New REMIC Regulations on Modifications of Commercial Loans and Related IRS Revenue Procedure

The Internal Revenue Service (the "IRS") has issued final regulations titled "Modifications of Commercial Mortgage Loans held by a Real Estate Mortgage Investment Conduit" ("REMIC") (the "New Regulations"). The New Regulations cover changes in collateral, guarantees, and credit enhancement on performing commercial mortgage loans, as well as changes to the recourse nature of such obligations. They represent an expansion of instances in which commercial mortgage loans may be modified without causing them to fail to be "qualified mortgages," which failure may jeopardize a REMIC's ability to qualify as such for tax purposes. The New Regulations, which have been pending since proposed regulations were issued in November 2007, are designed to make it easier for servicers to restructure securitized mortgage loans, and represent a part of ongoing government efforts to stave off a potential crisis in the commercial real estate market. The New Regulations are effective with respect to modifications made to the terms of obligations on or after September 16, 2009.

The New Regulations cover mortgages held by REMICs, but not by investment (grantor) trusts. Existing regulations provide that an investment trust is not classified as a trust if there is a power under the trust agreement to vary the investment of the certificate holders. Changes to the terms of commercial mortgage loans held by investment trusts may raise issues as to whether a "power to vary" is present, and it had been hoped that the scope of the REMIC regulation project would be expanded to permit investment trusts to modify commercial mortgage loans in the same manner as REMICs without jeopardizing trust status. The New Regulations did not, however, extend to modifications of mortgage loans held by investment trusts. Rather, simultaneously with the issuance of the New Regulations, the IRS issued Notice 2009-79, requesting comments on the extent to which, and in what fashion, the New Regulations should be so extended.

The IRS also issued a new Revenue Procedure 2009-45, which largely grants servicers the ability to modify commercial mortgage loans as to which there is a "significant risk of default" at maturity or at an earlier date, based upon credible borrower representations, without specifying any maximum time before maturity. This pronouncement complements the New Regulations by providing additional leeway to servicers to modify commercial loans even in the absence of a current default, or imminent default, *e.g.*, where a loan is performing but the borrower, in view of the current credit crunch, may not be able to count on obtaining refinancing of the loan at maturity.

Summary of New Regulations

Overview

In general, if there is a "significant modification" of an obligation that is held by a REMIC, then the modified obligation is treated as one that was newly issued in exchange for the unmodified obligation that it replaced. For this purpose, certain rules, set out in Section 1001 of the Internal Revenue Code (the "Code"), determine whether a modification is "significant." Because REMICs cannot acquire new loans after a prescribed initial period, a significantly modified obligation generally fails to be a qualified mortgage for REMIC purposes. Pre-existing regulations contained a list of modifications that were expressly permitted without regard to the Section 1001 modification rules, including changes occasioned by default or reasonably foreseeable default. The New Regulations expand this list of permitted exceptions. The new permissible changes may be made so long as the obligation continues to be "principally secured" by an interest in real property, as described in the New Regulations. The New Regulations also clarify when a release of a lien on real property securing a qualified mortgage will not disqualify the mortgage for REMIC purposes.

Additional Permitted Modifications

The New Regulations provide that a modification that releases, substitutes, adds, or otherwise alters a substantial amount of the collateral for, a guarantee on, or other form of credit enhancement for, a recourse or nonrecourse obligation, will not cause a disqualification of the mortgage, as long as the obligation continues to be principally secured by an interest in real property following the release, substitution, addition, or other alteration. Similarly, a change in the nature of the obligation from recourse (or substantially all recourse) to nonrecourse (or substantially all nonrecourse), or from nonrecourse (or substantially all nonrecourse) to recourse (or substantially all recourse), will not cause disqualification, again, as long as the obligation continues to be principally secured by an interest in real property following such a change.

The Lien Release Rule

The New Regulations clarify that a release of a lien on an interest in real property that does not result in a significant modification under the Section 1001 modification rules (*e.g.*, a release or substitution of collateral pursuant to the borrower's unilateral option under the terms of the mortgage loan) is not a release that disqualifies a mortgage loan, as long as the mortgage continues to be principally secured by real property, as described in the New Regulations, after giving effect to any releases, substitutions, additions, or other alterations to the collateral. Similarly, the New Regulations clarify that a lien release occasioned by a default or a reasonably foreseeable default is not a release that disqualifies the mortgage, again, as long as the principally-secured test continues to be satisfied.

Test for Determining Whether an Obligation Continues to be Principally Secured by Real Property and the Requirement to Retest the Collateral Value

An obligation is "principally secured" by an interest in real property if the fair market value of the real property that secures that obligation equals at least 80 percent of the adjusted issue price of the obligation. Pre-existing regulations require the 80-percent test to be satisfied either at the time the obligation was originated or at the time the sponsor contributes the obligation to the REMIC. If an obligation is significantly modified and deemed reissued, the 80-percent test must also be reapplied.

The New Regulations retain the retesting requirement in the new instances in which modification is permitted. Under the New Regulations, the fair market value of the interest in real property securing the obligation, determined as of the date of the modification, must be at least 80 percent of the adjusted issue price of the modified obligation, determined as of such date. If the servicer "reasonably believes" that the 80-percent test has been met, the modified obligation is deemed to satisfy this test. "Reasonable belief" can be based on:

- a formal current appraisal;
- an original appraisal that has been appropriately updated;

- a substantially contemporary sale of the real property interest in which the buyer assumes the seller's obligations under the mortgage;
- or some other "commercially reasonable" valuation method.

