

Clients & Friends Memo

Proposed REMIC Regulations on Modification of Mortgage Loans Held by REMICs

November 12, 2007

Introduction

On November 9, 2007, the Internal Revenue Service (the "IRS") issued proposed regulations (the "Proposed REMIC Regulations") that would permit certain types of modifications to commercial real estate mortgage loans held by a real estate mortgage investment conduit ("REMIC") without jeopardizing the qualification of the REMIC or causing a prohibited transaction with respect to the mortgage loan.¹ The Proposed REMIC Regulations would permit:

- (i) modifications that release, substitute, add or otherwise alter a substantial amount of the collateral for, a guarantee on, or other form of credit enhancement for a recourse or nonrecourse obligation; and
- (ii) a change in the nature of the obligation from recourse (or substantially all recourse) to nonrecourse (or substantially all nonrecourse);

provided that the mortgage loan continues to be "principally secured" by an interest in real property after the relevant modification (i.e., the loan-to-value (LTV) ratio is not greater than 125%). In addition, the Proposed REMIC Regulations require an independent third-party appraisal to be prepared at the time of the modification to establish the fair market value of the mortgaged property. Further, the preamble to the Proposed REMIC Regulations notes that even if a modification does not jeopardize the qualification of the REMIC or cause a prohibited transaction, the REMIC residual interest holder may recognize taxable gain or loss as a result of the modification.

The Proposed REMIC Regulations are the first guidance issued pursuant to the IRS's pilot program for soliciting industry input on technical tax issues.² Although the stated purpose of the Proposed

¹ Proposed Treas. Reg. § 1.860G-2(b), 72 Fed. Reg. 63523 (November 9, 2007). While the Proposed REMIC Regulations do not exclude residential mortgage loans, the types of modifications covered arise primarily in the commercial mortgage loan context. Residential loan modifications are also usually covered by the existing exception for loans in default or reasonably foreseeable default.

² See IRS Notice 2007-17, 2007-12 I.R.B. 748 (March 19, 2007).

REMIC Regulations is to address the concerns raised by the commercial real estate industry that the existing REMIC regulations do not adequately accommodate legitimate business needs in the commercial mortgage securitization market, they do not incorporate all the issues raised by industry participants and, in fact, raise some new concerns. In addition, the Proposed REMIC Regulations contain what appear to be technical errors that will need to be addressed before final regulations are issued.

The Proposed REMIC Regulations are not effective until they are published in final form and will apply prospectively to mortgage loan modifications made after that date.

Loan Modifications and the REMIC Rules

The REMIC provisions of the Internal Revenue Code were enacted by Congress in 1986 to be the exclusive means of issuing multiple classes of securities backed by a fixed pool of real estate mortgages without the imposition of an entity level tax. To ensure that REMICs remain static investment vehicles, REMICs are subject to several requirements regarding their asset composition, and are generally prohibited from actively managing their assets. In general, a REMIC has three months to acquire its initial assets and two years to substitute a new mortgage loan for a defective one. Substitutions after that date are not permitted, and the disposition of a performing mortgage loan generally constitutes a "prohibited transaction," subjecting the REMIC to a 100% penalty tax on any gain.

Because the collateral securing commercial mortgage loans are income-producing properties, borrowers under commercial mortgage loans held by a REMIC may request the servicer to change the terms of their mortgage loans in the ordinary course of managing their properties, reserves, transfers, etc. Treasury regulations governing the modification of all debt instruments (including mortgage loans) provide that if the change to the terms of a debt instrument constitutes a "significant modification," then the original obligation is deemed to be exchanged for the modified obligation at the time the modification occurs. Thus, if a REMIC were to significantly modify a mortgage loan more than three months after the startup day (two years for a loan subject to a breach of representation) and the mortgage loan was not in default (or default was not reasonably foreseeable), then the deemed exchange would be a prohibited transaction and would disqualify the mortgage loan and possibly the REMIC itself. These limitations have made it difficult for servicers to distinguish between permissible and impermissible modifications and stymied borrowers making legitimate business requests.

