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New Revenue Procedure Expands Tax-Safe Modifications for REMIC-Held Commercial Loans

On September 15, 2009, the Treasury Department ("Treasury") and the Internal Revenue Service ("IRS") published Revenue Procedure 2009-45 ("Rev. Proc. 2009-45"), expanding a REMIC's ability to modify troubled, commercial loans without jeopardizing the REMIC's tax status or exposing it to prohibited transaction taxes. Similar rules were put into effect to protect the grantor trust status of fixed investment trusts that modify troubled, commercial loans. Rev. Proc. 2009-45 applies to commercial loan modifications effected on or after *January 1, 2008*. For purposes of the revenue procedure, a loan is generally a "commercial loan" provided that before modification, the loan is not secured by a residence that contains fewer than five dwelling units and is not the principal residence of the issuer of the loan.

Background

Among other requirements, to be classified as a REMIC, most of an arrangement's assets must consist of certain assets such as qualified mortgages. "Qualified mortgages" are generally 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 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 (interest and any gain on sale) will be subject to a 100% "prohibited transactions" tax. The prohibited transactions tax also applies to the disposition of a loan by a qualified 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, then 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 Section 1001 of the Code. Under the REMIC regulations, however, certain modifications do not jeopardize a REMIC's tax status or expose it to a prohibited transaction tax even if the modification is a taxable event under general tax principles.

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These regulatory exceptions include modifications “occasioned by default or reasonably foreseeable default.”

Rev. Proc. 2009-45 explains additional circumstances under which the modification of a commercial mortgage by a REMIC will not result in the IRS challenging the tax status of the REMIC or imposing a prohibited transactions tax on the REMIC. Similar relief is provided to fixed investment trusts.

Revenue Procedure 2009-45

Reasons for Relief. The relief provisions in Rev. Proc. 2009-45, stated above, are predicated on the understanding of the Treasury and IRS about certain features and administration of commercial loans. Among other facts, the Treasury and IRS understood that:

- Commercial loans frequently require the principal be paid at maturity and at the time of origination it is expected that the borrower will pay the principal by obtaining a new loan secured by the same property. Based on current conditions, it appears that such refinancing may not be possible and that a borrower may default even if the underlying property is providing currently more cash flow than needed to satisfy the debt service on the loan.
- Pool administrators have procedures for monitoring the status of the commercial property securing a loan and can predict the likelihood of a borrower being unable to refinance a loan at maturity or sell the underlying property. Using these procedures, it may be possible to foresee this risk of foreclosure before the loan matures.
- Industry participants can predict with a reasonable degree of accuracy whether particular modifications, such as rate changes, principal forgiveness, extensions of maturity, and alterations in the timing of changes to an interest rate or to a principal amortization schedule, will allow a loan to continue to perform and reduce the risk of foreclosure.

- Often the complexity of commercial mortgage loans require that the negotiation of a modification begin a “substantial period” before maturity.

Operative Provisions. To take advantage of Rev. Proc. 2009-45, a REMIC or fixed investment trust that modifies a commercial loan must satisfy the following requirements:

- The pre-modification loan is not secured by a residence that contains fewer than five dwelling units and that is the principal residence of the issuer of the loan.
- Either **(1)** If a REMIC holds the pre-modification loan, then as of the end of the 3-month period beginning on the startup day, no more than ten percent of the stated principal of the total assets of the REMIC was represented by loans fitting the following description: At the time of contribution to the REMIC, the payments on the loan were then overdue by at least 30 days or a default on the loan was reasonably foreseeable; or **(2)** If an investment trust holds the pre-modification loan, then as of all dates when assets were contributed to the trust, no more than ten percent of the stated principal of all the debt instruments then held by the trust was represented by instruments the payments on which were then overdue by 30 days or more or for which default was reasonably foreseeable.
- Based on all the facts and circumstances, the holder or servicer reasonably believes that there is a significant risk of default of the pre-modification loan upon maturity of the loan or at an earlier date.
- Based on all the facts and circumstances, the holder or servicer reasonably believes that the modified loan presents a substantially reduced risk of default, as compared with the pre-modification loan.

Reasonable Belief There is a Significant Risk of Default. According to the revenue procedure, this reasonable belief must be based on a diligent contemporaneous determination of that risk, which may take into account credible written factual

representations made by the issuer of the loan if the holder or servicer neither knows nor has reason to know that such representations are false. In a determination of the significance of the risk of a default, one relevant factor is how far in the future the possible default may be. There is no maximum period, however, after which default is per se not foreseeable. For example, 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. Similarly, although past performance is another relevant factor for assessing default risk, in appropriate circumstances, a holder or servicer may reasonably believe that there is a significant risk of default even if the loan is performing.

Ten Percent Limit. Rev. Proc. 2009-45 will apply to a modification unless, as of the startup day or within three months thereafter, more than ten percent of the stated principal of the REMIC's total assets are represented by loans the payments on which are overdue by 30 days or more. A similar rule applies to fixed investment trusts. Although this limitation should not affect a routine REMIC or trust transaction, it would deny the benefits of the revenue procedure to those

REMICs or trusts expressly formed to modify delinquent loans. The Treasury and IRS imposed a similar limitation in Rev. Proc. 2008-28, which concerns the modification of residential loans.

Other Issues

REMICs and trusts should be aware that even if a loan modification is covered by Rev. Proc. 2009-45, the loan modification may still result in a REMIC or trust realizing taxable gain or loss under Section 1001 of the Code. Holders of a REMIC's regular interests should be aware that they may also realize taxable gain or loss in situations in which modifications to the REMIC's loans are deemed to create modifications of one or more of the REMIC's regular interests.

Implementation

Effective implementation of modifications under Revenue Procedure 2009-45 will depend on the underlying transaction documents governing each REMIC and the obligations of and comfort requested by the parties administering each such REMIC.

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