Volume 8 Issue 3 2009

Securitization Perspectives

By Will Cejudo, James Gouwar and Anne Laughlin

The IRS Issues New REMIC Rules Regarding Loan Modifications, Creating Problems for Some Loans and Opportunities for Others

On September 16, 2009, the IRS issued final regulations ("New Regulations") expanding the list of permitted modifications that can be made to mortgage loans held by a Real Estate Mortgage Investment Conduit (REMIC).[1] The IRS had requested comments on March 19, 2007, as to whether the REMIC regulations should be amended to expand the types of permissible modifications.[2] After consideration of several comments, the IRS published proposed regulations on November 9, 2007.[3] In response to the proposed regulations, the IRS received additional comments and held a public hearing on April 4, 2008.[4]

The New Regulations may be a timely attempt by the IRS to facilitate loan modifications. Whatever the reason for their release, given the current economic downturn and resulting need to modify a number of outstanding mortgage loans, the New Regulations may be a helpful addition to the recent promulgation of federal proposals addressing delinquencies and foreclosures.[5]

The New Regulations also address releases of liens.[6] In contrast to the view that the New Regulations' expansion of permitted loan modifications may be helpful, the portion of the New Regulations addressing releases of liens does not reflect current practice and fails to take into account provisions in existing mortgage loans held by REMICs. Accordingly, this portion of the New Regulations poses a major issue with respect to commercial mortgage loans held by REMICs.

Although the preamble to the New Regulations provides that the New Regulations are intended to address certain modifications that are often made to commercial mortgage loans, the terms of the New Regulations are not limited to commercial mortgage loans. However, the New Regulations may not have much application to residential mortgage loans.

Will Cejudo and **James Gouwar** are Partners, and **Anne Laughlin** is an Associate, at Bingham McCutchen LLP.

Background

Under the REMIC provisions of the Internal Revenue Code ("the Code"), substantially all of a REMIC's assets must be "qualified mortgage loans" and "permitted investments."[7] Reg. §1.860D-1(b)(3) interprets "substantially all" as allowing no more than a *de minimis* amount of other assets and provides a very limited safe harbor allowing a REMIC to hold nonpermitted assets with an aggregate tax basis of less than one percent of the aggregate tax basis of all its assets.

To be a "qualified mortgage" for this purpose, a mortgage loan generally must be transferred to the REMIC on its startup day.[8] A modification to a qualified mortgage held by a REMIC raises a concern as to whether the REMIC continues to hold the same loan for federal income tax purposes. For this determination, the REMIC regulations generally look to whether the modification is treated as an exchange of obligations under Code Sec. 1001. Pursuant to Reg. § 1.1001-3, the "significant modification" of a loan will result in an exchange—the unmodified loan is treated as having been exchanged for the modified loan. Such an exchange means that the REMIC disposed of one of its qualified mortgages and acquired a new loan. If the exchange occurs after the REMIC's startup day, the new loan will not meet one of the requirements for being a "qualified mortgage."[9]

Importantly, the REMIC rules contain a list of exceptions for certain modifications.[10] If one of these exceptions applies, the modified loan is not treated as one that was newly originated on the date of the modification, at least for purposes of the REMIC asset test. In contrast, a significant modification outside the list of exceptions means that the loan is no longer a "qualified mortgage" for the REMIC. A mortgage loan ceasing to be a "qualified mortgage" causes a REMIC two problems. First, income from the mortgage loan becomes income from a non-permitted asset, which under Code Sec. 860F(a)(2)(B) becomes a prohibited transaction. Consequently, the REMIC is subject to a tax equal to 100 percent of the net income derived from the loan. Second, and even more troubling, if the failure of the loan to constitute a "qualified mortgage" causes the entity to hold more than a *de minimis* amount of nonpermitted assets, the entity loses its status as a REMIC.[11]

Additionally, prior to the application of the New Regulations, the release of collateral securing a mortgage loan caused a loan to lose its status as a "qualified mortgage" unless the release was made in connection with a defeasance transaction.[12] This restriction raised a question as to the ability of an issuer to use a REMIC to securitize commercial mortgage loans secured by multiple properties. However, the IRS ruled privately that certain partial releases were permitted.[13] Consistent with this IRS view, the general consensus was that the regulatory language permitted a partial release accompanied by a corresponding pay down of the loan. Outside of these instances, the REMIC regulations, prior to the application of the New Regulations, did not generally permit a REMIC servicer the flexibility to agree to release or substitute a portion of the collateral securing a mortgage loan in the event that one or more of the properties was sold.

