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# IRS issues guidance regarding modifications of mortgages held by REMICs and investment trusts

On September 16, 2009, the Internal Revenue Service (the "Service") issued final regulations (the "Regulations") expanding the types of modifications that are permitted to be made to a mortgage loan held by a real estate mortgage investment conduit (a "REMIC").

Under the Regulations, a REMIC is now permitted to change the collateral for, the guarantees on, and the credit enhancement for, a mortgage loan and also to change the recourse nature of a mortgage loan without jeopardizing REMIC status. The Regulations also clarify that a release of a lien on real property under certain circumstances does not disqualify a mortgage loan. A modification or lien release is subject to the requirement that the modified mortgage loan continue to be principally secured by an interest in real property. The Regulations permit several methods for testing whether a mortgage loan is principally secured by real property; the proposed regulations would have required a current appraisal of the real property. Notably, the Regulations do not apply to investment trusts but in Notice 2009-79, the Service requested comments regarding additional guidance needed for modifications of commercial mortgage loans held by investment trusts.

Contemporaneously with the issuance of the Regulations, the Service issued Revenue Procedure 2009-45 which describes certain conditions under which the Service will not challenge the tax status of either a REMIC or an investment trust on account of a modification of a commercial mortgage loan. Significantly, Revenue Procedure 2009-45 permits a Servicer to treat a commercial mortgage loan as having a significant risk of default, even if the loan is performing and a default is not expected until deep into the future. Further, the revenue procedure requires only that there be a significant risk of default; prior published guidance had required a determination that "the issuer is in default" or that the issuer "will probably default…in the reasonably foreseeable future." Risk of default generally is a condition necessary to modify a mortgage loan without causing certain adverse tax consequences.

While the preamble to the Regulations indicates that the Regulations were intended to address issues that arise with commercial mortgage loans, neither the preamble nor the Regulations themselves limit their application to commercial mortgage loans. Revenue Procedure 2009-45 does not apply to modifications of one-to-four family residential mortgage loans or to any loan that is not secured by a mortgage.

## The Regulations

Under general tax principles, if a mortgage loan is subject to a significant modification, the modified mortgage loan is treated as a newly issued mortgage loan issued in exchange for the pre-modification mortgage loan. With limited exceptions, a mortgage loan acquired other than in connection with the establishment of a REMIC is not treated as a "qualified mortgage." Income from a mortgage loan that is not a qualified mortgage is subject to a 100 percent prohibited transaction tax and, if more than a *de minimis* amount of an entity's mortgage loans fails to qualify as "qualified mortgages," then an entity will lose its status as a REMIC.

Existing REMIC regulations provide a list of modifications that will not be treated, for purposes of the REMIC rules, as deemed exchanges and, thus, will not cause a modified mortgage loan to lose its status as a qualified mortgage. The final regulations expand the list of permitted modifications to include:

- 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 mortgage loan, and

- a change in the recourse nature of a mortgage loan from recourse (or substantially all recourse) to nonrecourse (or substantially all nonrecourse) or vice versa.

Notwithstanding objections from commentators to the proposed regulations, the Regulations adopt a retesting provision that requires a modified mortgage loan continue (after modification) to be principally secured by an interest in real property, after giving effect to any releases, substitutions, additions or other alterations to the collateral.

The final regulations also clarify that a modification of a mortgage loan that is a release of a lien on an interest in real property does not disqualify a mortgage loan as a qualified mortgage if the release does not result in a deemed exchange either under general tax principles or the REMIC regulations. This rule applies, however, only if the mortgage loan continues to be principally secured by an interest in real property following the release.

For purposes of the new rules, a modified mortgage loan is treated as principally secured by an interest in real property following the modification if the modified mortgage loan satisfies one of two tests.

First, a mortgage is treated as principally secured by an interest in real property if the fair market value of the interest in real property securing the mortgage loan, determined as of the date of modification, is at least 80 percent of the adjusted issue price of the modified mortgage loan, determined as of the date of modification. For this purpose, a modified mortgage loan is deemed to satisfy the 80 percent test if, as of the date of the modification, the Servicer reasonably believes that the mortgage loan satisfies the test. Such a belief must be based on:

- a current appraisal performed by an independent appraiser,
- 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,
- the 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
- some other commercially reasonable valuation method.

Significantly, an appraisal at the time of the modification is not required.

Second, a modified mortgage loan may be treated as principally secured by an interest in real property if the fair market value of the interest in real property that secures the mortgage loan immediately after the modification is equal to or exceeds the fair market value of the interest in real property that secured the mortgage loan immediately before the modification. Such fair market value is established by:

- a current appraisal,
- an original (and updated) appraisal, or
- some other commercially reasonable valuation method.

The second test is designed to provide relief in situations where the 80 percent test cannot be satisfied at the time of modification (whether due to a decrease in the fair market value of the property or because the mortgage loan did not satisfy the 80 percent test upon contribution to the REMIC) by permitting modifications in circumstances that do not reduce the REMIC's interest in the mortgaged property.

Under either test, the Servicer must not actually know (or have reason to know) that the valuation test is not satisfied.

The rules discussed above apply to modifications made on or after September 16, 2009.

## Revenue Procedure 2009-45

Revenue Procedure 2009-45 provides that the Service will not challenge the tax status of a REMIC or an investment trust (and, in the case of a REMIC, will not treat a modification as a "prohibited transaction") on

account of a modification of a commercial mortgage loan that meets all of the following criteria:

- the loan is not a one-to-four family residential mortgage loan,
- the holder or Servicer reasonably believes that there is significant risk of default of the pre-modification mortgage loan upon maturity of the mortgage loan or at an earlier date, and
- the holder or Servicer reasonably believes that the modified mortgage loan presents a substantially reduced risk of default, as compared with the pre-modification mortgage loan.

A reasonable belief that there is a significant risk of default must be based on a diligent contemporaneous determination of the risk which may take into account credible written factual representation made by the issuer of the mortgage loan if the holder or Servicer neither knows nor has reason to know that such representation is false. How far in the future the possible default may occur is not determinative. The revenue procedure states that there is no maximum period after which default is not *per se* foreseeable, specifically mentioning that a foreseen default more than one year in the future can constitute a reasonable belief in a significant risk of default. In addition, even if a mortgage loan is performing, the holder or Servicer may have a reasonable belief in a significant risk of default.

In addition to the foregoing, the revenue procedure only applies if, in very general terms, mortgage loans, the payments on which were overdue by at least 30 days or with respect to which default was reasonably foreseeable at the time of transfer to the REMIC or trust, comprised no more than 10 percent (measured by principal amount) of the REMIC's or trust's debt instruments on certain testing dates (generally at the times of transfer of assets to the REMIC or trust).

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