NEW YORK STATE BAR ASSOCIATION TAX SECTION

REPORT ON MODIFICATIONS TO COMMERCIAL MORTGAGE LOANS HELD BY A REAL ESTATE MORTGAGE INVESTMENT CONDUIT (REMIC)

March 6, 2008

Report No. 1151

NEW YORK STATE BAR ASSOCIATION

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I. INTRODUCTION

This report comments on the recently proposed regulations (the "Proposed Regulations") that would amend Treasury Regulation Section 1.860G-2 to expand the types of permissible modifications to mortgage loans held by a real estate mortgage investment conduit (a "REMIC").[1]

Very generally, and as discussed more fully in Part II of this report, mortgage loans held by a REMIC must be "qualified mortgages," *i.e.*, acquired by a REMIC on or within three months after the REMIC's startup day, and "principally secured by an interest in real property." A mortgage loan will be "principally secured by an interest in real property" if the fair market

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[1] This report was prepared by the Securitization and Structured Finance Committee of the New York State Bar Association Tax Section. Jiyeon Lee-Lim and Ayano Kato Creed were the principal drafters of this report. Helpful comments were received from S. Douglas Borisky, Dale S. Collinson, James M. Peaslee, Michael L. Schler and W. Kirk Wallace.

As a model for a pilot program to solicit greater input from the public in the initial development of certain guidance projects, the Treasury Department and the Internal Revenue Service (the "Service") asked taxpayers to submit draft changes to the existing regulations to permit certain modifications to securitized commercial mortgage loans. Notice 2007-17, 2007-12 IRB 748 (March 19, 2007). They received comments from industry members, and the Proposed Regulations were published in response to those comments. Prop. Treas. Reg. § 1.860G-2, 72 Fed. Reg. 63523 (2007).

value of the real property collateral securing the mortgage loan, either at the time the loan was originated or at the time it is contributed to the REMIC, is at least 80 percent of the mortgage loan's adjusted issue price. If, however, a qualified mortgage held by a REMIC is significantly modified so that it is deemed exchanged under Section 1001[2] and the REMIC rules, then the mortgage loan generally will cease to be a qualified mortgage. Because a REMIC may not own more than a *de minimis* amount of nonpermitted assets,[3] and given the relatively large size of most commercial mortgage loans, the deemed exchange of any single commercial mortgage loan may jeopardize the REMIC status of the entire securitization vehicle.[4]

In keeping with Congressional intent that REMICs be "flexible enough to accommodate most legitimate business concerns while preserving the desired certainty of income tax treatment,"[5] the current REMIC regulations permit four types of modifications to be made to mortgage loans.[6] Any loan modification covered by these exceptions would not jeopardize the status of either the mortgage loan as a qualified mortgage, or of the REMIC holding the mortgage loan, even if the modification is treated as a deemed exchange under Section 1001. However, as the current regulations were adopted in 1992 when mortgage securitizations involved mostly residential mortgage loans, these four exceptions cover only modifications

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2 All section references are to the Internal Revenue Code of 1986, as amended (the "Code"), and to the Treasury regulations promulgated thereunder.

3 Under a safe harbor, a REMIC may own assets that are neither qualified mortgages nor permitted investments if the aggregate of the adjusted bases of those nonpermitted assets is less than one percent of the aggregate basis of all of the REMIC's assets. Treas. Reg. § 1.860D-1(b)(3)(ii).

4 The consequences to a REMIC of a deemed exchange of a qualified mortgage are discussed in more detail in Part II of this report.

5 S. Rep. No. 99-313, 99th Cong., 2d Sess., at 791–792.

6 *See* footnote 20 and the accompanying text.

commonly requested for residential mortgage loans. Since then, commercial mortgage loans have become increasingly more common in REMIC transactions. Commercial mortgage loans present ongoing servicing concerns that residential mortgage loans usually do not, and the current REMIC regulations do not address commonly requested modifications for commercial mortgage loans adequately.

We commend the Treasury Department and the Internal Revenue Service (the "Service") for recognizing the need to amend the current REMIC regulations in order to permit loan modifications that are commonly requested by commercial loan borrowers. The Proposed Regulations address industry concerns by expanding the list of modifications that may be made to mortgage loans held by a REMIC without jeopardizing the status of the mortgage loan as a qualified REMIC asset or of the REMIC itself. We believe, however, that certain changes to the Proposed Regulations are appropriate to provide adequate relief in the commercial mortgage loan context, and do not present the potential for abuse. We therefore recommend the changes described below.

II. BACKGROUND

A. Existing Law

The REMIC provisions under Sections 860A through 860G provide for a pass-through vehicle (typically a trust) that issues multiples classes of interests in pools of mortgage loans. All income from the mortgage loans held by a REMIC is taxed to the holders of the interests in the REMIC. Section 860D(a)(4) provides that in order for an entity to qualify as a REMIC, among other things, "as of the close of the third month beginning after the REMIC's startup day and at all times thereafter, substantially all" of the assets of a REMIC must "consist of qualified

mortgages and permitted investments" (the "asset test").[7] A REMIC may hold only a *de minimis* amount of nonpermitted assets without failing the asset test. The REMIC regulations treat nonpermitted assets as being *de minimis* if the aggregate of their adjusted bases is less than one percent of the aggregate adjusted basis of all of the REMIC's assets.[8]

A mortgage loan that is acquired by the REMIC on or within three months after its startup day generally will be a "qualified mortgage" if it is "principally secured by an interest in real property."[9] This will be the case if the fair market value of the real property collateral securing the mortgage loan, either at the time the loan was originated or at the time it is contributed to the REMIC, is at least 80 percent of the mortgage loan's adjusted issue price (the "80 percent test").[10] Although a REMIC must continue to meet the asset test on an ongoing basis (*i.e.*, substantially all of a REMIC's assets must continue to be qualified mortgages or permitted investments following the third month after the REMIC's startup day), a mortgage loan held by a REMIC generally will continue to be a qualified mortgage as long as it met the

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7 A limited safe harbor applies to a 90 day liquidation period in connection with a qualified liquidation of a REMIC. Section 860D(a).

8 Treas. Reg. § 1.860D-1(b)(3)(ii).

9 Section 860G(a)(3)(A).

10 Treas. Reg. § 1.860G-2(a)(1)(i). The REMIC regulations also provide an alternative test, under which an obligation is principally secured by an interest in real property if substantially all of the proceeds of the obligation were used to acquire or to improve or protect an interest in real property that, at the origination date, is the only security for the obligation. Treas. Reg. § 1.860G-2(a)(1)(ii). For this purpose, certain loan guarantees or other credit enhancement are not viewed as additional security for a loan, and an obligation is not considered to be secured by property other than real property solely because the obligor is personally liable on the obligation. *Id.* This alternative test generally is not applicable for commercial mortgage loans, which are often secured by various other collateral such as reserve accounts holding cash.

80 percent test either at loan origination or upon the loan's contribution to the REMIC. In other words, revaluation of the real property collateral generally is not required after the startup day.

