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# IRS Clarifies REMIC Regulations and Provides Safe Harbor for Certain Property Release Transactions

JOSEPH HEIL, DAVID LINDER, MICHAEL RUFKAHR, AND MATTHEW CLARK

*This article poses and answers questions regarding how the Internal Revenue Service's 2010 Revenue Procedure addresses lien release issues raised by the 2009 Treasury Regulations.*

The Internal Revenue Service (“IRS”) released Revenue Procedure 2010-30<sup>1</sup> on August 17, 2010 (the “2010 Revenue Procedure”), which elucidates certain REMIC requirements relating to property releases set forth in final U.S. Treasury regulations<sup>2</sup> (the “2009 Regulations”) issued last September. The 2010 Revenue Procedure provides a safe harbor for certain releases of real property from the lien of the mortgage held in a REMIC (a “Lien Release”) that constitute either a “Grandfathered Transaction” or a “Qualified Pay-Down Transaction.” The 2009 Regulations represented a significant loosening of the restrictions on modifications to mortgage loans held in REMICs.<sup>3</sup> However, the 2009 Regulations also imposed certain restrictions on actions taken with respect to mortgage loans held in REMICs. Notably, the 2009 Regulations included an obligation to re-test loans upon the occurrence of any Lien Release (other than a defeasance) to determine if the mortgage loan continues to be “principally

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secured” by real property. This new requirement created the possibility of circumstances in which compliance with the REMIC Rules would make concurrent compliance with loan documents impossible. Generally, the 2010 Revenue Procedure attempts to fix this problem by setting forth two particular sets of circumstances under which the IRS will not challenge the REMIC qualifications of a mortgage loan as a result of a Lien Release. This article poses and answers questions regarding how the 2010 Revenue Procedure addresses Lien Release issues raised by the 2009 Regulations.

## **WHAT DO THE 2009 REGULATIONS REQUIRE IN CONNECTION WITH A LIEN RELEASE?**

The 2009 Regulations require that a mortgage loan be re-tested upon the occurrence of a Lien Release to ensure that the mortgage loan, after giving effect to the Lien Release, continues to be principally secured by real property. In order to satisfy this requirement, one of two tests must be met. The 2009 Regulations provide that following a Lien Release a mortgage loan remains principally secured by real property only if either:

- The fair market value of the real property serving as collateral for the mortgage loan is at least equal to 80 percent of the principal amount of the mortgage loan (the “80 Percent Test”); or
- The fair market value of the real property collateral immediately after the Lien Release is at least equal to the fair market value of the real property collateral immediately before the Lien Release (the “Equivalent Value Test”).

## **WHAT WAS THE IMPACT OF THE 2009 REGULATIONS’ RE-TESTING REQUIREMENT PRIOR TO THE 2010 REVENUE PROCEDURE?**

The re-testing requirement set forth in the 2009 Regulations could have prohibited Servicers from permitting Lien Releases in situations where the Servicer had the contractual obligation to do so under the mort-

gage loan documents or where the Servicer determined that a Lien Release would otherwise be in accordance with the servicing standard.

## **WHAT TRANSACTIONS COULD HAVE BEEN AFFECTED BY THE 2009 REGULATIONS' RE-TESTING REQUIREMENT?**

Any Lien Release undertaken in connection with a mortgage loan that was unable to satisfy the 80 Percent Test could have been affected by the 2009 Regulations' re-testing requirement. For example, this issue could have arisen in connection with:

- A Lien Release arising as a result of a borrower's unilateral right in a multi-property mortgage loan;
- A Lien Release as a result of a Servicer's exercise of mortgage loan remedies (*e.g.* the sale of properties in connection with a consensual workout or foreclosure);
- A Lien Release occasioned by condemnation or a sale-in-lieu of condemnation; or
- A Lien Release arising from the borrower's unilateral right to obtain the release of an outparcel.

