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New Rules Intended to Facilitate Commercial Real Estate Loan Modifications

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In mid-September, the IRS issued new rules in an effort to facilitate modifications of commercial real estate loans held by securitization vehicles, such as real estate mortgage investment conduits ("REMICs"). According to The Wall Street Journal*, an estimated $153 billion of those loans will be coming due by the end of 2012 and close to $100 billion of these will face difficulty getting refinanced. Recognizing the current situation in the credit markets for commercial real estate financing and refinancing, government officials hope the rule changes will help some borrowers avoid default as well as foreclosure of defaulted mortgage loan property by permitting loan modifications at an earlier point in time than might otherwise be allowed by the REMIC rules and by expanding the list of modifications permitted under the REMIC rules.*

In general, it is very difficult to modify mortgages held through a securitization vehicle without causing adverse tax consequences to the vehicle or its investors. For example, a securitization vehicle may lose its status as a REMIC if sufficient loan modifications that are not expressly permitted by the REMIC rules cause less than substantially all of the vehicle's assets to be "qualified mortgages." Even if a securitization vehicle's REMIC status does not terminate, any net income from a "prohibited transaction"—which includes net income from dispositions, including deemed dispositions of loans caused by modifications, that do not meet certain exceptions as well as net income that is attributable to an asset which is neither a qualified mortgage nor a permitted investment—may be subject to a 100% tax. As a result, many servicers have been unwilling to modify loans unless a default has occurred or is imminent.

The new rules are comprised of Revenue Procedure 2009-45 (the "Rev. Proc.") issued on September 15, 2009, and final regulations, published in the Federal Register on September 16, 2009, under Section 860G of the Internal Revenue Code (the "Final Regulations"). The Rev. Proc. applies to loan modifications occurring on or after January 1, 2008 and the Final Regulations apply to modifications made to the terms of an obligation on or after September 16, 2009. Taken together, they should help avoid borrower defaults and property foreclosures and better accommodate current practices in the commercial mortgage industry.

The Rev. Proc. provides a safe harbor pursuant to which certain modifications to commercial mortgage loans will not cause the IRS to challenge the tax status of the REMIC holding the loans or to assert that those modifications give rise to prohibited transactions. Provided that all the other conditions of the Rev. Proc. are satisfied, modifications will be permitted to commercial mortgage loans if, based on all the facts and circumstances, the holder or servicer reasonably believes there is a significant risk of default of the original mortgage loan upon maturity or at an earlier date and that the modified loan presents a substantially reduced risk of default, as compared with the original loan. The example in the Rev. Proc. describes a modification of a loan that will mature in 12 months, but, as the Rev. Proc. acknowledges, it is possible for a holder or servicer to reasonably believe, in appropriate circumstances, that there is a significant risk of default even though the perceived default is more than 12 months in the future. This is particularly pertinent in the commercial mortgage loan industry where much, if not all, of the principal is repaid at maturity and where borrowers typically anticipate satisfying such principal with refinancing proceeds.

The Final Regulations expand the modifications permitted to be made to loans held by REMICs to include (i) changes in the collateral for, guarantees on, or other forms of credit enhancement for mortgage loans, and (ii) changes in the nature of mortgage loans from recourse to nonrecourse or vice versa. In addition, the Final Regulations clarify that a release of a lien pursuant to certain changes in collateral would not cause a mortgage to cease to be a qualified mortgage on the release date.

However, the excepted modifications and lien releases will be permitted only so long as the mortgage loan continues to be principally secured by an interest in real property following the modification or lien release. Under the Final Regulations, the determination of whether a mortgage loan is principally secured by an interest in real property—typically made at the time of origination or at the time of contribution to the REMIC—must be made once again at the time of modification or lien release. In order to meet this test, the fair market value of the real property securing the obligation must equal at least 80 percent of the adjusted issue price of the obligation or, under an alternative test, the value of real property collateral after the modification must be no less than the value of the real property collateral immediately before.

Although the Final Regulations are narrower in scope than the Rev. Proc., they provide absolute certainty that the modifications permitted by the Final Regulations can be made without affecting the status of the REMIC. If a desired modification is not expressly permitted, even under the expanded regulations, the modification may still be made without affecting REMIC status if all the conditions set forth in the Rev. Proc. are met.

As a result of the Rev. Proc. and the Final Regulations, modifications that have become common in the commercial mortgage industry generally may now occur in the case of mortgage loans held by a REMIC. However, when considering making such newly permitted modifications, it is important to consider whether such modifications may still be prohibited under the relevant securitization or servicing documents, which, in some cases, may be tied closely to the language of the former regulations which prohibited modifications that may now be permitted. In addition, it remains to be seen whether servicers will be willing to risk the status of a REMIC on the basis of satisfying the “facts and circumstances” test provided by the Rev. Proc. if the modifications do not fall within the scope of the Final Regulations. Finally, certain modifications, even if permitted by the Rev. Proc., may nonetheless cause taxable exchanges under Section 1001 of the Internal Revenue Code, which, among other things, may cause the trust to realize taxable gain or loss.

The Rev. Proc. is applicable to modifications of mortgage loans held by both REMICs and investment trusts. Although the Final Regulations apply only to modifications of commercial mortgage loans held by REMICs, the IRS is considering allowing similar modifications to loans held by investment trusts and, in this connection, has issued Notice 2009-79 requesting guidance concerning modifications of mortgage loans held by such trusts.

If you have any questions about the content of this alert, please contact the Pillsbury attorney with whom you regularly work, or one of the attorneys listed below.

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