This represents an expansion over the "reasonable belief" standards set forth in earlier proposed regulations.

In addition, for changes that do not decrease the value of real property securing the mortgage loan, the New Regulations provide an alternative method for satisfying the principally-secured test. For these types of changes (*e.g.*, a change from recourse to nonrecourse, or vice versa), the New Regulations provide that a modified mortgage loan continues to be principally secured by real property if the fair market value of the interest in real property that secures the loan immediately after the modification equals or exceeds the fair market value of the interest in real property that secured the loan immediately before the modification.

The New Regulations also require retesting with respect to a lien release that is not a significant modification under the Section 1001 modification rules (*e.g.*, a release of real property collateral pursuant to the borrower's unilateral option under the terms of the mortgage loan). Here too, the principally-secured test is satisfied if either the 80-percent test is met based on the current value of the real property securing the mortgage, or if the value of the real property collateral after the modification is no less than the value of the real property collateral immediately before such modification. The preamble to the New Regulations states that for purposes of retesting with respect to alterations to real property collateral, the transaction causing the alteration is looked at in its entirety in determining the value of the real property collateral. For example, if, as part of an overall plan to make improvements to real property collateral that secures a mortgage loan, a borrower demolishes an existing building and constructs a new building on that real property, the fair market value of the real property collateral is determined by taking into account both the demolition of the existing building and the construction of the new building.

The alternate 80-percent test noted above has been criticized in respect of its application to releases of real property collateral, because in such case the fair market value will by definition decline by the value of the amount released, including where the release is accompanied by a principal paydown reducing the loan size in relation to the real property, or where the released property was not counted in meeting the 80-percent test at origination of the loan. An expansion of the test to cover, *inter alia*, situations where the loan-to-value ratio has not decreased, where a lien release must be agreed to by the REMIC, or where the loan is paid down in an amount equal to the net proceeds from a sale of the released collateral has been suggested. It remains to be seen if the IRS will agree to amend the New Regulations accordingly.

Summary of New Revenue Procedure

Revenue Procedure 2009-45 (the "Rev. Proc.") describes conditions under which modifications to certain mortgage loans will not cause the IRS to challenge the tax status of securitization vehicles that hold the loans, or to assert that those modifications give rise to "prohibited transactions" triggering adverse tax consequences. Specifically the Rev. Proc. provides that the IRS will not contend that modifications that fit within the guidelines described below will jeopardize a securitization vehicle's qualification as REMIC or as an investment trust, or cause a REMIC to be treated as having engaged in a prohibited transaction. The protection against challenge to REMIC status prohibits the IRS from asserting either that such loan modifications are not among the exceptions permitted under the REMIC regulations or that they result in a deemed reissuance of REMIC regular interests.

The Rev. Proc. applies to modifications of a mortgage loan (the “pre-modification loan”) that is held by a REMIC or an investment trust, if all of the following conditions are satisfied:

- The pre-modification loan is not secured by a residence that contains fewer than five dwelling units and that is the principal residence of the issuer of the loan.
- Either (i) if a REMIC holds the pre-modification loan, then as of the end of the three-month period beginning on the startup day, no more than 10 percent of the stated principal of the total assets of the REMIC was represented by loans, the payments on which, at the time of contribution of the loans to the REMIC, were then overdue by at least 30 days or a default on the loan was reasonably foreseeable; or (ii) if an investment trust holds the pre-modification loan, then as of all dates when assets were contributed to the trust, no more than 10 percent of the stated principal of all the debt instruments then held by the trust was represented by instruments the payments on which were then overdue by 30 days or more or for which default was reasonably foreseeable.
- Based on all the facts and circumstances, the holder or servicer “reasonably believes” that there is a significant risk of default of the pre-modification loan upon maturity of the loan or at an earlier date. In this connection, the Rev. Proc. states that this reasonable belief must be based on a diligent contemporaneous determination of that risk, which may take into account credible written factual representations made by the issuer of the loan if the holder or servicer neither knows nor has reason to know that such representations are false. It is further provided that, in a determination as to the significance of the risk of default, one relevant factor is how far in the future the possible default may be, but that there is no maximum period after which default is *per se* not foreseeable. For example, in appropriate circumstances, a holder or servicer may reasonably believe that there is a significant risk of default even though the foreseen default is more than one year in the future. Similarly, although past performance is another relevant factor for assessing default risk, in appropriate circumstances, a holder or servicer may reasonably believe that there is a significant risk of default even if the loan is performing.
- Based on all the facts and circumstances, the holder or servicer reasonably believes that the modified loan presents a substantially reduced risk of default, as compared with the pre-modification loan.

The Rev. Proc. states that no inference should be drawn about (i) whether the same protections against adverse tax consequences would apply if a transaction were to fall outside its scope or (ii) that, in the absence of the Rev. Proc., transactions covered by it would have impaired the tax status of securitization vehicles or given rise to prohibited transactions.

The Rev. Proc. applies to loan modifications effected on or after January 1, 2008.

Chicago Office
+1.312.583.2300

Los Angeles Office
+1.310.788.1000

Frankfurt Office
+49.69.25494.0

New York Office
+1.212.836.8000

London Office
+44.20.7105.0500

Shanghai Office
+86.21.2208.3600

Washington, DC Office
+1.202.682.3500

West Palm Beach Office
+1.561.802.3230