New Final Regulations Resolve Open Issues for Modifications of Commercial Mortgages Held by REMICs – But Modifications Held by Investment Trusts Remain Unanswered Pending Comments

[TD 9463, Rev. Proc. 2009-45, Notice 2009-79]

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News:
New Final REMIC Regulations Start September 16, 2009
Notice 2009-79 Comments re Investment Trusts are due November 14, 2009

New Final Regulations in Force:

On September 16, 2009, TD 9463 (26 CFR Parts 1 and 602) takes effect. TD 9463 **expands the list of permitted exceptions** under Section 1.860G-2(b)(3) to include (1) changes in **collateral, guarantees, and credit enhancement** and (2) clarifies when a release of a lien on real property securing a qualified mortgage does not disqualify the mortgage. Although these final regulations (TD 9463) resolve and clarify many issues for Modifications of commercial mortgages held by Real Estate Mortgage Investment Conduits (REMICs), the IRS and Treasury continue to study commentators' recommendations and solicit input concerning or comments on whether additional guidance may be appropriate on Modifications of Commercial Mortgage Loans Held by an Investment Trust (Notice 2009-79). Comments are due November 14, 2009.

Due to the current anemic credit markets, many commercial borrowers will not be able to refinance or satisfy the payment due at maturity (or conditions of refinance). With less liquidity and less sales, we see less take-outs and more liquidations. The accepted model of expecting to use the proceeds from refinancing to satisfy the principal balance due at maturity is facing great challenges and causing defaults, whether or not sufficient cash flow can satisfy the existing debt service.

At the Fitch MBS Conference in NYC (9/15/09), it was reported that, special servicers are seeing select short extensions or discounted payoffs. Short extensions were defined as 1 year or less, only to allow time for the borrower to seek foreseeable financing. The servicers are considering whether the impairment is temporary or permanent. If it is financially impracticable, it is likely to go to liquidation. Borrowers who can pay but are not willing, are more likely sent to liquidation. Borrowers who are in trouble and able to cure the temporary impairment are likely to obtain some limited extension to obtain financing or face liquidation. However, Borrowers should have a realistic plan in place with steps underway. Borrowers should contact the lender/servicer **before default or before reasonably foreseeable default** to afford the servicer more chances of fashioning a workout plan without invoking unnecessary costs, fees, or regulations. One tool used to advance this business judgment is found in the final regulations (TD 9463).

Historically:

Rev. Proc. 2009-45 applied to loan modifications effected on or after January 1, 2008. That "revenue procedure describes the conditions under which modifications to certain mortgage loans will not cause the Internal Revenue Service (Service) to challenge the tax status of certain securitization vehicles that hold the loans or to assert that those modifications give rise to prohibited transactions."
Rev. Proc. 2009-45 at Section 3 describes a REMIC regular interest as:

> A regular interest is one that is designated as a regular interest and whose terms are fixed on the startup day. Section 860G(a)(1). In addition, a regular interest must (1) unconditionally entitle the holder to receive a specified principal amount (or other similar amount), and (2) provide that interest payments, if any, at or before maturity are based on a fixed rate (or to the extent provided in regulations, at a variable rate).

Rev. Proc. 2009-45 at the following sections explains its history, intent and the consequences of non-compliance including the 100% tax on net income from prohibited transactions:

> .07 The legislative history of the REMIC provisions indicates that Congress intended the provisions to apply only to an entity that holds a substantially fixed pool of real estate mortgages and related assets and that "has no powers to vary the composition of its mortgage assets." S. Rep. No. 99–313, 99th Cong., 2d Sess. 791–92, 1986–3 (Vol. 3) C.B. 791–92.
> .08 Section 1.1001–3(c)(1)(i) defines a "modification" of a debt instrument as any alteration, including any deletion or addition, in whole or in part, of a legal right or obligation of the issuer or holder of a debt instrument, whether the alteration is evidenced by an express agreement (oral or written), conduct of the parties, or otherwise. Section 1.1001–3(e) governs which modifications of debt instruments are "significant." Under §1.1001–3(b), for most federal income tax purposes, a significant modification produces a deemed exchange of the original debt instrument for a new debt instrument.
> .09 Under §1.860G–2(b), related rules apply to determine REMIC qualification. Except as specifically provided in §1.860G–2(b)(3), 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. See §1.860G-2(b)(1). For this purpose, the rules in §1.1001–3(e) determine whether a modification is "significant." See §1.860G-2(b)(2). Thus, even if an entity initially qualifies as a REMIC, one or more significant modifications of loans held by the entity may terminate the qualification if the modifications cause less than substantially all of the entity's assets to be qualified mortgages.

