

# A Compelling New Opportunity For Real Estate Borrowers

**September 2009**

## **The Opportunity**

On September 15, 2009, the Internal Revenue Service (the “IRS”) issued new guidelines relating to commercial mortgage loan modifications held by Real Estate Mortgage Investment Conduits (“REMICs”). The new guidelines, which are effective as of September 16, 2009 and apply to loan modifications effected on or after January 1, 2008, will provide loan servicers with greater flexibility to modify commercial mortgage loans without the concern that such modifications may incur significant tax penalties. The goal of the new guidelines is to ensure the continued performance of performing loans and maximize the probability that troubled loans will perform.<sup>1</sup>

Many borrowers have been frustrated with their inability to discuss loan modifications with a servicer of a CMBS pool while no “event of default” has occurred. In fact this frustration has become in some cases so severe that some borrowers have resorted to orchestrating an “event of default” so that they could get the attention of their servicer. Happily for borrowers, the new IRS guidelines provide that modifications of loans held by CMBS pools formed as REMICs (which is generally the case) may be pursued in connection with deteriorating, yet technically-performing, mortgage loans. Modifications may be pursued by the servicer and a borrower not only if there has been a default, but also, if there is a “reasonably foreseeable default.” The question of whether a default is reasonably foreseeable is based on the totality of the circumstances, and the servicer must conduct due diligence sufficient to show a “significant risk of default.” For example, a borrower might demonstrate that net operating income has been steadily deteriorating and a future increase in debt service payments will likely result in a default. This allows borrowers to introduce future events into a restructuring conversation with a servicer. This may not have been a realistic option in the past. Previously, borrowers often believed that servicers resisted these initiatives.

Accordingly, if a servicer reasonably believes that the modified loan presents a “substantially reduced risk of default,” even if the loan presents no imminent signs of non-performance, the loan may be modified without disqualifying the mortgages. This represents a significant benefit to borrowers subject to securitized indebtedness.

## **Background**

Many commercial mortgage loans are held in REMICs as a way to provide investors with the ability to diversify the risks of holding individual loans. A REMIC is exempt from federal taxes at the entity level and, as such, qualification of an entity as a REMIC requires, among other things, that as of the close of the third month after the startup day and at all subsequent times, “substantially all of its assets consist of qualified mortgages and permitted investments.”<sup>2</sup> When originally enacted, Congress intended the REMIC provisions to apply only to entities that (i) hold a substantially fixed pool of real estate mortgages and (ii) have “no power to vary the composition of its mortgage assets.”<sup>3</sup> Under the previous regulations, a “significant modification” of an obligation held by a REMIC was deemed to be an exchange of the original debt for a new debt.<sup>4</sup> Therefore, even if an entity originally qualified as a REMIC, one or more significant modifications of loans held by that entity could cause it to lose its REMIC status if such modifications caused “less than substantially all of the entity’s assets to be qualified mortgages.”<sup>5</sup>

## **Final Implementation of Notice 2007-176**

In November, 2007, in response to requests from the commercial real estate industry, the IRS issued proposed regulations which permitted certain types of modifications to be made to commercial mortgage loans held in a REMIC without causing a termination of its tax-exempt status.<sup>7</sup>

The final regulations, which finalize and clarify the proposed regulations, provide that releases or substitutions of collateral, lien releases and changes in guarantees, credit enhancements and changes to the recourse nature of obligations are permitted modifications (and will not cause any such modified mortgages to fail to be “qualified mortgages”), as long as the loan obligations continue to be “principally secured” by real property (the “Final Regulations”).<sup>8</sup> Under the Final Regulations, the loan obligations will continue to be “principally secured” if the servicer “reasonably believes” that either (a) the fair market value of the real property that secures the loan obligations is at least 80% of the adjusted issue price after giving effect to the modification, or (b) if the fair market value of the real property that secures the loan obligations is no longer valued at 80% of the adjusted issue price, the fair market value of the real property immediately after the modification equals or exceeds the fair market value of the real property immediately before the modification.<sup>9</sup> To arrive at a “reasonable belief,” the servicer is no longer required to obtain a new or updated appraisal, as was required under the proposed regulations. Instead, the servicer may use the sales price of the real property interest, if a substantially contemporaneous sale has occurred and the buyer assumes the seller’s obligations under the mortgage, or may rely upon “some other commercially reasonable valuation method.”<sup>10</sup>