In applying the 80 percent test, the current rules do not require that a REMIC sponsor (or the REMIC itself) receive an appraisal to determine the value of real property collateral. Instead, a sponsor may make its own reasonable determination, which may be, but is not required to be, based on an appraisal performed by an independent appraiser. A mortgage loan generally is treated as a qualified mortgage if the sponsor reasonably believes that the mortgage loan meets the 80 percent test at the time it contributes the loan to the REMIC, using collateral values either as of loan origination or contribution to the REMIC, as long as the sponsor does not actually know or have reason to know that the loan fails the 80 percent test.[11] Neither the definition of a "qualified mortgage" nor the reasonable belief safe harbor requires a formal appraisal. If it is discovered that a mortgage loan, after having been transferred to a REMIC, is not in fact principally secured by an interest in real property (*e.g.*, the mortgage loan did not in fact meet the 80 percent test at loan origination or at REMIC startup), the mortgage loan remains a "qualified mortgage" until 90 days after the date of discovery.[12] This permits the securitization vehicle to maintain its REMIC status as long as it disposes of the mortgage loan within 90 days of discovery. These rules are consistent with Congress's intention to make the REMIC regime flexible to accommodate legitimate business concerns. They recognize the practical realities of

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11 Treas. Reg. § 1.860G-2(a)(3)(i). A sponsor may base such a reasonable belief on (i) representations and warranties made by the originator of the obligation, or (ii) evidence indicating that the originator of the obligation typically made mortgage loans in accordance with an established set of parameters and that any mortgage loan originated in accordance with those parameters would satisfy the 80 percent test. Treas. Reg. § 1.860G-2(a)(3)(ii).

12 Treas. Reg. § 1.860G-2(a)(3)(iii).

mortgage loans, as well as the disastrous consequences to a REMIC of holding more than a *de minimis* amount of nonpermitted assets. It is important that any amendments to the rules to address modifications of commercial mortgage loans take this same approach.

If a qualified mortgage held by a REMIC is significantly modified so that it is deemed exchanged under Section 1001 then, unless the modification falls under any of four current exceptions, the consequences to a REMIC are potentially dire. The deemed exchange would be treated as a disposition by the REMIC of the unmodified mortgage loan, which would constitute a prohibited transaction under Section 860F(a)(2),[13] followed by a transfer to the REMIC of the modified mortgage loan. Unless the deemed transfer occurs within three months after the REMIC's startup day, or in exchange for a "defective obligation" within two years after the REMIC's startup day, the modified mortgage loan will not be a qualified mortgage.[14] If the modified loan is large enough or a sufficient number of loans are modified such that more than one percent of the assets are nonpermitted assets, then the securitization vehicle may no longer

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13 The disposition of a qualified mortgage generally constitutes a prohibited transaction unless it is incident to foreclosure, default, or imminent default of the mortgage. Any gain from the deemed disposition would be subject to a tax equal to 100 percent of the net income derived from such disposition, except to the extent it is considered interest under Section 1272(a)(6) or accrued market discount under the market discount rules.

14 In order for the modified mortgage loan to be a qualified mortgage, it must be a "qualified replacement mortgage," which is a mortgage loan that would be a qualified mortgage if transferred to the REMIC on the startup day, and that is received by the REMIC in exchange for either another obligation within three months after the startup day or a "defective obligation" within two years after the startup day. Section 860G(a)(4). A "defective obligation" is a mortgage loan that (i) is in default, or with respect to which a default is reasonably foreseeable, (ii) was fraudulently procured by the mortgagor, (iii) was not in fact principally secured by an interest in real property (*i.e.*, did not meet the 80 percent test at either loan origination or REMIC startup, or the alternative test described in footnote 10), or (iv) does not conform to a customary representation or warranty given by the REMIC sponsor or the prior owner of the mortgage loan regarding the characteristics of the mortgage or of the pool of mortgages of which the mortgage is a part. Treas. Reg. § 1.860G-2(f)(1).

meet the asset test, in which case it would cease to qualify as a REMIC. Given the relatively large size of most commercial mortgage loans, the deemed exchange of a single commercial mortgage loan could cause a REMIC to fail the asset test. Even if the modified mortgage loan is sufficiently small so that the vehicle maintains its REMIC status, the modified mortgage loan would constitute a nonpermitted asset, the net income from which would be subject to forfeiture.[15]

Outside of the REMIC context, a deemed exchange of a commercial mortgage loan is often unimportant, as the amount realized in the exchange generally is the face amount of the loan under Section 1274, so that an exchange at par produces no gain or loss. Lenders and borrowers make frequent changes to commercial mortgage loans, based on non-tax factors such as whether such changes would impair the lender's economic position.[16] If the loan is held by a REMIC, however, unless the requested modification falls under any of the four current exceptions under Treasury Regulation Section 1.860G-2(b)(3), the REMIC servicer must analyze whether the requested modification would result in a deemed exchange of the mortgage loan under Section 1001 in order to determine whether the modification would result in the loss of REMIC status for the securitization vehicle. This analysis is often complex, and because the consequences are potentially dire, servicers will often require an opinion of counsel. At best, this results in additional cost and delay for some requested modifications. At worst, requested

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15 A REMIC is subject to a tax equal to 100 percent of the net income from any asset that is neither a qualified mortgage nor a permitted investment. Section 860F(a)(2)(B).

16 For example, borrowers may request release of an unimproved out parcel from the mortgage loan lien; approval of the grant of an easement; application of a cash reserve to make tenant improvements in a manner not contemplated by the original loan documents; consent to the substitution of parking lot A for parking lot B as collateral in a shopping center loan; waiver of a requirement that now-unobtainable insurance against terrorism be maintained; or changes in restrictions on prepayments.

modifications may be denied if an opinion cannot be obtained. This may mean that the REMIC may not permit modifications that are otherwise commercially appropriate, and may also mean that real property collateral cannot be developed.[17]

The legislative history to the REMIC provisions indicates that a REMIC must consist of a substantially fixed pool of real estate mortgages and related assets and have "no powers to vary the composition of its mortgage assets."[18] By prohibiting any "power to vary," Congress intended to restrict the REMIC rules to relatively passive vehicles that did not function like banks. However, recognizing the practical realities of mortgage loans, Congress also intended that REMICs be "flexible enough to accommodate most legitimate business concerns,"[19] and the current REMIC regulations expressly provide four types of modifications that may to be made to mortgage loans held by a REMIC without jeopardizing the status of either the mortgage loan as a permissible REMIC asset, or of the REMIC holding the mortgage loan.[20] These modifications

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17 For example, real property collateral may not be sold to a third party developer because it cannot be released from the lien of a mortgage loan held by a REMIC. See footnote 16, above, for other examples.

18 S. Rep. No. 99-313, 99th Cong., 2d Sess., at 791–792.

19 *Id.*, at 792.

20 Treasury Regulation Section 1.860G-2(b)(3) currently provides for four types of changes in the terms of a qualified mortgage that are not treated as significant modifications for this purpose: (i) changes in the terms of the obligation occasioned by default or a reasonably foreseeable default; (ii) assumption of the obligation; (iii) waiver of a due-on-sale clause or a due on encumbrance clause; and (iv) conversion of an interest rate by a mortgagor pursuant to the terms of a convertible mortgage. As discussed above, these modifications cover the most commonly requested changes for residential mortgage loans, but do not address commonly requested changes for commercial mortgage loans.

The current REMIC regulations were adopted before the regulations under Section 1001 regarding significant modifications of debt were adopted in 1996. While in some respects, the adoption of Treasury Regulation Section 1.1001-3 helps taxpayers by providing guidance on permissible modifications of loans held by a REMIC, it also hurts taxpayers in that some modifications are now clearly deemed exchanges for purposes of

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are permitted under the current regulations without regard to the modification rules of Section 1001. Reflecting the fact that mortgage securitizations involved for the most part residential mortgage loans when the current regulations were adopted in 1992, these four exceptions cover the most common changes affecting residential mortgage loans. However, neither the REMIC regulations nor the REMIC statute distinguishes between residential and commercial mortgage loans, and the REMIC rules clearly apply to commercial mortgage loans as well. Indeed, in the last ten to fifteen years, commercial mortgage loans have become increasingly more common in REMIC transactions and present ongoing servicing concerns that residential mortgage loans usually do not. In the same way that the current regulations permit common modifications to residential mortgage loans, the regulations should permit common modifications to commercial mortgage loans. However, the regulations should also prevent taxpayers from using REMICs to securitize loans that are not principally secured by interests in real property, and should preserve the essentially passive nature of the REMIC.

