

# Clients & Friends Memo

## IRS Guidance on Release of Real Properties Securing Mortgage Loans Held by REMICs

August 18, 2010

### Summary

On August 17, 2010, the Internal Revenue Service (the “IRS”) released Revenue Procedure 2010-30 (the “Revenue Procedure”), which clarifies Treasury regulations issued in September 2009 (the “Modification Regulations”), discussed [here](#) concerning changes in the collateral securing mortgage loans held by real estate mortgage investment conduits (“REMICs”).<sup>1</sup>

The Revenue Procedure addresses the “qualified mortgage” status of commercial mortgage loans held by REMICs when there is a partial release of real property, if the loan to value (“LTV”) ratio after the release exceeds 125%. The Revenue Procedure clarifies that a mortgage loan will not lose its qualified status as a result of a release, even if the remaining LTV ratio exceeds 125%, if:

- The release is at the unilateral option of the borrower or is otherwise required by the terms of the loan, and the loan providing such option or requiring such release was entered into on or before December 6, 2010;
- or
- When the lien is released, the loan’s principal balance is reduced by (1) the sum “net proceeds” of the sale, condemnation proceeds and insurance proceeds, (2) a release amount provided under the loan based on the relative fair market values of the properties at origination, (3) the fair market value of the released property at the time of release, or (4) an amount such that the LTV ratio of the loan does not increase after the release.

The Revenue Procedure helps the commercial mortgage securitization industry by grandfathering releases at the unilateral option of the borrower under loans issued on or before December 6, 2010. While the Modification Regulations explicitly required that the LTV ratio not exceed 125%

---

<sup>1</sup> See <http://www.irs.gov/pub/irs-drop/rp-10-30.pdf>.

for a release to occur, the release provisions in these loan agreements did not necessarily impose such a requirement. In addition, the Revenue Procedure acknowledges the existence of pay-down provisions in loans in conjunction with a release (both voluntary and involuntary) as an alternative to the Modification Regulations' strict requirement of maintaining an LTV ratio of not more than 125%. In situations other than for loans eligible for the grandfather provision described above, the Revenue Procedure does not allow releases of real property (including outparcels) without a required pay-down at a time when the LTV ratio exceeds 125%. The Revenue Procedure describes four types of pay-downs, but it is not clear if such paydowns are necessarily consistent with customary mortgage loan terms or typical loan servicing practices. The Revenue Procedure is effective retroactively to September 16, 2009, the date of the Modification Regulations.

### Background

The Modification Regulations expanded the types of permitted modifications that can be made to mortgage loans without jeopardizing the qualification of a REMIC that holds the mortgage loans or giving rise to prohibited transaction treatment.<sup>2</sup> The Modification Regulations permit a modification that releases, substitutes, adds, or otherwise alters a substantial amount of the collateral for, a guarantee on, or other form of credit enhancement for, a recourse or nonrecourse obligation, provided that the mortgage loan continues to be "principally secured" by an interest in real property after the relevant modification. The test for "principally secured" requires that either (1) the loan be at least 80% secured by real property, *i.e.*, have an LTV ratio of not more than 125%, measured by the fair market value of the underlying property or properties (as determined by an appraisal or other "commercially reasonable valuation method") immediately after giving effect to the modification, or (2) the value of the property or properties securing the loan after the modification be equal to or greater than the value of the property or properties securing the loan prior to the modification.

*Concerns Relating to the Modification Regulations.* Without further IRS clarification, the alternative test in (2) above precluded releases of real property if the remaining LTV ratio after the release exceeded 125%. Under the prior REMIC regulations,<sup>3</sup> a mortgage loan's satisfaction of the "principally secured" requirement was tested either at origination of the loan or at the REMIC's closing date. A decline in the value of the underlying real property after that date did not disqualify the mortgage loan. By contrast, under the Modification Regulations, modifications that were

---

<sup>2</sup> T.D. 9463, 74 Fed. Reg. 47436 (Sept. 16, 2009) (amending Treas. Reg. §§ 860G-2(a)(8) and 1.860G-2(b)). The Modification Regulations were issued close to two years after the issuance of proposed regulations, which were the first guidance issued pursuant to the IRS's pilot program for soliciting industry input on technical tax issues. See Prop. Treas. Reg. § 1.860G-2(b), 72 Fed. Reg. 63523 (Nov. 9, 2007); IRS Notice 2007-17, 2007-12 I.R.B. 748 (Mar. 19, 2007). References to the "Code" are to the Internal Revenue Code of 1986, as amended, and references to "Treas. Reg." are to regulations of the U.S. Department of the Treasury issued thereunder.