## **WHEN IS THE 2010 REVENUE PROCEDURE EFFECTIVE?**

The 2010 Revenue Procedure applies to Lien Releases of interests in real property securing mortgage loans held by REMICs that are effected on or after September 16, 2009.

## **WHAT ARE THE TWO CATEGORIES OF LIEN RELEASES THAT COME WITHIN THE SAFE HARBORS UNDER THE 2010 REVENUE PROCEDURE?**

The two safe harbors are:

- Grandfathered Transactions; and
- Qualified Pay-Down Transactions.

## **WHAT IS A “GRANDFATHERED TRANSACTION”?**

A “Grandfathered Transaction” is a Lien Release transaction in which:

- The Lien Release is effected pursuant to a borrower’s unilateral option under the mortgage loan documents; and
- The provisions of the mortgage loan documents relating to that Lien Release are contained in a contract that was executed no later than December 6, 2010.

A Lien Release undertaken pursuant to a waiver, consent, or other modification of a mortgage loan will not qualify as a Grandfathered Transaction because to be a Grandfathered Transaction the Lien Release must be accomplished pursuant to the existing terms and provisions of the mortgage loan documents to come within the 2010 Revenue Procedure safe harbor. Furthermore, to the extent a Lien Release is effected pursuant to a unilateral option of the borrower contained in the mortgage loan documents, the underlying contract granting that option must have been executed on or prior to December 6, 2010.

## **WHAT IS A BORROWER’S “UNILATERAL RIGHT” TO OBTAIN A LIEN RELEASE?**

A borrower’s unilateral right to obtain a Lien Release means the release of a property subject to satisfaction of objective criteria contained in the mortgage loan documents. Prior to the 2009 Regulations, multi-property mortgage loan documents often included provisions permitting the borrower to obtain a release of a single property from the lien of the related mortgage. The release mechanism was typically structured as an enforceable right of the borrower, subject only to the satisfaction of certain conditions — ordinarily including the payment of a “release price”

(typically 105 percent — 125 percent of the allocated loan amount for the applicable property). To the extent the borrower satisfied the conditions to property release, the lender (or Servicer on its behalf) usually had little or no discretion in consenting to the property release.

## WHAT IS A “QUALIFIED PAY-DOWN TRANSACTION”?

A “Qualified Pay-Down Transaction” occurs when a borrower makes a principal repayment of the mortgage loan in a “Qualifying Amount” simultaneously with the occurrence of the Lien Release. A Qualifying Amount is an amount equal to or greater than at least one of the following:

- The sum of (i) the net proceeds payable to the borrower from an arms’ length sale of the property to an unrelated person, (ii) the net proceeds from the receipt of a condemnation award with respect to the property, and (iii) the net proceeds from the receipt of an insurance settlement or other litigation settlement with respect to the property;
- The “release price” set forth in the mortgage loan documents, provided such amount equals or exceeds the product obtained by multiplying the outstanding principal balance of the mortgage loan as of the date of the Lien Release by a fraction equal to the fair market value (as of the date the mortgage loan was originated) of the released property divided by the aggregate fair market value (as of the date the mortgage loan was originated) of all real estate securing the mortgage loan immediately prior to the Lien Release;
- The fair market value on the date the Lien Release occurs of the real property released (plus the amount of any litigation or insurance settlement received with respect to the real property that is not reflected directly or indirectly in the property’s fair market value at the time of the transaction); or
- An amount sufficient to cause the loan-to-value ratio of the mortgage loan immediately after the Lien Release to be no greater than the loan-to-value ratio existing immediately prior to the Lien Release.

