

New Permitted Loan Modifications and Revised Lien Release Rule for REMICs

The IRS has issued final regulations under section 860G of the Internal Revenue Code (T.D. 9463), effective September 16, 2009, that provide for two new categories of loan modifications that will be permitted without presenting qualification or prohibited transaction concerns for REMICs that hold such loans even where a modification results in a deemed re-issuance of the loan for general tax purposes. The two new categories of permitted modifications are (1) a change (release, substitution, addition or other alteration) in credit enhancement for the loan and (2) a change in the nature of the loan from recourse to non-recourse (or vice versa), in each case so long as the loan continues to be principally secured by an interest in real property following such a change as determined pursuant to standards set forth in the new regulations.

The final regulations also provide for a new exception to an existing anti-abuse rule that may otherwise disqualify a loan for REMIC purposes if the REMIC releases its lien on real property securing the loan. This is in addition to an existing exception for certain defeasances. Under the new exception, a real property lien release will not disqualify the loan if made in a modification that is not considered significant under the REMIC rules (e.g., if the modification does not give rise to a deemed reissuance of the loan for general tax purposes or if it falls under one of the six categories of permitted modifications specified in the REMIC rules), so long as the loan continues to be principally secured by an interest in real property following the modification as determined pursuant to standards set forth in the new regulations.

Although the final regulations in large part adopt the proposed regulations that were released in November 2007, certain changes were made in response to comments received in connection with the public comment process. Several of the changes are more taxpayer-favorable as compared to the proposed regulations. For example, although the final regulations retain the requirement that real property collateral value be retested at the time of modification in order to determine whether the modified loan satisfies the "principally secured" test, the final regulations include a non-exclusive list of commercially reasonable valuation methods that servicers can use for retesting, rather than requiring a current independent appraisal in all instances. The final regulations also provide an alternative method for satisfying the "principally secured" test if the modification does not decrease the value of the real property securing the loan.

In contrast, the changes to the lien release anti-abuse rule may have the effect of imposing additional restrictions as compared to the proposed regulations and prior law. For example, prior to the issuance of the final regulations, it was common practice in the CMBS industry to permit partial releases of real property collateral in connection with a partial prepayment of a loan without retesting real property collateral values as of the release date, if made pursuant to a unilateral option of the borrower under the original loan terms. However, in light of the new "principally secured" requirement for all real property lien releases (other than in connection with certain defeasances), this practice may no longer be possible without risking disqualification of the loan for REMIC purposes, at least in those circumstances where depressed property values make it impossible to satisfy the "principally secured" test. This new

Additional Resources

For a copy of Treasury Decision 9463, please click [here](#).

For a copy of Notice 2009-79, please click [here](#).

For a copy of Revenue Procedure 2009-45, please click [here](#).

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requirement also may have adverse tax consequences in a loan workout setting where a partial release is sought in connection with the restructuring.

Because the final regulations generally were meant to provide more flexibility under the REMIC rules in order to accommodate evolving practices in the commercial mortgage industry, it is unclear whether the new restrictive elements of the revised lien release rule were intended. Perhaps this issue will be revisited in future guidance, in particular if economic conditions continue to make it difficult to satisfy the new "principally secured" requirement.

Servicers of commercial mortgage loans held by REMICs should be aware of the changes introduced by the final regulations, in particular with respect to their restrictive impact on lien releases, in connection with any future loan modifications.

While the types of modifications covered by the new regulations generally arise in the commercial setting and the preamble to the final regulations notes that the changes are necessary to better accommodate evolving practices in the commercial mortgage industry, the text of the regulations is not limited to commercial mortgage loan modifications.

A copy of Treasury Decision 9463 can be found by clicking [here](#).

Request for Comments on Loan Modifications for Investment Trusts

The final regulations described above relate to modifications of mortgage loans held by REMICs, but not other common securitization vehicles such as investment trusts. But as the preamble to the final regulations notes, modifications of mortgage loans held by investment trusts may also present investment trust qualification issues, and commentators on the proposed regulations had requested that the regulation project be expanded to cover investment trusts.

Rather than delay the issuance of the final regulations to determine whether investment trusts should be covered, the IRS issued a separate notice (Notice 2009-79) requesting additional comments on this issue, including analysis as to the extent to which the modifications at issue are consistent with existing case law and administrative pronouncements that govern whether an investment trust is classified as a trust for federal income tax purposes.

Comments should be submitted to the IRS by November 14, 2009.

A copy of Notice 2009-79 can be found by clicking [here](#).

Additional Guidance on Modifications of Troubled Commercial Loans

In a separate revenue procedure (Revenue Procedure 2009-45) issued concurrent with the final regulations, the IRS provided additional guidance as to when modifications of troubled commercial loans will not present REMIC or investment trust qualification or prohibited transaction tax issues, which under certain circumstances may include modifications of currently performing loans.

The revenue procedure covers commercial loan modifications effected on or after January 1, 2008 where, based on all the facts and circumstances, the holder or servicer of the loan reasonably believes that (1) there is a significant risk of default of the pre-modification loan upon maturity of the loan or at an earlier date and (2) the modified loan presents a substantially reduced risk of default, as compared with the pre-modification loan. The revenue procedure notes that in determining the significance of the risk of a default, one relevant factor is how far in the future the possible default may be, but that there is no maximum period after which default is per se not foreseeable.

It should be noted that the relief provided by the revenue procedure does not appear to supersede the additional restrictions on real property lien releases contained in the final regulations described above. As a result, it appears that modifications that involve releases of real property collateral and that otherwise qualify for relief under the revenue procedure may also need to satisfy the "principally secured" requirement of the final regulations in order to avoid disqualification of the loan for REMIC purposes.

The revenue procedure does not cover residential mortgage loans, nor does it cover a REMIC or investment trust if more than 10% of its startup assets consisted of 30+ day delinquent loans or loans with respect to which default was reasonably foreseeable.

Of course, a servicer will still be required to adhere to the relevant servicing standards under applicable contractual arrangements and may not have the authority to make a loan modification even if it is otherwise permitted under the revenue procedure.

A copy of Revenue Procedure 2009-45 can be found by clicking [here](#).

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