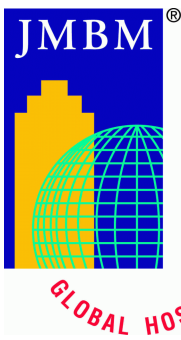

Final IRS Regulation on CMBS Loan Modification

T.D. 9463, 09/15/2009; Reg. § 1.860A-1, Reg. § 1.860G-2

TD 9463. Modifications of Commercial Mortgage Loans Held by a Real Estate Mortgage Investment Conduit (REMIC)

AGENCY: Internal Revenue Service (IRS), Treasury.
ACTION: Final Regulation.

SUMMARY: This document contains final regulations that expand the list of permitted loan modifications to include certain modifications that are often made to commercial mortgages. Changes to the regulations are necessary to better accommodate evolving practices in the commercial-mortgage industry. These changes will affect lenders, borrowers, servicers, and sponsors of securitizations of mortgages in REMICs.

DATES: Effective Date: These regulations are effective on or after [INSERT DATE THIS DOCUMENT IS PUBLISHED IN THE FEDERAL REGISTER].

Applicability Date: For date of applicability, see §1.860A-1(b). FOR FURTHER INFORMATION CONTACT: Diana Imholtz or Susan Thompson Baker at (202) 622-3930 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collection of information contained in this final regulation has been reviewed and approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act of 1995 (44 U.S.C. 3507(d)) under control number 1545-2110. The collection of information in this final regulation is in §1.860G-2(b)(7). This information is required in order to show that certain modifications to mortgages permitted by this final regulation will not cause the modified mortgage to cease to be a qualified mortgage. The collection of information is voluntary to obtain a benefit.

An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a valid OMB control number.

Books or records relating to a collection of information must be retained as long as their contents may become material in the administration of any internal revenue law. Generally, tax returns and tax return information are confidential, as required by 26 U.S.C. 6103.

Background

This document contains amendments to 26 CFR part 1 under section 860G of the Internal Revenue Code (Code). In Notice 2007-17 (2007-1 CB 748 (March 19, 2007)), the IRS and the 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. See §601.601(d)(2)(ii)(b). The IRS and the Treasury Department received several comments in response to this request (the Notice 2007-17 Comments). After consideration of the Notice 2007-17 Comments, the IRS and the Treasury Department published in the Federal Register (72 FR 63523) on November 9, 2007, proposed regulations (REG-127770-07) that would expand the list of permitted loan modifications to include certain modifications that are often made to commercial mortgages. The IRS and the Treasury Department received additional comments in response to the proposed regulations (the Proposed Regulation Comments). A public hearing was requested and was held on April 4, 2008 (73 FR 12041). After consideration of the Proposed Regulation Comments, the proposed regulations are adopted as revised by this Treasury decision.

Summary of Comments and Explanation of Provisions

Except as specifically provided in §1.860G-2(b)(3), if there is a significant modification of an obligation that is held by a REMIC, then the modified obligation is treated as one that was newly issued in exchange for the unmodified obligation that it replaced. See §1.860G-2(b)(1). For this purpose, the rules in §1.1001-3(e) determine whether a modification is "significant." See §1.860G-2(b)(2). Because of when it is treated as having been acquired in the deemed exchange, a significantly modified obligation generally fails to be a qualified mortgage. Section 1.860G-2(b)(3), however, contains a list of modifications that are expressly permitted without regard to the section 1001 modification rules.

The final regulations expand this list of permitted exceptions to include changes in collateral, guarantees, and credit enhancement of an obligation and changes to the recourse nature of an obligation. These changes are permitted so long as the obligation continues to be principally secured by an interest in real property. The final regulations also clarify when a release of a lien on real property securing a qualified mortgage does not disqualify the mortgage. The Proposed Regulation Comments included requests for clarification and recommendations relating to the following: (i) the lien release rule; (ii) the requirement to retest the collateral value; (iii) the appraisal requirement; (iv) changes in the nature of an obligation from nonrecourse to recourse; (v) investment trusts; and (vi) other proposals set forth in the Notice 2007-17 Comments that were not included in the proposed regulations.