## **HOW DO YOU CALCULATE “NET PROCEEDS” FOR PURPOSES OF DETERMINING A QUALIFYING AMOUNT?**

The 2010 Revenue Procedure specifies that the term “net proceeds,” for purposes of the determining Qualifying Amounts, means the amount realized for purposes of computing gain or loss under Section 1001 of the Internal Revenue Code.<sup>4</sup> While Section 1001 and the regulations thereunder do not specifically permit offsetting the gross proceeds by the amount of customary selling costs and expenses (including brokerage commissions and legal fees) incurred in connection with a sale or disposition in determining the amount realized, reducing the amount realized by the amount of such costs and expenses is a long-established practice (for sellers who are not dealers disposing of inventory) confirmed by both leading commentators and proposed regulations. Thus, “net proceeds” should be computed by deducting customary selling costs and expenses from the gross consideration received by a seller (other than a dealer) in connection with a sale or disposition of property. This definition may be problematic in connection with a Lien Release occurring as a result of a partial condemnation, however, where condemnation proceeds are applied first toward the costs associated with restoring the remaining portion of the property. The 2010 Revenue Procedure appears to permit no such deduction and instead requires all proceeds to be applied toward repayment of the outstanding principal balance of the mortgage loan.

## **HOW DOES A SERVICER DETERMINE IF A PRINCIPAL REPAYMENT MADE IN CONNECTION WITH A LIEN RELEASE CONSTITUTES A QUALIFYING AMOUNT?**

With respect to the third and fourth criteria for determining the Qualifying Amount, above, the 2010 Revenue Procedure provides that the Servicer must “reasonably believe” the principal repayment (*i.e.*, the amount by which the mortgage loan is being reduced) satisfies the applicable Qualifying Amount criteria set forth above. Under the 2009 Regulations, the Servicer must base its reasonable belief upon:

- A current appraisal from an independent appraiser;
- An appraisal that was obtained in connection with the origination of the mortgage loan (if appropriate, updated for the passage of time and other changes that might affect the value of the real estate);
- The sales price of the real estate in the case of a substantially contemporaneous sale in which the buyer assumes the seller's obligations under the mortgage; or
- Another commercially reasonable valuation method.

## **LOOKING FORWARD, WHAT CHANGES WILL LENDERS MAKE TO THE LIEN RELEASE PROVISIONS IN LOAN DOCUMENTS?**

In light of the changes to the REMIC Rules set forth in the 2009 Regulations and the 2010 Revenue Procedure, it is expected that prudent lenders will modify the release provisions of their standard mortgage loan documents.

- First, it is expected that any Lien Release contemplated by the mortgage loan documents will require, as a condition precedent to such release, the delivery of a legal opinion that the Lien Release will not adversely affect the status or taxation of the REMIC under the REMIC Rules.
- Second, it is expected that lenders may not allow Lien Releases without principal pay-downs in a Qualifying Amount (to the extent that the fair market value of the remaining real property collateral does not equal or exceed at least 80 percent of the outstanding principal balance of the mortgage loan). This will be an especially important restriction on outparcel releases which typically do not require the payment of an associated release price and thus ordinarily will not be able satisfy the 2010 Revenue Procedure's safe harbor as a Qualified Pay-Down Transaction.
- Third, to ensure any principal repayment will be in a Qualifying Amount, it is expected that lenders will tailor allocated loan amounts

for individual properties to mirror appraised values and may include a list of appraised values as an exhibit to the mortgage loan documents. Lenders may supplement debt service coverage tests (a common Lien Release requirement) with loan-to-value tests to ensure that any release price represents a Qualifying Amount in situations where the other criteria for a Qualified Pay-Down Transaction do not apply.

## NOTES

<sup>1</sup> See <http://www.irs.gov/pub/irs-drop/rp-10-30.pdf>.

<sup>2</sup> See <http://edocket.access.gpo.gov/2009/pdf/E9-22215.pdf>.

<sup>3</sup> For purposes of this article (i) the Internal Revenue Service is referred to as the “IRS,” (ii) real estate mortgage investment conduits are referred to as “REMICs,” (iii) references to the “Servicer” mean the Master Servicer or the Special Servicer, as applicable, under the applicable pooling and servicing agreement, and (iv) the provisions of the Internal Revenue Code and accompanying regulations are generally referred to herein as the “REMIC Rules.”

<sup>4</sup> I.R.C. § 1001(b).