### **Revenue Procedure 2009-45**

Under the regulations, servicers are permitted to modify commercial mortgage loans held by REMICs in a manner that results in a “significant modification,” without causing any such modified mortgages to fail to be “qualified mortgages,” if a mortgage loan was actually in default or if such default was “reasonably foreseeable.”<sup>11</sup> Revenue Procedure 2009-45 expands the circumstances under which a servicer may modify such commercial mortgage loans to include situations where the servicer “reasonably believes there is a significant risk of default” either upon loan maturity or at some earlier date.<sup>12</sup> In determining this, a servicer may take into account (a) “credible written factual representations” made by the borrower which the servicer neither knows, nor has reason to know, are false, (b) how far into the future the possible default may be, though the Revenue Procedure does not provide a maximum period (i.e., there could be a significant risk of default even if the foreseen default is more than a year away) and (c) past performance of the loan, even if the loan is currently performing.<sup>13</sup>

If a modification qualifies under Revenue Procedure 2009-45, the IRS will not (i) challenge the REMIC's continued qualification as a REMIC on the grounds that the modification is not excepted from the definition of a "significant modification," (ii) contend that the REMIC has engaged in a "prohibited transaction" on grounds that a modification has resulted in one or more dispositions of qualified mortgages and that the dispositions are not otherwise excepted from the definition of "prohibited transaction," (iii) challenge the REMIC's continued qualification as a REMIC on the grounds that the modification is a "power to vary the investment of the certificate holders" (which would otherwise make it ineligible for treatment as an investment trust), or (iv) challenge the REMIC's continued qualification as a REMIC on the grounds that the modification results in a deemed reissuance of the REMIC regular interests.<sup>14</sup> The effect of this expansion to the regulations is that it allows borrowers to begin discussions with servicers regarding anticipated defaults well in advance of the defaults, giving both parties the necessary time and flexibility to discuss and determine appropriate modifications before the default occurs.

### **Notice 2009-79**

Concurrently with the issuance of the Final Regulations, the IRS issued a notice seeking guidance on whether the types of loan modifications now permitted for loans held by REMICs should be permitted for fixed investment trusts (grantor trusts).<sup>15</sup> The notice, therefore, invites comments regarding what, if any, additional guidance is necessary with respect to fixed investment trusts.

### **Conclusion**

In today's economic landscape, these new guidelines will be instrumental in providing servicers and borrowers with greater flexibility to restructure commercial mortgage loans held in CMBS pools without jeopardizing the favorable tax treatment of the REMIC holding such pools. For borrowers, this represents an opportunity to be proactive in their discussions with servicers to address looming (but not imminent) signs of default. On the other hand, servicers may still be reluctant to engage in modification discussions with respect to performing loans. Not only would such discussions represent a time and expense burden, servicers could be concerned about liability to holders of senior securities who would likely oppose any restructuring and could claim that preemptive modifications represent a violation of "accepted servicing practices."

## Footnotes

[1] However, it is important to note that the new guidelines only affect the REMIC structure. They do not change or adjust the loan modification restrictions that may be contained in the securitization documents.

[2] IRC §860D(a)(4).

[3] See Rev. Proc. 2009-45, 2009-40 I.R.B. (Sept. 15, 2009).

[4] Treas. Reg. §1.1001-3.

[5] *Id.*

[6] 2007-12 I.R.B. 748.

[7] Prop. Treas. Reg. §1.860G-2(b), 72 Fed. Reg. 63523 (Nov. 9, 2007). The proposed regulations pre-dated the commercial real estate credit crisis.

[8] See T.D. 9463, 74 Fed. Reg. 178 (Sept. 16, 2009).

[9] *Id.*

[10] *Id.*

[11] Treas. Reg. §1.860G-2(b)(3)(i).

[12] See Rev. Proc. 2009-45, 2009-40 I.R.B. (Sept. 15, 2009).

[13] *Id.*

[14] *Id.*

[15] See Notice 2009-79, 2009-40 I.R.B. (Sept. 15, 2009).

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