1. The Lien Release Rule

The proposed regulations would provide that a lien release pursuant to certain changes in collateral would not cause a qualified mortgage to cease to be a qualified mortgage on the date the lien is released. Commentators indicated that, as drafted, the proposed regulations could be interpreted to prohibit other types of lien releases, including lien releases that are occasioned by a default or reasonably foreseeable default under §1.860G-2(b)(3)(i) and lien releases that are permitted pursuant to the terms of the mortgage loan and are not modifications for purposes of §1.1001-3. In response to these comments, the final regulations clarify that a release of a lien on real property that does not result in a significant modification under §1.1001-3 (for example, a release or substitution of collateral pursuant to the borrower's unilateral option under the terms of the mortgage loan) is not a release that disqualifies a mortgage loan, so long as the mortgage continues to be principally secured by real property after giving effect to any releases, substitutions, additions, or other alterations to the collateral. Similarly, the final regulations clarify that a lien release occasioned by a default or a reasonably foreseeable default is not a release that disqualifies the mortgage, so long as the principally-secured test continues to be satisfied.

2. The Requirement to Retest the Collateral Value

Section 1.860G-2(a)(1) of the regulations provides that an obligation is principally secured by an interest in real property if the fair market value of the real property that secures the obligation equals at least 80 percent of the adjusted issue price of the obligation. The regulations require the 80-percent test to be satisfied either at the time the obligation was originated or at the time the sponsor contributes the obligation to the REMIC. After the startup day, the regulations do not require ongoing satisfaction of the 80-percent test. Because certain types of modifications permitted by the proposed regulations could affect the value of the collateral securing the mortgage loan, the proposed regulations would require the 80-percent test to be satisfied at the time the mortgage loan is modified with respect to changes in collateral, guarantees, and credit enhancement of an obligation or with respect to changes to the recourse nature of an obligation. Commentators indicated that retesting should be required only when the modification could cause a decrease in the value of real property collateral relative to the mortgage loan amount. For this reason, commentators further indicated that changes in guarantees, credit enhancements or the recourse nature of an obligation, as well as the addition of collateral, do not have the effect of decreasing the value of the real property securing the mortgage loan and, therefore, these types of changes should not require retesting. To ensure that a modified mortgage loan continues to be principally secured by an interest in real property, the IRS and the Treasury Department continue to believe that it is appropriate to retest at the time of the modification. Accordingly, the final regulations retain the retesting requirement, but amend the proposed standards for satisfying the principally secured test as described in section 3 in this preamble. In addition, to provide a more flexible standard for changes that do not decrease the value of real property securing the mortgage loan, the final regulations provide an alternative method for satisfying the principally secured test. For these types of changes (for example, a change from recourse to nonrecourse, or vice versa), the final regulations provide that a modified mortgage loan continues to be principally secured by real property if the fair market value of the interest in real property that secures the loan immediately after the modification equals or exceeds the fair market value of the interest in real property that secured the loan immediately before the modification. This alternative test is consistent with the general rule that a decline in the value of collateral does not cause a mortgage loan to cease to be principally secured by real property. The final regulations provide an example to illustrate the application of this alternative method for satisfying the principally secured test. The final regulations also require retesting with respect to a lien release that is not a significant modification for purposes of §1.1001-3 (for example, a release of real property collateral pursuant to the borrower's unilateral option under the terms of the mortgage loan). Here as well, the principally secured test is satisfied if either the 80-percent test is satisfied based on the current value of the real property securing the mortgage or the value of the real property collateral after the modification is no less than the value of the real property collateral immediately before. For purposes of retesting with respect to alterations to real property collateral, the transaction causing the alteration is looked at in its entirety in determining the value of the real property collateral. For example, if, as part of an overall plan to make improvements to real property collateral that secures a mortgage loan, a borrower demolishes an existing building and constructs a new building on that real property, the fair market value of the real property collateral is determined by taking into account both the demolition of the existing building and the construction of the new building.