It is important to note that, although the REMIC rules are in form elective, in practice they are generally the only method for multiple class securitizations of commercial mortgage loans, as non-REMIC structures require equity and involve additional taxes due to the taxable mortgage pool rules of Section 7701(i).[21] As a result, REMICs are often the only practical

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Section 1001 even though they are not very significant economically and do not involve a new extension of credit. The adoption of Treasury Regulation Section 1.1001-3 did not eliminate the need for special REMIC modification rules.

21 Non-REMIC vehicles require some level of equity to ensure that the obligations they issue will be treated as debt of the issuing vehicle rather than disguised equity. The taxable mortgage pool ("TMP") rules of Section 7701(i) generally provide that a vehicle that issues multiple classes of debt obligations (with different maturities) backed by mortgage loans, and that does not make a REMIC election, will be treated for federal

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choice to securitize mortgage loans. Because a REMIC generally may not dispose of a mortgage loan absent a default scenario,[22] lenders wishing to securitize mortgage loans must ensure that their loans comply with the REMIC rules on an ongoing basis. It is therefore particularly important that the REMIC rules be flexible enough to allow commercially appropriate modifications to mortgage loans so that borrowers are not unduly constrained. At the same time, the REMIC rules must not permit taxpayers to use them to securitize non-real estate mortgage assets, or to use them as active trading vehicles.[23]

B. Proposed Regulations

The Proposed Regulations would provide exceptions from exchange treatment with respect to two types of modifications: (i) changes (releases, substitutions, additions or other alterations) to the collateral for, guarantees on, or other forms of credit enhancement contracts for, a mortgage loan, and (ii) changes in the nature of a mortgage loan from recourse to nonrecourse, in each case so long as the mortgage loan continues to be principally secured by an interest in real property. In determining whether a mortgage loan continues to be principally secured by an interest in real property, the Proposed Regulations would require that the 80 percent test be met with respect to the fair market value of the real property collateral as of

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income tax purposes as a corporation that cannot be consolidated with any other corporation.

22 The disposition of a qualified mortgage, other than incident to the foreclosure, default, or imminent default of the mortgage, or pursuant to a qualified liquidation of the entire REMIC, generally will constitute a prohibited transaction for the REMIC. Section 860F(a)(2).

23 It is also important to keep in mind that, although the REMIC statute is limited to pools of mortgage loans, as a policy matter there is no reason to impose a narrow definition of "mortgage loans." The REMIC statute was so limited because need and understanding were greatest in the mortgage area, and not because the rules would not have functioned correctly for other debt.

the modification date, as determined by an appraisal performed by an independent appraiser. The Proposed Regulations would therefore require retesting under the 80 percent test as of the modification date for any mortgage loan whose collateral, guarantees or credit enhancement is altered, or whose nature changes from recourse to nonrecourse.

In the absence of the Proposed Regulations, these two types of modifications would be governed by the deemed exchange rules of Section 1001. First, a change to the collateral, guarantee, or other credit enhancement for a mortgage loan will constitute a significant modification of the loan, unless (i) the change is pursuant to a unilateral borrower option under the terms of the loan (*i.e.,* the change is not a modification of the loan terms), (ii) the change does not result in a change in payment expectations, if the loan is a *recourse* loan, or (iii) the change does not alter a substantial amount of the collateral, guarantee, or credit enhancement, if the loan is a *nonrecourse* loan.[24] The treatment under Section 1001 of changes to credit enhancement for a nonrecourse loan is particularly troublesome in the REMIC context as there is no threshold for economic materiality (*i.e.*, no change in payment expectation is required to trigger a deemed exchange). For example, assume a REMIC holds a nonrecourse mortgage loan that is secured not only by real property collateral (in an amount sufficient to meet the 80 percent test, as of either loan origination or REMIC startup) but also by a third party guarantee for the entire amount of the loan. The borrower wishes to sell the real property securing the mortgage loan to a third party purchaser who is willing to assume the mortgage loan.[25] The guarantor,

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24 Treas. Reg. §§ 1.1001-3(c) & (e)(4)(iv). Any modification that releases (including pursuant to a substitution) real property collateral would also be subject to the general release prohibition discussed below in Part IX of this report.

25 The assumption of the mortgage loan is a permitted modification under the current REMIC rules. Treas. Reg. § 1.860G-2(b)(3)(ii).

however, will not extend its guarantee to cover the purchaser's obligation under the mortgage loan. The borrower therefore requests that the loan be modified, to be secured by a replacement guarantee by a new guarantor. Assuming that this constitutes the alteration of a "substantial amount" of the guarantee, Section 1001 would treat this change in guarantor as a deemed exchange of the mortgage loan, even in the absence of any change in payment expectations and regardless of the fact that there is no change to the real property collateral securing the mortgage loan.

Second, a change in the nature of a mortgage loan from recourse to nonrecourse will constitute a significant modification of the mortgage loan under Section 1001 unless the loan continues to be secured only by the original collateral *and* the change does not result in a change in payment expectations.[26] This means that a change from recourse to nonrecourse will trigger a deemed exchange if it is in conjunction with a change in security for the loan. For example, assume a recourse mortgage loan held by a REMIC is secured by real property collateral and equity interests in the borrower as additional collateral. The borrower wishes to sell the real property securing the mortgage loan to a third party purchaser who is willing to assume the mortgage loan[27] but only on a nonrecourse basis. In addition, the borrower wishes to remove its equity interests from the lien of the mortgage loan, and the purchaser is willing to post additional personal property collateral (*e.g.*, cash in a reserve account) instead. The borrower therefore requests that the loan be modified to be a nonrecourse loan and to change the collateral by substituting a cash reserve for the borrower's equity interests. Section 1001 would treat the

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26 Treas. Reg. §§ 1.1001-3(c)(2)(i) & (e)(5)(ii).

27 As discussed above, the assumption of the mortgage loan is a permitted modification under the current REMIC rules. Treas. Reg. § 1.860G-2(b)(3)(ii).

change from recourse to nonrecourse as a deemed exchange of the mortgage loan because the loan will not continue to be secured only by the original collateral, even in the absence of any change in payment expectations and regardless of the fact that there is no change to the real property collateral securing the mortgage loan.[28]

It is appropriate to provide exceptions for these two types of modifications so that certain changes to the collateral for, guarantees on, or other forms of credit enhancement contracts for a mortgage loan, and changes in a mortgage loan from recourse to nonrecourse in connection with a change in security for the loan, do not disqualify the REMIC that holds the loan. We commend the Treasury Department and the Service for addressing these modifications in the Proposed Regulations. However, as described below, we believe that the requirement that the REMIC receive a formal appraisal of the underlying real property before agreeing to these changes is onerous and inconsistent with the existing regulations under which a mortgage loan remains a qualified mortgage even if the real property collateral declines in value.

C. Recommendations

In December 2002, we submitted a report to the Treasury Department and the Service detailing a number of recommendations relating to securitization transactions, including modifications of mortgage loans held by a REMIC.[29] In that report, we recommended that loan modifications be assessed based on an implicit economic materiality test of whether the REMIC is in substance providing new credit rather than under Section 1001 and the regulations

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28 If the loan remained a recourse loan, the change in the guarantee would not itself constitute a deemed exchange as long as there is no change in payment expectations.