> The test for determining whether an obligation is principally secured under the New Regulations is narrower than that under Reg. §1.860G-2(a)(1) for determining whether a mortgage loan is "principally secured" at the time it is contributed to a REMIC.

Expanded List of Permitted Modifications

The New Regulations include two new categories of expressly permitted modifications that are not treated as "significant modifications" under the REMIC provisions. Pursuant to the New Regulations, a modification that changes (i) the collateral for, guarantees on, or other forms of credit enhancement related to a mortgage loan, or (ii) the recourse nature of a mortgage loan is permissible.

Both of these newly permitted modifications are subject to the requirement that the mortgage loan "continues to be principally secured by an interest in real property" following the modification.[14] The New Regulations provide two alternative means of satisfying this requirement. The first alternative requires that the fair market value of the real estate securing the mortgage loan, determined on the date of the modification, be at least 80 percent of the outstanding loan balance. In other words, the fair market value of the real estate securing the mortgage loan, as determined on the date of the modification, must meet a 125 percent loan-to-value ratio test ("125 percent LTV test"). Under the New Regulations, a mortgage loan sufficiently meets the 125 percent LTV test if the servicer "reasonably believes" that the test has been met. The servicer's reasonable belief must be based on (i) a current appraisal performed by an independent appraiser; (ii) an appraisal that was obtained in connection with the origination of the mortgage loan, 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; (iii) a current sales price of the interest in real property in the case of a substantially contemporary sale in which the buyer assumes the seller's obligations under the mortgage; or (iv) any other commercially reasonable valuation method.

The second alternative requires that the fair market value of the interest in real property securing the obligation, immediately after the modification, be at least equal to the fair market value of the interest in real property securing the obligation immediately prior to the modification. Such fair market value must be established by (i) a current appraisal, (ii) an original (and updated) appraisal, or (iii) any other commercially reasonable valuation method. Additionally, the servicer must not actually know, or have reason to know, that this is not true.

By comparison, the test for determining whether an obligation is principally secured under the New Regulations is narrower than that under Reg. §1.860G-2(a)(1) for determining whether a mortgage loan is "principally secured" at the time it is contributed to a REMIC. Pursuant to the test under Reg. §1.860G-2(a)(1), a loan can satisfy the 125 percent LTV test based on the value of the property when the loan was originated or when it was contributed to the REMIC. In addition, under an alternative test, if the mortgaged property is the sole security for the loan and substantially all of the loan's proceeds were used to acquire, improve or protect the real property, the loan is considered principally secured regardless of the loan-to-value ratio.

Lien Releases

The New Regulations also modify the treatment of lien releases with respect to mortgaged properties. Previously, the regulations only addressed releases of collateral securing mortgage loans in the context of defeasances (*i.e.*, where substitute collateral was pledged to obtain a release). However, the language of the regulations was not limited strictly to defeasances, but literally applied to all releases. Specifically, the language in Reg. §1.860G-2(a)(8) prior to amendment provided that "[i]f a REMIC releases its lien on an interest in real property that secures a qualified mortgage, that mortgage ceases to be a qualified mortgage on the date the lien is released unless" substitute collateral consisting solely of government securities was pledged and certain other criteria were satisfied.

> [T]he New Regulations seem to greatly expand the scope of workout activity that can be conducted through REMICs.

In LTR 9833015,[15] the IRS construed then-existing Reg. §1.860G-2(a)(8) as an anti-abuse provision aimed at the prevention of the collateralization of a REMIC with obligations that are not qualified mortgages. In the ruling, a REMIC requested guidance that a modification of a nonrecourse loan to allow the release of a portion of the collateral that secured the loan did not cause the loan to fail to be a "qualified mortgage." In granting the requested guidance, the IRS concluded that a release of collateral accompanied by a pay down of the loan was not a material modification under Reg. §1.1001-3(e)(4)(iv)(B)[16] or a violation of Reg. §1.860G-2(a)(8). The IRS based its conclusions under both regulations on the same two facts. First, the amount paid for the release of the collateral, excluding any prepayment premium, was required to be applied in its entirety to the outstanding balance of the loan. Second, the loan-to-value ratio of the loan after the release and pay down did not "differ to a significant degree" from the loan-to-value ratio prior to such release and pay down.

