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RECENT IRS GUIDANCE ON THE TAX CONSEQUENCES OF MODIFICATIONS OF COMMERCIAL MORTGAGE LOANS HELD BY REMICS AND INVESTMENT TRUSTS

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On September 15, 2009, the Internal Revenue Service released important guidance dealing with modifications of commercial mortgage loans held by REMICs. The guidance comprised three separate items: (i) final regulations expanding the list of loan modifications by REMICs that do not result in the modified obligation ceasing to be a qualified mortgage loan for a REMIC, (ii) a new Revenue Procedure setting forth the conditions under the IRS will not challenge the income tax status of mortgage loan securitization vehicles (including REMICs), or assert that REMIC loan modifications resulted in a prohibited transaction, where the holder or servicer modified a mortgage loan (not then in default) that the holder or servicer reasonably believed was at a significant risk of default upon maturity (or earlier), and (iii) a Notice soliciting whether additional IRS guidance is appropriate. This guidance addressed a number of concerns that industry groups had expressed to the Treasury on these issues.

BACKGROUND

REMICs had been a commonly employed securitization vehicle used by originators of commercial real estate mortgage loans to access sources of capital for real estate investments. The benefit gained from using a REMIC to raise capital for financing real estate projects came at a cost, however. REMICs are especially fragile income tax entities that are notorious for their inability to deal with changes in the project or the collateral after the loan has been transferred to the REMIC. In a world where the refinancing of commercial mortgages was almost effortless, this defect went largely unnoticed. Because of the lack of any depth in the market for real estate loans, there is no longer any expectation that the REMIC mortgage loans will be refinanced as they come due. As a result, a financing vehicle that was ill-designed to deal with mortgage loan workouts is now being faced with a multitude of such problems. Because of the organizational frailty of the REMIC, however, a misstep by the REMIC in restructuring the mortgage loan could result in substantial adverse tax consequences for the holders of the interests in the REMIC. The IRS guidance is addressed to these situations.

On a practical level, the recent IRS guidance is a good first step to mitigate what is anticipated to be a flood of CMBS defaults resulting from loans coming due without the availability of refinancing. The success of consistent, proactive loan modifications in response to the IRS guidance will depend, however, on whether the loans intended to benefit from the IRS guidance are otherwise in good order in spite of the continuing recession and on the ability of Master Servicers and Special Servicers to coordinate and make adjustments to their loan review and servicing responsibilities in an expeditious manner. On the first point, many CMBS loans, particularly in the retail and hospitality sectors, are afflicted with more than just the issue of unavailability of refinancing in the face of impending loan maturities. In the case of retail properties, borrowers have been confronted with tenant bankruptcies and closures, as well as competition for occupancy from more modern shopping centers in the vicinity. In the case of the hospitality industry, the increased competition among brand tiers has resulted in hotel franchisors' imposition of expensive property improvement plans on mid-tier hotels with the penalty of franchise termination for failure to implement. In these cases, while a loan extension and interest rate reduction may be a good first start, the borrower will in all likelihood need additional concessions from the lender to keep the loan afloat and protect the value of the real estate collateral from further deterioration,. These concessions may require, for example, the use of net operating income to pay tenant improvements and leasing commissions for a prospective tenant who plans on filling a vacant anchor space and a reduction in monthly reserve requirements. Moreover, it can be expected that a borrower who garners the attention of a servicer for a loan modification will ask for everything as part of a loan modification package.

OVERVIEW OF THE RECENT GUIDANCE

Under the REMIC rules, "significant" modifications to the terms of debt instruments owned by the REMIC are deemed to result in an exchange of the unmodified debt obligation for the modified debt obligation. Following the deemed exchange, the modified debt obligation generally fails to constitute a qualified mortgage loan for a REMIC. Because a REMIC is not permitted to own more than a *de minimus* amount of non-permitted assets, and in view of the relatively large size of most commercial mortgage loans, the deemed exchange could jeopardize the REIT classification of the entire securitization vehicle. The final Regulations expand the existing loan modification safe harbors, which permit certain modifications to occur without triggering a deemed exchange for REMIC purposes. This expansion is accomplished by: (i) permitting the release of a mortgage lien on the collateral where the loan continues to be principally secured by an interest in real property, provided that the release does not result in a modification of the loan, taking into the special REMIC loan modification safe harbors, (ii) although requiring that a modified mortgage loan be retested at the point of the modification to determine if it is continues to satisfy the "principally secured by an interest in real property" test of the Regulations, prescribing a more flexible retesting standard for changes to a loan that do not decrease the value of the real property securing the loan, (iii) liberalizing the retesting methodology as it applies to modified debt obligations by eliminating the requirement in the proposed Regulations that the retesting be evidenced by an independent appraisal and substituting a more liberal approach permitting a servicer to determine the value of the collateral based on a current or updated appraisal or on "some other commercially reasonable valuation method", provided that the servicer did not know that the valuation was incorrect, and (iv) permitting the mortgage obligation to change from recourse (or substantially recourse) to nonrecourse (or substantially nonrecourse), or vice versa, provided that the loan continues to meet the principally secured by an interest in real property standard. These more liberal rules for determining whether the loan is "principally secured" by an interest in real property should make it easier to accomplish a modification of a mortgage loan that is undersecured because of a decline in the value of the collateral from the time where the loan was issued, where the collateral is not released in connection with the workout.