<sup>3</sup> See T.D. 8458 (Dec. 23, 1992).

permitted under prior law — *e.g.*, releases at the unilateral option of the borrower, non-material releases, and releases when default has occurred or is reasonably foreseeable — give rise to a reapplication of the “principally secured” test immediately after the modifications are made.

Many typical release situations were implicated by the Modification Regulations if the real property securing a loan declined in value to less than 80% of the principal balance (an all-too-common occurrence in recent economic times), including: (1) a release of a property and partial pay-down of the loan at the unilateral option of the borrower upon the satisfaction of certain criteria; (2) a release of an outparcel that was not included in the loan’s underwriting, with no pay-down of the loan; (3) a release of cross-collateralization on a multi-property loan upon an assumption or otherwise; (4) a release in connection with a casualty or condemnation; and (5) a release of one of several properties incident to the workout or liquidation of a defaulted mortgage loan. In each of these situations, the Modification Regulations posed a barrier if the LTV ratio after the release exceeded 125%.

### **Revenue Procedure 2010-30**

The IRS issued the Revenue Procedure in an effort to address industry concerns caused by the addition of the “principally secured” requirement for releases of real property collateral. Although the Modification Regulations continue to require that the loan be “principally secured” following a release, the Revenue Procedure provides that the IRS will not challenge the qualified mortgage status of a loan held by a REMIC even if, following a release of real property, the LTV ratio is over 125% but the release occurs in either a “**grandfathered transaction**” or a “**qualified pay-down transaction**.”

1. *Grandfathered Transaction.* The IRS will not challenge a release that occurs pursuant to the borrower’s exercise of a unilateral option permitted under a release provision in a loan agreement, or a release that is required under a loan agreement (*e.g.*, following a casualty or condemnation), in each case, that was entered into on or before December 6, 2010. While this gives a transition period for newly originated loans, it is not clear that an outstanding loan could now be amended to include such a provision.

2. *Qualified Pay-Down Transaction.* The IRS will not challenge a release if the release is accompanied by a pay-down of the principal balance of the loan equal to at least a “qualified amount.” A “qualified amount” is any one of the following:

- (1) The sum of (i) the net proceeds (*i.e.*, the “amount realized” as determined under Section 1001 of the Code) of an arms-length sale of the property by the borrower to an unrelated third party and (ii) the net proceeds from the receipt of a condemnation award or an insurance or tort settlement with respect to the property, if any;

(2) An amount provided for in the loan agreement (e.g., an allocated loan amount) at least equal to the product of (x) the “adjusted issue price” of the mortgage loan (generally, the then outstanding principal balance) and (b) the fair market value at origination of the released property, divided by the aggregate fair market value at origination of all real property that secured the mortgage loan immediately prior to the release;

(3) The fair market value of the released property at the time of the release, plus the amount of any tort or insurance settlement that is expected to be, or has been, received with respect to the property and that is not reflected directly or indirectly in the property’s fair market value at the time of the release; and

(4) An amount such that the LTV ratio of the loan immediately after the release is no greater than the LTV ratio immediately before the release.

It is noteworthy that clause (1) above requires all “net proceeds” and clause (3) above requires the entire fair market value of the released property to be used to pay down the loan, and they seemingly do not permit any portion of such amounts to be held back in a reserve fund, to pay accrued interest or to be otherwise applied.

### **Impact of the Revenue Procedure on Common Release Transactions**

*Conflicts Between Existing Loans and the Modification Regulations.* The Grandfathered Transaction provision alleviates much of the concern of industry participants relating to loans entered into prior to the effective date of the Modification Regulations and which permitted unilateral borrower releases but did not require an LTV test. For example, many loans conditioned release on the satisfaction of a DSCR test but not an LTV test, and in any event, many loans permitted the release of an outparcel without the satisfaction of any meaningful economic criteria. Without this guidance, where a borrower exercised its right to a release at a time when the LTV ratio exceeded 125%, under the Modification Regulations, loan servicers faced the choice of being sued by borrowers if they prevented the release, or causing the securitization trust to lose its REMIC status if they permitted the release. In the future, loan documents will have to be drafted so that non-Grandfathered Transactions will either meet the 125% LTV ratio test or will constitute Qualified Pay-Down Transactions. This is true of both releases of income-producing properties as well as outparcels.