The existing REMIC regulations provide that certain alterations in the terms of a mortgage loan held by a REMIC are not treated as modifications even if those changes would otherwise constitute a significant modification of the mortgage loan under the general debt modification regulations. These are changes occasioned by (1) default or reasonably foreseeable default, (2) assumption of the mortgage loan, (3) waiver of a due-on-sale or due-on-encumbrance clause, or (4) adjustment of

the interest rate on a convertible mortgage.³ These exceptions were adopted in 1992 and accommodated the most frequent issues that arose at that time in the context of residential mortgages, but predated the growth in the market for commercial mortgage loans and therefore are inadequate to deal with the complex issues that arise in the day-to-day administration of commercial mortgage loans.

Issues Raised by the Proposed Regulations

- (1) **Principally secured test.** Under the existing REMIC regulations, a mortgage loan's satisfaction of the "principally secured" requirement is tested either at origination or at the REMIC's closing date. A decline in the value of real property after the testing date does not disqualify a mortgage loan. However, under the Proposed REMIC Regulations, a substantial change in the collateral, a guarantee or other credit enhancement, or a change from recourse nature to nonrecourse is only allowed if a new "principally secured" test is met. While it would be sensible for the regulations to prohibit a release or substitution of collateral that would cause a mortgage loan to fail the principally secured test, there should be no policy concern if, for example, (a) a release is accompanied by a principal pay down that maintains or improves the LTV ratio of the mortgaged property, (b) a property of equal or greater value is substituted for a removed property or (c) property is added that improves the LTV ratio. Furthermore, there is no reason to re-test the "principally secured" nature of the mortgage loan if the change is to a guarantee or other form of credit enhancement, because these do not affect the value of the mortgaged property.
- (2) **The appraisal requirement.** The qualified mortgage test that applies at the inception of a REMIC does not require that the LTV ratio be established by any particular method. To require an appraisal by an independent appraiser in order to permit a modification is a potentially onerous new requirement. An appraisal can be time-consuming and expensive, particularly if the mortgage loan is secured by multiple properties. Less cumbersome alternatives exist, such as brokers' price opinions and "desktop" appraisals by the servicer that use usual appraisal methodologies. The cost of such an appraisal will lie either with the borrower, who may be unwilling to bear it, or with the REMIC itself, causing unexpected losses to subordinate certificateholders.
- (3) **What is a "substantial" amount?** Under existing REMIC regulations, servicers typically require an opinion of counsel to determine whether a "substantial" change in collateral, a guarantee, or credit enhancement will cause a disqualifying "significant modification" of a mortgage loan. The Proposed REMIC Regulations will still require this legal judgment or order to determine whether the "principally secured" test applies and whether an appraisal must be obtained. This requirement eliminates the greater efficiency sought by servicers.

³ Treas. Reg. §1.860G-2(b)(3).

- (4) **Unintended effect on non-substantial and unilateral changes.** By providing that a mortgage loan ceases to be a qualified mortgage unless its lien is released in compliance with the above rules for altering a “substantial amount” of the collateral, the Proposed REMIC Regulations could be read to disallow (a) a non-substantial release of collateral and (b) a unilateral change by the borrower that the lender cannot prevent, which would not have been “significant modification” under the general debt modification regulations in the first place. These implications are likely unintentional and can be changed through technical corrections.
- (5) **Changes from nonrecourse to recourse.** As drafted, the Proposed REMIC Regulations cover a change from recourse (or substantially all recourse) to nonrecourse (or substantially all nonrecourse), but not vice versa. However, the preamble to the Proposed REMIC Regulations appears to contemplate that a change from nonrecourse (or substantially all nonrecourse) to recourse (or substantially all recourse) would also be allowed. This glitch should be corrected in final regulations.
- (6) **Industry proposals not included.** In response to IRS Notice 2007-17, commentators suggested that any new regulations expressly apply to the following modifications: (a) changes in a permitted prepayment date or defeasance provision, (b) the substitution of a new obligor or the addition or deletion of a co-obligor, (c) the imposition or waiver of a prepayment penalty or other fee, and (d) a change in a principal payment schedule following a prepayment. The Proposed REMIC Regulations do not include these changes. The preamble to the Proposed REMIC Regulations explains that these suggestions were not adopted because either the modification is adequately dealt with under the general debt modification regulations or, in the case of defeasance, no expansion of the current provisions is warranted. The Proposed REMIC Regulations also fail to adopt the industry proposal that the REMIC exceptions for modifications be extended to grantor trusts that hold mortgage loans, leading to potentially different treatment depending on whether a REMIC or grantor trust is used.

