

September 16, 2009

Commercial Mortgage Modifications

IRS Guidance on Modifications of Commercial Mortgages Held by Real Estate Mortgage Investment Conduits and Fixed Investment Trusts

SUMMARY

On September 15, 2009, the Internal Revenue Service (the "IRS") issued three pieces of guidance on commercial mortgage modifications.

Revenue Procedure 2009-45 gives real estate mortgage investment conduits ("REMICs") and fixed investment trusts additional discretion to modify certain commercial mortgage loans without adversely affecting their tax treatment. By giving this additional discretion, the IRS seeks to remove obstacles created by the REMIC and fixed investment trust rules that might otherwise hinder the restructuring of commercial mortgage loans. The Revenue Procedure permits a REMIC or fixed investment trust to anticipate a default on a performing commercial mortgage by providing that modifications made to such mortgage that meet certain criteria will generally not provide a basis for treating such modifications as "prohibited transactions" in the case of a REMIC or for challenging the qualification of the securitization vehicle as a REMIC or a fixed investment trust if the holder or servicer "reasonably believe that there is a significant risk of default" upon maturity or at an earlier date.

Additionally, the IRS and the Treasury Department issued final regulations clarifying that certain modifications of a type often made to commercial mortgages are not impermissible within a REMIC. The Final Regulations do not apply to fixed investment trusts, but in Notice 2009-79, the IRS asked for comments on the extent to which fixed investment trusts are used to securitize commercial mortgage loans and on what guidance, if any, is needed on modifications of commercial mortgages that are held by fixed investment trusts.

The IRS guidance does not address real estate investment trusts that hold commercial mortgages.¹

BACKGROUND

A. REMICS

Originators of commercial mortgages, like originators of residential mortgages, commonly employed securitization vehicles to access capital markets and provide investors with securities that diversify the risks inherent in holding individual loans. Commercial mortgage securitization vehicles are often REMICs, which give issuers the flexibility to create multiple-class securitization pools and avoid entity-level corporate income tax.

Qualification of an entity as a REMIC requires, among other things, that “substantially all” of its assets are either “qualified mortgages” or other “permitted investments” at the close of the third month after it is started up or at any subsequent time.² Mortgages generally are not “qualified mortgages” unless they are principally secured by an interest in real property and are transferred to the REMIC either (i) on the startup day in exchange for regular or residual interests in the REMIC or (ii) within three months of the startup day under a contract in effect on the startup day.³ The scope of other “permitted investments” for REMICs is limited to “cash-flow investments”⁴ (amounts received under qualified mortgages that are temporarily reinvested in other assets prior to distribution), certain “qualified reserve assets”⁵ and “foreclosure property.”⁶

Because the present Treasury Regulations provide that a “significant” modification to a debt instrument held by a REMIC causes the original instrument to be treated as if it was retired and reissued,⁷ a “significant” modification to a mortgage can cause an investment to cease to be a “qualified mortgage.” In general, a modification is “significant” if it would be “significant” under Regulations § 1.1001-3(e). However, certain amendments that might otherwise be “significant” under Regulations § 1.1001-3(e),

¹ REITs have asked for such guidance. See, for example, the National Association of Real Estate Investment Trusts sent a letter to the IRS on August 12, 2009, requesting guidance to the effect that (1) a deemed exchange under Treas. Reg. § 1.1001-3 does not change the “loan value of the real property” for purposes of the REIT qualification tests if the loan was in default or default was reasonably foreseeable and (2) the “amount” of a newly-acquired distressed mortgage loan is the REIT’s highest adjusted basis during the year of acquisition (rather than the principal amount of the loan).

² Code § 860D(a)(4). The applicable Treasury Regulations provide a safe harbor for entities if their holdings in assets other than “qualified mortgages” and “permitted investments” are, as measured by adjusted basis, less than one percent of the entity’s total assets. Treas. Reg. § 1.860D-1(b)(3)(ii).

³ Code § 860G(a)(3)(A)(i) & (ii).

⁴ Code § 860G(a)(5)(A).

⁵ Code § 860G(a)(5)(B).

⁶ Code § 860G(a)(5)(C).