The New Regulations expressly allow a lien release or substitution of property securing a "qualified mortgage" by a REMIC. The New Regulations provide that, in addition to a release for a permitted defeasance, a REMIC may release its lien in a modification so long as the loan "continues to be principally secured by an interest in real property," using one of the two alternative tests discussed above. For purposes of illustration, the New Regulations contain an example allowing the substitution of one property securing a qualified mortgage for another property even though the loan did not have a loan-to-value ratio at or under 125 percent either immediately before or immediately after the substitution, because the new property was more valuable than the released property, and therefore, the second alternative test was met. The facts of LTR 9833015 do not reveal whether the loan was principally secured at the time of the modification, only that the modification did not cause the loan-to-value ratio to differ to a significant degree. Because the letter ruling does not address the loan-to-value ratio of the modified loan, the New Regulations' more stringent test for lien releases has caught many practitioners by surprise. This is particularly true for cases in which the loan itself is not being "modified" within the meaning of the regulations under Code Sec. 1001.

The New Matrix for Changes to Loan Terms

In light of the New Regulations, a change to the terms of a "qualified mortgage" held by a REMIC can be classified depending on whether the change constitutes a "significant modification" under Reg. §1.1001-3 and whether the change involves a "release" of the lien. Given these two independent questions and two possible outcomes to each question, there are four situations to consider.

The first situation involves a change that does not constitute a "significant modification" under Reg. §1.1001-3 and does not "release" the lien. This type of change has not been affected by the New Regulations and continues to be permissible, but likely involves a minor change to the mortgage note. For example, assume the borrower and the servicer negotiate a change to a financial covenant to a mortgage loan held by a REMIC. Provided the change is not "significant,"[17] the REMIC rules do not prohibit the change.

The second situation involves a change that constitutes a "significant modification" under Reg. §1.1001-3 but does not "release" the lien. In this situation, the modification needs to meet one of the exceptions provided in Reg. §1.860G-2(b)(4). For example, assume the mortgage loan being modified is in default. Here, the REMIC rules allow the change, even though it constitutes a "significant modification."

The third situation involves a modification that does not constitute a "significant modification" under Reg. §1.1001-3 but does "release" the lien. Assume, for example, that a borrower has a right under its mortgage loan to a release of the lien on a portion of the property securing an "obligation" upon a prepayment of a *pro rata* portion of the loan. Here, the New Regulations require that the obligation "continues to be principally secured by an interest in real property" and prescribe specific rules for making such a determination. As noted below, this fact pattern has been cited as a major problem for existing REMICs—a REMIC is obligated under the loan to release the lien but may run afoul of the New Regulations if it does so.

The fourth situation involves a modification that constitutes a "significant modification" under Reg. §1.1001-3 and that "releases" the lien. This situation is illustrated in the example in the New Regulations. The example involves a situation in which it was reasonably foreseeable that the borrower "might default." The example describes a modification involving, among other changes, a release of the lien on the property securing the unmodified loan in exchange for a lien on a different property. This aspect of the New Regulations provides additional flexibility in working out loans held by a REMIC.

Problems for Existing Loans

The New Regulations present a number of issues for existing loans held in REMICs.[18] One concern is that, to be covered by the new lien release rule, the New Regulations require that a REMIC release its lien in a "modification" of an obligation, but the New Regulations do not define "modification" for this purpose. For purposes of Reg. §1.1001-3, an alteration of a legal right or obligation that occurs by operation of the terms of the debt instrument is not a "modification" unless it results in a change in the obligor, a change in the recourse nature of the debt instrument or converts the instrument into something other than a debt instrument. However, it does not appear that the term "modification" is interpreted as narrowly for purposes of the New Regulations. The preamble to the New Regulations states that the final regulations were clarified from the proposed regulations to provide that "a release of a lien on real property that does not result in a significant modification under [Reg.] §1.1001-3 (for example, a release or substitution of collateral pursuant to the borrower's unilateral option under the terms of the mortgage loan) is not a release that disqualifies a mortgage loan, so long as the mortgage continues to be principally secured by real property after giving effect to any releases, substitutions, additions, or other alterations to the collateral."[19] Therefore, although a unilateral option is not a modification under Reg. §1.1001-3, the IRS seems to have intended to treat it as a "modification" under the New Regulations.

A greater concern regarding the New Regulations relates to the need to establish the requisite loan-to-value ratio after a release of a lien, even in the event of a default. The second alternative test only helps if substitute real property is being pledged in lieu of the released property. As a result, a REMIC cannot work out a mortgage loan that is significantly underwater by allowing the borrower to arrange a sale of a portion of the property without also forgiving part of the principal balance. When a mortgage loan is underwater, any sale of a portion of the property will necessarily make the loan-to-value ratio worse even when all of the proceeds are used to pay down the loan.