29 See *New York State Bar Association Tax Section, Report on Securitization Reform Measures*, Report No. 1024 (December 20, 2002) (the "2002 Report").

thereunder. Under such a test, a qualified mortgage held by a REMIC would not cease to be a qualified mortgage upon a modification of the mortgage so long as the modification does not extend the weighted average maturity date of the mortgage or increase its outstanding principal balance, without regard to whether such modification causes a deemed exchange under Section 1001.[30]

We continue to believe that this standard ensures that a REMIC remains a passive, liquidating vehicle comprising a pool of mortgage loans, and does not engage in an active, ongoing business, while accommodating the business needs of commercial loan borrowers. As discussed in the 2002 Report, this standard would allow modifications that are clearly deemed exchanges under Section 1001. However, the REMIC regulations and the regulations under Section 1001 address different concerns. The exceptions that already exist under the current REMIC regulations acknowledge that the Section 1001 standard is not always appropriate in the REMIC context. In addition, using a different framework from Section 1001 does not mean that any gain would escape taxation. Any modification that results in a deemed exchange under Section 1001 would still trigger gain or loss, if any,[31] which in the case of a REMIC would be passed through to the holder of the REMIC's residual interest. Any gain would therefore still be subject to tax. Arguably, a deemed exchange would more surely result in tax in the case of a REMIC, as a REMIC residual interest holder (who is taxed on the REMIC's income) generally

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30 In addition, as described below, a qualified mortgage would not remain a qualified mortgage if real property collateral is released such that it fails the 80 percent test.

31 As discussed above, a deemed exchange of a commercial mortgage loan often results in no gain or loss, because the amount realized in the exchange generally is the face amount of the loan under Section 1274 and the exchange generally will be at par.

must be a U.S. taxpayer,[32] and the excess inclusion rules of Section 860E require that a REMIC residual interest holder include a certain amount in its taxable income, without offset by any unrelated losses or loss carryovers.[33]

The Service indicated in the preamble to the Proposed Regulations that it considered but decided not to adopt this broader change, and that it would continue to use Section 1001 as the applicable standard, subject only to two additional types of permissible loan modifications that may be made without regard to Section 1001. Although we continue to recommend the broad approach we suggested in 2002, we accept that the Service has rejected it. Therefore, our

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32 Each holder of a REMIC residual interest must take into account his allocable share of the REMIC's taxable income or taxable loss. Section 860C(a). A REMIC must prohibit its residual interests from being beneficially owned by any "disqualified organization," which generally is an organization that not subject to tax (*i.e.,* governmental entities, tax-exempt organizations, and certain cooperatives). Sections 860D(a)(6)(A) and 860E(e)(5).

33 Section 860E(a)(1) provides that the taxable income of any holder of a REMIC residual interest shall in no event be less than the "excess inclusion" for such taxable year. The "excess inclusion" for a REMIC residual interest is the residual interest holder's allocated share of the REMIC's quarterly taxable income, in excess of the income that would have accrued on the interest during the quarter at a constant, compounded rate equal to 120 percent of the applicable long-term federal rate. Section 860E(c).

In addition, an excess inclusion is treated as unrelated business taxable income ("UBTI") if the residual interest holder is a pension plan or other organization that is subject to tax only on its UBTI, is not eligible for any exemption from, or reduction in the rate of, withholding tax if the holder is a foreign investor, and may not be offset with an increased deduction for variable contract reserves if the holder is a life insurance company. Section 860E(b); Section 860G(b)(2); Section 860E(f).

We do not know whether the fact that certain loan modifications (*e.g.*, certain changes in payment schedule) are not permitted under current law has any impact on the pricing of REMIC residual interests or inducement fees paid to takers of REMIC residual interests. If it is the case that certain loan modifications, if newly permitted under regulations and agreed upon by REMIC servicers, would have an adverse effect on pricing, such an effect could be avoided by prohibiting the REMIC servicers from agreeing to such modifications in a REMIC's operative documents.

comments follow the general framework of Section 1001 relied on by the Proposed Regulations, with additional permissible loan modifications.

We believe that the addition of two types of permissible modifications will help mitigate some of the most common concerns that servicers face. However, in order for the Proposed Regulations to achieve their intended result and to provide an efficient, administrable set of simple, bright-line rules that mortgage loan servicers may follow for certain commonly requested modifications, we believe that some amendments are necessary. The Proposed Regulations would require a current appraisal for any such modification to qualify as a permissible modification. This would add significant cost and delay to any proposed modification, and we believe it is unnecessary. In addition, the Proposed Regulations considered but did not accept other modifications that commentators recommended, on the basis that the existing regulations under Section 1001 adequately address the relevant issues. We believe, however, that testing modifications under Section 1001 would involve complex analysis and often call for an opinion or advice of tax counsel, which is inconsistent with the legislative intent to provide flexibility to accommodate legitimate business concerns. Therefore, we suggest that the requirement of a current appraisal be eliminated, and also that some additional, specific, straightforward modifications be permitted (even though we recognize that many modifications described in our recommendations would not produce deemed exchanges under Section 1001).

III. SUMMARY OF RECOMMENDATIONS ON THE PROPOSED REGULATIONS

Our specific recommendations on the Proposed Regulations are as follows:

- Retesting of the value of collateral for modified mortgage loans at the time of modification should be required only where the modification itself decreases the ratio of real property collateral to outstanding loan amount.

- Where retesting of collateral value is required, servicers should be permitted to rely on the collateral values that were initially used to determine the mortgage loan's eligibility as a REMIC asset at startup, unless the modification itself changes the value of any particular piece of collateral or the overall collateral.

- Where collateral value is to be retested as of the modification date, servicers should be permitted to use any reasonable method in valuing collateral.

- The regulations should permit changes in the nature of obligations from nonrecourse to recourse (rather than only from recourse to nonrecourse).

- The regulations should permit certain other commonly requested modifications, such as (i) a change in the date on which a qualified mortgage may be prepaid or defeased in whole or in part, or the addition of a defeasance provision; (ii) changes to the obligor, including the addition or deletion of a co-obligor; (iii) the imposition or waiver of a prepayment penalty or other fee; and (iv) a change in payment schedule after a partial prepayment, as long as the weighted average maturity date and the ultimate maturity date are not extended.

- The regulations should clarify that a release of a lien on a portion of real property collateral pursuant to the terms of a mortgage loan that is not a significant modification of the mortgage loan under Section 1001 is not a release that disqualifies the mortgage loan from being a qualified REMIC asset so long as the value of the remaining real property collateral is sufficient to permit the mortgage to remain a qualified mortgage, based on the value of the real property collateral as of any of the origination of the mortgage loan, the contribution of the mortgage loan to the REMIC, or the release of real property collateral.

- The regulations should extend all proposed changes regarding loan modifications to grantor trusts.

IV. RETESTING OF QUALIFIED MORTGAGE STATUS

Under current law, a mortgage loan that is a qualified mortgage loan when it is contributed to a REMIC does not lose its status as a qualified mortgage, even if the real property collateral declines in value so that its value is less than 80 percent of the outstanding loan amount at any time after the REMIC startup day. There is no ongoing testing of REMIC assets after the startup day.[34] This is essential, because after a REMIC is formed on its startup day, the composition of its assets does not change over time; once a mortgage loan is transferred to a REMIC, it generally will remain in the REMIC until it is paid down, absent a default scenario. Without knowing in advance that a REMIC's assets will qualify, REMIC interests could not be

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34 As discussed, above, although the REMIC asset test must be met after the third month following the REMIC startup day, the determination is based on whether the mortgage loan assets met the 80 percent test at either loan origination or REMIC startup, and not on an revaluation of real property securing those mortgage loans.

sold to investors. Ongoing testing of REMIC assets therefore is inconsistent with the static nature of the entity and cannot be required as a general rule. It is also unnecessary from a policy perspective, and there is no potential for abuse.

The modification of a qualified mortgage should not change this basic approach. We believe reapplication of the 80 percent test should be required only where the *modification* itself *causes* a decrease in the ratio of real property collateral to mortgage loan amount. Accordingly, modifications that add collateral or other credit enhancements, replace real property with other real property of equal or greater value, or change the nature of the loan from recourse to nonrecourse (or *vice versa*) should not require a revaluation of the real property collateral (or an appraisal). On the other hand, a release of real property collateral, or the demolition of a real property improvement, for example, should require retesting of the remaining real property collateral under the 80 percent test at the time of the modification.