⁷ Treas. Reg. § 1.860G-2(b)(1).

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including those “occasioned by default or a reasonably foreseeable default” are not “significant” modifications for REMIC purposes.⁸ If an entity no longer holds “substantially all” of its assets in “qualified mortgages” and other “permitted investments,” that entity can also lose its REMIC status and become subject to entity-level taxation as a taxable mortgage pool. Moreover, REMICs are subject to a 100% tax on any net income derived from “prohibited transactions,” which include the disposition of a “qualified mortgage” in many cases.⁹

B. FIXED INVESTMENT TRUSTS

Commercial mortgages may also be securitized through the use of fixed investment trusts. Securitization vehicles that are structured as fixed investment trusts may, however, cease to be fixed investment trusts, and possibly become “taxable mortgage pools” that are subject to corporate tax if the trust agreement provides a power to “vary the investment of the certificate holders.”¹⁰ Whether a fixed investment trust is a taxable mortgage pool will depend on whether it has two or more classes of interests.

C. RECENT DEVELOPMENTS

In response to market conditions affecting residential mortgages, and apart from the guidance issued on September 15, the IRS recently issued four revenue procedures giving securitization vehicles additional discretion to modify residential mortgage loans without adversely affecting the tax status of the securitization vehicle as a REMIC or a fixed investment trust:

- In 2007, the IRS released Revenue Procedure 2007-72,¹¹ which provided that the use of the streamlined loan modification procedures described in the American Securitization Forum’s “Statement of Principles, Recommendations and Guidelines for a Streamlined Foreclosure and Loss Avoidance Framework for Securitized Subprime Adjustable Rate Mortgage Loans”¹² would generally not provide grounds for the IRS to challenge the tax status of a REMIC or fixed investment trust, or allege that such modifications were “prohibited transactions;”
- Subsequently, after the American Securitization Forum issued an updated protocol that permitted modifications after the initial interest rate reset date, the IRS issued Revenue Procedure 2008-47, which clarified that the IRS would similarly not allege that modifications

⁸ Treas. Reg. § 1.860G-2(b)(3).

⁹ See Code § 860F.

¹⁰ Treas. Reg. § 301.7701-4(c)(1).

¹¹ 2007-52 I.R.B. 1257.

¹² This framework recommended procedures under which servicers could identify subprime mortgages that met certain criteria and use a “fast track” procedure to modify these loans before an initial interest rate reset date. These criteria included (1) the loan having an initial fixed-rate period of 36 months or less, (2) the loan being originated after December 31, 2004 and before August 1, 2007, (3) the loan being securitized and (4) the loan having an initial interest rate reset date between January 1, 2008 and July 31, 2010.

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made though the American Securitization Forum's updated protocol are "prohibited transactions" or constitute a reason for challenging the tax status of a securitization vehicle;¹³

- Under Revenue Procedure 2008-28,¹⁴ modifications made to mortgage loans under a systemic "foreclosure prevention program" or under circumstances where the holder has a "reasonable belief" that both (1) the original loan bears a significant risk of foreclosure and (2) the modified loan "presents a substantially reduced risk of foreclosure" will also generally not provide grounds for the IRS to allege that the modification is a "prohibited transaction" or challenge the tax status of a securitization vehicle;¹⁵ and
- In Revenue Procedure 2009-23¹⁶, the IRS indicated that loan modifications made to securitized mortgages under the federal government's Home Mortgage Affordability Program would be entitled to comparable deference.

THE REVENUE PROCEDURE

The Revenue Procedure applies to commercial mortgages¹⁷ that are held by a REMIC or fixed investment trust if all of the following criteria are satisfied:

- The holder or servicer "reasonably believes that there is a significant risk of default" on the loan, either on the maturity date or at an earlier date, after taking all relevant facts and circumstances into account. Such "reasonable belief" must be grounded in a "diligent contemporaneous determination" of the default risk (which may include "credible written factual representations" made by the obligor). The Revenue Procedure notes that although the timeframe on which a default may occur is "one relevant factor" in determining the "significance" of a risk of default, there is "no maximum period . . . after which default is *per se* not foreseeable," observing that "in appropriate circumstances, a holder or servicer may reasonably believe that there is a significant risk of default even though the foreseen default is more than one year in the future." Additionally, although the Revenue Procedure observes that the obligor's payment history may be one factor that is relevant in assessing the significance of a default risk, a servicer or holder could reasonably believe that a "significant risk of default" exists on a currently performing loan.
- The holder or servicer must, after taking all relevant facts and circumstances into account, reasonably believe that the modification will cause the loan to present "a substantially reduced risk of default."
- If the loan is held by a REMIC, as of the end of the three-month period that begins with the startup day of the REMIC, no more than 10% of the assets held by the REMIC (as measured

¹³ Revenue Procedure 2008-47 is discussed further in the Sullivan & Cromwell LLP publication titled "Real Estate Mortgage Investment Conduits and Fixed Investment Trusts: IRS Issues Revenue Procedure Giving Securitization Vehicles Additional Flexibility to Make 'Fast Track' Modifications to Certain Subprime Mortgages Without Risking Adverse Tax Consequences" (July 9, 2008), which may be obtained by following the instructions at the end of this publication.

¹⁴ 2008-23 I.R.B. 1054.

¹⁵ Revenue Procedure 2008-28 is discussed further in the Sullivan & Cromwell LLP publication titled "Real Estate Mortgage Investment Conduits and Fixed Investment Trusts: IRS Issues Revenue Procedure Giving Loan Servicers Additional Flexibility to Modify Mortgage Terms Without Risking Adverse Tax Consequences" (May 19, 2008), which may be obtained by following the instructions at the end of this publication.

¹⁶ 2009-17 I.R.B. 884.

¹⁷ Mortgages qualifying under the Revenue Procedure are mortgages that are not secured by a real property consisting of four or fewer dwelling units, one of which is occupied by the obligor.

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by stated principal value) may have been either (1) loans that were overdue by at least 30 days or (2) loans on which a default was “reasonably foreseeable.”

- If the loan is held by a fixed investment trust, as of all of the dates on which assets were contributed to the fixed investment trust, no more than 10% of the assets held by the fixed investment trust (as measured by stated principal value) may have been either (1) loans that were overdue by at least 30 days or (2) loans on which a default was “reasonably foreseeable.”

If a modification qualifies under the Revenue Procedure:

- The IRS will not contend that a REMIC ceases to qualify as a REMIC because the modification constitutes a “significant modification” that is not exempted from the definition of a “significant modification” under the special rules applicable to REMICs;¹⁸
- The IRS will not assert that a REMIC has engaged in a “prohibited transaction”¹⁹ because a modification has caused the disposition of one or more qualified mortgages that is not otherwise exempted from the definition of a “prohibited transaction;”
- The IRS will not contend that a REMIC ceases to qualify as a REMIC because the REMIC’s regular interests were deemed to be reissued as a result of the modification; and
- The IRS will not contend that the modification is a “power to vary the investment of the certificate holders” of a trust, which would otherwise make such an entity ineligible for qualification as an investment trust.

The Revenue Procedure is effective for modifications effected after January 1, 2008.

THE FINAL REGULATIONS

A. GENERAL

Waivers of due-on-sale clauses and due-on encumbrance clauses do not constitute “significant modifications” under the Final Regulations. Likewise, the Final Regulations provide that changes in the nature of the obligation from recourse (or substantially all recourse) to nonrecourse (or substantially all nonrecourse) or vice versa, and modifications that release, substitute, add or otherwise alter “a substantial amount of the collateral” or a guarantee or other credit enhancement are not “significant modifications” for REMIC purposes, so long as the mortgage remains “principally secured by an interest in real property.”²⁰

B. LIEN RELEASES

The Final Regulations provide that a lien release (whether in connection with default, reasonably foreseeable default or otherwise) will not cause a mortgage to lose its status as a “qualified mortgage” so long as (1) the lien release either would not result in a “significant modification” or would be exempted from the definition of “significant modification” under the special rules applicable to REMICs and (b) the

¹⁸ See Treas. Reg. § 1.860G-2(b)(3)(v) & (vi).

¹⁹ Code § 860F(a)(2).