The only way to get the mortgage loan in balance and fit within the New Regulations is to forgive part of the principal balance in connection with the release. To the extent that a borrower has a unilateral right to withdraw property, a REMIC may also be forced to forgive part of the principal balance to keep the loan within the loan-to-value ratio requirement. However, a REMIC may not be able to forgive principal without creating a more significant tax issue. A forgiveness of principal may mean that a regular interest will not be paid a portion of its principal balance. Under Reg. §1.860G-1(a)(5), the principal amount of a regular interest must not be contingent. Although a credit loss does not cause the principal amount of a regular interest to be contingent for this purpose, it is not clear that the loan here is in default or that default is reasonably foreseeable. Failure to comply with this requirement likely results in the loss of REMIC status.

Another question that the New Regulations present, but do not answer, is what it means to "release" a lien in a modification. If a REMIC holds a first lien and accepts a partial prepayment and subordinates its lien to a lien created in favor of the party providing the funds for the prepayment, has it "released" the first lien? If it has, then it may not be able to continue to hold a subordinate lien if the total liens exceed the fair market value of the property by much. Pursuant to Reg. §1.860G-2(a)(2), under the "principally secured" test of Reg. §1.860G-2(a)(1), the value of real property must be reduced by the balance of any senior liens. Although this rule is not expressly stated to apply for purposes of the New Regulations, it is difficult to envision the IRS not asserting that subordinating the REMIC's lien to a newly created senior lien should be treated as a reduction in the value of the real property securing a loan. For example, if a REMIC holds a first lien of $100 on a property worth $80, and a subsequent lender agrees to provide a new first lien of $64 with all of the proceeds going to the REMIC, the value of the real property securing the loan to the REMIC is a net of $16. This would mean that the REMIC could only hold a second lien of $20 (125 percent of $16) and would need to release any claim above this amount (that is, the $16 in excess of the $64 senior lien and the $20 junior lien).

Finally, the New Regulations do not address whether there is a single "obligation" secured by property pledged to a REMIC. The original issue discount regulations contain a "*pro rata* prepayment" rule, which treats a single debt instrument as multiple debt instruments in certain cases.[20] Could the REMIC rules be read as providing similar treatment? For example, assume a single borrower originates two loans with identical terms, except that one loan is secured by Property X and the other is secured by Property Y. The loans contain cross-default provisions. Further, the borrower can prepay either loan and obtain the release of the lien on the related property. Here, a prepayment of one loan should not create any issue for the REMIC when it releases its lien on the related property, assuming that the IRS does not assert that the prepaid loan released security for the loan that was not prepaid. Should a borrowing with the same economics, but that is evidenced by a single loan document, be treated any differently?

Opportunities for Future Loans and Workouts

Despite the concerns for existing loans, the New Regulations may create additional opportunities for future loans and some future workouts. For example, assume a developer borrows money secured by a new housing development. The developer has the right under its loan to a release of the lien on houses that are sold and can either prepay the loan or substitute new property having a value at least equal to the value of the sold houses. This structure seems to work under the New Regulations. Now assume the developer has no other property available to secure the loan when it sells the houses but wants to keep the financing outstanding. Can the borrower defease the loan with U.S. Treasuries, assuming this is otherwise provided for in the loan and occurs beyond the second anniversary of the startup day of the REMIC? Assume that the developer later acquires additional real property and grants the REMIC a lien on the real property and thereby obtains a release of the U.S. Treasuries. Assuming the additional property satisfies the REMIC loan-to-value ratio test, does the loan continue to be a "qualified mortgage" for the REMIC?

Now assume that a REMIC holds a loan that is in default. In this situation, the New Regulations link the default rule and the lien release rule. As a result, if a loan is in default or default is reasonably foreseeable, not only can any terms of the loan itself be modified, but the collateral securing the loan can also be changed. Prior to the New Regulations, a default would seem to have allowed a change to any terms of the note except for the lien. Thus, any modified loan would seem to have been tied in some way to the property securing the original loan. This is no longer the case. Indeed, the example included in the New Regulations illustrates this very point. Further, Reg. §1.1001-3(a)(1) provides that a modification can be effected through an amendment to an existing debt or through an exchange of debt and can be accomplished directly between the lender and the borrower or through one or more transactions with third parties. Given that all of the terms of a loan, including the borrower and the security for the loan, can now be changed, the New Regulations seem to greatly expand the scope of workout activity that can be conducted through REMICs.