Conclusion

The Proposed REMIC Regulations broaden the permissible mortgage loan modifications in a way that should help property and loan administration. However, as drafted, the Proposed REMIC Regulations do not significantly reduce compliance issues for servicers and trustees in responding to requests for changes in loan terms or reduce the expense and time needed to process such requests. Further, the new appraisal requirement would add time and expense without any practical necessity. Finally, the Proposed REMIC Regulations will not avoid the need to determine if a modification results in the recognition of gain or loss to the REMIC, and therefore to the REMIC residual holder.

The IRS has requested comments and requests for a public hearing, due by February 7, 2008.

A copy of the Proposed REMIC Regulations is attached to this memorandum.

If you have any questions regarding the foregoing or other aspects of the Proposed REMIC Regulations, please contact:

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Gary Silverstein	212-504-6858	gary.silverstein@cwt.com
Bob Davis	202-862-2422	bob.davis@cwt.com)

2. Section 232.101 is amended by:
a. Revising paragraphs (a)(1)(iv) and (v), the introductory text of paragraph (a)(2), paragraph (a)(2)(i), the first sentence of paragraph (a)(3), and paragraph (c)(6); and
b. Removing and reserving paragraph (c)(11).

The revisions read as follows:

§ 232.101 Mandated electronic submissions and exceptions.

(a) * * *
(1) * * *

(iv) Documents filed with the Commission pursuant to sections 8, 17, 20, 23(c), 24(b), 24(e), 24(f), and 30 of the Investment Company Act (15 U.S.C. 80a-8, 80a-17, 80a-20, 80a-23(c), 80a-24(b), 80a-24(e), 80a-24(f), and 80a-29) and any application for an order under any section of the Investment Company Act (15 U.S.C. 80a-1 et seq.);

(v) Documents relating to offerings exempt from registration under the Securities Act filed with the Commission pursuant to Regulation E (§§ 230.601-230.610a of this chapter);

(2) The following amendments to filings and applications, including any related correspondence and supplemental information except as otherwise provided, shall be submitted as follows:

(i) Any amendment to a filing or application submitted by or relating to a registrant or an applicant that is required to file electronically, including any amendment to a paper filing or application, shall be submitted in electronic format;

(3) Supplemental information, including documents related to applications under any section of the Investment Company Act, shall be submitted in electronic format except as provided in paragraph (c)(2) of this section.

(6) Except as provided in paragraph (a)(1)(v) of this section, filings relating to offerings exempt from registration under the Securities Act, including filings made pursuant to Regulation A (§§ 230.251-230.263 of this chapter) and Regulation D (§§ 230.501-230.506 of this chapter), as well as filings on Form 144 (§§ 239.144 of this chapter) where the issuer of the securities is not subject to the reporting requirements of section 13 or 15(d) of the Exchange Act (15 U.S.C. 78m or 78o(d), respectively);

3. Amend § 232.201 by revising paragraph (a) introductory text.

§ 232.201 Temporary hardship exemption.

