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IRS Guidance on Modifications of Securitized Commercial Mortgage Loans Provides New Flexibility and Also Imposes New Requirements

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On September 15, 2009, the Internal Revenue Service ("IRS") released a package of official guidance on modifications of securitized commercial mortgage loans, providing both increased flexibility and new restrictions on the ability to modify such loans without adverse tax consequences. The package of guidance included:

- Revenue Procedure 2009-45 (the "Revenue Procedure") providing increased flexibility to lenders and servicers of commercial mortgage loans securitized by real estate mortgage investment conduits ("REMICs") or investment trusts to modify such loans without jeopardizing the tax status of the securitization vehicle or the tax treatment of such loans. The Revenue Procedure applies to modifications effected on or after January 1, 2008.
- Treasury Regulations ("Final Regulations") expanding the list of permissible modifications to loans securitized by REMICs to include changes in (i) collateral, guarantees, and credit enhancement of the loan, and (ii) the recourse nature of the loan, provided that the modified loan continues to be principally secured by an interest in real property. The Final Regulations also impose a new requirement to retest the collateral value of a loan after modification to determine whether it is principally secured by an interest in real property at such time, although such retesting may utilize a new alternative test for determining value. The Final Regulations are effective beginning September 16, 2009.
- Notice 2009-79 requesting comments on whether the new guidance in the Final Regulations for modifications of mortgage loans held by REMICs should also be extended to mortgage loans held by investment trusts.

REVENUE PROCEDURE 2009-45

Increased Flexibility to Modify Mortgage Loans Held By REMICs and Investment Trusts

The Revenue Procedure provides standards for modifying distressed mortgage loans which if observed will not jeopardize the pass-through tax status of the REMIC or investment trust and will not cause the modification to be subject to the REMIC prohibited transactions tax.1

This should allow flexibility to modify distressed mortgage loans when the lender or servicer reasonably believes, based on all the facts and circumstances prior to modification, that there is a significant risk of default on the loan at or before maturity and that the modification of the loan substantially reduces this risk of default. The reasonable belief regarding the significant risk of default must be based on a diligent contemporaneous determination of such risk, which may be based in part on credible written factual representations made by the issuer of the loan provided that the lender or servicer does not know or have reason to know that such representations are false.

From a practical standpoint based on industry practice, servicers are reluctant to restructure securitized loans prior to an imminent default. However, the Revenue Procedure states that there is no maximum period after which default is per se not foreseeable, and in appropriate circumstances there may be a significant risk of default even if the possible default would occur more than one year in the future. In addition, a significant risk of default may exist even if a loan is still performing at the time of the modification. The standards provided in the Revenue Procedure may provide some comfort in situations where a modification is economically appropriate but default cannot be said to be imminent and there are several months before maturity.

FINAL REGULATIONS & NOTICE 2009-45

Expanded List of Permitted Modifications of Loans Held by REMICs

To qualify as a REMIC, a substantial amount of the REMIC's assets must be qualified mortgages that are principally secured by an interest in real property. If there is a "significant modification"[2] of a loan after the start-up period,[3] the loan will cease to be a qualified mortgage and the REMIC could lose its pass-through tax status. However, Treasury Regulations specify certain modifications that will not adversely impact REMIC status.[4]

The Final Regulations expand the list of expressly permitted loan modifications to include:

(i) changes in collateral, guarantees, and credit enhancement of the loan, and

(ii) changes in the nature of the loan from recourse to nonrecourse or *vice versa*.

In each case, the loans must continue to be principally secured by an interest in real property following any modification.

The Final Regulations further clarify that a release of a lien on real property in certain circumstances[5] will not cause a loan to cease to be a qualified mortgage, provided that after such lien release the obligation continues to be principally secured by an interest in real property.

New Requirements for Retesting Collateral Value After Modifications and Lien Releases

In order to be principally secured by an interest in real property, the fair market value of the interest in real property securing the mortgage must be at least 80-percent of the obligation's adjusted issue price ("80-percent test") at the time the obligation is originated or contributed to the REMIC. Under prior law, there was no requirement to continually satisfy the 80-percent test after the start-up period. The Final Regulations, however, impose a new requirement to retest the collateral value of the obligation at the time it is modified to reflect a change in collateral, guarantee or credit enhancement, a change in recourse nature, or a release of a real property lien that does not result in a significant

modification (such as in connection with a substitution of collateral pursuant to a borrower's unilateral option under the loan documents).

