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SERT ALERT
Strategic Economic Response Team

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IRS Announces New REMIC Rules

On September 15, 2009, the United States Internal Revenue Service (IRS) released two significant pronouncements relating to modifications of loans held by real estate mortgage investment conduits (REMICs). The new rules significantly relax the previous IRS restrictions on such modifications. The IRS action responded in part to problems that have affected the commercial mortgage market during the current economic crisis, and in part to long-standing concerns that have been raised by industry participants.

Background

Although the market for newly-issued commercial mortgage-backed securities (CMBS) has collapsed since the onset of the current financial crisis, several hundred billion dollars worth of commercial mortgage loans were financed by the issuance of such securities during the period from 1998 to the present. The bulk of these CMBS, and the loans they financed, remain outstanding.

Under the Internal Revenue Code (Code), the issuance of CMBS involves the formation of a REMIC, a legal entity governed by Sections 860A through 860G of the Code. The REMIC is a trust or other entity which holds commercial mortgages and pays the interest and principal it receives from those mortgages to its owners, the holders of the CMBS. An entity which complies with the REMIC rules is treated as a pass-through entity for tax purposes, i.e., the income it receives is taxed to the CMBS holders, but the REMIC itself does not owe any tax.

Congress and the IRS have been concerned that the exemption from entity-level tax granted to REMICs not be available to entities engaged in an active business, but only to entities that serve as passive investment vehicles. Accordingly, tax rules prohibit a REMIC from, among other things, buying or trading mortgages. Complications arise because the Income Tax Regulations generally treat any significant modification of a mortgage loan as an exchange of the original loan for the modified loan. Thus, a significant modification of a mortgage loan held by a REMIC may cause the REMIC to lose its favorable tax status or to face punitive taxes on a "prohibited transaction."

Prior to the latest IRS action, only limited relief was available from the general rule restricting loan modifications by REMICs. Of particular significance in the current economic climate was a rule that permitted loan modifications "occasioned by default or reasonably foreseeable default," resulting in concern among borrowers that REMIC servicers would consider loan modifications only if default had already occurred or was expected within, for example, the next two or three months. This interpretation has had the effect in certain cases of permitting loan modifications only within a very narrow time window, and has discouraged efforts by some borrowers to pro-actively address problems before loan defaults occur.

Loan modifications proposed outside a default context have also sometimes been hampered by the REMIC rules. For instance, shopping center owners frequently approach lenders to suggest outparcel releases, or renovations or repositionings of the center, beyond the actions permitted to the borrower as of right under the loan documents. However, current law does not permit the release or substitution of a substantial amount of collateral, unless such an action is expressly permitted by the applicable loan documents. (The demolition of one building and its replacement by another would generally be considered a substitution of collateral.) These rules impair the ability of retail owners and other borrowers to obtain lender approval for what a number of borrowers consider to be economically rational actions.

Latest IRS Action

The latest IRS action has two parts. First, the IRS announced, in Rev. Proc. 2009-45, a more relaxed interpretation of the phrase "reasonably foreseeable default." Second, the IRS amended the existing REMIC regulations to allow a wider range of loan modifications, subject only to the restriction that the loan held by the REMIC continue to be principally secured by real estate. Note that, as discussed below, although the IRS has changed the applicable tax law standards, the provisions of the applicable Pooling and Servicing Agreement (PSA), including the applicable servicing standard, continue to apply to any proposed loan modification.

Rev. Proc. 2009-45 makes three significant clarifications to the existing rule permitting loan modifications by REMICs occasioned by "reasonably foreseeable" default.

- The Rev. Proc. states that "there is no maximum time period after which default is per se not foreseeable." So, if a REMIC servicer believes that a maturity default is likely on a particular loan, it may agree to a loan modification even if the maturity date is, for example, more than a year in the future.
- The Rev. Proc. provides that a default is reasonably foreseeable if the holder or servicer "reasonably believes that there is a significant risk of default" either upon maturity or at an earlier date. This language clarifies that default must not be certain, only that there be a significant risk.
- The Rev. Proc. states that the determination of whether there exists a "significant risk of default" must be based on "a diligent contemporaneous determination . . . which may take into account credible written factual representations made by the [borrower under] the loan." So the REMIC servicer could rely, for instance, on a borrower's representation that it had explored various alternatives for replacing a tenant, or refinancing a loan at maturity, and had not experienced success in those attempts, and the servicer could determine, based on that representation, that a default is reasonably foreseeable.

If a default is "reasonably foreseeable" after application of the foregoing rules, and the holder or servicer of the loan believes that a proposed modification will substantially reduce the risk of default, the modification is permissible (subject to any restriction contained in the PSA). The Rev. Proc. is effective retroactively to January 1, 2008. These new rules apply to modifications of commercial mortgage loans (i.e., mortgage loans not secured by one- to four-family residences) and are subject to various other technical restrictions specified in the Rev. Proc.

The IRS also amended several sections of Section 1.860G-2 of the Income Tax Regulations. The new regulations permit a REMIC to release, substitute, add, or otherwise alter a substantial amount of collateral for a mortgage loan, or make certain other modifications (such as releasing guarantees, or converting loans from recourse to nonrecourse and vice versa), so long as the loan continues to be "principally secured" by an interest in real property. For these purposes, a loan is "principally secured" by real estate so long as the value of the mortgaged real property immediately after the loan modification equals at least 80 percent of the “adjusted issue price” of the loan. The “adjusted issue price” will usually equal the outstanding principal balance of the loan. Expressed in more conventional terms, this test permits a loan-to-value ratio of up to 125%. Alternatively, an obligation is considered to be “principally secured” by real estate so long as the value of the mortgaged real property immediately after the loan modification is not less than the value of the mortgaged real property immediately before the modification. The value of the mortgaged property may be established by a new appraisal, an update of the appraisal obtained when the loan was originated, a sale in which the loan is assumed, or some other commercially reasonable valuation method. (The regulations do not supply any guidance as to what might be a commercially reasonable method of valuation other than an appraisal.)

Consequences

Rev. Proc. 2009-45 should facilitate workout negotiations between borrowers and REMIC servicers (and special servicers). The changes to Section 1.860G-2 of the regulations may have even more far-reaching effects, at least under normal economic conditions. These new regulations should not only facilitate workouts, but should permit such changes as the substitution of one property for another, substantial renovations or alterations of mortgaged property, and various other commercially customary transactions currently forbidden to REMICs.

However, neither of the recent IRS actions will address all current borrower and servicer concerns with securitized loans. Crucially, REMIC master and special servicers are still bound by the PSA that governs a particular transaction. So, while Rev. Proc. 2009-45 permits modifications of loans based on a projected default a year or more in the future, for example, the applicable PSA may not permit such modifications unless the default is expected more imminently. Similarly, while the Rev. Proc. permits reliance on representations of the borrower, the applicable PSA may spell out stricter standards for servicer action. The applicable PSA may also specify who may make particular decisions (i.e., the master or the special servicer) and may contain substantive limits on permissible loan modifications in particular circumstances. Careful analysis of the applicable PSA will be necessary to determine what a REMIC servicer can do in any particular case.

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