



## Where Things Stand

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### No Need to Pretend – Just Extend – if Borrowers Ask to Delay Repayment

Today's high interest rate environment presents a challenge to many commercial real estate borrowers whose loans are now reaching maturity. Some borrowers are unable to repay their loans, while others are approaching the loan servicers in commercial mortgage-backed securities ("CMBS") transactions to request an extension in the hopes of refinancing later when market conditions have improved. Servicers have generally been willing to grant extensions when it is prudent to do so, but have sought concessions such as the paydown of some principal, an increase in the interest rate or the posting of reserves.

For mortgage loans securitized in a real estate mortgage investment conduit ("REMIC"), servicers should understand the interplay between the REMIC rules and the more generally applicable tax rules regarding modifications to loans. An agreement between borrower and lender to extend the maturity date of a loan is a "modification" under the tax law, and an extension that is "significant" will cause the modified loan to be treated as having been newly issued in exchange for the original, unmodified loan. The REMIC rules prohibit a REMIC from acquiring newly issued loans, including any loans that have been significantly modified, more than three months after the closing date of the securitization. However, the REMIC rules do permit significant modifications that are "occasioned by default or a reasonably foreseeable default." This generally means greater latitude for modifications involving borrowers facing financial trouble.

Where an actual default has not yet occurred, the servicer must reasonably believe that there is a "significant risk of default." Accordingly, servicers faced with a request to grant an extension prior to an actual default should have detailed knowledge of the circumstances of the borrower and the underlying property in order to determine whether a default is reasonably foreseeable. IRS guidance suggests looking at "credible written factual representations" made by the borrower, but it also indicates that a servicer may conclude that there is a significant risk of default even though the possibility of default is more than one year in the future, and even if the loan is currently performing.

As for borrowers seeking to extend in order to take advantage of their existing lower interest rate – but where there is no apparent risk of default – more modest modifications may still be permitted under the tax rules without a deemed exchange for new debt. Treasury regulations provide a safe-harbor period for extensions that are less than 50% of the original term (or five years, whichever is less). Indeed, a short-term extension may be just enough time for borrowers of CMBS loans to refinance under better market conditions, although a servicer would still be limited by any non-tax provisions in the servicing agreement. Further, any contemporaneous changes to the loan, such as increasing the interest rate or adding an extension fee, must also be aggregated and tested for significance under section 1001 by examining the change in yield. For example, if an extension fee were to increase the yield on the modified loan by more than the greater of 25 basis points or 5% of the annual yield, then the modification would be "significant" notwithstanding the length of the extension.

Given the current interest rate environment, many borrowers are unable (or merely reluctant) to repay their loans when due, but the REMIC rules provide some flexibility. Servicers should determine whether a modification is "occasioned by default or a reasonably foreseeable default" for maximum flexibility in making loan modifications and carefully document their conversations with borrowers to preserve a record of the parties' concerns regarding timely repayment. However, servicers may still be able to accommodate more modest extensions even if such a determination is not certain.

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