

To: Our Clients and Friends

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## Guidance for REMIC Mortgage Modifications

### Background

The typical structure for the securitization of commercial real estate loans is a real estate mortgage investment conduit (“REMIC”). There are numerous technical requirements to qualify as a REMIC and those rules can be adversely affected where a mortgage is modified or a lien is released in whole or in part. Specifically, if a loan held by a REMIC is modified and the modification is a “significant modification,”<sup>1</sup> then the modified obligation is treated as a newly originated obligation contributed to the REMIC and the pre-modified obligation is deemed to have been disposed of by the REMIC. This can have numerous adverse consequences for the REMIC, including (i) a 100 percent prohibited transactions tax on any gain realized from the deemed disposition and, in some circumstances, (ii) imposition of a 100 percent prohibited transactions tax on the post-modification income from the loan or (iii) failure of the REMIC to continue to qualify as a REMIC.

The present economic environment has exacerbated the need to make mortgage modifications and changes to the underlying collateral. In recognition of these necessities, the Internal Revenue Service (the “IRS”) issued a guidance package on September 15 consisting of (i) Treasury Decision 9463<sup>2</sup> enacting final regulations that, among other things, allow various modifications to commercial mortgages held by REMICs without triggering negative tax consequences (the “Final Regulations”), (ii) Revenue Procedure 2009-45<sup>3</sup> explaining the conditions under which changes to certain mortgage loans at risk of default will not cause the IRS to challenge the tax status of certain securitization vehicles

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<sup>1</sup> Treas. Reg. 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. Treas. Reg. Section 1.1001-3(e) governs which modifications of debt instruments are “significant”.

<sup>2</sup> T.D. 9463, 74 Fed. Reg. (No. 178, Sept. 16, 2009).

<sup>3</sup> Rev. Proc. 2009-45, 2009-40 I.R.B. (Sept. 15, 2009).

that hold the loans or to assert that those changes lead to prohibited transactions, and (iii) IRS Notice 2009-79<sup>4</sup> soliciting further comments.

## Summary

The Final Regulations and Revenue Procedure 2009-45 provide the following:

- Modifications that release, substitute, add or otherwise alter a substantial amount of collateral are permitted if the loan continues to be “principally secured”.
- Modifications that release collateral, whether in default or pursuant to a unilateral option or otherwise are not a “significant modification” must meet the Principally Secured Test (defined below).
- “Principally secured” means either (i) satisfies the 80 percent test based on the current value of the real property or (ii) post modification value of the collateral is no less than the collateral value prior to modification.
- Valuation can be based on any “commercially reasonable valuation method” and takes into account the impact of the full transaction, e.g., demolition and improvement.
- Loans can go from recourse to nonrecourse or vice versa so long as they continue to be “principally secured”.

The determination of whether a modification occurs in connection with a “reasonably foreseeable default” will be based on whether or not there is a reasonable belief of default based on a diligent contemporaneous determination of the risk of default, which may take into account credible written factual representations made by the issuer of the loan if the holder or servicer neither knows nor has reason to know that such representations are false. The Revenue Procedure clarifies that a loan need not be nonperforming or that default need not be imminent to satisfy the reasonably foreseeable default standard. In a determination of the significance of the risk of a default, one relevant factor is how far in the future the possible default may be. There is no maximum period, however, after which default is *per se* not foreseeable. Servicers should note, however, that just because the REMIC rules permit a modification does not mean that a pooling and servicing agreement (“PSA”) will permit a modification to be undertaken prior to a “transfer event” to the special servicer pursuant to the PSA. Most PSA’s significantly limit a Master Servicer’s ability to modify a loan.

## The Final Regulations

Treas. Reg. Section 1.860G-2(b)(3)<sup>5</sup> contains a list of modifications that are expressly permitted without regard to the Section 1001 modification rules. The Final Regulations expanded this list of permitted modifications to include modifications that release, substitute, add, or otherwise

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<sup>4</sup> I.R.S. Notice 2009-79, 2009-40 I.R.B. (Sept. 15, 2009).