For practical purposes, this new collateral value retesting requirement may complicate or inhibit partial releases of real property liens pursuant to a borrower's unilateral option, and releases of real property liens securing loans in actual or reasonably foreseeable default. Under prior law, such lien releases could generally be accomplished without retesting collateral value. However, under the Final Regulations these lien releases generally will trigger a collateral value retesting requirement and, depending on the valuation facts, could cause the modified loan to fail to qualify as a qualified mortgage due to not being principally secured by an interest in real property.

We note that if the requirements of the Revenue Procedure are satisfied (such as reasonable belief that there is a significant risk of default and that the modified loan reduces this risk), then the IRS will not challenge a REMIC's tax status based on a modification covered by the Revenue Procedure. Thus, notwithstanding the Final Regulations, it should still be possible to modify a loan (including the release of a real property lien securing the loan) without triggering the new collateral value retesting requirement provided that the requirements of the Revenue Procedure are satisfied. This result may not be consistent with the intent of the Final Regulations.

Alternative Method for Collateral Value Test

In addition to imposing new collateral value retesting requirements, the Final Regulations also provide an alternative method to the 80-percent test for determining whether an obligation continues to be principally secured by an interest in real property. Pursuant to the Final Regulations, a mortgage is principally secured by an interest in real property if either (i) the 80-percent test is satisfied based on the current value of the real property securing the 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. Additionally, the modified mortgage will be treated as principally secured by an interest in real property if the servicer reasonably believes that the modified obligation satisfies the 80-percent test or the alternative method test. The servicer's reasonable belief must be based on a new appraisal, an original appraisal from the origination that has been updated for the passage of time and changes in value, the sale price of the interest in real property in a contemporaneous sale by the borrower, or another commercially reasonable valuation method.

Request for Comments on Application of Final Regulations to Loans Held by Trusts

The Final Regulations only apply to modifications of mortgage loans held by REMICs, not to modifications of loans held by investment trusts. Investment trusts generally may not have the power to vary the investments of the trust without jeopardizing their flow-through tax status. Thus, some commentators suggested that the IRS should expand the scope of its mortgage loan modification guidance to permit investment trusts to modify mortgage loans held in the trust without violating the restrictions on the trust's power to vary its investments. The IRS issued Notice 2009-79 requesting additional comments on this issue.

Expanding the guidance on securitized mortgage loan modifications to include loans held by investment trusts would provide consistent treatment for loans held in pass-through securitization structures, such as the collateralized debt obligation ("CDO") structure. Real estate investment trusts and other commercial mortgage market participants frequently use CDO structures to securitize pools of mortgage loans through the issuance of various rated tranches of trust interests by the CDO

vehicle, which in turn are generally sold by the CDO sponsor to investors. Until further guidance is issued, modifications of loans held in such CDO structures may be subject to more restrictive modification limits than comparable loans held by REMICs due to the concern that such modifications could constitute impermissible variations of trust investments, thus jeopardizing the pass-through tax status of the investment trust securitization vehicle.

CONCLUSION

The Final Regulations and the Revenue Procedure provide lenders and servicers with increased flexibility to restructure distressed mortgage loans. Perhaps most importantly, the Revenue Procedure addresses current industry practice of requiring a mortgage loan to be in imminent danger of default by allowing restructuring to occur well in advance of a potential default. However, the Final Regulations also impose new requirements regarding retesting collateral value after a modification or real estate lien release (which may not be required for modifications covered by the Revenue Procedure), and limited relief for modifications of loans held in investment trusts (such as CDOs) rather than REMICs. Thus, while this guidance offers some practical utility in specific and not uncommon factual situations, the overall set of procedures is subject to some very significant limitations.

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1 REMICs are subject to a tax equal to 100-percent of the net income derived from "prohibited transactions," including a disposition of a qualified mortgage unless an exception applies.

2 Determination of whether there is a "significant modification" of a loan is made in accordance with Treas. Reg. § 1.1001-3.

3 The "start-up period" extends from the REMIC's "start-up day" to the end of the third month beginning after the start-up day. A "start-up day" is any day selected by a REMIC that is on or before the first day on which interests in the REMIC are issued

4 See Treas. Reg. § 1.860G-2(b)(3). Prior to the issuance of the Final Regulations, there were only four types of "significant modifications" under Treas. Reg. § 1.1001-3 that were expressly permitted for loans held by REMICs under Treas. Reg. § 1.860G-2(b)(3): 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, and conversion of an interest rate by a mortgagor under a convertible mortgage.

5 The clarification in the Final Regulations on releases of liens on real property applies to (i) a release of a lien on real property that does not result in a significant modification under Treas. Reg. § 1.1001-3 (such as the substitution of collateral at the borrower's unilateral option under the loan documents), and (ii) a release of a lien on real property caused by an actual or reasonably foreseeable default.