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Game-Changing New Treasury Regulations Relax Mortgage Loan Modification Rules

The Internal Revenue Service released final regulations on September 15, 2009 expanding the list of modifications to mortgage loans held in a REMIC securitization vehicle that can be made without jeopardizing the tax status of the REMIC, effective as of September 16, 2009. Aspects of the new rules will likely prove to be "game changers" for commercial mortgage loan industry participants. And while the new rules provide helpful flexibility for mortgage loan modifications, they also harbor a trap in the form of a newly expanded loan-to-value test imposed in conjunction with certain modifications. In separate releases, the IRS addresses modifications in situations where a servicer of a commercial mortgage loan reasonably believes there is a significant risk of default at a future date, but that risk does not meet the existing standard for a "reasonably foreseeable" default, and asks for comments on the need for additional guidance focused on modifications of commercial mortgage loans held by investment trusts treated as grantor trusts.

New Regulations for Modification of Mortgage Loans Held in REMICs

Mortgage loans held in a REMIC generally cannot be significantly modified without adversely affecting the qualification of the REMIC, subject to exceptions specified in Treasury regulations. Before promulgation of the new regulations, the specified exceptions applied to modifications occasioned by a default or a reasonably foreseeable default on a mortgage loan, assumption of a mortgage loan by a new owner of a mortgaged property, waiver of a due-on-sale or due-on-encumbrance provision, and interest rate conversions on convertible loans. The new regulations expand that list of permitted exceptions to include changes in collateral, guarantees and credit enhancement of a loan and changes to the recourse/nonrecourse nature of a loan. This expanded ability to release, substitute, add or otherwise alter collateral or credit enhancement even in the absence of a prospective default will be very significant in a wide variety of commercial mortgage loan situations.

The roses have thorns, however. The new regulations impose a requirement that the collateral value for a mortgage loan be retested under a loan-to-value test when a modification within the scope of the expanded permitted exceptions described above occurs. Thus, a modification that alters a substantial amount of the collateral for, or guarantee or other credit enhancement for, a mortgage loan, or that changes the nature of the loan from recourse to nonrecourse (or *vice versa*), is permitted under the new regulations only if the value of the collateral following the modification is sufficient to cause the mortgage loan to be viewed to be principally secured by an interest in real property under the loan-to-value test described below.

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The REMIC rules require that mortgage loans held by a REMIC be principally secured by an interest in real property, which means that the value of the real property that secures the loan must be at least 80% of the adjusted issue price of the loan. Before the new regulations took effect, that test was applied alternatively as of the time of origination of the mortgage loan or at the time the loan was contributed to the REMIC, and there was no ongoing requirement that the 80% test be satisfied.

The new regulations now require that this test be met as of the date of any of the newly permitted modifications, but provide a safe harbor under which the test is deemed to be satisfied if the value of the collateral securing the loan immediately following the modification is not less than the value of the collateral immediately before the modification. The 80% test is deemed to be met where the servicer reasonably believes as of the date of the modification that the test is met based upon (i) a current appraisal, (ii) an appraisal obtained when the loan was originated that has been appropriately updated, (iii) the sale price of the property where there is a contemporaneous sale with an assumption of the mortgage loan, or (iv) some other commercially reasonable valuation method. While the retesting requirement did not exist prior to promulgation of the new regulations, that requirement as adopted in the new regulations represents a relaxation of the requirement originally proposed by the IRS that would have more rigidly required appraisals and would not have contained a safe harbor for modifications that do not decrease the amount of the collateral securing the loan.

Even before the arrival of the new regulations, the REMIC rules provided that a loan held by a REMIC would cease to be a qualified mortgage for REMIC purposes if the lien on property securing the mortgage were released unless the release were pursuant to a qualifying defeasance. Many industry participants believed that where a release of a lien was not a significant modification of the loan (for example, where loan documents give a borrower a unilateral right to obtain a partial release of a lien on an outlying parcel to permit a sale of that parcel), that release would not cause the loan to cease to be a qualified mortgage for REMIC purposes. Moreover, many industry participants believed that a release of a lien in connection with an actual default or a reasonably foreseeable default would not cause a loan to cease to be a qualified mortgage.