Request for Relief

Various industry groups have contacted the IRS and the Treasury, citing dire consequences of not revising the "lien release" provisions of the New Regulations.[21] At this time, however, it remains to be known whether or when the IRS or the Treasury may respond and what actions they might take. In the absence of any relief from the IRS or the Treasury (or perhaps even if relief is not as broad as some might hope), trustees and servicers will grapple with the choice between complying with a borrower's exercise of a unilateral option to obtain a release of a portion of a lien and complying with the New Regulations. Of course, some parties may consider seeking a "self-help" resolution, particularly where both the borrower and the holders of the related REMIC interests agree that a change to the terms of a mortgage loan is beneficial. Because the REMIC rules generally require that the REMIC's assets and its interests remain static (or at least that any changes comply with the New Regulations), pressure would seem to be put on the parties' ability to negotiate a resolution outside of the REMIC itself.

Endnotes

1. T.D. 9463, IRB 2009-40, 442.
2. Notice 2007-17, 2007-1 CB 748.
3. Proposed Reg. §§1.860A-1(b)(6) and 1.860G-2(a)(8).
4. 73 FR 12,041.
5. For more information regarding such proposals and the tax consequences for REMICs and REMIC investors holding a residential mortgage loan that undergoes a "significant modification," *see* Will Cejudo, James Gouwar & Brooke Hintmann, *Modifying Residential Mortgage Loans: Tax Consequences for REMICs and REMIC Investors*, 7 J. Tax'n Fin'l Products 53 (2008). *See also* Rev. Proc. 2009-45, IRB 2009-40, 471, addressing certain modifications to commercial loans in light of a significant risk of default.
6. This provision of the New Regulations and remainder of this article focus on releases of liens on interests in real property. Accordingly, the references below to releases of liens are intended to address solely releases of liens on interests in real property.
7. Code Sec. 860D(a)(4). A REMIC must meet this so-called asset test by the end of the third month beginning after the REMIC's startup day, which is generally the date on which the deal closes and the REMIC issues its regular and residual interests. "Permitted investments" include the investment of cash from qualified mortgage loans pending distribution, qualified reserve fund assets and foreclosure property. Code Sec. 860G(a)(5).
8. Code Sec. 860G(a)(3)(A)(i). Exceptions are provided elsewhere in Code Sec. 860G(a)(3) for certain loans transferred to a REMIC after its startup day.
9. This conclusion and the remainder of this article assume that the modified loan would not be a "qualified replacement mortgage" under Code Sec. 860G(a)(4).
10. Reg. §1.860G-2(b)(3).
11. This is subject to some potential relief for inadvertent terminations under Code Sec. 860D(b)(2)(B).
12. Reg. §1.860G-2(a)(8) prior to amendment by the New Regulations. "Defeasance" is narrowly defined, and includes a requirement that the borrower pledge replacement property consisting solely of U.S. government securities. *See* Reg. §1.860G-2(a)(8)(i) (2009).
13. LTR 9833015 (May 18, 1998).
14. Reg. §1.860G-2(a)(8) and (b)(3).
15. *Supra* note 13.
16. Pursuant to Reg. §1.1001-3(e)(4)(iv)(B), "[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 nonrecourse debt instrument is a significant modification."
17. *See* Reg. §1.1001-3(e)(6) ("A modification that adds, deletes, or alters customary accounting or financial covenants is not a significant modification").
18. *See* Letter from Dottie Cunningham, Chief Executive Officer, Commercial Mortgage Securities Association, John Courson, President and Chief Executive Officer, Mortgage Bankers Association & Jeffrey DeBoer, President and Chief Executive Officer, The Real Estate Roundtable, to Joshua D. Odintz, Acting Tax Legislative Counsel, Department of the Treasury (Nov. 4, 2009); Letter from Charles M. Adelman, Chair, Tax Committee, American Securitization Forum, to Joshua Odintz, Acting Tax Legislative Counsel, U.S. Department of the Treasury (Oct. 13, 2009); Letter from Charles M. Adelman, Chair, Tax Committee, American Securitization Forum, to William J. Wilkins, Chief Counsel, Internal Revenue Service & Michael F. Mundaca, Acting Assistant Secretary (Tax Policy) and Deputy Assistant Secretary (International Tax Affairs), U.S. Department of the Treasury (Sept. 30, 2009).
19. 74 FR 47,437.
20. Reg. §1.1275-2(f).
21. *See supra* note 18.