

Real Estate Update

Real Estate Group

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IRS Releases Final Regulations Regarding Modifications of Commercial Mortgage Loans Held by REMICs and Investment Trusts

Introduction

As maturity dates for billions of dollars worth of commercial mortgage loans draw near, industry participants are concerned that, given the current economic environment, refinancing will be extremely difficult. Because many borrowers anticipated using the proceeds from refinancing to satisfy the balance due upon the maturity of their original loans, these borrowers are now at risk of defaulting on the original loan. This is true even in situations where the borrower is having no trouble servicing the debt prior to maturity. Since many commercial mortgage loans are securitized and held in "real estate mortgage investment conduits" ("REMICs")¹ or investment trusts, the Internal Revenue Service ("IRS") has taken steps to permit modifications of loans prior to their anticipated default.

Summary

The IRS recently issued final regulations relating to Sections 860A and 860G of the Internal Revenue Code ("Final Regulations"), and also Revenue Procedure 2009-45 ("Revenue Procedure"), each relating to the tax consequences of modifications to the terms of commercial mortgage-backed loans. The Final Regulations are effective as of September 15, 2009, and apply only to those loans held in REMICs, while the Revenue Procedure applies to loan modifications effective on or after January 1, 2008, and affects both REMICs and investment trusts.

The Final Regulations and the Revenue Procedure are designed to provide more flexibility to REMICs and investment trusts to modify certain terms of commercial mortgage loans in order to prevent a future default under the loans.

The Final Regulations

The Final Regulations expand the list of permitted loan modifications, so long as the loan continues to be secured by real property after such modification occurs, to include the following:

- a release of a lien on real property;
- a release, substitution, addition or other alteration of the collateral for a loan;
- a release, substitution, addition or other alteration of a guarantee on a loan;
- an other form of credit enhancement for a loan; or
- a change to a loan from recourse to nonrecourse, or vice-versa.

The Final Regulations require that a loan undergoing a newly-permitted modification be re-tested on the date of such modification to ensure that the real property collateral securing the loan has a value of at least 80% of the loan amount. If this 80% test is not met, that

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the fair market value of the real property collateral immediately after the modification is equal to or greater than the fair market value of such modification immediately prior to such modification.

The Revenue Procedure

The Revenue Procedure grants lenders increased flexibility to modify certain commercial loans that the lender or servicer determines pose a “significant risk of default.” The IRS acknowledges in the Revenue Procedure that lenders and servicers are particularly well-situated to determine if a modification would prevent a commercial mortgage loan from going into default, and therefore will no longer challenge modifications that aim to prevent such defaults,² so long as the following conditions are satisfied:

- The pre-modification loan is not secured by a residence that contains fewer than five (5) dwelling units, and is the principal residence of the borrower of the loan.
- Either: (i) if a REMIC holds the pre-modification loan, then at the end of the three-month start up period, no more than 10% of the REMIC’s loans at the time of their contribution had payments which were 30 days overdue, or were loans for which default was reasonably foreseeable; or (ii) 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 then held by the trust was represented by instruments the payments on which were then overdue by 30 days or more, or for which default was reasonably foreseeable.
- 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. This “reasonable belief” must be based on “diligent contemporaneous determination of that risk.”
- The holder or servicer reasonably believes that the modified loan presents a substantially reduce the risk of default, as compared with the pre-modification loan.

Example

To illustrate the application of the Revenue Procedure, the IRS has provided the following example:

As part of its business, S services mortgage loans that are held by R, a REMIC Borrower B is the issuer of one of the mortgage loans held by R. B’s mortgage loan is non-amortizing, and thus the entire principal amount is due upon maturity. The real property securing B’s mortgage loan is an office building. All of B’s required payments on the mortgage loan have been timely, and the loan is not scheduled to mature for another 12 months. B expects that in order to repay the loan when it matures, B will have to refinance the maturing mortgage loan into a newly issued mortgage loan. There are factors, however, that indicate that refinancing options may be unavailable to B at the time the mortgage loan matures. These factors include either or both of the following: current economic conditions in the relevant credit markets, and the current market value of the real property securing the loan. B provides a written factual representation to S showing that B will probably not be able to repay or refinance the mortgage loan at maturity. S neither knows, nor has reason to know, that the

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representation is false. Based on all the facts and circumstances and a diligent contemporaneous determination, S reasonably believes that, if the loan to B is not modified, there is a significant risk of default by B upon maturity of the mortgage loan. Therefore, S and B agree to modify the mortgage loan by extending its maturity and increasing the interest rate. S reasonably believes that this modification reduces the risk of default. The modification is a significant modification under § 1.1001-3(e). The modification occurs after the effective date of this revenue procedure.

S reasonably believed that the pre-modification loan presented a significant risk of default and that the modification substantially reduced that risk. Accordingly, the modification is within the scope of this revenue procedure.

Conclusion

The Final Regulations and the Revenue Procedure provide lenders and servicers with increased flexibility to restructure distressed mortgage loans, and importantly, allow for the early modification of loans that may eventually fall into default. These changes appear to offer a significant opportunity to servicers and borrowers to modify commercial mortgage loans in order to reduce the risk of default without jeopardizing the favorable tax treatment of the REMIC holding such loans, but some commentators have expressed concern that the changes did not go far enough and that current rules governing Pooling and Servicing Agreements³ will continue to prohibit servicers from undertaking many loan modifications that may now be permitted under the Final Regulations and the Revenue Procedure. Only time will tell the effect of the Final Regulations and the Revenue Procedure on the commercial mortgage market. Industry participants that may benefit from or otherwise be affected by these new provisions should not hesitate to seek counsel for further guidance.

¹ REMICs are special purpose vehicles used for the pooling of mortgage loans and the issuance of mortgage-backed securities. First authorized as part of the Tax Reform Act of 1986, REMICs offer favorable pass-through tax treatment, but not without restriction. Substantially all of a REMICs' holdings are required to be "qualified mortgages" or other related assets. REMICs have three months after its "startup day" to acquire its initial assets, and two years to substitute new loans for nonperforming loans. Other substitutions are considered prohibited transactions and are subject to a 100% tax on any gain from the substitution. Prior to the Final Regulations, many material loan modifications would have been considered prohibited transactions. The Final Regulations seek to ease this restriction.

² Citing specifically interest rate changes, principal forgiveness, maturity date extensions and alterations to the timing of interest rate resets and adjustments to amortization schedules.

³ Pooling and Servicing Agreements are agreements that govern how multiple individual loans may be collected and serviced collectively by a special servicer.

The lawyers in our **Real Estate Group** represent owners, developers, lenders and users of real property in the full range of transactions concerning the ownership, development, financing, restructuring and use of commercial, industrial and residential properties. We have handled real estate transactions throughout the United States and abroad, representing U.S. and foreign banks, insurance companies, individuals, partnerships, corporations, REITs and governmental agencies.

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