

Commercial Mortgage Insight[®]

THE MAGAZINE FOR COMMERCIAL MORTGAGE FINANCE

Increased REMIC Flexibility May Ease Loan Resolution

New guidance from the IRS should help servicers modify mortgages held in REMICs, but some legal details remain unclear.

By **Harvey Berenson**

In recent years, many lenders have securitized their loans on commercial properties in real estate mortgage investment conduits (REMICs). A REMIC is a special-purpose entity used for the pooling of mortgage loans, which are acquired with the proceeds from mortgage-backed securities.

A REMIC will assemble mortgages into pools and issue pass-through certificates in various classes to investors. Each class has different payment rights, including the time and order in which the class will be paid. Generally, higher-ranked classes are repaid first and have less risk, and the lower-ranked classes are subordinated.

A REMIC is not subject to tax, and the income generated by the mortgages generally is taxed to the investors as interest income. A REMIC also enables the originating lender to treat the transfer of the mortgages to a REMIC as a sale of assets for financial reporting purposes, removing the mortgages from its balance sheet. Consequently, this vehicle is a tax-efficient method of obtaining financing for mortgages that also provides financial reporting benefits.

A REMIC is operated by a servicer, which may be an affiliate of the originating lender. The servicer collects a fee for providing administrative services, such as collecting debt-service payments from the borrowers and en-

forcing the borrower's obligations under the mortgages.

Troubled mortgages usually are assigned to a special servicer. An originating lender not only earns a profit upon the transfer of its mortgages to the REMIC, but may also continue to earn fees as a servicer.

The tax rules governing REMICs are strict. A REMIC is intended to be a passive vehicle whose assets are qualifying mortgages that were acquired at the time the REMIC was organized or within three months following its commencement pursuant to a binding contract on the REMIC's start-up date.

A qualified mortgage is a debt obligation principally secured by real property, which means that the fair market value of the real property interest securing the debt must be at least 80% of the adjusted issue price (usually the amount loaned) of the debt or substantially all of the borrowed funds used to acquire, construct or improve real property.

Except for qualified mortgages, investments that may be held by a REMIC are passive investments held temporarily prior to payments to investors, reserves and foreclosure property. Foreclosure property is property that the REMIC acquires following a default in the mortgage; such property

may be held for three years following the year of foreclosure.

If more than 1% of the REMIC's assets are not permitted assets, the entity will no longer be treated as a REMIC for tax purposes. If a REMIC fails the asset tests, it will be classified as a C corporation.

As a result, the REMIC will be subject to corporate income tax, which will substantially reduce the cash that is available to distribute to its investors. A REMIC is also subject to a 100% tax on prohibited transactions, which includes income generated by nonqualifying mortgages.

Modification danger

It is crucial that the mortgages held by the REMIC be treated as qualified mortgages at all times. Borrowers' circumstances change, sometimes as a result of macroeconomic changes and sometimes as a result of adverse developments related solely to the borrower or the property. The tax rules do not always allow a REMIC to be responsive to such changes.

Specifically, if a mortgage is modified by the REMIC, it may no longer be a qualified mortgage. The REMIC rules import the debt-modification rules - established to deal with cancellation of indebtedness income - to determine whether a modification of a mortgage will be treated as a "qualified replacement" mortgage.

Under the debt-modification rules, a "substantial modification" is deemed



Harvey Berenson

to create a new debt instrument. For example, if the interest rate on a loan is changed by more than 5% of the yield to maturity or by more than 25 basis points, the tax rules treat the modified debt as a new loan.

Other automatic triggers include deferral of debt service or maturity, reductions of principal, changes in collateral, changes from recourse to nonrecourse debt and substitutions of an obligor on recourse debt. Other changes may be treated as substantial modifications under a “facts and circumstances” test set forth in the regulations.

Until recently, a mortgage loan held by a REMIC could be modified in only one of four ways and still be classified as a “qualified replacement mortgage.” The four acceptable changes included the following: an assumption of the mortgage by a purchaser, waiver of a due-on-sale or a due-on-encumbrance clause, conversion of an interest rate under the terms of the mortgage, or changes occasioned by default or reasonably foreseeable default.

If a mortgage loan was “substantially modified” outside of these four exceptions, the mortgage would no longer qualify. In view of the draconian consequences if a modification were to not fit within the above rules, the industry interpreted the default provision to mean that the terms of a mortgage could not be renegotiated unless there was an actual or imminent default.

In the last two years, the commercial real estate world has turned upside down. Many properties acquired in recent years are troubled, because the projected cashflows upon which the purchase and financing decisions were based did not materialize.

In other cases, capitalization rates have increased markedly, effectively reducing the value of properties. At the same time, the debt markets have seized up.

In 2007, the securitization industry met with the U.S. Internal Revenue Service (IRS) and the U.S. Department of the Treasury to discuss revisions to the REMIC rules. The IRS proposed new regulations in late

2007, and the securitization industry continued to press the IRS for more flexibility.

Regulatory exceptions

Seeking to stem the tide of residential foreclosures, the IRS first issued new rules for REMICs holding residential mortgages. On Sept. 16, the IRS provided help (effective immediately) to REMICs holding commercial loans but, at the same time, imposed new restrictions. In addition to the four exceptions listed above, two new exceptions were added to the list.