<sup>5</sup> All Section references provided for herein refer to the Internal Revenue Code of 1986, as amended (the “Code”), and all “Treas. Regs.” references are to the Treasury Regulations promulgated thereunder.

alter a substantial amount of the collateral for, a guarantee on, or other form of credit enhancement for, a recourse or nonrecourse obligation and changes to the recourse nature of an obligation. These changes are permitted so long as the obligation continues to be “principally secured” by an interest in real property. The Final Regulations also clarify when a release of a lien on real property securing a qualified mortgage does not disqualify the mortgage.

### ***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 Treas. Reg. Section 1.1001-3 (for example, a release 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 mortgage continues to be “principally secured” by real property. These requirements will in fact add a retesting burden in cases in which lien releases ostensibly were permitted prior to the effective date of the Final Regulations.

The Final Regulations also require retesting with respect to a lien release that is not a significant modification for purposes of Treas. Reg. Section 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). In this situation, the Principally Secured Test (defined below) is satisfied if either the 80 percent test is satisfied 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 (this alternative is explained below).

### ***The Requirement to Retest the Collateral Value***

Treas. Reg. Section 1.860G-2(a)(1) 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 (the “Principally Secured Test”). The regulations require the 80 percent test to be satisfied either at the time the obligation was originated or at the time the sponsor contributes the obligation to the REMIC. After the startup day, the regulations do not require ongoing satisfaction of the 80 percent test.

Because certain types of modifications permitted by the Final Regulations could affect the value of the collateral securing the mortgage loan and to ensure that a modified mortgage loan continues to be “principally secured” by an interest in real property, the Final Regulations require the 80 percent test to be satisfied at the time the mortgage loan is modified with respect to changes in collateral, guarantees, and credit enhancement of an obligation or with respect to changes to the recourse nature of an obligation. 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, described below, 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.

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. For these type 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.

### ***Changes in the Nature of an Obligation from Nonrecourse to Recourse***

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.

### ***Investment Trusts***

The scope of the Final Regulations has not been expanded to include modifications of commercial mortgage loans held by investment trusts. However, under Revenue Procedure 2009-45, the IRS will not challenge a securitization vehicle’s qualification as a trust under Treas. Reg. Section 301.7701-4(c) on the grounds that the modifications manifest a power to vary the investment of the certificate holders. In a separate notice, Notice 2009-79, the IRS and the Treasury Department have requested comments on this issue.

## **Revenue Procedure 2009-45**

Additionally, it should be noted that the IRS issued Revenue Procedure 2009-45<sup>6</sup> to outline the conditions under which modifications to certain mortgage loans will not cause the IRS to challenge the tax status of certain securitization vehicles that hold the loans or to assert that those modifications give rise to prohibited transactions. Also, in Revenue Procedure 2009-45, the IRS clarified the meaning of what is meant by “occasioned by default or a reasonably foreseeable default” when considering the first exception under Treas. Reg. Section 1.860G-2(b)(3).

Pursuant to Revenue Procedure 2009-45, the IRS will not (A) challenge a securitization vehicle’s qualification as a REMIC on the grounds that the modifications are not among the exceptions listed in Treas. Reg. Section 1.860G-2(b)(3), (B) contend that the modifications are prohibited transactions

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<sup>6</sup> This revenue procedure applies to a modification (including an actual exchange to which Treas. Reg. Section 1.1001-3 applies) of a mortgage loan that is held by a REMIC, or by an investment trust.