V. DATE OF VALUATION

If a modification causes a mortgage loan to be subject to retesting under the 80 percent test, we recommend that servicers be permitted to rely either on the collateral values originally used in determining qualification of the mortgage loan (*i.e.*, collateral values at either loan origination or REMIC startup), or on current values as of the time of modification, unless the modification itself changes the value of the collateral in question. For example, the borrower of a commercial mortgage loan secured by multiple parcels of real property may request a release of one or more individuals parcels from the mortgage lien (a "partial release") upon prepayment of a *pro rata* portion (based on collateral values as of loan origination or REMIC startup) of the

loan.[35] In this instance, the modification would not change the inherent value of the collateral (*e.g.*, it would not decrease the value of any individual parcel of real property securing the loan or of any portion of any such parcel) but would instead merely decrease the amount of collateral securing the remaining loan as well as the amount of the remaining loan. A partial release should be permitted as long as the 80 percent test would be met after the partial release and corresponding partial prepayment, using collateral values as of either loan origination or REMIC startup.[36] For this purpose, the valuation date (loan origination, REMIC startup, or release date) should be consistent for all real property collateral securing any single mortgage loan.

Permitting the use of the values as of loan origination or REMIC startup is consistent with the notion that had the loan originally consisted of only the remaining loan amount (remaining after partial prepayment) secured by the remaining collateral (remaining after partial release), then the loan would have met the 80 percent test (either at loan origination or REMIC startup), and any subsequent change in the value of such collateral would have been irrelevant. It is also consistent with existing practices regarding partial releases made according to the original terms of a mortgage loan, where original collateral values are routinely used.[37]

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35 For example, assume a $10 million commercial mortgage loan is secured by two properties, property A and property B, with a fair market value at loan origination of $3 million and $9 million, respectively. After some time, when the outstanding principal balance of the loan remains $10 million, the borrower requests that the mortgage loan be modified to release the lien on property A upon prepayment of $2.5 million.

36 Continuing the example in footnote 35, a redetermination of the value of property B should not be required upon the partial release of property A. The servicer should be able to rely on the origination date value of $9 million for property B to determine that the 80 percent test is met as of loan modification because the value of the remaining collateral ($9 million, for property B) exceeds 80 percent of the outstanding loan amount ($7.5 million).

37 *See* discussion in Part IX, below.

VI. NO APPRAISAL REQUIREMENT

The current rules do not require that a REMIC sponsor (or the REMIC itself) receive an appraisal to determine that a mortgage loan initially meets the 80 percent test when it is contributed to a REMIC. Instead, a sponsor may make its own reasonable determination, which may be, but is not required to be, based on an appraisal performed by an independent appraiser.[38] It would be consistent with this approach to permit servicers to make their own reasonable determination as to collateral values at the time a mortgage loan is modified. When retesting of real property collateral value is required (*e.g.*, due to a substitution of real property collateral, or a change to the real property collateral), a servicer should be permitted to rely on any reasonable valuation method, which may include a formal appraisal.[39] Requiring a formal appraisal in connection with a loan modification would be a stricter, more onerous burden than is required at the startup of a REMIC, and adds cost and delay that the parties themselves do not believe to be necessary.

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38 The current regulations provide a safe harbor under which a mortgage loan generally is treated as a qualified mortgage if the sponsor reasonably believes that the mortgage loan meets the 80 percent test at the time it contributes the loan to the REMIC using collateral values either as of loan origination or contribution to the REMIC, as long as it does not actually know or have reason to know that the loan does not meet the 80 percent test. Treas. Reg. § 1.860G-2(a)(3)(i). A sponsor may base such a reasonable belief on (i) representations and warranties made by the originator of the obligation, or (ii) evidence indicating that the originator of the obligation typically made mortgage loans in accordance with an established set of parameters and that any mortgage loan originated in accordance with those parameters would satisfy the 80 percent test. Treas. Reg. § 1.860G-2(a)(3)(ii). Neither the definition of a "qualified mortgage" nor the reasonable belief safe harbor requires a formal appraisal.

39 Some examples of valuation methods that may be used in lieu of an appraisal performed by an independent appraiser include (i) the use of a recent sale price of the real property collateral (in the case of a sale in which the buyer assumes the seller's obligations under the mortgage loan), (ii) a market-based broker opinion, and (iii) a formula-based approach (*e.g.*, current net operating income divided by historic capitalization rates).

In addition, mortgage loans do not always require the borrower to pay for an appraisal. Requiring a formal appraisal upon loan modification would present a practical issue for a REMIC that would be required to pay for the appraisal, as well as for borrowers that must wait for an appraisal to be completed. This issue is magnified if, as is often the case, a modified loan is secured by multiple properties.

VII. CHANGES IN NATURE OF OBLIGATION

The Proposed Regulations would permit a qualified mortgage to be changed from a recourse (or substantially all recourse) obligation to a nonrecourse (or substantially all nonrecourse) obligation, so long as the loan meets the 80 percent test as of the change. As discussed above, we believe retesting under the 80 percent test is not warranted in this circumstance because there is no change in the real property collateral securing the loan. In addition, we recommend that a modification that causes a nonrecourse loan to be recourse to the borrower also be treated as a permitted modification that does not disqualify a mortgage loan, without retesting under the 80 percent test. In either case, the loan would remain secured by the same real property collateral as before the change. A loan can change from nonrecourse to recourse, as well as from recourse to nonrecourse, and we see no reason to treat a change in one direction differently from a change in the other direction. In fact, guidance on changes from nonrecourse to recourse would be more helpful to taxpayers, as the regulations under Section 1001 provide limited relief for changes from recourse to nonrecourse, but none for changes from nonrecourse to recourse.[40] In addition, commercial mortgage loan borrowers are

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40 Treasury Regulation Section 1.1001-3(e)(5)(ii)(B)(2) provides that a change of a recourse debt instrument to a nonrecourse debt instrument is not a significant modification under Section 1001 as long as the instrument continues to be secured only by the original

(Continued)

often special purpose vehicles whose assets consist solely of the real property and related assets. For these borrowers, whether a loan is nonrecourse (*i.e.*, recourse only to the loan collateral) or recourse to the borrower (*i.e.*, recourse to all of the borrower's assets, which consist solely of the collateral) makes little commercial difference.

VIII. OTHER MODIFICATIONS

The preamble to the Proposed Regulations describes four factors used by the Treasury Department and the Service to assess the list of modifications requested by industry groups that could be made to a qualified mortgage without disqualifying it:

- Whether the modification would be likely to produce any significant gain or loss to the REMIC (in order to minimize changes to REMIC cash flows after the startup day);

- Whether a mortgage loan would remain principally secured by real property after the modification;

- The Service's ability to review and administer compliance with the requirements of a particular modification; and

- The business needs indicated by the industry, and whether that business need was adequately addressed by the currently regulations.

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collateral and the modification does not result in a change in payment expectations. By comparison, a change of a nonrecourse debt instrument to a recourse debt instrument is a significant modification without exception.