First, it is now permissible to release, substitute, add or otherwise alter a substantial amount of the collateral for, a guarantee of, or other form of credit enhancement for the mortgage, as long as the loan is still principally secured by real property.

A change in the character of the loan from recourse to nonrecourse (or vice versa), as long as the loan is still principally secured by real property, is also allowed.

For these purposes, “principally secured” means that the fair market value of the real estate securing the loan is at least 80% of the amount of the loan. The rules require retesting any time that the mortgage lien is released on property securing the mortgage.

Prior to the new rules, as long as the 80% test was met upon origination, there was no retesting requirement upon the release of property secured by the mortgage. The new rules appear to apply to both residential and commercial mortgage securitizations.

As originally proposed, the regulations would have required the servicer to obtain an independent appraisal. The final rules require the servicer to reasonably believe that the new collateral satisfies the 80% test. This test result can be based on a new appraisal, an update of the original appraisal, the contemporary sales price of the property or another commercially reasonable method.

However, in many cases, the existing property may no longer satisfy the 80% test, because the value of the property has declined. The new rules take this condition into account, allowing a borrower to satisfy the 80% test,

as long as the fair market value of the substituted real property now securing the mortgage is at least equal to the current fair market value of the original collateral.

For example, assume that a REMIC holds a \$90 million mortgage on Property A that originally had a fair market value of \$100 million. Later, the loan defaults when Property A is worth \$70 million. The servicer agrees to various changes in the loan, including the substitution of Property B with a \$75 million value.

Although the fair market value of Property B securing the loan is worth less than 80% of the face amount of the loan, the substitution will meet the “principally secured” test, because the value of Property B is not less than the value of Property A at the time that the substitution is made and the loan is modified.

Additional guidance

The new rules are helpful, but they impose additional requirements on REMICs before an existing lien may be released. For example, the loan documents may permit a partial release of property securing the mortgage.

In this case, the REMIC must satisfy the 80% test, which may not be required under the loan documents. The borrower likely will insist on its contractual rights, placing the REMIC in a difficult position if the remaining collateral does not satisfy the 80% test. Representatives of the securitization industry have made the IRS aware of this issue.

Simultaneously with the new regulations, the IRS issued guidance increasing the flexibility of a servicer to deal with commercial mortgage loans where the servicer reasonably believes there may be a significant risk of default in the future.

Under the guidance, which is retroactive to Jan. 1, 2008, a servicer may modify a loan if it reasonably believes the loan may go into default at maturity or earlier. There is no maximum period, and the IRS indicates that the servicer may look more than one year into the future.

The servicer should obtain sufficient evidence, which may include documen-

tation from the borrower establishing that the current mortgage is subject to a significant risk of default in the future. The servicer must also believe that the modified loan represents a substantially reduced risk of default.

If the REMIC meets this safe-harbor guidance, then the servicer may modify mortgages meeting the future default criteria without threatening the REMIC's tax status.

The new guidance is a response to the inability of borrowers to refinance existing debt. Examples of modifications that are permitted include changes in interest rates, reduction of principal, extensions of maturity and debt-service payment changes.

For example, a mortgage loan held by a REMIC may mature in late 2010, and the borrower is paying debt service currently. However, the borrower and the servicer believe that the borrower will be unable to refinance the property and pay off the mortgage at maturity.

The new guidance allows the servicer to deal with the problem today, instead of waiting until the mortgage is not repaid at maturity and there is an actual default. In view of the

distress in the commercial real estate markets, the borrower and the lender now are afforded time to negotiate a solution to their mutual problem.

The guidance relates only to loans that do not secure owner-occupied residential property of five or fewer units. Additionally, no more than 10% of the mortgages held on the REMIC's start-up date may be in default or have payments more than 30 days overdue. A newly formed REMIC with troubled debt will not be eligible for the safe-harbor protection.

The additional flexibility provided by the tax rules will not, in and of itself, allow the servicer to deal with problem loans. The documents governing the securitization may not allow the required changes.

The servicer may be in a position where, if it makes what the servicer believes are the changes necessary to stabilize the property, the lower-ranked classes will lose all of their recovery. At the same time, if the changes are not made, the property may continue to deteriorate, threatening recovery for higher-ranked classes.

In some cases, the mortgages are

pooled by an investment trust that is treated as a grantor trust for tax purposes and not as a REMIC. In granting the relief to REMICs, the IRS allowed trusts to take advantage of the new "substantial risk of default" safe harbor, but generally excluded trusts from the general exceptions to the substantial modification rules otherwise available to REMICs. The IRS has asked for comments on why investment trusts should be governed by the same rules as REMICs.

The new rules provide additional flexibility and protection to REMICs in working out troubled mortgages. Until the legal issues related to the mortgage documents and securitization are resolved, it is unclear whether servicers will be willing or able to take advantage of the new rules in renegotiating such troubled debt. **CMJ**

Harvey Berenson is a managing director in the business tax advisory group of FTI Schonbraun McCann Group. He is based in New York City and can be contacted at harvey.berenson@fticonsulting.com or (212) 840-7383.



The Schonbraun
McCann Group