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## Final Regulations Expand Tax Safe Harbors for Certain Common Modifications of REMIC-Held Commercial Mortgage Loans

On September 15, 2009, the Treasury Department ("Treasury") and the Internal Revenue Service ("IRS") published T.D. 9463, finalizing regulations (the "New Regulations") that expand a REMIC's ability to make certain common modifications to commercial mortgage loans without jeopardizing the REMIC's tax status or exposing it to prohibited transactions taxes. The New Regulations apply to modifications made after September 15, 2009.

Unlike the new rules in Rev. Proc. 2009-45, published the same day, the new rules in T.D. 9463 do not apply to commercial mortgage loans held by fixed investment trusts that are treated as "grantor trusts." Instead, the Treasury and IRS published Notice 2009-79, also dated September 15, 2009, soliciting comments on whether the new rules should also apply to grantor trust-held mortgage loans.

### Background

Among other requirements, to be classified as a REMIC, substantially all of an arrangement's assets must consist of certain assets, including "qualified mortgages." "Qualified mortgages" are generally mortgage loans that are both principally secured by interests in real property and acquired within three months of the REMIC's startup date (ordinarily, the closing date). If a mortgage loan held by a REMIC ceases to be a qualified asset, then the REMIC may fail the asset test and any future income from the loan (accruing interest and any gain recognized on its sale) will be subject to a 100% "prohibited transactions" tax. The prohibited transactions tax also applies to the disposition of a qualified loan by a REMIC other than in limited circumstances, such as upon default of the loan or as part of the REMIC's liquidation.

If a REMIC-held loan is "significantly" modified more than three months after the startup date, the REMIC is treated as if it exchanged that loan for a new loan. Thus, the modification is a prohibited transaction (that is, a disposition of the "old" loan) and the "new" loan is no longer a qualified asset, subjecting the REMIC to possible loss of its tax status and loss of any income from the "new" loan.

Ordinarily, a modification is "significant" if it triggers a taxable gain or loss under the general tax principles of Section 1001 of the Code. Under the REMIC regulations,

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however, certain modifications do not jeopardize a REMIC's tax status or expose it to a prohibited transactions tax even if the modification is a taxable event under general tax principles. Before T.D. 9463, the regulatory exceptions included modifications occasioned by: (1) default or reasonably foreseeable default, (2) assumption of the obligation, (3) waiver of a due on sale clause or due on encumbrance clause and (4) conversion of an interest rate by a mortgagor pursuant to the terms of a convertible mortgage. Now the regulatory exceptions will also include modifications such as certain changes in: (1) collateral, (2) guarantees, (3) credit enhancement and (4) the recourse nature of an obligation (old and new exceptions together, the "Regulatory Exceptions"). The New Regulations also explain circumstances under which a real property lien securing a mortgage may be released without jeopardizing the status of the mortgage as a qualified REMIC asset.

All of the new provisions share a common element. After a modification or release, the mortgage loan must continue to be "principally secured by an interest in real property." A mortgage loan satisfies this test if either (1) the value of the real property securing the mortgage loan is at least 80% of the mortgage loan's adjusted issue price or (2) the value of any substituted collateral equals the value of any released collateral. The New Regulations explain that the value of the real property and adjusted issue price of the mortgage loan must be determined "as of the date of the modification." They also explain how the value of collateral may be determined.

### Operative Rules

Under the New Regulations, provided that it continues to be principally secured by an interest in real property afterwards, a mortgage loan will remain a REMIC-qualified asset following:

- A modification that releases, substitutes, adds, or otherwise alters a substantial amount of the collateral for, a guarantee on, or other form of credit enhancement for, a recourse or nonrecourse obligation;

- A change in the nature of the obligation from recourse (or substantially all recourse) to nonrecourse (or substantially all nonrecourse), or from nonrecourse (or substantially all nonrecourse) to recourse (or substantially all recourse);\* and
- The release of a lien in a modification that either (1) is not a significant modification (that is, a modification that fails to trigger a taxable gain or loss under Section 1001 of the Code) or (2) is one of the listed Regulatory Exceptions.

*Establishing Fair Market Value.* In general, and subject to the special rule for underwater properties discussed below, a mortgage loan is deemed to be principally secured by an interest in real estate on the modification date if the servicer reasonably believes that the obligation satisfies the 80% test on such date. A servicer, however, **must** base a reasonable belief on:

- A current appraisal performed by an independent appraiser;
- An appraisal that was obtained in connection with the origination of the obligation and, if appropriate, that has been updated for the passage of time and for any other changes that might affect the value of the interest in real property;
- The sales price of the interest in real property in the case of a substantially contemporaneous sale in which the buyer assumes the seller's obligations under the mortgage; or
- Some other commercially reasonable valuation method.

A reasonable belief does not exist if the servicer actually knows, or has reason to know, that the criterion is not satisfied.

*Special Rule For Underwater Properties.* The value of the real estate securing a REMIC-held mortgage may decline to the point where the mortgage no longer satisfies the 80% test. Under

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\* This rule should generally eliminate the persistent questions relating to the effect of "springing" recourse and non-recourse carveout provisions.

those circumstances, a modification that involves the substitution of collateral may not satisfy the ordinary “primarily secured” standard even if the values of the old collateral and the new are identical. Absent a special rule, the modification could jeopardize REMIC classification and implicate a prohibited transactions tax although the creditor’s position, as an economic matter, hadn’t changed. Therefore, under the New Regulations, a mortgage will be treated as principally secured by an interest in real property after a modification if the fair market value of the interest in real property that secures the obligation immediately after the modification equals or exceeds the fair market value of the interest in real property that secured the obligation immediately before the modification. This criterion must be established by a current appraisal, an original (and updated) appraisal, or some other commercially reasonable valuation method; and the servicer **must** not actually know, or have reason to know, that the criterion in the preceding sentence is not satisfied.

### Residential Mortgages

Unlike the new rules in Rev. Proc. 2009-45, the application of the New Regulations is not limited to “commercial mortgage loans” as a technical matter: they also apply to residential mortgages. However, as indicated by the preamble to the New

Regulations, Treasury and IRS apparently believed that the types of modifications described in the New Regulations would ordinarily just be relevant to commercial mortgage loans.

### Other Issues

REMIC servicers, trustees and administrators should be aware that even if a modification of a loan is covered by the New Regulations and, therefore, does not threaten REMIC qualification or implicate a prohibited transactions tax, a modification may still result in a REMIC realizing taxable gain or loss under Section 1001 of the Code, which can affect the taxable income and “excess inclusions” of the REMIC’s residual interest holders.

### Implementation

Effective implementation of the New Regulations will depend on whether the underlying transaction documents governing a REMIC permit the changes described in the New Regulations and on the obligations of and comfort requested by the parties administering the REMIC. If changing the REMIC’s governing documents would be desirable, the REMIC administrator should determine whether the changes could be accomplished unilaterally.

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