Applying these factors, the Service and the Treasury Department declined to permit certain modifications that are commonly requested by commercial loan borrowers to be made to qualified mortgages.[41] However, the preamble to the Proposed Regulations indicates that the Service's rejection of those requested modifications was based on the conclusion that those modifications are adequately addressed by the current regulations under Section 1001 (the fourth factor) and that those modifications generally would not be considered significant modifications under the Section 1001 regulations

We do not believe that the four factors articulated in the preamble to the Proposed Regulations are helpful in assessing whether proposed modifications to a qualified mortgage should be permitted. As long as the modifications do not result in the REMIC extending new credit, or releasing real property collateral in a manner that violates the 80 percent test, we believe that a mortgage loan should maintain its qualified mortgage status. With respect to changes in cash flows to the REMIC and gain or loss to the REMIC (the first factor), we note that although some of the modifications would result in a change in cash flows to the REMIC after startup, they would not be the equivalent of an extension of new credit as there would be no deferral of payments beyond the stated maturity date.[42] In any event, any gain or loss to the

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41 As indicated in the preamble to the Proposed Regulations, commentators requested the following additional modifications be addressed: (i) change in the date on which a qualified mortgage may be prepaid or defeased in whole or in part, or the addition of a defeasance provision; (ii) changes to the obligor, including the addition or deletion of a co-obligor; (iii) imposition or waiver of prepayment penalty or other fee; and (iv) change in payment schedule after partial prepayment, as long as the ultimate maturity date is not extended. We discuss each of these proposals below.

42 In addition, servicers are governed by applicable servicing standards which generally would require them to service and administer mortgage loans in the best interests of and for the benefit of holders of interests in the applicable REMIC, so that they would permit only those modifications that are economically appropriate.

REMIC would be passed through and taxed to the holder of the residual interest, and the REMIC excess inclusion rules would ensure that any gain is subject to tax. With respect to whether a mortgage loan would remain principally secured by real property after the modification (the second factor), we believe that applying the retesting requirement as we recommend above should dispel any concerns.[43] With respect to the Service's ability to review and administer compliance with the requirements of a particular modification (the third factor), we suggest that review and administration of the proposed modifications would be no more difficult or burdensome than review and administration of loan modifications that are permitted under the current regulations. With respect to whether the current regulations adequately address business concerns (the fourth factor), while the Section 1001 regulations may provide an analytical framework for some of the requested modifications, the analysis required is often very complicated. Moreover, because the consequences of an error may be catastrophic (*i.e.*, loss of REMIC status), servicers typically secure opinions of counsel before consenting to any modifications, leading to unnecessary delay and expense. Therefore, we believe it is important for the REMIC regulations to provide specific guidance in the form of a simple set of rules that can be applied by servicers for commonly requested modifications, without the need to consult with outside legal counsel.

A. Change in the Date on which a Qualified Mortgage May Be Prepaid or Defeased in Whole or in Part, or the Addition of a Defeasance Provision

Mortgage loan borrowers may request to prepay all or a portion of their loans. For example, assume a mortgage loan held by a REMIC provides for a five year term to maturity and is secured by three separate parcels of real property. Voluntary prepayment (and, if the

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43 *See* discussions in Parts IV, V and VI of this report, above.

prepayment is at least equal to a specified amount, partial release of collateral[44]) is permitted under the terms of the loan after four years (*i.e.*, there is a four year "lockout period" for prepayments). In year 3, the borrower wishes to sell one of the parcels of real property securing the mortgage to a third party purchaser who does not want to assume the mortgage loan and who requires that the loan be prepaid and the lien on the property be released before it will purchase the property. The borrower therefore requests that the loan be modified to permit partial prepayment before the end of the lockout period. Because this would constitute a modification of the mortgage loan, the REMIC servicer requires an opinion of counsel that the modification will not result in a deemed exchange of the mortgage loan under Section 1001. We believe that an analysis under Section 1001 and opinions of counsel add unnecessary cost and delay. Even if a requested acceleration would be economically significant and would result in a significant modification of the mortgage loan, we believe that the modification should not be prohibited because it does not rise to the level of activity that would cause the REMIC to be treated as engaging in active lending. Although acceleration would change cash flows to the REMIC after the startup day, it would not be the equivalent of an extension of new credit as there would be no deferral of payments. To the extent a requested partial prepayment involves a release of collateral, the same requirements discussed above relating to the release of collateral and the application of the 80 percent test would apply. Thus, a mortgage loan would remain principally secured by real property after the modification.

The borrower in the above example may request that the lien on the real property collateral be released through defeasance, rather than through prepayment. In a defeasance, the

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44 Partial release of collateral pursuant to the terms of a mortgage loan is discussed in Part IX of this report.

borrower would pledge substitute collateral that consists solely of government securities, and the lien on the real property collateral would be released. Defeasance therefore would allow the borrower to dispose of a property unencumbered by the mortgage. The current REMIC regulations generally permit a qualified mortgage to be defeased with government securities after two years from the REMIC's startup day as long as the mortgage documents permit the defeasance.[45] The preamble to the Proposed Regulation indicates that the Treasury Department and the Service believe that the current defeasance exception already adequately accommodates the legitimate business need of providing borrowers with the ability to defease a mortgage loan if certain conditions are met. However, the current exception does not address borrowers whose loans do not provide for a defeasance provision (or whose provisions permit defeasance only after a period exceeding the two years required under the current regulations), or do not provide for prepayment. It should be noted that the REMIC provisions place restrictions on loan modifications and other special conditions. Accordingly, unless the lender intends to securitize the loan through a REMIC when the loan is originated, it may not initially include REMIC-related provisions in the loan agreement.

For example, assume a mortgage loan is contributed to a REMIC one year after it is originated. The mortgage loan permits defeasance only after five years from origination (*i.e.*, four years from the REMIC's startup day), or does not include an explicit defeasance provision at all. Three years after the mortgage loan is contributed to the REMIC, the borrower wishes to sell the real property securing the mortgage loan to a third party purchaser who does

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45 The lien on the real property collateral must also be 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. Treas. Reg. § 1.860G-2(a)(8).

not wish to assume the loan and who requires that the lien on the real property be released before it will purchase the property. The defeasance would only occur after the two year period required by the current REMIC regulations, but would be prohibited by the Proposed Regulations as they would not fall under the exception for defeasance (which requires that defeasance be allowed by the mortgage documents) and the mortgage loan would not continue to meet the 80 percent test after the substitution of collateral.

Changing the date on which a loan may be defeased, or permitting defeasance of a mortgage loan whose documents do not explicitly provide for one, in either case after at least two years after REMIC startup as required by the existing regulations, would not change any cash flows to the REMIC. Although collateral would change from interests in real property to government securities, this is already permitted in the current REMIC regulations. Although it is appropriate to ensure that a REMIC will not be collateralized with obligations that are not real estate mortgages, the existing safeguard against collateralizing a REMIC with loans secured by anything other than interests in real property would remain in place. Moreover, as a practical matter, borrowers have no incentive to defease a qualified mortgage with government securities unless the borrower is disposing of the property because government securities provide relatively low interest rates. These are changes that would be reasonable as a commercial matter, but are currently not permitted where the holder of the mortgage loan is a REMIC.

B. Changes to the Obligor, Including the Addition or Deletion of a Co-Obligor

The current REMIC regulations permit the assumption of a qualified mortgage that would result in the substitution of the obligor. They are however silent as to the addition or deletion of a co-obligor. The Treasury Department and the Service have indicated in the preamble to the Proposed Regulations that the Proposed Regulations do not provide for changes to the obligor of

a qualified mortgage because the vast majority of commercial mortgage loans are nonrecourse so that the current regulations under Section 1001 would already permit most changes. However, some commercial mortgage loans are structured as recourse loans.[46] In addition, Treasury Regulation Section 1.1001-3(e)(4)(iii) provides that an addition or deletion of a co-obligor (other than as part of a transaction or series of related transactions that results in the substitution of a new obligor) of a recourse loan will result in a deemed exchange if it results in a change in payment expectations. This may be a difficult determination for servicers to make on their own. We recommend that all changes to the obligor be permitted, including the addition or deletion of a co-obligor, regardless of the recourse nature of the loan in question or whether it would result in a change in payment expectations. These changes would not change any cash flows to the REMIC or any of the collateral for the loan, and do not result in the extension of new credit by the REMIC. We also note that the Proposed Regulations would eliminate the "change in payment expectations" test that currently applies under the Section 1001 regulations with respect to changes in collateral for recourse loans.[47] It would be consistent to do so in this context as well.

