
MEMORANDUM

October 5, 2009

RE: Client Alert - New REMIC Regulations

The IRS and Department of the Treasury have finalized regulations that liberalize rules relating to the modification of commercial loans held by REMICs and issued separate guidance regarding modifications of a loan held by a REMIC as to which there is a “significant risk” of default.

The Final Regulations

The final regulations adopt, with some modifications, the proposed regulations issued on November 9, 2007. The regulations expand the types of modifications that can be made to mortgages held by a REMIC without negative tax implications to the REMIC. Specifically, the regulations permit the release, substitution, addition or other change in the collateral or credit enhancement for, or guarantee on, a mortgage held by a REMIC. A change to the recourse nature of a mortgage held by a REMIC also would be permitted. In either case, the exception applies only if the mortgage continues to be “principally secured” by an interest in real estate property after giving effect to such modification.

Under the proposed regulations, a mortgage generally would be considered to be principally secured by an interest in real property if the value of the real property that secures the loan equals at least 80 percent of the outstanding principal balance of the loan at the time of the modification (the “80% Test”). The final regulations retain this provision and, to address taxpayer comments, add an alternative fair market value method of satisfying the principally secured test (the “Fair Market Value Test”). Under the Fair Market Value Test, if the fair market value of the interest in real property that secures the loan immediately after the modification is greater than or equal to the fair market value of the interest in real property that secured the loan immediately before the modification, the principally secured test is satisfied. The Fair Market Value Test specifically was added to increase flexibility with respect to modifications that do not decrease the value of the real property securing the loan (e.g., a change to the recourse nature of the loan).

The final regulations also liberalize the rules for determining if the principally secured test has been satisfied under either the 80% Test or the Fair Market Value Test. The proposed regulations required that the interest in real property be valued at the time of the modification

through an appraisal performed by an independent appraiser. Under the final regulations, however, the test generally is satisfied if the servicer has a reasonable belief that the test will be satisfied at the time of the modification based on (i) a current appraisal, (ii) an appraisal conducted at the time of the loan's origination that has been updated as necessary, (iii) a sales price in a substantially contemporaneous assumption transaction, or (iv) any "commercially reasonable" valuation method. In the absence of specific guidance as to under what circumstances and original valuation must be updated or when another valuation method will be considered "commercially reasonable," it is unclear whether the final regulations address taxpayer concerns that compliance with the principally secured test is overly burdensome.

The final regulations are effective for modifications to the terms of an obligation made on or after September 16, 2009.

Revenue Procedure 2009-45

The IRS also issued Revenue Procedure 2009-45, which generally provides considerable discretion to modify the terms of commercial mortgage loans held by REMICs in cases where there is a "significant risk" of default, without risking the qualification of the REMIC for U.S. federal income tax purposes or the treatment of the modification as a "prohibited transaction" under the REMIC rules. Importantly, the Revenue Procedure is retroactive and specifically applies to the modification of a commercial mortgage loan occurring on or after January 1, 2008.

Under the Revenue Procedure, the modification of a commercial mortgage loan generally will not result in adverse REMIC consequences if:

- The property securing the pre-modification loan is not a residence containing fewer than five units and is not the principal residence of the issuer of the loan;
- As of the end of the three month period beginning on the startup day, no more than 10% of the stated principal of the total assets of the REMIC that holds the loan was attributable to loans where, as of the time of contribution to the REMIC, payments were overdue by thirty days or where default was reasonably foreseeable;
- The holder or servicer of the loan reasonably believes, based on all of the facts and circumstances, that there is a significant risk of default of the pre-modification loan; and
- The holder or servicer reasonably believes, based on all of the facts and circumstances, that the modified loan has a substantially lower risk of default than the pre-modified loan.

Whether there is a "significant risk" of default must be based on diligent and contemporaneous analysis of the risk by the holder or servicer. It can be based on credible and written factual determinations of the issuer, if the holder and servicer do not know or have reason to know that the representations are false.

Under the guidance, the risk of default need not be in the near term, and a risk of default more than one year into the future can still be significant. Past performance also can be indicative of risk of default, but there can be a reasonable belief of a significant risk of default even if the loan is performing. This final point may be particularly relevant in cases where the borrower is current but is expected to have difficulties refinancing at maturity.

The guidance is intended to be a clarification of Treasury Regulation § 1.860G-2(b)(3)(i), which permits changes to the terms of a obligation caused by default or reasonably foreseeable default without triggering adverse REMIC consequences. In other words, the Revenue Procedure is intended to clarify when a default is “reasonably foreseeable.”