²⁰ Treas. Reg. § 1.860G-2(b)(3).

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loan remains “principally secured by real property” after the release of the lien. Importantly, the preamble to the Final Regulations notes that “a release . . . pursuant to the borrower’s unilateral option . . . 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.” It is not clear at this point how REMIC servicers should deal with borrowers who have unilateral property release rights under their mortgage loans (e.g., a right to obtain the release of one of several properties in exchange for a prepayment of 100% (or more) of the portion of the loan allocated to such property) without regard to whether the “principally secured” test will be satisfied subsequent to such release.²¹

C. “PRINCIPALLY SECURED BY AN INTEREST IN REAL PROPERTY” TEST

The Final Regulations also specify alternative tests for determining whether an obligation remains “principally secured by an interest in real property.” Under the Final Regulations, the fair market value of the underlying security is deemed to be at least 80% of the adjusted issue price of the modified obligation (which is the standard that otherwise must be satisfied for an obligation to be “principally secured” by an interest in real property) if the servicer “reasonably believes” that the fair market value of the real property securing the loan is at least 80% of the adjusted issue price of the modified loan. To arrive at a “reasonable belief” that this criterion is satisfied, a servicer is not required to obtain a new or updated independent appraisal. Instead, the servicer may use (1) the sales price of the interest, if a “substantially contemporary” sale has occurred under which the buyer assumed the mortgage; or (2) “some other commercially reasonable valuation method.”²² Additionally, the Final Regulations provide an alternative test under which, if the fair market value of the real property securing the loan is not at least 80% of the adjusted issue price of the modified loan, the mortgage will nonetheless be “principally secured by an interest in real property” if the fair market value of the real estate that secures the loan immediately after the modification equals or exceeds the fair market value of the property that secured the loan immediately before the modification, as determined by a current appraisal, an original (and updated) appraisal or some other commercially reasonable method, and the servicer must not actually know, or have reason to know, that the criterion is not satisfied.²³ This alternative “principally secured” test will facilitate modifications of “underwater” loans where collateral is not released in connection with the modification.

D. EFFECTIVE DATE, SCOPE AND REQUEST FOR COMMENT

The Final Regulations will be effective on September 16, 2009. The Final Regulations are limited in scope to REMICs, and thus do not apply to fixed investment trusts. In conjunction with the Final

²¹ The potential applicability of this “principally secured” test to unilateral releases also suggests that borrowers and lenders should discontinue the occasional practice of temporarily warehousing within the loan collateral “surplus” land or other property with a release price of zero, a practice employed because of subdivision or similar difficulties at the time of origination.

²² Treas. Reg. § 1.860G-2(b)(7)(ii).

²³ Treas. Reg. § 1.860G-2(b)(7)(iii).

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Regulations, the IRS issued a notice²⁴ requesting comment on what further guidance, if any, is necessary with respect to modifications of commercial mortgages held in fixed investment trusts. In particular, the IRS and Treasury Department have requested comment on the following:

- Whether commercial mortgage loans are commonly held in fixed investment trusts;
- If commercial mortgages are commonly held in fixed investment trusts, what structure may be used and the business purpose behind this structure;
- Whether there are fact patterns (other than in the terms of the obligation occasioned by default or a reasonably foreseeable default) in which one or more of the modifications permitted in the REMIC regulations (as modified by the Final Regulations) would be consistent with prior case law and IRS guidance if conducted by a fixed investment trust; and
- Whether alternative structures that are consistent with case law and prior administrative guidance would permit modified loans to be held by a fixed investment trust; and whether any changes to the REMIC rules would be necessary to facilitate these alternative structures.

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²⁴ Notice 2009-79.

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CONTACTS

New York

Andrew S. Mason	+1-212-558-3759	masona@sullcrom.com
David C. Spitzer	+1-212-558-4376	spitzerd@sullcrom.com
Willard B. Taylor	+1-212-558-3604	taylorw@sullcrom.com
Michael Orchowski	+1-212-558-7916	orchowskim@sullcrom.com

Washington, D.C.

Donald L. Korb	+1-202-956-7675	korbd@sullcrom.com
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