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46 We understand that some loans are intentionally structured as recourse loans because changes relating to collateral securing recourse loans (as opposed to nonrecourse loans) are subject to a higher threshold for triggering a deemed exchange. The alteration of the collateral, guarantee, or other credit enhancement for a *nonrecourse* loan is a significant modification. Treas. Reg. § 1.1001-3(e)(4)(iv)(B). Such an alteration for a *recourse* loan, however, will result in a deemed exchange only if it results in a change in payment expectations. Treas. Reg. § 1.1001-3(e)(4)(iv)(A).

47 Treas. Reg. § 1.1001-3(e)(iv)(A) currently permits changes to the collateral (or guarantee or credit enhancement) for recourse debt if it does not result in a change in payment expectations. The Proposed Regulations would permit such changes, regardless of whether they result in a change in payment expectations, as long as the collateral continued to meet the 80 percent test as of modification. This 80 percent test goes only to
(Continued)

C. Waiver or Imposition of Prepayment Penalty or Other Fee

The waiver of a prepayment penalty may result in a change in yield on an obligation. The change in yield would result in a significant modification of a qualified mortgage under Treasury Regulation Section 1.1001-3(e)(2) if the annual yield of the modified obligation (with an issue price equal to the adjusted issue price of the unmodified instrument on the modification date) varies from that of the unmodified obligation (determined as of the modification date) by more than the greater of 25 basis points or 5 percent of the yield of the unmodified instrument. For this purpose, a commercially reasonable prepayment penalty for a *pro rata* prepayment is not taken into account in determining the yield of the modified obligation.[48] In addition, the yields are calculated as of the date on which the modification is agreed upon among the parties. Because borrowers need certainty, a waiver is often agreed upon in advance of the actual prepayment.

As an example, assume a $10 million mortgage loan is issued on January 1 of year 1 with a stated annual interest rate of 6.0%. Interest is payable monthly in arrears. The stated term to maturity is five years, when principal is payable in full. The loan is voluntarily prepayable, in whole or in part, at any time prior to maturity with the payment of a prepayment penalty equal to 0.5% of the amount prepaid. On November 15 of year 1, the borrower informs the lender that it exercises its right to prepay the loan in full on January 1 of year 2, and requests that the lender agree in advance to waive the prepayment penalty.

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real property collateral value, and therefore does not assess credit quality, which the "change in payment expectations" test would measure.

48 Treas. Reg. § 1.1001-3(e)(2)(iii)(B). The *imposition* of a prepayment penalty would not cause a change in yield for this purpose if it falls under this regulation. This regulation does not apply to any non-*pro rata* prepayment, or to the *waiver* of a prepayment penalty.

If the lender agrees on December 1 to waive the prepayment penalty for the prepayment to occur on the following January 1, the lender must compare the annual yield of the modified obligation with that of the unmodified obligation determined as of December 1. The modified obligation is one that will be prepaid after one month without any prepayment penalty; its yield would therefore equal 6.0%. As of the date of modification, the unmodified instrument would be expected to prepay in full the following month with the applicable prepayment penalty; its yield would therefore be approximately 6.5%. Because the difference in yields exceeds the safe harbor amount (in this case, 5 percent of the yield of the unmodified instrument), the waiver of the prepayment penalty in this example would result in a deemed exchange of the mortgage loan.

The Proposed Regulations do not address the consequences of a change in yield arising from the imposition or waiver of a prepayment penalty under the theory that such an imposition or waiver generally does not cause a significant modification. However, in fact, such an imposition or waiver may indeed produce a modification under the Section 1001 regulations. Moreover, the analysis to determine whether such an imposition or waiver produces a significant modification under Section 1001 is complex and, in light of the dire consequences of an error, often requires a legal opinion. Servicers must perform this yield analysis every time the wavier of a fee is requested or the imposition of a fee would be commercially desirable. The imposition or waiver of a fee would change cash flows to a REMIC, but does not amount to the REMIC engaging in any active lending and would not change any collateral for any qualified mortgage. As such, a complicated analysis is unwarranted. Therefore, we believe that the imposition or waiver of a prepayment penalty or other fee should be a permissible modification.

D. Change in Payment Schedule After Partial Prepayment, as Long as the Term Is Not Extended

Loan documents do not always provide for an adjustment in the amortization schedule after a partial prepayment. Therefore, servicers often require borrowers to continue making principal payments under the original principal payment schedule, even after a partial prepayment. A *pro rata* reduction in all remaining principal payments would not result in a modification of the remaining loan; however, all other deferrals of principal payments currently must be analyzed as to whether they are material for purposes of Treasury Regulation Section 1.1001-3(d)(3).

For example, assume a mortgage loan with a principal balance of $10 million has an annual interest rate of 5.5% and a fifteen year stated term to maturity. Monthly payments for the first five years are interest only (the "interest only period," during which borrower owes monthly interest payments of $45,833.33), and the loan amortizes fully over the remaining ten years (the "amortizing period," during which borrower owes monthly payments of principal and interest of $108,526.28). The loan is voluntarily prepayable in whole or in part, but does not explicitly provide for any adjustment to the monthly payments (of interest and principal) following any prepayment. At the end of year 1 (when the outstanding principal balance of the loan remains $10 million), the borrower prepays $2 million of principal. If the parties keep the original fixed payment schedule ($108,526.28 per month for years 6 through 15), the term to maturity would be accelerated. In order to maintain the 15 year term to maturity originally contemplated by the parties, the borrower may request that all monthly payments be reduced *pro rata* (*i.e.*, by 20 percent), and such a change would not result in a modification of the mortgage loan for purposes of Section 1001. Alternatively, the borrower may request that the interest only period for the loan be extended (and the amortization period deferred), given that the borrower has

prepaid $2 million in principal. Such a deferral must be analyzed under Section 1001, as scheduled principal payments at the start of the original amortization schedule would be deferred.

Treasury Regulation Section 1.1001-3(e)(3) provides that a modification that changes the timing of payments (including any resulting change in the amount of payments) due under a debt instrument is a significant modification if it results in the material deferral of scheduled payments. The regulations provide for a safe-harbor period, deferrals over which are not considered material for this purpose. The safe-harbor period extends for a period equal to the lesser of five years or fifty percent of the original term of the loan, so that in our example of the fifteen year loan, the safe-harbor period would be five years.[49] Each principal payment under both the original payment schedule and the modified payment schedule must be analyzed to determine which payments have been deferred and whether the deferral falls within the safe-harbor period. We believe that such an analysis is unnecessary where the deferral does not extend the weighted average maturity or the ultimate maturity of the loan, and therefore no new financing is being provided by the REMIC.

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[49] For purposes of analyzing the weighted average maturity of the loan, the relevant comparison would be between (i) the loan before the modification, without prepayment, and (ii) the loan after modification and prepayment. Thus, in our earlier example of the fifteen year loan, since the $2 million prepayment would otherwise shorten the weighted average maturity of the loan, the borrower should be permitted to reduce its remaining scheduled principal payments, as long as the weighted average maturity of the loan is not extended. It is unclear how the safe harbor under Treasury Regulation Section 1.1001-3(e)(3) would apply to this example. It is possible to read the safe harbor to compare (i) the loan before modification with prepayment (since the safe harbor calls for the yield of the unmodified instrument to be determined as of the date of modification), with (ii) the loan after modification and prepayment. We believe that this should not be the relevant comparison, and that a special rule for REMICs is appropriate.