The new regulations clarify that, in addition to defeasances, a release of a lien that is not a significant modification, or that comes within the expanded list of exceptions to significant modification treatment for REMIC purposes, will not cause a loan to cease to be a qualified mortgage, provided that the 80% test is met following the modification. This new retesting requirement may present special issues in situations where modifications are permitted under loan documents without a contractual requirement that the 80% test be met following the modification. There is a possibility that a release of collateral might be permitted as a unilateral option under loan documents drawn when the REMIC rules did not require any loan-to-value retest, and the new retesting requirement would cause the modified loan to fail to satisfy the qualified mortgage test, with potentially adverse consequences to the REMIC.

Of course, contractual obligations and limitations will still govern the loans themselves and the latitude of servicers under pooling and servicing agreements and similar documents. Servicers may not have the authority under governing contractual arrangements to make certain modifications permitted under the new regulations.

The IRS discussion of the new regulations indicates that they are intended to accommodate evolving practices in the commercial-mortgage industry. The changes made by the new regulations, however, are not limited to commercial mortgage loans, but apply technically to residential mortgages as well. As a practical matter, the impact of the new regulations will be most significant for commercial mortgage loans.

Revenue Procedure 2009-45

On September 15, the IRS also released Revenue Procedure 2009-45, which permits modifications to commercial mortgage loans in certain additional circumstances independent of the expanded modification rules in the new regulations described above. The revenue procedure notes that current credit market conditions raise concerns that many commercial mortgage loans held in securitization structures will not be able to be refinanced timely as they mature over the next couple of years, raising the specter of repayment defaults at maturity of the existing loans, even though the loans are currently performing and the underlying properties are generating ample cash flows to satisfy debt service until maturity. While servicers have determined that modifications made now to many of those mortgages could permit the mortgage loans to continue performing, there has been uncertainty whether the prospect of default at a maturity six or more months in the future, for example, would satisfy the hurdle for permissible significant modifications occasioned by a "reasonably foreseeable default."

The revenue procedure addresses this uncertainty by providing that where a servicer reasonably believes that there is a significant risk of default at or before maturity of a commercial mortgage loan and modifies the loan to reduce that risk, the IRS will not challenge the qualification of the vehicle holding the loan as a REMIC or fixed investment trust as a result of the modification. The range of modifications permissible under the revenue procedure is significantly greater than those permitted under the new regulations where default has not occurred and is not imminent, and include, for example, significant changes in interest rates and maturity extensions. The revenue procedure explicitly states that there is no maximum period after which default is *per se* not foreseeable, and states 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. Requirements as to the delinquency profile of the pool of loans held by the REMIC or investment trust apply.

Notice 2009-79

In Notice 2009-79, the IRS noted that commentators to the proposed form of the regulations described above had requested that the scope of the regulations project be expanded to permit commercial mortgage loans held in investment trusts treated as grantor trusts to be modified to the same extent as those held by REMICs under the new rules. The IRS asked for comments providing detailed explanations of why changes are needed for loans held by investment trusts.

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This update was authored by Michael J. Rufkahr (+1 202 261 3437; michael.rufkahr@dechert.com).

Practice group contacts

For more information, please contact one of the attorneys listed, or any Dechert attorney with whom you regularly work. Visit us at www.dechert.com/tax.

Adrienne M. Baker
Boston
+1 617 728 7151
adrienne.baker@dechert.com

Richard D. Belford
New York
+1 212 698 3607
richard.belford@dechert.com

Daniel M. Dunn
New York
+1 212 698 3857
daniel.dunn@dechert.com

Frederick J. Gerhart
Philadelphia
+1 215 994 2838
frederick.gerhart@dechert.com

Mark D. Grimm
Philadelphia
+1 215 994 2394
mark.grimm@dechert.com

Richard M. Hervey
New York
+1 212 698 3568
richard.hervey@dechert.com

Michael Hirschfeld
New York
+1 212 698 3635
michael.hirschfeld@dechert.com

Edward P. Lemanowicz*
Philadelphia
+1 215 994 2492
edward.lemanowicz@dechert.com

James H. Nix
New York
+1 212 698 3595
james.nix@dechert.com

Jennifer A. O'Leary
Philadelphia
+1 215 994 2464
jennifer.oleary@dechert.com

Michael J. Rufkahr
Washington, D.C.
+1 202 261 3437
michael.rufkahr@dechert.com

David G. Shapiro
Philadelphia
+1 215 994 2456
david.shapiro@dechert.com

Richard P. Wild
Philadelphia
+1 215 994 2670
richard.wild@dechert.com

**Chair*

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