3. The Appraisal Requirement

For purposes of retesting as of the date of modification, the proposed regulations would require a current appraisal determined by an independent appraiser. Several commentators indicated that requiring a formal appraisal in connection with a loan modification is a stricter standard than is currently required for satisfying

the 80-percent test at the startup day. See §1.860G- 2(a)(3). For a number of business reasons, commentators indicated that servicers need more flexibility in complying with this retesting requirement and, therefore, requested that the proposed regulations be amended to permit servicers to use other types of reasonable valuation methods.

In response to these comments and to make the retesting requirement more consistent with the current rules for satisfying the 80-percent test at the startup day, the final regulations provide that the principally-secured test will be satisfied if the servicer reasonably believes that the modified mortgage loan satisfies the 80-percent test at the time of the modification. The final regulations provide that a servicer must base a reasonable belief upon a commercially reasonable valuation method. The final regulations set forth a nonexclusive list of commercially reasonable valuation methods that can be used by servicers for retesting purposes. These same commercially reasonable methods can be used under the alternative test to establish that the value of the real property collateral immediately after the modification is no less than the value of the real property collateral immediately before it.

4. Changes in the Nature of an Obligation from Nonrecourse to Recourse
The final regulations clarify that changes in the nature of an obligation from nonrecourse (or substantially all nonrecourse) to recourse (or substantially all recourse) are permitted so long as the obligation continues to be principally secured by an interest in real property.

5. Investment Trusts

Section 301.7701-4(c) of the Procedure and Administration Regulations provides that an investment trust is not classified as a trust if there is a power under the trust agreement to vary the investment of the certificate holders. The IRS and the Treasury Department understand that changes to the terms of commercial mortgage loans held by investment trusts may raise issues as to whether a "power to vary" is present, and commentators recommended that the scope of the regulation project be expanded to permit investment trusts to modify commercial mortgage loans in the same manner as REMICs. To avoid a significant delay in the publication of these final regulations, their scope has not been expanded to include modifications of mortgage loans held by investment trusts. In a separate notice to be published in the Internal Revenue Bulletin contemporaneously with these final regulations, the IRS and the Treasury Department intend to request comments on this issue.

6. Other Proposals Set Forth in the Notice 2007-17 Comments

In the Proposed Regulation Comments, commentators requested that the IRS and the Treasury Department reconsider other proposed loan modifications that were set forth in the Notice 2007-17 Comments but that were not included in the proposed regulations. For the reasons indicated in the preamble to the proposed regulations, the IRS and the Treasury Department determined that the remaining changes requested by commentators should not be included in the final regulations.

Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It has also been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to this regulation.

It is hereby certified that the collection of information requirement in this regulation will not have a significant economic impact on a substantial number of small business entities. This certification is based on the fact that the REMICs affected by this regulation will not be classified as small business entities. According to the Small Business Administration definition of a "small business," 13 C.F.R. 121.201, a REMIC is classified under

Sector 52 (Finance and Insurance), Subsector 525 (Funds, Trusts and Other Financial Vehicles) under the category "Other Financial Vehicle", NAICS code 525990, and is only considered a small business entity if it accumulates less than 6.5 million dollars in annual receipts. REMICs affected by this regulation generally hold pools of commercial mortgage loans with an average loan size of 18.1 million dollars, and have greater than 6.5 million dollars in annual receipts. Therefore, a Regulatory Flexibility Analysis under the Regulatory Flexibility Act (5 U.S.C. chapter 6) is not required.