*Casualty and Condemnation.* The Modification Regulations did not distinguish between voluntary and involuntary releases. The Qualified Pay-Down Transaction provision of the Revenue Procedure protects releases that occur due to a casualty or condemnation if for example, all net proceeds of the casualty or condemnation (and any related sales) are used to pay down the loan. Again, in the

future, loan provisions will have to be carefully reviewed to ensure that no part of the lien is released without a paydown of a “qualified amount.”

*Negotiated Releases (Including Following a Default).* The Modification Regulations, together with the Revenue Procedure, permit negotiated releases as long as the loan either has an LTV ratio of 125% or less following the release, or is paid down by a “qualified amount.” Significant issues remain with respect to releases in connection with workouts of defaulted loans, particularly since loans in this context often have LTV ratios above 125%. For example, all or a portion of sales proceeds from a released parcel are often retained in a reserve fund and are not used to pay down the loan, possibly making it difficult to qualify as a Qualified Pay-Down Transaction. In addition, releases that occur in connection with the uncrossing of loans and the assumption of a portion of the loan by a new borrower often contain no pay-down provisions. The Revenue Procedure provides no relief for this common loan workout modification. In these circumstances it may be necessary to forgive enough principal in order to attain an LTV ratio of 125% or less, or at least an LTV ratio not greater than the LTV ratio immediately before the release.

\* \* \* \*

If you have any questions regarding this memorandum, please contact:

Charles M. Adelman	+1 212 504 6477	charles.adelman@cwt.com
Gary T. Silverstein	+1 212 504 6858	gary.silverstein@cwt.com
Robert A. Davis	+1 202 862 2422	bob.davis@cwt.com
Charles C. Kaufman	+1 212 504 6333	charles.kaufman@cwt.com

or please contact:

**Tax Group:**

Adam F. Blakemore	+44 (0) 20 7170 8697	adam.blakemore@cwt.com
Mark P. Howe	+1 202 862 2236	mark.howe@cwt.com
David S. Miller	+1 212 504 6318	david.miller@cwt.com
Richard M. Nugent	+1 212 504 6499	richard.nugent@cwt.com
Linda Swartz	+1 212 504 6062	linda.swartz@cwt.com

**Capital Markets Group:**

Angus Duncan	+44 (0) 20 7170 8640	angus.duncan@cwt.com
Michael S. Gambro	+1 212 504 6825	michael.gambro@cwt.com
Karen B. Gelernt	+1 212 504 6911	karen.gelernt@cwt.com
Anna H. Glick	+1 212 504 6309	anna.glick@cwt.com

Stuart N. Goldstein	+1 704 348 5258	stuart.goldstein@cwt.com
Gregg S. Jubin	+1 202 862 2485	gregg.jubin@cwt.com
Henry A. LaBrun	+1 704 348 5149	henry.labrun@cwt.com
Lisa J. Pauquette	+1 212 504 6298	lisa.pauquette@cwt.com
Frank Polverino	+1 212 504 6820	frank.polverino@cwt.com
Patrick T. Quinn	+1 212 504 6067	pat.quinn@cwt.com
Jeffrey Rotblat	+1 212 504 6401	jeffrey.rotblat@cwt.com
Jordan M. Schwartz	+1 212 504 6136	jordan.schwartz@cwt.com
Robert L. Ughetta	+1 704 348 5141	robert.ughetta@cwt.com
Neil J. Weidner	+1 212 504 6065	neil.weidner@cwt.com

## **Real Estate Finance Group:**

Fredric L. Altschuler	+1 212 504 6525	fredric.altschuler@cwt.com
James P. Carroll	+1 704 348 5116	james.carroll@cwt.com
James S. Hassan	+1 704 348 5162	james.hassan@cwt.com
Steven M. Herman	+1 212 504 6054	steven.herman@cwt.com
Melissa C. Hinkle	+1 212 504 6972	melissa.hinkle@cwt.com
William P. McInerney	+1 212 504 6118	william.mcinerney@cwt.com
W. Christopher White	+1 212 504 6633	christopher.white@cwt.com
John M. Zizzo	+1 212 504 6431	john.zizzo@cwt.com