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CLIENT ALERT

IRS Guidance on Modifications to Commercial Mortgage Loans

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Today, The Department of the Treasury, issued three pieces of guidance relating to commercial mortgage loans:

Treasury took final action to expand the types of permitted modifications allowed to be made to commercial loans held by a real estate mortgage investment conduit (REMIC) to include changes in collateral, guarantees, and credit enhancement of an obligation and changes to the recourse nature of an obligation. The final regulations incorporate comments submitted by the coalition in response to Notice 2007-17, in which the IRS and Treasury Department requested input on whether the present REMIC regulations should be amended to permit additional types of modifications incurred in connection with commercial mortgage loans. The final regulations expand the list of loan modifications that are not considered "significant modifications" of an obligation to include:

i. Release of a lien on real property that does not result in a significant modification under Treas. Reg. 1.1001-3, so long as the mortgage continues to be "principally secured by an interest in real property";

ii. Release of a lien on real property occasioned by a default or a reasonably foreseeable default, so long as the mortgage continues to be "principally secured by an interest in real property";

iii. 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 or nonrecourse obligation, so long as the obligation continues to be "principally secured by an interest in real property"; and

iv. Change in the nature of the obligation from nonrecourse (or substantially all nonrecourse) to recourse (or substantially all recourse) so long as the obligation is "principally secured by an interest in real property".

v. The IRS also issued Revenue Procedure 2009-45, which describes the conditions under which modifications to certain mortgage loans will not cause the IRS to challenge the tax status of REMICs or investment trusts. A modification will not cause the IRS to challenge if *all* of the following factors are present:

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

    ii. If a REMIC holds the pre-modification loan, then no more than 10% of the stated principal of the total assets of the REMIC was represented by loans on which, at the time of the contribution to the REMIC, the payments on the loan were overdue by 30 days or more, or a default on the loan was reasonably foreseeable; and

iii. Based on "all the facts and circumstances," the holder or servicer "reasonably believes that there is a significant risk of default of the pre-modification loan upon maturity of the loan or at an earlier date." The reasonable belief must be based on a "diligent contemporaneous determination of that risk," which may take into account credible written factual representations made by the borrower if the holder or servicer "neither knows nor has reason to know that such representations are false." In determining the significance of the risk of default, a relevant factor may be how far in advance the possible default is. This is no maximum period after which default is "per se not foreseeable." For example, the Revenue Procedure states that a holder or servicer could reasonably believe that there is a significant risk of default even though the foreseen default is more than one year in the future. Further, although past performance is a factor in assessing risk, a holder or servicer may have a reasonable belief of risk of default even if the loan is performing; and

iv. Based on all the facts and circumstances, the holder or servicer reasonably believes that the modified loan presents a "substantially reduced risk of default, as compared with the pre-modification loan.

Lastly, the IRS and Treasury issued Notice 2009-79 and are requesting comments on what additional guidance, if any, is needed regarding modifications of commercial mortgage loans held by investment trusts.

For more information, please contact the professional(s) listed below, or your regular Crowell & Moring contact.