Pursuant to section 7805(f) of the Internal Revenue Code, the notice of proposed rulemaking preceding this regulation was submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Drafting Information

The principal author of these regulations is Diana Imholtz of the Office of Associate Chief Counsel (Financial Institutions and Products). Other personnel from the IRS and the Treasury Department participated, however, in their development.
List of Subjects
26 CFR Part 1
Income taxes, Reporting and recordkeeping requirements.
26 CFR Part 602
Reporting and recordkeeping requirements.
Adoption of the Amendments to the Regulations
Accordingly, 26 CFR parts 1 and 602 are amended as follows:
PART 1—INCOME TAXES
Paragraph 1. The authority citation for part 1 is amended by adding entries in numerical order to read in part as follows:
Authority: 26 U.S.C. 7805 ***
Section 1.860A-0 also issued under 26 U.S.C. 860G(e).
Section 1.860G-2 also issued under 26 U.S.C. 860G(e). ***
Par. 2. Section 1.860A-0 is amended by revising the entry for §1.860G-2(a)(8) and adding an entry for §1.860G-2(b)(7) to read as follows:
Reg § 1.860A-0.
§1.860A-0 Outline of REMIC provisions.
*****
§1.860G-2 Other rules.
(a) ***
(8) Release of a lien on an interest in real property securing a qualified mortgage; defeasance.
*****
(b) ***
(7) Test for determining whether an obligation continues to be principally secured following certain types of modifications.
*****
Par. 3. Section 1.860A-1 is amended by adding paragraph (b)(6) to read as follows:
Reg § 1.860A-1.
§1.860A-1 Effective dates and transition rules.
*****
(b) ***

(6) Exceptions for certain modified obligations. Paragraphs (a)(8)(i), (b)(3)(v), (b)(3)(vi), and (b)(7) of §1.860G-2 apply to modifications made to the terms of an obligation on or after [INSERT DATE THIS DOCUMENT IS PUBLISHED IN THE FEDERAL REGISTER].
Par. 4. Section 1.860G-2 is amended by:
1. Revising paragraphs (a)(8), (b)(3)(iii) and (b)(3)(iv).
2. Adding paragraphs (b)(3)(v), (b)(3)(vi) and (b)(7).
The additions and revisions read as follows:
Reg § 1.860G-2.
§1.860G-2 Other rules.
(a) ***
(8) Release of a lien on an interest in real property securing a qualified mortgage; defeasance. If a REMIC releases its lien on an interest in real property that secures a qualified mortgage, that mortgage ceases to be a qualified mortgage on the date the lien is released unless—
(i) The REMIC releases its lien in a modification that—
(A) Either is not a significant modification as defined in paragraph (b)(2) of this section or is one of the listed exceptions set forth in paragraph (b)(3) of this section; and
(B) Following that modification, the obligation continues to be principally secured by an interest in real property as determined by paragraph (b)(7) of this section; or
(ii) The mortgage is defeased in the following manner—
(A) The mortgagor pledges substitute collateral that consists solely of government securities (as defined in section 2(a)(16) of the Investment Company Act of 1940 as amended (15 U.S.C. 80a-1));
(B) The mortgage documents allow such a substitution;
(C) The lien is released to facilitate the disposition of the property or any other customary commercial transaction, and not as part of an arrangement to collateralize a REMIC offering with obligations that are not real estate mortgages; and
(D) The release is not within 2 years of the startup day.
*****
(b) ***
(3) ***
(iii) Waiver of a due-on-sale clause or a due-on-encumbrance clause;
(iv) Conversion of an interest rate by a mortgagor pursuant to the terms of a convertible mortgage;
(v) 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 obligation, so long as the obligation continues to be principally secured by an interest in real property following the release, substitution, addition, or other alteration as determined by paragraph (b)(7) of this section; and
(vi) A change in the nature of the obligation from recourse (or substantially all recourse) to nonrecourse (or substantially all nonrecourse), or from nonrecourse (or substantially all nonrecourse) to recourse (or substantially all recourse), so long as the obligation continues to be principally secured by an interest in real property following such a change as determined by paragraph (b)(7) of this section.
*****
(7) Test for determining whether an obligation continues to be principally secured following certain types of modifications. (i) For purposes of paragraphs (a)(8)(i), (b)(3)(v), and (b)(3)(vi) of this section, the obligation continues to be principally secured by an interest in real property following the modification only if, as of the date of the modification, the obligation satisfies either paragraph (b)(7)(ii) or paragraph (b)(7)(iii) of this section.
(ii) The fair market value of the interest in real property securing the obligation, determined as of the date of the modification, must be at least 80 percent of the adjusted issue price of the modified obligation, determined

