

**Federal Tax ADVISORY**

August 18, 2010

**IRS Issues Guidance to Supplement 2009 REMIC Regulations for Commercial Mortgage Modifications**

On September 16, 2009, the Internal Revenue Service (IRS) finalized regulations under Sections 860A and 860G of the Internal Revenue Code (the “Final REMIC Regulations”), dealing with the federal income tax consequences of modifications to the terms of securitized commercial mortgage loans. The Final REMIC Regulations apply only to loans held in “real estate mortgage investment conduits” (REMICs). While the Final REMIC Regulations generally provided more flexibility to REMICs with respect to certain loan modifications, they also imposed additional restrictions on real property lien releases.

The IRS released guidance in the form of Revenue Procedure 2010-30 on August 17, 2010 (the “Revenue Procedure”), easing some of these restrictions on real property lien releases, which is effective immediately and retroactive to September 16, 2009, the effective date of the Final REMIC Regulations. Generally, the Revenue Procedure provides two circumstances—grandfathered transactions, or qualified pay-down transactions (both discussed below)—in which a real property lien release of a commercial mortgage will continue to be treated as a qualified mortgage even if the Principally Secured Requirement set forth in the Final REMIC Regulations is not met.

**THE FINAL REMIC REGULATIONS**

The Final REMIC Regulations permit certain commercial mortgage loan modifications, so long as the loan continues to be principally secured by real property after giving effect to the modification (the “Principally Secured Requirement”), including a release of a lien on real property. To meet the Principally Secured Requirement, a loan must either be secured by real property collateral that was at least 80 percent of the amount of the loan (the “80 Percent Test”), or if the 80 Percent Test is not satisfied, the fair market value of the real property collateral for the loan immediately after the modification must equal or exceed the fair market value of the real property collateral for the loan immediately before the modification.

The Final REMIC Regulations had some unexpected consequences for loans that (i) contractually permit a partial release of real property, (ii) are in default or a default is reasonably foreseeable and (iii) are the subject of a condemnation. By adding the Principally Secured Requirement for all real property lien releases, a borrower was required to satisfy both the partial release conditions in the negotiated loan documents and the Principally Secured Requirement. With respect to loans in default

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or reasonably foreseeable default, the Final REMIC Regulations required that a servicer determine whether the Principally Secured Requirement was satisfied before allowing the release. Oftentimes, due to the troubled nature of a loan that is in default or reasonably foreseeable default, such a loan would not meet the Principally Secured Requirement and therefore the loan's servicer could not agree to the release. CMBS Industry members, including Alston & Bird, provided comments to the IRS asking for further guidance and relief from the new onerous lien release rule.

## THE REVENUE PROCEDURE

The Revenue Procedure fortunately eases some of the restrictions placed upon real property lien releases by the Final REMIC Regulations. The Revenue Procedure provides that in either of two circumstances, a loan that undergoes a real property lien release that fails the Principally Secured Requirement will continue to be treated as a qualified mortgage. Specifically, if a release of a lien occurs as a result of either (i) a grandfathered transaction, or (ii) a qualified pay-down transaction, then the subject loan does not need to meet the Principally Secured Requirement.

### Grandfathered Transaction

A grandfathered transaction for purposes of the Revenue Procedure is one in which the release of the lien is occurring as provided for in the terms of the debt instrument (e.g., it is contemplated in the loan documents) and such debt instrument was executed no later than December 6, 2010.

The benefit of the grandfathered transaction exception provided for by the Revenue Procedure is that if a borrower and its lender negotiated for a real property release at origination (on or prior to December 6, 2010), and the subject real property release is being effected in accordance with that provision, the loan need not satisfy the Principally Secured Requirement.

### Qualified Pay-Down Transaction

A qualified pay-down transaction for purposes of the Revenue Procedure is one in which a lien on real property is released and, as a part of that release, the borrower makes a payment that results in the reduction of the adjusted issue price of the loan by a "qualified amount." A "qualified amount" includes (i) an amount of money that is equal to or greater than the net proceeds from an arm's-length sale or condemnation award, (ii) an amount determined under the loan documents that is at least the parcel's proportionate amount of the adjusted principal balance of the loan based on the fair market value assigned at origination, (iii) an amount equal to the fair market value of the real property released or (iv) an amount such that the loan-to-value ratio is no greater than it was immediately before the release. If a loan does not satisfy the grandfathered transaction exception discussed above, the qualified pay-down transaction exception may apply. Although this exception will allow special servicers to avoid the Principally Secured Requirement, the level of the required pay-down may, in certain cases, prevent them from working out troubled loans with borrowers.

For purposes of (iii) and (iv) above, if the loan's servicer has a "reasonable belief" that the transaction satisfies one of these criteria, then it is deemed satisfied. A servicer cannot have a reasonable belief if it knows or has reason to know that the criterion is not satisfied, and such reasonable belief must be based on either a current appraisal performed by an independent appraiser or one that was obtained at origination (and updated if appropriate), the sales price in an arm's-length transaction or some other commercially reasonable valuation method.

## Conclusions and Implications

The benefit of the Revenue Procedure is that real property lien releases that result from either a grandfathered transaction or a qualified pay-down transaction do not need to be tested for the Principally Secured Requirement. This will enable servicers to abide by many of their pre-negotiated contractual obligations, in the case of grandfathered transactions. In qualified pay-down transactions, servicers will be able to release a lien on real property without application of the Principally Secured Requirement where, for example, the loan is subject to a condemnation proceeding or the loan is in default or reasonably foreseeable default. In short, the Revenue Procedure lifts some of the burdens placed on loan servicers by the Final REMIC Regulations.

Unfortunately, because the grandfathered transaction exception will not be available for loans originated after December 6, 2010, the documents for such loans will need to take into account the Principally Secured Requirement and the qualified pay-down transaction exception from the Revenue Procedure.

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