In circumstances in which the Revenue Procedure applies, the IRS: (1) will not challenge the qualification of the REMIC based on the modification not being among the exceptions listed in Treasury Regulation § 1.860G-2(b)(3); (2) will not argue that the modification is a prohibited transaction on the grounds that the modification results in the disposition of qualified mortgages that are not among the exceptions in section 860F(a)(2)(A)(i)-(iv) of the Code; and (3) will not challenge qualification as a REMIC on the grounds that the modifications result in deemed reissuance of the REMIC regular interests.



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Robb Chase is a member of Sutherland's Tax Practice Group and focuses his practice on domestic and international tax planning and the taxation of financial products.

In the area of tax planning, Robb has extensive experience analyzing issues relating to acquisitions, dispositions, joint ventures, restructurings and finance company arrangements. He has counseled multi-national corporations in all aspects of structuring, negotiating, documenting and reporting cross-border transactions. Robb also has experience representing taxpayers in complex tax audit and litigation matters.

Robb regularly advises clients on tax issues relating to domestic and foreign public and private debt offerings, synthetic and hybrid instruments, foreign currency transactions, swaps and derivatives, hedging transactions, and other complex financial products and transactions. He routinely counsels clients on the tax implications of modifications to, and defeasances of, commercial mortgages held by Real Estate Mortgage Investment Conduits (REMICs), as well as other aspects of the tax rules applicable to REMICs.

PRACTICE FOCUS

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Derivatives
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International
International Taxation
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EDUCATION

J.D., *with honors*, George
Washington University Law School,
1997

Member, *George Washington
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B.S., University of Utah, 1994

BAR MEMBERSHIPS

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REPRESENTATIVE EXPERIENCE

Robb's recent representative experience includes:

- Representing Kraft Foods Inc. as tax counsel in its purchase of Group Danone's global biscuit business for approximately \$7.6 billion.
- Acting as tax counsel to Philip Morris International Inc. in its acquisition of an increased stake in its Mexican tobacco business for approximately \$1.1 billion.
- Providing tax advice to Tyco Electronics regarding the consequences to it and its shareholders of the proposed change in its jurisdiction of incorporation.
- Representing Philip Morris International Inc. following its spin-off from Altria on tax considerations relating to its tax-free debt and commercial paper programs.
- Advising Philip Morris International Inc. on the tax aspects of its acquisition of a 100% interest in Industria de Tabaco León Jimenes, S.A. in exchange for its interest in E. León Jimenes, C. por. A., the Dominican beer, cigarette and cigar joint venture.
- Advising Philip Morris International Inc. on the tax aspects of its acquisition of 97.95% of the shares of PT HM Sampoerna Tbk, an Indonesian kretek cigarette manufacturer.
- As a member of the Mortgage Bankers Association's REMIC Working Group, providing industry comments and proposals to the Internal Revenue Service (IRS), which it used in drafting recently proposed modifications to the REMIC regulations.

PROFESSIONAL HONORS AND AWARDS

- Named among Washington, D.C.'s "40 Under 40" by *Legal Times* magazine (2009)

PROFESSIONAL AND COMMUNITY INVOLVEMENT

- Member, American Bar Association
- Member, District of Columbia Bar

RECENT PUBLICATIONS AND SPEAKING ENGAGEMENTS

- Author, "Prevention of Mismatching of Interest and OID Deductions and Income Inclusions in Transactions with Related Foreign Persons" in "Leading Practitioner Commentary on the International Tax Provisions of the American Jobs Creation Act of 2004 P.L. 108-357," Vol. 45, No. 25, *Tax Management Memorandum* 563 (2004)
- Author, "Proposed Contingent Notional Principal Contract Regulations (Warning: Don't Try This at Home)," Vol. 17, No. 5, *Journal of Taxation and Regulation of Financial Institutions* 36 (2004)
- Co-author, "Regulations Proposed to Nullify Certain 'Disregarded Entity' Elections," Vol. 29, No. 3, *Tax Management International Journal* 131 (2000)
- Co-author, "The Administration's Corporate Tax Shelter Proposals: What are the Limits of Appropriate Tax Planning?" Vol. 40, No.7, *Tax Management Memorandum* S-99 (1999)
- Note, "Rate Review: Applying Chevron Deference to FERC Determination of its Jurisdiction" 64 *George Washington Law Review* 1195 (1996)
- Speaker, Tax Executives Institute (TEI) European Chapter Winter Conference (January 28–29, 2008)
- Speaker, "Tax Aspects of Financing U.S. Operations," Council for International Tax Education (CITE) 9th Annual Conference on U.S. Inbound and Withholding Tax Update (April 23, 2007)