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as of the date of the modification. If, as of the date of the modification, the servicer reasonably believes that the obligation satisfies the criterion in the preceding sentence, then the obligation is deemed to do so. A reasonable belief does not exist if the servicer actually knows, or has reason to know, that the criterion is not satisfied. For purposes of this paragraph (b)(7)(ii), a servicer must base a reasonable belief on—
(A) A current appraisal performed by an independent appraiser;
(B) An appraisal that was obtained in connection with the origination of the obligation 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;
(C) 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
(D) Some other commercially reasonable valuation method.
(iii) If paragraph (b)(7)(ii) of this section is not satisfied, the fair market value of the interest in real property that secures the obligation immediately after the modification must equal or exceed the fair market value of the interest in real property that secured the obligation immediately before the modification. The criterion in the preceding sentence must be established by a current appraisal, an original (and updated) appraisal, or some other commercially reasonable valuation method; and the servicer must not actually know, or have reason to know, that the criterion in the preceding sentence is not satisfied.
(iv) Example. The following example illustrates the rules of this paragraph (b)(7).

Example. (i) 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. The original amount of B's mortgage loan was $100,000, and the loan was secured by real property X. At the time the loan was contributed to R, property X had a fair market value of $90,000. Sometime after the loan was contributed to R, B experienced financial difficulties such that it was reasonably foreseeable that B might default on the loan if the loan was not modified. Accordingly, S altered various terms of B's loan to substantially reduce the risk of default. The alterations included the release of the lien on property X and the substitution of real property Y for property X as collateral for the loan. At the time the loan was modified, its adjusted issue price was $100,000. The fair market value of property X immediately before the modification (as determined by a commercially reasonable valuation method) was $70,000, and the fair market value of property Y immediately after the modification (as determined by a commercially reasonable valuation method) was $75,000.
(ii) The alterations to B's loan are a significant modification within the meaning of §1.1001-3(e). The modification, however, is described in paragraphs (a)(8)(i) and (b)(3) of this section. Accordingly, the modified loan continues to be a qualified mortgage if, immediately after the modification, the modified loan continues to be principally secured by an interest in real property, as determined by paragraph (b)(7) of this section.
(iii) Because the modification includes the release of the lien on property X and substitution of property Y for property X, the modified loan must satisfy paragraph (b)(7)(i) of this section (which requires satisfaction of either paragraph (b)(7)(ii) or paragraph (b)(7)(iii) of this section). The modified loan does not satisfy paragraph (b)(7)(ii) of this section because property Y is worth less than $80,000 (the amount equal to 80 percent of the adjusted issue price of the modified mortgage loan). The modified loan, however, satisfies paragraph (b)(7)(iii) of this section because the fair market value of the interest in real estate (real property Y) that secures the obligation immediately after the modification ($75,000) exceeds the fair market value of the interest in real estate (real property X) that secured the obligation immediately before the modification ($70,000). Accordingly, the modified loan satisfies paragraph (b)(7)(i) of this section and continues to be principally secured by an interest in real property.
*****

PART 602—OMB CONTROL NUMBERS UNDER THE PAPERWORK REDUCTION ACT

Par. 5. The authority citation for part 602 continues to read as follows: Authority: 26 U.S.C. 7805.

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Par. 6. Section 602.101, paragraph (b) is amended by adding the entry in numerical order to the table to read as follows:
Reg § 602.101.
§602.101 OMB Control numbers.
*****
(b)***
CFR part or section where Current OMB
identified and described control No.
* * * * *
1.860G-2............................ 1545-2110
* * * * *
Linda M. Kroening
Acting Deputy Commissioner for Services and Enforcement.
Approved: September 9, 2009
Michael Mundaca
Acting Assistant Secretary of the Treasury (Tax Policy).