In addition, there would be no change to the collateral securing the loan. Therefore, changes in a mortgage loan's payment schedule after partial prepayment should be permitted as an additional exception under Treasury Regulation Section 1.860G-2(b)(3) as long as the weighted average maturity date and the ultimate maturity date of the mortgage loan are not extended.

IX. RELEASE OF COLLATERAL PURSUANT TO MORTGAGE LOAN TERMS

Treasury Regulation Section 1.860G-2(a)(8) provides that a REMIC's release of a lien on real property securing a qualified mortgage will cause the loan to cease to be a qualified mortgage, unless (i) the mortgagor pledges substitute collateral consisting of government securities, (ii) the mortgage documents allow the substitution, (iii) 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 (iv) the release is not within two years of the startup day. Although this regulation might appear literally to prohibit *any* release outside of the defeasance context, it has been interpreted to be an anti-abuse rule, and to permit the release of real property collateral pursuant to the terms of a mortgage loan, where the loan-to-value ratio of the mortgage loan does not change significantly.[50] Indeed, this is critical, as a REMIC does not have the ability to prevent the release of collateral where it is permitted under the terms of the mortgage loan.

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50 *See* PLR 9833015 (May 18, 1998) (modification of a loan to allow the sale of property upon payment of a release price later than the last due date allowed by the loan agreement does not violate the release rule where the release and prepayment do not significantly alter the loan-to-value ratio). The private letter ruling provides that the regulation "is an anti-abuse provision aimed at the prevention of the collateralization of a REMIC with obligations that are not qualified mortgages, required under Section 860G(a)(3)(A) to be obligations principally secured by an interest in real property." *Id.*

Commercial mortgage loans are often secured by multiple parcels of real property, and permit by their terms the partial release of individual parcels upon payment of a predetermined release price. Typically, the release price of any individual property is set to be a percentage (at least 100 percent) of the amount of the entire loan that is allocated to such property, based on its fair market value relative to the fair market values of the other properties securing the loan as of loan origination.[51] These partial releases are permitted pursuant to a unilateral option of the borrower under the original mortgage loan terms, and do not involve any modification of the mortgage loan. Further, it is important to borrowers that the partial releases be pre-approved. As a commercial matter, borrowers cannot be locked into owning every piece of real property that serves as collateral over the entire term of the loan. This would be contrary to Congressional intent that legitimate business needs of borrowers be addressed.

Another common practice in commercial mortgage loans is to permit the release of an unimproved parcel of real property collateral. These parcels are not necessary for the mortgage loan to meet the 80 percent test at either loan origination or REMIC startup due to the value of remaining real property collateral securing the loan. Such parcels or "out parcels" may not be included in the appraisal of the real property collateral that is obtained at loan origination, or may be assigned a zero value. Out parcels may be included in the original collateral if, for example,

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51 For example, a $10 million loan is secured by two properties, property A and property B, with a fair market value at loan origination of $3 million and $9 million, respectively. Based on their relative fair market values, the "allocated loan amount" for property A and property B is $2.5 million and $7.5 million, respectively, and the mortgage loan permits the borrower to obtain a partial release of either property upon prepayment of the loan in the amount of 110% of the allocated loan amount for such property (*i.e.*, $2.75 million for property A or $8.25 million for property B). The parties should be permitted to use the collateral values obtained as of loan origination in determining that the 80 percent test would be met upon partial release of either property pursuant to the terms of the mortgage loan.

the unimproved portion of the property does not yet constitute a separate tax parcel for property tax purposes. The borrower may separate the parcel for property tax purposes in the future, and obtain a partial release, permitting the out parcel to be sold and developed separately. Commercial mortgage loans will often permit these specified parcels to be released at the borrower's option.

Although the Proposed Regulations would provide that a release pursuant to a permissible loan *modification* would not disqualify a qualified mortgage under Treasury Regulation Section 1.860G-2(a)(8), they are silent as to whether a release that does *not* constitute a modification (such as a release or substitution of collateral pursuant to the borrower's unilateral option under the terms of the mortgage loan) would disqualify a qualified mortgage under Treasury Regulation Section 1.860G-2(a)(8). It is important that the regulations not adversely affect established practices regarding releases pursuant to loan terms. It is therefore important that, if (contrary to our recommendations) the appraisal requirement is maintained with respect to loan modifications, the Service not create any inference that the appraisal requirement applies to releases that are not pursuant to a loan modification. Accordingly, we recommend that the Service clarify that a release of a lien on real property pursuant to the terms of a loan that does not result in a modification of the loan under Treasury Regulation Section 1.1001-3 is not a release that disqualifies a mortgage loan under Treasury Regulation Section 1.860G-2(a)(8) so long as the loan meets the 80 percent test based on the original collateral values (as of loan origination or REMIC startup) or the collateral values as of the release date. We previously recommended this approach and suggested language to implement it in the 2002 Report. Although this approach utilizes a lower threshold than the standard articulated in Private Letter Ruling 9833015 (which, as discussed above in footnote 50, relied on the loan-to-value ratio not

being "significantly altered"), we believe it would ensure that the loans remain secured by interests in real property and is consistent with current practices relating to partial releases (including releases of out parcels).

X. LOAN MODIFICATIONS BY GRANTOR TRUSTS

Mortgage loans are securitized not only through REMICs, but also through non-REMIC vehicles taxed as grantor trusts. An investment trust, such as a securitization vehicle holding mortgage loans, will qualify as a grantor trust only if there is no power under the trust agreement to vary the underlying investment.[52] This requirement differentiates a passive investment vehicle, appropriately taxed as a grantor trust, from an active business endeavor that is more properly taxed as a business entity.[53] For this purpose, a power to vary is one whereby the trustee, or some other person, has some kind of managerial power over the trusteed funds that enables him to take advantage of variations in the market to improve the investment of all the beneficiaries.[54] The existence of a power to sell trust assets does not give rise to a power to vary the investment. Rather, it is the ability to substitute new investments, the power to reinvest, that requires an investment trust to be classified as a business entity.[55] The power to make the limited modifications discussed above does not take advantage of any market variations or constitute reinvestments, as no new credit would be extended to borrowers.

Modifications of mortgage loans held by a grantor trust currently present issues similar to those posed by modifications of mortgage loans held by a REMIC, as a vehicle will fail to

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52 Treas. Reg. § 301.7701-4(c)(1).

53 *See* Treas. Reg. § 301.7701-4(b).

54 Rev. Rul. 75-192, 1975-1 C.B. 384 (Jan. 1975).

55 Rev. Rul. 78-149, 1978-1 C.B. 448 (Jan. 1978).

qualify as a grantor trust if it has the power to vary the underlying investment. The policies underlying the reinvestment prohibition for grantor trusts are very similar to the prohibition on significant modification under the REMIC rules. We recommend that all of the proposed changes relating to REMICs (as well as the permissible modifications under the current REMIC regulations) be extended to grantor trusts, by providing that the power to make permissible modifications to mortgage loans does not constitute a prohibited power to vary under the grantor trust rules. The Service has already taken this approach with changes to first-lien residential adjustable rate mortgage loans in Revenue Procedure 2007-72,[56] which provides that the Service will neither challenge a securitization vehicle's qualification as a REMIC on the grounds that such changes do not constitute a permissible loan modification under the REMIC regulations, nor challenge a securitization vehicle's qualification as a grantor trust on the grounds that such changes manifest a power to vary the investment of the certificate holders.[57] We recommend that the Service take the same approach with the permissible loan modifications by REMICs and extend them to grantor trusts.

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56 2007-52 I.R.B. 1257 (Dec. 6, 2007).

57 The Revenue Procedure also provides that the Service will not contend that such modifications are prohibited transactions under the REMIC regulations, and that the Service will not challenge a securitization vehicle's qualification as a REMIC on the grounds that the modifications resulted in a deemed reissuance of the REMIC regular interests.