IRS Issues Revenue Procedure Providing Additional Guidance on Qualified Status of Mortgage Loans held by REMICs — Expansion of "Lien Release Rules"

Introduction

The Internal Revenue Service (the "IRS") recently issued a revenue procedure ("Rev. Proc. 2010-30") designed to liberalize instances in which a release of a lien on real property securing a mortgage loan can be effected without jeopardizing the ability of an entity to qualify as a "real estate mortgage investment conduit" (or "REMIC"). Rev. Proc. 2010-30, described in more detail below, is a follow-on to REMIC regulations issued last year (the "Regulations"), which were designed to make it easier to restructure securitized mortgage loans without creating tax issues for REMICs. The Regulations failed to deal with certain issues raised in the lien release context. Rev. Proc. 2010-30 goes at least some way toward resolving such issues.

Background

The Regulations became effective with respect to modifications made to REMIC-held mortgage obligations on or after September 16, 2009. The Regulations covered changes in collateral, guarantees, and credit enhancement on performing commercial mortgage loans, as well as changes to the recourse nature of such obligations. The Regulations represented 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. Nevertheless, the Regulations left certain issues unresolved that are of concern to loan servicers and others involved in the mortgage-backed debt market.

Under the Regulations, and the REMIC rules generally, a mortgage loan is a "qualified mortgage" only if it is "principally secured" by an interest in real property. A loan is "principally secured" by an interest in real property if the fair market value of the interest in real property securing the obligation (i) is at least 80% of the adjusted issue price of the obligation at the time the obligation was originated or (ii) is equal to at least 80% of the adjusted issue price of the obligation when the sponsor contributes such obligation to the REMIC.

The Regulations provide that if a REMIC releases its lien on an interest in real property that secures a qualified mortgage, such mortgage ceases to be a qualified mortgage on the date of such release unless (i) the REMIC releases its lien in a modification that (A) is either not a "significant modification" for tax purposes or is a specifically listed permissible modification under the REMIC rules (in either of which cases, there is no deemed reissuance of the loan for income tax purposes) and (B) following such modification, the obligation continues to be "principally secured" by an interest in real property or (ii) the mortgage is defeased in the manner specifically provided by the Regulations, including substituting government securities as collateral. It is the first exception — specifically, the requirement that an obligation that undergoes even a modification that does not rise to the level of a "significant modification" (or is otherwise permissible under other provisions of the Regulations) must be retested at the time of such modification to determine whether the obligation is "principally secured" by an interest in real property — that has given rise to concern.

Following a modification, and consistent with the rule noted above, an obligation continues to be "principally secured" by an interest in real property only if (i) as of the date of such modification, the fair market value of the interest in real property securing the obligation is at least 80% of the adjusted issue price of the modified obligation or (ii) the fair market value of the interest in real property that secures the obligation immediately after the modification equals or exceeds the fair market value of the interest in real property that secured the obligation immediately before the modification.

In light of current market conditions, many properties that initially were valued at an amount enabling the loan to be a "qualified mortgage" may well be at a value below the 80% threshold required under the "principally secured" test discussed above, at the time of a loan modification. Accordingly, the commercial real estate industry expressed concern with the requirement that a mortgage loan that has undergone a non-significant modification (including a modification pursuant to a unilateral option of the borrower to release collateral) be retested under the "principally secured" test, thus potentially threatening REMIC status. Rev. Proc. 2010-30 provides some relief on this point, albeit not, in certain respects, as broadly as had been suggested by certain industry representatives.

Details of Rev. Proc. 2010-30

Rev. Proc. 2010-30 provides that if a release of a lien on an interest in real property that secures a mortgage loan held by a REMIC does not satisfy the "principally secured" (by an interest in real property) test, as applied after a mortgage loan undergoes a modification, the IRS will, nevertheless, not challenge the mortgage loan's status as a qualified mortgage following the lien release if one of two requirements is satisfied.

Requirement 1 (Grandfathered Transaction)

This requirement is considered satisfied if there is any release of a lien on an interest in real property, and (1) such lien release is not a "modification" (as such term is defined in generally applicable regulations dealing with when a "modification" to a loan may or may not result in a deemed reissuance thereof) because such release occurred by operation of the terms of the debt instrument (including a lien release that occurs pursuant to the exercise of a "unilateral option" of the borrower) and (2) the terms providing for such lien release are contained in a contract that was executed on or before December 6, 2010.

Requirement 1 is apparently aimed at accommodating situations where a loan agreement permits a release, even if the result is real estate collateral with little or no value, but only, as indicated, for agreements executed on or before a specific date. After that, presumably, lenders will need to require an appraisal or other assurance as to the value of the remaining collateral (at least unless Requirement 2 is met).

Requirement 2 (Qualified Pay-Down Transaction)

This requirement is considered satisfied if a lien is released on an interest in real property and the borrower makes a payment resulting in a reduction in the adjusted issue price of the loan by a "qualified amount." The "qualified amount" is an amount that is equal to or greater than at least one of the following:

1. The sum of (a) the net proceeds available to the borrower from an arm's-length sale of the property to an unrelated person, (b) the net proceeds from the receipt of a condemnation award with respect to the property, and (c), in a case to which (a) or (b) above applies, the net proceeds from the receipt of an insurance or tort settlement with respect to the property.

2. An amount that is determined under the loan agreement and that equals or exceeds the product of (x) the adjusted issue price of the obligation at the time of the lien release and (y) a fraction equal to the fair market value at origination of the released interest, divided by the aggregate fair market value at origination of all of the interests in real property that secured the loan immediately before the lien release.
3. The fair market value (at the time of the transaction) of the interest in real property the lien on which is released, plus the amount of any tort or insurance settlement that is expected to be, or has been, received with respect to the property and that is not reflected directly or indirectly in the property's fair market value at the time of the transactions.
4. An amount such that, immediately after the transaction, the ratio of the adjusted issue price of the loan to the fair market value of the interests in real property securing the loan is no greater than such ratio immediately before the transaction.

Rev. Proc. 2010-30 states that if the servicer "reasonably believes," as of the date of the lien release, that the transaction satisfies one of the criteria set forth in items 3 or 4 above, then that criterion is deemed satisfied. A "reasonable belief" must be based on certain information and methods set forth in the Regulations and will not be deemed to exist if the servicer actually knows, or has reason to know, that the criterion is not satisfied.

The concept behind Requirement 2 appears to be to permit a failure to comply with the "principally secured" test as long as there is some evidence of the lender having acted reasonably under the circumstances, *i.e.*, by getting some paydown of the loan. Arguably, the IRS could have gone further, for example, by permitting non-compliance where new property is substituted that at least maintains the loan-to-value ratio at a level equal to what it was immediately before the modification, even in the absence of a reduction in the loan amount. The question is, therefore, whether Rev. Proc. 2010-30 goes far enough to accommodate industry concerns.

Rev. Proc. 2010-30 applies to releases of liens on interests in real property securing mortgage loans held by REMICs that are effected on or after September 16, 2009, thus dovetailing with the effective date of the Regulations.

Chicago Office +1.312.583.2300	**Frankfurt Office** +49.69.25494.0	**London Office** +44.20.7105.0500
Los Angeles Office +1.310.788.1000	**Menlo Park Office** +1.650.319.4500	**New York Office** +1.212.836.8000
Shanghai Office +86.21.2208.3600	**Washington, DC Office** +1.202.682.3500	**West Palm Beach Office** +1.561.802.3230