IRS Rev Proc permitting more CMBS loan modifications without adverse tax consequences

Rev Proc 2009-45, 2009-40 IRB

SECTION 1. PURPOSE

This revenue procedure describes the conditions under which modifications to certain mortgage loans will not cause the Internal Revenue Service (Service) to challenge the tax status of certain securitization vehicles that hold the loans or to assert that those modifications give rise to prohibited transactions.

No inference should be drawn about whether similar consequences would obtain if a transaction falls outside the limited scope of this revenue procedure. Furthermore, there should be no inference that, in the absence of this revenue procedure, transactions within its scope would have impaired the tax status of securitization vehicles or would have given rise to prohibited transactions.

SECTION 2. BACKGROUND—COMMERCIAL MORTGAGE LOANS

.01 Under the terms of many commercial mortgage loans, all or a large portion of the original stated principal is due at maturity. Typically, at the time of loan origination, both the borrower and the lender expected the borrower to obtain funds to satisfy the large payment at maturity by obtaining a new mortgage loan secured by the same underlying interest in real property.

.02 The current situation in the credit markets is affecting the availability of financing and refinancing for commercial real estate. In particular, borrowers under many of the commercial mortgage loans that will mature in the next few years are concerned that they will encounter great difficulty in obtaining refinancing for these loans. Because they had always anticipated using the proceeds from refinancing to satisfy the principal balance due at maturity, these borrowers are often at risk of defaulting when their loans mature. This may be true even for loans in which the underlying commercial real estate is providing more than enough cash flow to satisfy debt service before maturity.

.03 Many commercial mortgage loans are held in securitization vehicles such as investment trusts and real estate mortgage investment conduits (REM ICS). Typically, these pools of loans are administered by servicers that handle the day-to-day operations of the mortgage loan pools and by special servicers that handle the modification and restructuring of defaulted loans, as well as foreclosure or similar conversion of defaulted mortgage loan property.

.04 Many loan pool administrators have developed and implemented procedures for monitoring both the status of the commercial properties securing the mortgage loans and the likelihood of borrowers being able to refinance their mortgage loans or sell the mortgaged property as the loans mature. The personnel who implement these procedures are often experienced in negotiating with borrowers, restructuring troubled commercial loans, and foreclosing on commercial properties. It may be possible, therefore, to foresee impending difficulties for a mortgage loan well in advance of any actual payment default.

.05 Many industry participants have concluded that the monitoring procedures that have been adopted and the level of experience of those implementing the procedures make it possible to assess with substantial accuracy whether particular commercial mortgage loans present an unacceptably high risk of eventual foreclosure. It may be possible to foresee this risk of foreclosure even when no payment default has yet occurred and when the event of default may not occur until the maturity of the loan.

.06 Many industry participants have also concluded that it is possible to predict with a reasonable degree of accuracy whether proposed modifications will allow mortgage loans to continue to perform (and so avoid the necessity of property foreclosure). Modifications that may be considered include interest rate changes, principal forgiveness, extensions of maturity, and alterations in the timing of changes to an interest rate or to a principal amortization schedule. In many cases, modifications that include extensions of the maturity and, thus, postpone the need for refinancing, may reduce the risk of foreclosure.

.07 Often the complexity of the mortgage loans themselves and the consequent complexity of modifications to them necessitate a substantial period prior to any expected payment or maturity default for the negotiation of any such modifications.

SECTION 3. BACKGROUND—REMICS

.01 REMICs are widely used securitization vehicles for mortgages. REMICs are governed by sections 860A through 860G of the Internal Revenue Code.

.02 For an entity to qualify as a REMIC, all of the interests in the entity must consist of one or more classes of regular interests and a single class of residual interests, see section 860D(a), and those interests must be issued on the startup day, within the meaning of § 1 .860G–2(k) of the Income Tax Regulations.