MODIFICATIONS OF "UNDERWATER" LOANS WHERE COLLATERAL IS NOT RELEASED IN CONNECTION WITH THE MODIFICATION

The IRS did not adopt any of the changes urged by commentators to extend the REMIC safe harbors to include a change in the date on which a qualified mortgage may be prepaid or defeased or changes in the loan's payment schedule following a partial prepayment.

The IRS also provided a limited safe harbor for loan modifications of mortgage loans not currently in default addressed to cases where a default was likely because of the inability of the issuer to obtain refinancing for the amount of the outstanding balance at the loan's maturity. The IRS published a Revenue Procedure dealing with mortgage loan modifications made in anticipation of a default which set forth the conditions under which it would not challenge the tax status of the securitization vehicles, both REMICs and investment trusts, or assert that the mortgage loan modifications give rise to a REMIC prohibited transaction, where the holder or servicer reasonably believed that there was a significant risk of default of the pre-modification mortgage loan upon its maturity or upon some earlier date. The Revenue Procedure was intended to permit modifications of mortgage loans to occur before the mortgage loan is in default or default is reasonably foreseeable without triggering adverse consequences to the REMIC or the non-REMIC investment trust. If the conditions of the Revenue Procedure are met, the IRS will not contend:

(i) that the loan modifications were outside the REMIC safe harbor for modifications "occasioned by default or a reasonably foreseeable default,"
(ii) resulted in a REMIC prohibited transaction, or
(iii) adversely impacted an investment trust's classification as a "trust" or a REMIC's classification as a REMIC (because of a deemed reissuance of the REMIC regular interests).

In order to satisfy the conditions of the Revenue Procedure, the holder or servicer's reasonable belief concerning the risk of a default must be based on a diligent, contemporaneous determination of the risk, taking into account credible written factual representations made by the issuer of the loan, where the holder or servicer neither knows or has reason to know that the representations are false. A relevant factor in assessing the risk of default includes how far into the future the possible default may occur, although there is no maximum period after which the risk of default is per se not foreseeable. In the accompanying Example, the Service indicated that, in a case where the loan maturity was not to occur for 12 months but other factors indicated that refinancing options may not be available to the borrower at the time of the maturity of the mortgage loan, the servicer or holder could agree to modify the mortgage loan by extending its maturity date and changing the interest rate and that the modifications would be treated as within the scope of the Revenue Procedure's safe harbor.

The recent IRS guidance does not address real estate mortgage loans held by real estate investment trusts.

WHAT DOES THE FUTURE HOLD FOR BORROWERS AND REMICS FOLLOWING THE RELEASE OF THIS GUIDANCE?

It remains to be seen how quickly the servicers will act upon the IRS guidance and start modifying loans. The respective responsibilities and liabilities of the Master Servicer versus a Special Servicer in respect of a loan, including the ability to modify a loan, are governed by, and set forth in great detail in, the applicable pooling and servicing agreement. To avoid liability to the Special Servicer and to the certificateholders, the Master Servicer would likely insist on an amendment to the pooling and servicing agreement to delineate boundaries for its obligations and liabilities in response to the IRS guidance prior to assuming that it, instead of the Special Servicer, can approve a borrower's early request to modify a loan. Since the ability to modify a loan under the IRS guidance is also predicated upon the reasonable belief of the servicer, after considering all of the facts and circumstances, that the modified loan has a substantially reduced risk of default, it is even more important as between the Master Servicer and the Special Servicer that any adjustments to their roles and responsibilities are clearly defined so as to combat the enemy of time that has hastened deterioration in property values and increased the likelihood of loan defaults and foreclosures.

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