the 163(j) limitation calculation will use earnings before interest, taxes, depreciation, and amortization. For tax years beginning after December 31, 2025, the 163(j) limitation will apply to capitalized interest. Interest expense attributable to a securitization transaction may be included in the 163(j) calculations of the owner of interests treated as equity, as described above. It is important to remember that many securitization vehicles hold interest-income-generating assets, therefore frequently the interest income generated by a securitization vehicle will exceed the interest expense of the vehicle. For transactions holding non-interest-income-generating assets, such as those securitizing lease income, 163(j) will possibly create a significant planning concern.

Non-deductible expenses

Deductions for individuals for miscellaneous itemized deductions that exceed 2 percent of an individual’s adjusted gross income are no longer allowed. These deductions were previously allowable under IRC Section 212 prior to the Tax Cuts and Jobs Act of 2017. Under the One Big Beautiful Bill Act, the miscellaneous itemized deductions are permanently eliminated for tax years beginning after December 31, 2025. Within a securitization, examples of these expenses are management fees, servicing fees, and other administrative fees. These previously could have been the largest deduction of a securitization partnership, aside from interest expense. Individuals holding interests treated as equity in flow-through entities, such as partnerships or grantor trusts, should consider the impact of this provision.



Contacts



Authors

Lakshmanan (Bala) Balachander

Consulting Services Principal | Deloitte & Touche LLP
+1 212 436 5340
lbalachander@deloitte.com

William Fellows

Audit & Assurance Partner | Deloitte & Touche LLP
+1 718 508 6888
wfellows@deloitte.com

Michelle Markowitz

Tax Managing Director | Deloitte Tax LLP
+1 713 982 4265
mmarkowitz@deloitte.com

Rishin Pandya

Consulting Services Managing Director | Deloitte & Touche LLP
+1 312 486 7585
ripandya@deloitte.com

Andrew Pidgeon

Audit & Assurance Partner | Deloitte & Touche LLP
+1 415 783 6426
apidgeon@deloitte.com

Greg Sobreiro

Audit & Assurance Managing Director | Deloitte & Touche LLP
+1 212 436 2487
gsobreiro@deloitte.com

Contributors

In memoriam:

James Cahalan

Managing Director | Deloitte & Touche LLP

Cara Bhalla

Audit & Assurance Senior Manager | Deloitte & Touche LLP
+1 703 251 1475
cbhalla@deloitte.com

Christy Bihm

Audit & Assurance Managing Director | Deloitte & Touche LLP
+1 203 761 3110
cbihm@deloitte.com

Elisa Esposito

Audit & Assurance Managing Director | Deloitte & Touche LLP
+1 212 436 4216
eesposito@deloitte.com

Aadarsh Malayil

Consulting Services Senior Consultant | Deloitte & Touche LLP
+1 212 436 4570
amalayil@deloitte.com

Christie Murphy

External Communications QRM Support Specialist Manager |
Deloitte & Touche LLP
+1 313 394 5017
christimurphy@deloitte.com



Prefer the complete perspective?

Latest updates on accounting, tax and regulatory considerations for securitizations.

[View full handbook](#)



This publication contains general information only and Deloitte is not, by means of this publication, rendering accounting, business, financial, investment, legal, tax, or other professional advice or services. This publication is not a substitute for such professional advice or services, nor should it be used as a basis for any decision or action that may affect your business. Before making any decision or taking any action that may affect your business, you should consult a qualified professional advisor. Deloitte shall not be responsible for any loss sustained by any person who relies on this publication.

About Deloitte

Deloitte refers to one or more of Deloitte Touche Tohmatsu Limited, a UK private company limited by guarantee ("DTTL"), its As used in this document, "Deloitte" means Deloitte & Touche LLP, and Deloitte Tax LLP. These entities are separate subsidiaries of Deloitte LLP. Please see www.deloitte.com/about for a detailed description of our legal structure. Certain services may not be available to attest clients under the rules and regulations of public accounting.

Copyright © 2026 Deloitte Development LLC. All rights reserved.