.03 A regular interest is one that is designated as a regular interest and whose terms are fixed on the startup day. Section 860G(a)(1). In addition, a regular interest must (1) unconditionally entitle the holder to receive a specified principal amount (or other similar amount), and (2) provide that interest payments, if any, at or before maturity are based on a fixed rate (or to the extent provided in regulations, at a variable rate).

.04 An interest issued after the startup day does not qualify as a REMIC regular interest.

.05 Under section 860D(a)(4), an entity qualifies as a REMIC only if, among other things, as of the close of the third month beginning after the startup day and at all times thereafter, substantially all of its assets consist of qualified mortgages and permitted investments. This asset test is satisfied if the entity owns no more than a *de minimis* amount of other assets. See § 1 .860D–1 (b)(3)(i). As a safe harbor, the amount of assets other than qualified mortgages and permitted investments is *de minimis* if the aggregate of the adjusted bases of those assets is less than one percent of the aggregate of the adjusted bases of all of the entity's assets. § 1 .860D–1 (b)(3)(ii).

.06 With limited exceptions, a mortgage loan is not a qualified mortgage unless it is transferred to the REM IC on the startup day in exchange for regular or residual interests in the REM IC. See section 860G(a)(3)(A)(i).

.07 The legislative history of the REMIC provisions indicates that Congress intended the provisions to apply only to an entity that holds a substantially fixed pool of real estate mortgages and related assets and that "has no powers to vary the composition of its mortgage assets." S. Rep. No. 99–313, 99th Cong., 2d Sess. 791–92, 1986–3 (Vol. 3) C.B. 791–92.

.08 Section 1.1001–3(c)(1)(i) defines a "modification" of a debt instrument as any alteration, including any deletion or addition, in whole or in part, of a legal right or obligation of the issuer or holder of a debt instrument, whether the alteration is evidenced by an express agreement (oral or written), conduct of the parties, or otherwise. Section 1.1001–3(e) governs which modifications of debt instruments are "significant." Under § 1.1001–3(b), for most federal income tax purposes, a significant modification produces a deemed exchange of the original debt instrument for a new debt instrument.

.09 Under § 1 .860G–2(b), related rules apply to determine REM IC qualification. Except as specifically provided in § 1 .860G–2(b)(3), if there is a significant modification of an obligation that is held by a REM IC, then the modified obligation is treated as one that was newly issued in exchange for the unmodified obligation that it replaced.

See § 1.860G-2(b)(1). For this purpose, the rules in § 1.1001–3(e) determine whether a modification is "significant." See § 1 .860G-2(b)(2). Thus, even if an entity initially qualifies as a REMIC, one or more significant modifications of loans held by the entity may terminate the qualification if the modifications cause less than substantially all of the entity's assets to be qualified mortgages.

.10 Certain loan modifications, however, are not significant for purposes of § 1.860G–2(b)(1), even if the modifications are significant under the rules in § 1.1001–3. In particular, under § 1 .860G–2(b)(3)(i), if a change in the terms of an obligation is "occasioned by default or a reasonably foreseeable default," the change is not a significant modification for purposes of § 1 .860G–2(b)(1), regardless of the modification's status under § 1.1001–3.

.11 Discussions between a holder or servicer and a borrower concerning a possible modification of a loan may occur at any time and need not begin only after the loan is in default or there is a reasonably foreseeable default.

.12 The Service understands that many industry participants believe that a loan modification necessarily fails to be "occasioned by default or a reasonably foreseeable default" unless the loan is not performing or default is imminent.

.13 Section 860F(a)(1) imposes a tax on REMICs equal to 100 percent of the net income derived from "prohibited transactions." The disposition of a qualified mortgage is a prohibited transaction unless the "disposition [is] pursuant to—(i) the substitution of a qualified replacement mortgage for a qualified mortgage . . . , (ii) a disposition incident to the foreclosure, default, or imminent default of the mortgage, (iii) the bankruptcy or insolvency of the REM IC, or (iv) a qualified liquidation." Section 860F(a)(2)(A).

