

Akerman Practice Update

SECURITIZATION & STRUCTURED FINANCE

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New IRS Regulations Expand Flexibility to Servicers to Modify Mortgages

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On September 15, 2009, the IRS issued final regulations on the modifications to commercial mortgage loans in Real Estate Mortgage Investment Conduits (REMICs). The final regulations will affect borrower, lenders, servicers and arranger/sponsors of securitized commercial loans included in REMICs. The final regulations provide for the expansion of permitted exceptions to the general rule under Section 1.1001-3, Treasury Regulations that restricts significant modifications to qualified mortgages held by the REMIC. A significant modification to a mortgage loan included in a REMIC could lead to the disqualification of the REMIC's tax status, treatment of a transaction as a prohibited transaction and the imposition of a 100% tax on the REMIC's net income from a prohibited transaction. Prior to the passing of the final regulations, changes to the terms of mortgage loans were permitted exceptions to the significant modification rule if such change was occasioned by default or a reasonably foreseeable default. The final regulations expand the permitted exceptions to provide more flexibility to servicers who are faced with the decision to modify the qualified mortgages to limit or avoid a default or reasonably foreseeable default by a borrower. The final regulations also provide guidance for when a release of a lien on real property securing a qualified mortgage would not disqualify such mortgage.



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The following exceptions to the significant modification rule were included in the final regulations:

- A modification that releases, substitutes, adds or otherwise alters a substantial amount of the collateral for, a guarantee on or other credit enhancement of a qualified mortgage; and
- A change in the nature of the obligation from recourse to non-recourse or vice versa.

In both cases, following the date of release, substitution, addition or alteration to the qualified mortgage, such mortgage must continue to be principally secured by an interest in real property as determined by Section 1.860G-2(b)(7), Treasury Regulations.

In addition, the final regulations provide that a release of a lien on real property securing a qualified mortgage does not cause such mortgage loan to cease to be a qualified mortgage if such release is made under a permitted exception and, following the modification the mortgage loan, such obligation continues to be principally secured by an interest in real property as determined by Section 1.860G-2(b)(7), Treasury Regulations.

Under the final regulations, the test for determining whether an obligation continues to be principally secured by an interest in real property is set forth in Sections 1.860G-2(b)(7)(ii) or (iii), Treasury Regulations. Pursuant to

Section 1.860G-2(b)(7)(ii), Treasury Regulations, the fair market value of the real property securing the mortgage as of the date of the modification must be at least 80% of the adjusted issue price of the modified mortgage as determined on such date of modification. The servicer has some flexibility in determining this value if it reasonably believes that the mortgage satisfies the 80% criterion. A servicer must base its reasonable belief that the mortgage satisfies the 80% criterion on any of the following:

- A current appraisal from an independent appraiser;
- An original appraisal obtained at origination of the mortgage loan updated for any changes that might affect the value of the interest in real property;
- The sales price of a recent sale in which the buyer assumes the seller's obligations under the mortgage loan; or
- Some other commercially reasonable valuation method.

The IRS did not define or provide further guidance as to what is "some other commercially reasonable valuation method". This lack of clarity may present more challenges to borrowers and servicers alike since, generally speaking, the standard of commercial reasonableness requires a party to look to what other similarly situated parties in the industry are doing. Nevertheless,

once a servicer takes action, it would appear that such action would serve as the baseline practice for the other servicers.

If a servicer actually knows, or has reason to know, that the 80% criterion is not satisfied, then it cannot agree to the modification unless the servicer determines that the fair market value of the interest in real property that secures the mortgage loan immediately after the modification equals or exceeds the fair market value of such interest immediately before the modification. Servicers must determine the fair market value using the same valuation methods described above and set forth in Section 1.860G-2(b)(7)(ii), Treasury Regulations. The effective date of the final regulations is September 16, 2009.

In Rev. Proc. 2009-45, the IRS similarly adopted revenue procedures to foster the modification of commercial mortgage loans. The revenue procedure applies to modifications effected on or after January 1, 2008. The scope of the revenue procedure includes modifications to a mortgage loan (a "pre-modification loan") held by a REMIC or an investment trust as to which all of the following conditions are satisfied:

- The pre-modification loan is not secured by a residence of fewer than five dwelling units and is not the principal residence of the issuer of the loan.

- Either of:
 - If a REMIC holds the pre-modification loan, then as of the end of the 3-month period on the startup day of the REMIC, no more than 10% of the stated principal of the total assets of the REMIC was represented by loans that at the time of contribution of such loan to the REMIC the payment on the loan were overdue by at least 30 days or a default on the loan was reasonably foreseeable; or
 - If an investment trust holds the pre-modification loan, then as of all dates when assets were contributed to the trust, no more than 10% of the stated principal of all the debt instruments held by the trust was represented by instruments the payment of which were overdue by at least 30 days or more for which a default was reasonably foreseeable.
- Based on all the facts and circumstances, the holder or servicer of the pre-modification loan reasonably believes that there is a significant risk of default of the pre-modification loan upon maturity or at an earlier date and the reasonable belief is based on a diligent contemporaneous determination of that risk. The holder or servicer of the pre-modification loan may take into account credible written factual

“The servicers may reasonably determine that the significant risk of default may go beyond one year in the future or apply to a performing loan”

representations made the by borrower if the holder or servicer does not know or have reason to know that such representations are false. A relevant factor in determining the risk of default is how far in the future the possible default may be. The IRS did not provide a maximum period. In appropriate circumstances, the IRS stated that the holder or servicer may reasonably determine that the significant risk of default may go beyond 1 year in the future or apply to a performing loan.

- Based on all the facts and circumstances, the holder or servicer of the pre-modification loan reasonably believes that the modified loan presents a substantially reduced risk of default as compared to the risk of default that the pre-modification presents without the modification being effectuated.

Therefore, under Rev. Proc. 2009-45, if a modification to a pre-modification loan is within the scope of the revenue procedure, the IRS will not (1) challenge a securitization vehicle's qualification as a REMIC on grounds that the modifications to mortgage loans are not among the exceptions listed in Section 1.860G-2(b)(3), Treasury Regulations; (2) contend that the modifications are prohibited transactions under Section 860F(a)(2)(A)(i)-(iv), Internal Revenue Code, on grounds that the modifications result in dispositions of qualified mortgages and that the dispositions are not among the listed exceptions in Section 860F(a)(2)(A)(i)-(iv), Internal Revenue Code; (3) challenge a securitization vehicle's qualification as a trust under Section 301.7701-4(c), Treasury Regulations, on grounds that the modification manifest a power to vary the investment of the certificate holders; and (4) challenge a securitization vehicle's qualification as a REMIC on grounds that the modifications to mortgage loans result in a deemed reissuance of the REMIC regular interest.

Certainly, servicers of commercial mortgage loans should find that the revenue procedure and final negotiations provide more flexibility and a basis for future modifications to such loans.

We hope that you have found this alert informative. Should you have any questions about these new regulations, please feel free to contact Milton Vescovacci at 305-982-5671 or Frank Cordero at 305-374-5696.

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