.10 Certain loan modifications, however, are not significant for purposes of §1.860G–2(b)(1), even if the modifications are significant under the rules in §1.1001–3. In particular, under §1.860G–2(b)(3)(i), if a change in the terms of an obligation is **"occasioned by default or a reasonably foreseeable default,"** the change is not a significant modification for purposes of §1.860G–2(b)(1), regardless of the modification's status under §1.1001–3.
.11 Discussions between a holder or servicer and a borrower concerning a possible modification of a loan may occur at any time and need not begin only after the loan is in default or there is a reasonably foreseeable default.
.12 The Service understands that many industry participants believe that a loan modification necessarily fails to be "occasioned by default or a reasonably foreseeable default" unless the loan is not performing or default is imminent.
.13 Section 860F(a)(1) imposes a tax on REMICs equal to 100 percent of the net income derived from "prohibited transactions." The disposition of a qualified mortgage is a prohibited transaction unless the "disposition [is] pursuant to—(i) the substitution of a qualified replacement mortgage for a qualified mortgage . . . , (ii) a disposition incident to the foreclosure, default, or imminent default of the mortgage, (iii) the bankruptcy or insolvency of the REMIC, or (iv) a qualified liquidation." Section 860F(a)(2)(A).

Rev. Proc. 2009-45 at Section 5 at 01 describes its applicability and what conditions are required for a "pre-modification loan" held by a REMIC or an investment trust as follows:

.01 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.
.02 Either—(1) If a REMIC holds the pre-modification loan, then as of the end of the 3–month period beginning on the startup day, no more than ten percent of the stated principal of the total assets of the REMIC was represented by loans fitting the following description: At the time of contribution to the REMIC, the payments on the loan were then overdue by at least 30 days or a default on the loan was reasonably foreseeable; or
(2) If an investment trust holds the pre-modification loan, then as of all dates when assets were contributed to the trust, no more than ten 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.

Final Regulations Effective September 16, 2009:

The author is pleased to report that TD 9463 **expands the list of permitted exceptions** under Section 1.860G-2(b)(3) to include:

(1) changes in **collateral, guarantees, and credit enhancement** of an obligation and changes to the recourse nature of an obligation, so long as the obligation continues to be principally secured by an interest in real property, and

(2) clarify when a release of a lien on real property securing a qualified mortgage does not disqualify the mortgage.

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The Summary of Comments on page 3 state:

> Except as specifically provided in §1.860G-2(b)(3), 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. See §1.860G-2(b)(1). For this purpose, the rules in §1.1001-3(e) determine whether a modification is "significant." See §1.860G-2(b)(2). Because of when it is treated as having been acquired in the deemed exchange, a significantly modified obligation generally fails to be a qualified mortgage. Section 1.860G-2(b)(3), however, contains a list of modifications that are expressly permitted without regard to the section 1001 modification rules.

The regulations conclude its position to the following key issues in part as follows:

1. The Lien Release Rule - The final regulations clarify that a release of a lien on real property that does not result in a significant modification under §1.1001-3 (for example, 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, so long as the mortgage continues to be principally secured by real property after giving effect to any releases, substitutions, additions, or other alterations to the collateral. Similarly, the final regulations clarify that a lien release occasioned by a **default or a reasonably foreseeable default is not a release that disqualifies the mortgage**, so long as the principally-secured test continues to be satisfied. (Emphasis added)

2. The Requirement to Retest the Collateral Value - Generally, regulations require that an 80-percent test of the fair market value of the property be satisfied at origination, contribution but not after the start-up. Section 1.860G-2(a)(1) of the regulations provides that an obligation is principally secured by an interest in real property if the fair market value of the real property that secures the obligation equals at least 80 percent of the adjusted issue price of the obligation. TD 9463 states in part:

   > To ensure that a modified mortgage loan continues to be principally secured by an interest in real property, the IRS and the Treasury Department continue to believe that it is appropriate to retest at the time of the modification. Accordingly, the final regulations retain the retesting requirement, but amend the proposed standards for satisfying the principally secured test as described in section 3 in this preamble. In addition, to provide a more flexible standard for changes that do not decrease the value of real property securing the mortgage loan, the final

> regulations provide an alternative method for satisfying the principally secured test.
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> For these types of changes (for example, a change from recourse to nonrecourse, or vice versa), the final 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. This alternative test is consistent with the general rule that a decline in the value of collateral does not cause a mortgage loan to cease to be principally secured by real property. The final regulations provide an example to illustrate the application of this alternative method for satisfying the principally secured test.
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> The final regulations also require retesting with respect to a lien release that is not a significant modification for purposes of §1.1001-3 (for example, a release of real property collateral pursuant to the borrower's unilateral option under the terms of the mortgage loan). Here as well, the principally secured test is satisfied if either the 80–percent test is satisfied based on the current value of the real property securing the mortgage or the value of the real property collateral after the modification is no less than the value of the real property collateral immediately before.

