

**Federal Tax ADVISORY**

September 16, 2009

**IRS Issues Final REMIC Regulations and Additional Guidance for Commercial Mortgage Loan Modifications**

On September 15, 2009, the Internal Revenue Service (IRS) issued final regulations under Sections 860A and 860G of the Internal Revenue Code (the "Final REMIC Regulations") and Revenue Procedure 2009-45 (the "Revenue Procedure"), both 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) and are effective on September 16, 2009, while the Revenue Procedure applies to both REMICs and investment trusts and is retroactively effective as of January 1, 2008.

While the Final REMIC Regulations generally provide more flexibility to REMICs with respect to certain loan modifications, they also impose additional restrictions on real property lien releases. Although the Revenue Procedure attempts to remove tax-related restrictions on a lender's ability to modify a commercial mortgage loan held in a REMIC or investment trust to prevent a future default, the relief granted by the Revenue Procedure does not supersede the additional restrictions on real property lien releases. As the Final REMIC Regulations are effective as of September 16, 2009, servicers of REMIC securitizations holding commercial mortgage loans ("Servicers") should familiarize themselves with these new rules, especially with respect to any commercial loan modifications already in progress, as such modifications may need to be revisited in light of the Final REMIC Regulations.

**THE FINAL REMIC REGULATIONS**

In May of 2007, IRS and Treasury officials met with CMBS industry members, including Alston & Bird LLP, to discuss revisions to the existing REMIC regulations following their issuance of proposed changes to the existing REMIC regulations for certain commonly requested commercial mortgage loan modifications. The Final REMIC Regulations adopt certain of the proposed changes issued by the IRS and Treasury on November 8, 2007, while adding some unexpected provisions that were not included in the proposed regulations.

**Permitted Modifications Under the Final REMIC Regulations**

The Final REMIC Regulations permit the following 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"):

- a release of a lien on real property;
- a release, substitution, addition or other alteration of the collateral for, a guarantee on, or other form of credit enhancement for, a loan; or

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- a change to a loan from recourse (or substantially all recourse) to nonrecourse (or substantially all nonrecourse), or vice-versa.

Prior to the issuance of the Final REMIC Regulations, at either origination or securitization, each mortgage loan in a REMIC was required to be secured by real property collateral that was at least 80 percent of the amount of the loan (the "80 Percent Test"). The Final REMIC Regulations now require a loan undergoing a modification of the type described above to be re-tested on the date of the modification. For purposes of this re-testing, a loan is principally secured by an interest in real property if it meets 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 equals or exceeds the fair market value of the real property collateral for the loan immediately before the modification.

To determine whether a loan meets the Principally Secured Requirement, a Servicer can rely on an independent appraisal, an update of an appraisal performed at origination or another commercially reasonable valuation method. For purposes of determining fair market value for the 80 Percent Test alone, a Servicer can also rely on a sales price established in a purchase contract for a sale of the real property in connection with an assumption of the debt.

### **Unexpected Consequences**

The Final REMIC Regulations have some unexpected consequences for loans that contractually permit a partial release of real property, and loans that are in default or reasonably foreseeable default. By adding the Principally Secured Requirement for all real property lien releases, a borrower must now satisfy both the partial release conditions in the negotiated loan documents and the Principally Secured Requirement. In these situations, a Servicer will be faced with balancing a borrower's demand for the partial release provided in the loan documents and the risk of adverse tax consequences to the REMIC. We expect there will be a substantial amount of discussion among Servicers, borrowers and the IRS on this issue.

With respect to loans in default or reasonably foreseeable default, the prior regulations provided flexibility in allowing a real property lien release. However, under the Final REMIC Regulations, such a loan is also now subject to the Principally Secured Requirement. If a real property lien release that is occasioned by a default or reasonably foreseeable default is proposed, a Servicer must now determine whether the Principally Secured Requirement is satisfied before allowing the release. This issue may come up frequently as decreased property values may make it difficult to satisfy the Principally Secured Requirement.

### **Effective Date of Final REMIC Regulations**

The Final REMIC Regulations are effective as of September 16, 2009. If a modification is in progress as of September 16, 2009, the Servicer should discuss the transaction with counsel to determine what effect, if any, the Final REMIC Regulations will have on the proposed modification.

## THE REVENUE PROCEDURE

Under the Revenue Procedure, a lender has increased flexibility to modify certain commercial mortgage loans for which it reasonably believes there is a “significant risk of default.” The Revenue Procedure’s relief applies retroactively to any qualifying commercial mortgage loan modifications effective on or after January 1, 2008.

The Revenue Procedure is aimed at preventing a potential maturity default in situations where there may be sufficient cash flow to satisfy debt service payments, but, without modification, the loan presents a significant risk of default. Treasury and the IRS believe that Servicers are in a unique position to determine the type of modifications that could be made to prevent such a default. The Revenue Procedure cites interest rate changes, principal forgiveness, maturity date extensions and alterations to the timing of interest rate resets and adjustments to amortization schedules as examples of potential modifications.

In order to utilize this Revenue Procedure, the lender or Servicer must reasonably believe that a significant risk of default exists absent the modification, and that by agreeing to the modification, the risk of default is substantially reduced. Relevant factors in formulating this “reasonable belief” include credible written factual representations, so long as the lender or Servicer does not know or have reason to know that such representations are false, and the length of time until the potential default.

Although the Revenue Procedure does not require modifications to the types of loans described above, it does provide the flexibility to do so without risking adverse tax consequences to the securitization. In many instances a Servicer of a performing loan may not have the authority under a securitization’s governing documents to make the modifications allowed by the Revenue Procedure, and the industry will need to find a way to resolve this issue in those situations before borrowers can benefit from the relief the Revenue Procedure is intended to provide.

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