under Section 860F(a)(2) on the grounds that the modifications result in one or more dispositions of qualified mortgages and that the dispositions are not among the exceptions listed in Section 860F(a)(2)(A)(i)-(iv), (C) challenge a securitization vehicle's qualification as a trust under Treas. Reg. Section 301.7701-4(c) on the grounds that the modifications manifest a power to vary the investment of the certificate holders, and (D) challenge a securitization vehicle's qualification as a REMIC on the grounds that the modifications resulted in a deemed reissuance of the REMIC regular interests, if the following circumstances are met: (i) 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, (ii) 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 10 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 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, (iii) based on all the facts and circumstances, the holder or servicer reasonably believes that there is a significant risk of default of the pre-modification loan upon maturity of the loan or at an earlier date, and (iv) based on all the facts and circumstances, the holder or servicer reasonably believes that the modified loan present a substantially reduced risk of default, as compared with the pre-modification loan.

The IRS understood that many industry participants believed that a loan modification failed to be "occasioned by default or a reasonably foreseeable default" unless the loan was not performing or default was imminent. However, in Revenue Procedure 2009-45, the IRS clarified that in certain circumstances, it will not challenge the determination that there is a reasonably foreseeable default even if a loan is still performing and default is not imminent. The IRS specifically did not address contractual limitations in PSAs and mortgage loan servicers are frequently significantly restricted under PSAs as to what modifications they can make. The Revenue Procedure in many cases may have little practical impact on when a servicer can entertain a significant modification. The Revenue Procedure states that a reasonable belief of default must be based on a diligent contemporaneous determination of the risk of default, which may take into account credible written factual representations made by the issuer of the loan if the holder or servicer neither knows nor has reason to know that such representations are false. In a determination of the significance of the risk of a default, one relevant factor is how far in the future the possible default may be. There is no maximum period, however, after which default is *per se* not foreseeable. For example, 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. Similarly, although past performance is another relevant factor for assessing default risk, in appropriate circumstances, a holder or servicer may reasonably believe that there is a significant risk of default even if the loan is performing.

The IRS's standard for a reasonable belief of default is illustrated in the following example:

Facts: As part of its business, S services mortgage loans that are held by R, a REMIC that is described in Revenue Procedure 2009-45 (a REMIC that holds a pre-modification loan, that as of the end of the 3 month period beginning on the startup day, no more than 10 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 at least 30 days or a default on the loan was reasonably foreseeable). Borrower B is the issuer of one of the mortgage loans held by R. B's mortgage loan is non-amortizing, and thus the entire principal amount is due upon maturity. The real property securing B's mortgage loan is an office building. All of B's required payments on the mortgage loan have been timely, and the loan is not scheduled to mature for another 12 months. B expects that in order to repay the loan when it matures, B will have to refinance the maturing mortgage loan into a newly issued mortgage loan. There are factors, however, that indicate that refinancing options may be unavailable to B at the time the mortgage loan matures. These factors include either or both of the following: current economic conditions in the relevant credit markets, and the current market value of the real property securing the loan. B provides a written factual representation to S showing that B will probably not be able to repay or refinance the mortgage loan at maturity. S neither knows, now has reason to know, that the representation is false.

Based on all the facts and circumstances and a diligent contemporaneous determination, S reasonably believes that, if the loan to B is not modified, there is a significant risk of default by B upon maturity of the mortgage loan. Therefore, S and B agree to modify the mortgage loan by extending its maturity and increasing the interest rate. S reasonably believes that this modification reduces the risk of default. The modification is a significant modification under Treas. Reg. Section 1.1001-3(e). The modification occurs after the effective date of Revenue Procedure 2009-45 (January 1, 2008).

Analysis: S reasonably believed that the pre-modification loan presented a significant risk of default and that the modification substantially reduced that risk. Accordingly, the modification is within the scope of Revenue Procedure 2009-45.

#### *EXAMPLES: FINAL REGULATIONS*

The following examples illustrate the implications of the Final Regulations.

