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IRS Guidance Expands Permissible Lien Releases for Qualified Mortgages Held by REMICs

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The Internal Revenue Service ("IRS") released official guidance that expands the situations in which a release of a lien on an interest in real property securing a mortgage loan held by a real estate mortgage investment conduit ("REMIC") will not cause such loan to fail to be a qualified mortgage under the REMIC rules. Under these rules, ***lien releases pursuant to the existing terms of the debt instrument or certain significant pay-downs of the debt will not adversely affect a REMIC's status***.

The new guidance continues the IRS's recent approach of expanding and relaxing the REMIC rules in response to turmoil in the commercial real estate market.[1] Planning opportunities exist under the new guidance for REMICs and commercial mortgage loan servicers, although certain planning opportunities will expire after December 6, 2010.

Background

To qualify for pass-through taxation as a REMIC, substantially all the REMIC's assets must be qualified mortgages and other permitted investments as of the end of the REMIC's three-month start-up period and at all times thereafter. A mortgage loan must be principally secured by an interest in real property in order to be a qualified mortgage.

- In general, the principally secured test is based on the fair market value of the interests in real property securing the mortgage loan at the time it was originated by or contributed to the REMIC.
- If there is a "significant modification" of a loan after the REMIC's three-month start-up period, the loan, except as set forth below, will cease to be a qualified mortgage and the REMIC would lose its pass-through tax status. However, Treasury Regulations specify that the following types of modifications will not adversely impact REMIC status:
  - Changes in the terms of the obligation due to default or a reasonably foreseeable default;
  - Assumption of the obligation;
  - Waiver of a due-on-sale clause or a due-on-encumbrance clause;

- Conversion of an interest rate by a mortgagor under a convertible mortgage;
- Changes in collateral, guarantees, or credit enhancement of the loan; and
- Changes in the recourse nature of the loan.

The latter two types of modifications above require a retesting for the principally secured by an interest in real property requirement.

- When there is a release of a lien on an interest in real property securing a qualified mortgage, it generally is necessary to retest for the principally secured by an interest in real property requirement whether or not the lien release is a significant modification. The new IRS guidance provides two exceptions to this general rule, as discussed below.

Permissible Lien Releases Under New IRS Guidance

In Revenue Procedure 2010-30, the IRS announced that it will not challenge the status of a REMIC's mortgage loan as a qualified mortgage due to the loan not satisfying the principally secured test after a lien release in either a "grandfathered transaction" or a "qualified pay-down transaction" occurring on or after September 16, 2009.

- **Grandfathered Transaction**:
  - The lien release occurs by operation of the terms of the debt instrument (including pursuant to the exercise of a unilateral option of the borrower); and
  - The terms providing for the lien release are contained in a contract that is executed no later than December 6, 2010.
- **Qualified Pay-Down Transaction**: the lien release transaction includes a payment by the borrower resulting in a reduction of the loan's adjusted issue price by at least a "qualified amount." A "qualified amount" is any of the following:
  - The sum of the net proceeds available to the borrower from an arm's-length sale of the property, the net proceeds from the receipt of a condemnation award with respect to the property, or the net proceeds from the receipt of an insurance or tort settlement with respect to the property;
  - An amount determined under the loan agreement and that is at least equal to a proportionate amount of the adjusted issue price of the obligation at the time of the lien release relative to the fair market value of all the real estate interests securing the loan at such time;
  - The fair market value (at the time of the lien release transaction) of the real property interest the lien on which is released, plus any additional tort or insurance settlement that has been or is expected to be received with respect to such property (if not reflected in the fair market value at such time); or
  - An amount such that the ratio of the adjusted issue price of the loan to the fair market value of the interests in real property securing it is no greater than such ratio immediately before the lien release transaction.

Planning Opportunities

- The new IRS guidance may permit lien releases by REMICs and loan servicers without jeopardizing qualified mortgage status even in certain situations where the fair market value of the remaining underlying real property security has fallen to a level that would not currently satisfy the principally secured test.

- It may be possible to modify existing mortgage loans so that a subsequent lien release will qualify as a "grandfathered transaction" under the new IRS guidance by providing for such release to occur by the terms of the debt instrument. However, (1) any such modification would need to be in place by December 6, 2010, and (2) since such modification will be a significant modification of the existing obligation, it will likely be necessary to retest for the principally secured by an interest in real property requirement at the time of such modification.

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[1] For a discussion of recent IRS guidance applicable to REMICs, see our September 2009 Client Alert (available at http://www.paulhastings.com/publicationDetail.aspx?PublicationId=1407).