3. The Appraisal Requirement - TD 9463 in pertinent part states:
In response to these comments and to make the retesting requirement more consistent with the current rules for satisfying the 80-percent test at the startup day, the final regulations provide that the principally-secured test will be satisfied if the servicer reasonably believes that the modified mortgage loan satisfies the 80-percent test at the time of the modification. The final regulations provide that a servicer must base a reasonable belief upon a commercially reasonable valuation method. The final regulations set forth a nonexclusive list of commercially reasonable valuation methods that can be used by servicers for retesting purposes. These same commercially reasonable methods can be used under the alternative test to establish that the value of the real property collateral immediately after the modification is no less than the value of the real property collateral immediately before it.

4. Changes in the Nature of an Obligation from Nonrecourse to Recourse - TD 9463 states: The final regulations clarify that changes in the nature of an obligation from nonrecourse (or substantially all nonrecourse) to recourse (or substantially all recourse) are permitted so long as the obligation continues to be principally secured by an interest in real property.

5. Investment Trusts – TD 9463 in pertinent part states: The IRS and the Treasury Department understand that 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 commentators recommended that the scope of the regulation project

> be expanded to permit investment trusts to modify commercial mortgage loans in the same manner as REMICs. To avoid a significant delay in the publication of these final regulations, their scope has not been expanded to include modifications of mortgage loans held by investment trusts. In a separate notice to be published in the Internal Revenue Bulletin contemporaneously with these final regulations, the IRS and the Treasury Department intend to request comments on this issue.

Comments on Notice 2009-79:

Notice 2009-79 specifies that issues in want of comment. A few miscellaneous and select issues or excerpts are as follows:

> The scope of the final regulations remained focused on § 1.860G-2(b)(3) and was not expanded to include modifications of commercial mortgage loans held by investment trusts. The IRS and the Treasury Department note that, although REMICs and investment trusts are often used to securitize mortgages, the requirements for classification as a REMIC are not identical to the requirements for classification as a trust. The IRS and the Treasury Department continue to study the commentators' recommendation and in this notice solicit input concerning whether additional guidance may be appropriate.
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> In Rev. Rul. 90-63, 1990-2 C.B. 270, a trustee has the power to consent to changes in the credit support of debt obligations held by the trust, but the power is exercisable only if the trustee reasonably believes that the changes are needed to maintain the value of the trust assets by preserving the credit rating of the obligations. Rev. Rul. 90-63 concludes that this power to change the credit support, exercisable only if needed to preserve the value of the trust assets, is not a power to vary.
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> The request for comments is as follows:

Request for Comments

> The IRS and the Treasury Department welcome further comments regarding what additional guidance, if any, is needed regarding modifications of commercial mortgage loans held by investment trusts. To be most useful, the comments should also analyze the extent to which the modifications at issue are consistent with existing case law and administrative pronouncements that govern whether an investment trust is classified as a trust for federal income tax purposes. Answers to the following questions would be particularly helpful:
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> 1. Is it common business practice to hold commercial mortgage loans through an investment trust? If so, please describe the structure of an investment trust that holds commercial mortgage loans. Also, if commercial mortgages are held by a REMIC through an investment trust, please explain the utility of this structure and its business purpose.
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> 2. Are there fact patterns which are not described in § 1.860G-2(b)(3)(i) and in which one or more modifications permitted to REMICs under

§ 1.860G-2(b)(3)(ii) through (vi) would be consistent with the case law and prior administrative pronouncements if carried out by an investment trust?

3. Are there alternative structures that would be consistent with the case law and prior administrative pronouncements and would allow the modified mortgage loans to be held by an investment trust? Are there any changes or additions to the REMIC rules that would be needed to facilitate these alternative structures?

Interested parties are invited to submit comments on this notice by November 14, 2009. Comments should be submitted in writing, and should include a reference to Notice 2009-79. Send submissions to: CC:PA:LPD:PR (Notice 2009-79), Room 5203, Internal Revenue Service, PO Box 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand delivered Monday through Friday between the hours of 8 a.m. and 4 p.m. to CC:PA:LPD:PR (Notice 2009-79), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC. Alternatively, comments may be submitted electronically directly to the IRS via the following e-mail address: *Notice.comments@irscounsel.treas.gov*. Please include "Notice 2009-79" in the subject line of any electronic communication. All materials submitted will be available for public inspection and copying.

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