##### Example 1:

Facts: S services mortgage loans that are held by R, a REMIC. Borrower B is the issuer of one of the mortgage loans held by R. The original amount of B's mortgage loan was \$100,000, and the loan was secured by real property X. At the time the loan was contributed to R, property X had a fair market value of \$90,000. Sometime after the loan was contributed to R, B experienced financial difficulties such that it was reasonably foreseeable that B might default on the loan if the loan was not modified. Accordingly, S altered various terms of B's loan to substantially reduce the risk of default. The alterations included the release of the lien on property X and the substitution of real property Y for property X as collateral for the loan. At the time the loan was modified, its adjusted issue price was \$100,000. The fair market value of property X immediately before the modification (as determined by a commercially reasonable valuation method) was \$70,000, and the fair market value of property Y immediately after the modification (as determined by a commercially reasonable valuation method) was \$75,000.

**Analysis:** The alterations to B's loan are a significant modification within the meaning of Treas. Reg. Section 1.1001-3(e). The modification, however, is included in the list of modifications, as amended by the Final Regulations, that are expressly permitted without regard to the Section 1001 modification rules. Accordingly, the modified loan continues to be a qualified mortgage if, immediately after the modification, the modified loan continues to be "principally secured" by an interest in real property, as determined by Treas. Reg. Section 1.860G-2(b)(7).

Because the modification includes the release of the lien on property X and substitution of property Y for property X, the modified loan must satisfy Treas. Reg. Section 1.860G-2(b)(7)(i) (which requires satisfaction of either Treas. Reg. Section 1.860G-2(b)(7)(ii) (the 80 percent test) or Treas. Reg. Section 1.860G-2(b)(7)(iii) (value is no less than prior to modification)). The modified loan does not satisfy Treas. Reg. Section 1.860G-2(b)(7)(ii) because the property Y is worth less than \$80,000 (the amount equal to 80 percent of the adjusted issue price of the modified mortgage loan). The modified loan, however, satisfies Treas. Reg. Section 1.860G-2(b)(7)(iii) because the fair market value of the interest in real estate (real property Y) that secures the obligation immediately after the modification (\$75,000) exceeds the fair market value of the interest in real estate (real property X) that secured the obligation immediately before the modification (\$70,000). Accordingly, the modified loan satisfies Treas. Reg. Section 1.860G-2(b)(7)(i) and continues to be "principally secured" by an interest in real property.

**Example 2: Unilateral Option**

**Facts:** Borrower's property is secured by a mall which includes a parking lot pad site. The loan documents provide that the pad site can be released when Borrower meets certain leasing targets. Borrower has met these tests. The fair market value however has declined so that the property no longer meets the 80 percent "principally secured" test. Further, immediately after the release the real property would be worth less than before the release.

**Analysis:** Notwithstanding the contractual obligation to release the pad site, the Final Regulations would not be satisfied. The requirement that the "principally secured" test be met can not be satisfied. Accordingly, the loan would no longer be a "qualified mortgage" held by the REMIC if the pad site were released.

**Example 3: Nonrecourse to Recourse**

**Facts:** Borrower requests assumption. For credit reasons, Special Servicer requests full guaranty.

**Analysis:** This is fully permitted by the Final Regulations. The change from nonrecourse to recourse would not be a significant modification so long as the loan continues to be "principally secured" by real property.

**Example 4: Additions to Reserves/Demolition**

**Facts:** Developer wants to accommodate a major retail tenant. Major retail tenant has a store on the existing site. Major retail tenant asks for the existing store to be demolished to

make room for “super store”. The servicer needs reserves in excess of 10% of collateral value to secure the loan while the property is redeveloped.

Analysis: The demolition of the old store, the construction of the new “super store”, and the addition of the reserve would not be a significant modification of the loan so long as, after construction, the loan was “principally secured” by real property. The Principally Secured Test would take into consideration the new value of the collateral.

Bryan Cave LLP has extensive experience in assisting clients in such matters, and our Tax Advice and Controversy and Private Client practice groups have a broad and diverse client base ranging from individuals and closely held businesses to Fortune 500 companies.

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