.14 Under section 860C(b)(1), "The taxable income of a REMIC shall be determined under an accrual method of accounting . . . except that— . . . (C) there shall not be taken into account any item of income, gain, loss, or deduction allocable to a prohibited transaction, ..."

SECTION 4. BACKGROUND—TRUSTS

.01 Section 301.7701–2(a) of the Procedure and Administration Regulations defines a "business entity" as any entity recognized for federal tax purposes (including an entity with a single owner that may be disregarded as an entity separate from its owner under § 301.7701–3) that is not properly classified as a trust under § 301.7701– 4 or otherwise subject to special treatment under the Code.

.02 Section 301.7701–4(a) provides that an arrangement is treated as a trust if the purpose of the arrangement is to vest in trustees responsibility for the protection and conservation of property for beneficiaries who cannot share in the discharge of this responsibility and, therefore, are not associates in a joint enterprise for the conduct of business for profit.

.03 Section 301.7701–4(c) provides that an "investment" trust is not classified as a trust if there is a power under the trust agreement to vary the investment of the certificate holders.

SECTION 5. SCOPE

This revenue procedure applies to a modification (including an actual exchange to which § 1.1001-3 applies) of a mortgage loan (the "pre-modification loan") that is held by a REM IC, or by an investment trust, if all of the following conditions are satisfied:

.01 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.

.02 Either—(1) If a REMIC holds the pre-modification loan, then as of the end of the 3–month period beginning on the startup day, no more than ten percent of the stated principal of the total assets of the REMIC was represented by loans fitting the following description: At the time of contribution to the REM IC, the payments on the loan were then overdue by at least 30 days or a default on the loan was reasonably foreseeable; or
(2) If an investment trust holds the pre-modification loan, then as of all dates when assets were contributed to the trust, no more than ten percent 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.

.03 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 a diligent contemporaneous determination of that risk, which may take into account credible written factual representations made by the issuer of the loan if the holder or servicer neither knows

nor has reason to know that such representations are false. In a determination of the significance of the risk of a default, one relevant factor is how far in the future the possible default may be. There is no maximum period, however, after which default is per se not foreseeable. For example, in appropriate circumstances, a holder or servicer may reasonably believe that there is a significant risk of default even though the foreseen default is more than one year in the future. Similarly, although past performance is another relevant factor for assessing default risk, in appropriate circumstances, a holder or servicer may reasonably believe that there is a significant risk of default even if the loan is performing.

.04 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.

SECTION 6. APPLICATION

If one or more modifications of pre-modification loans are within the scope of Section 5 of this revenue procedure—

.01 The Service will not challenge a securitization vehicle's qualification as a REM IC on the grounds that the modifications are not among the exceptions listed in § 1 .860G-2(b)(3);

.02 The Service will not contend that the modifications are prohibited transactions under section 860F(a)(2) on the grounds that the modifications result in one or more dispositions of qualified mortgages and that the dispositions are not among the exceptions listed in section 860F(a)(2)(A)(i)–(iv);

.03 The Service will not challenge a securitization vehicle's classification as a trust under § 301.7701–4(c) on the grounds that the modifications manifest a power to vary the investment of the certificate holders; and

.04 The Service will not challenge a securitization vehicle's qualification as a REM IC on the grounds that the modifications result in a deemed reissuance of the REMIC regular interests.

SECTION 7. EXAMPLE

The following example illustrates the application of this revenue procedure:

.01 Facts. As part of its business, S services mortgage loans that are held by R, a REMIC that is described in Section 5.02(1) of this revenue procedure. 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 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.

.02 Analysis. 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.

SECTION 8. EFFECTIVE DATE

This revenue procedure applies to loan modifications effected on or after January 1, 2008.

SECTION 9. DRAFTING INFORMATION

The principal author of this revenue procedure is Diana Imholtz of the Office of Associate Chief Counsel (Financial Institutions and Products). For further information, contact Ms. Imholtz on (202) 622–3930 (not a toll-free call).