(a) If an electronic filer experiences unanticipated technical difficulties preventing the timely preparation and submission of an electronic filing other than a Form 3 (§ 249.103 of this chapter), a Form 4 (§ 249.104 of this chapter), a Form 5 (§ 249.105 of this chapter), a Form ID (§§ 239.63, 249.446, 269.7 and 274.402 of this chapter), a Form TA-1 (§ 249.100 of this chapter), a Form TA-2 (§ 249.102 of this chapter), a Form TA-W (§ 249.101 of this chapter), or an application for an order under any section of the Investment Company Act (15 U.S.C. 80a-1 et seq.), the electronic filer may file the subject filing, under cover of Form TH (§§ 239.65, 249.447, 269.10 and 274.404 of this chapter), in paper format no later than one business day after the date on which the filing was to be made.

PART 270—RULES AND REGULATIONS, INVESTMENT COMPANY ACT OF 1940

4. The authority citation for part 270 continues to read in part as follows:

Authority: 15 U.S.C. 80a-1 et seq., 80a-34(d), 80a-37, and 80a-39, unless otherwise noted.

5. Amend § 270.0-2 by:
a. Removing the last sentence in paragraph (b);
b. Revising paragraph (d);
c. Removing paragraph (g);
d. Redesignating paragraph (h) as paragraph (g); and
e. Removing the authority citation following the section.

The revision reads as follows:

§ 270.0-2 General requirements of papers and applications.

(d) Verification of applications and statements of fact. Every application for an order under any provision of the Act, for which a form with instructions is not specifically prescribed and every amendment to such application, and every statement of fact formally filed in support of, or in opposition to, any application or declaration shall be verified by the person executing the same. An instrument executed on behalf of a corporation shall be verified in substantially the following form, but suitable changes may be made in such form for other kinds of companies and for individuals:

The undersigned states that he or she has duly executed the attached _____ dated _____, 20____ for and on behalf of (name of company); that he or she is (title of officer) of such company; and

that all action by stockholders, directors, and other bodies necessary to authorize the undersigned to execute and file such instrument has been taken. The undersigned further states that he or she is familiar with such instrument, and the contents thereof, and that the facts therein set forth are true to the best of his or her knowledge, information and belief.

(Signature)
* * * * *

By the Commission.
Dated: November 1, 2007.

Florence E. Harmon,
Deputy Secretary.
[FR Doc. E7-21911 Filed 11-8-07; 8:45 am]
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DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[REG-127770-07]

RIN 1545-BG77

Modifications of Commercial Mortgage Loans Held by a Real Estate Mortgage Investment Conduit (REMIC)

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking.

SUMMARY: This document contains proposed regulations that would expand the list of permitted loan modifications to include certain modifications of commercial mortgages. Changes to the regulations are necessary to better accommodate evolving commercial mortgage industry practices. These changes will affect lenders, borrowers, servicers, and sponsors of securitizations of mortgages in REMICs.

DATES: Written or electronic comments and requests for a public hearing must be received by February 7, 2008.

ADDRESSES: Send submissions to: CC:PA:LPD:PR (REG-127770-07), room 5203, Internal Revenue Service, PO Box 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand-delivered Monday through Friday between the hours of 8 a.m. and 4 p.m. to CC:PA:LPD:PR (REG-127770-07), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW., Washington, DC, or sent electronically via the Federal eRulemaking Portal at www.regulations.gov (IRS REG-127770-07).

FOR FURTHER INFORMATION CONTACT:

Concerning the proposed regulations, Diana Imholtz or Susan Thompson Baker, (202) 622-3930; concerning submissions of comments and requests for a public hearing, Kelly D. Banks, (202) 622-7180 (not toll free numbers).

SUPPLEMENTARY INFORMATION:**Paperwork Reduction Act**

The collection of information contained in this notice of proposed rulemaking has been submitted to the Office of Management and Budget for review in accordance with the Paperwork Reduction Act of 1995 (44 U.S.C. 3507(d)). Comments on the collection of information should be sent to the Office of Management and Budget, Attn: Desk Officer for the Department of the Treasury, Office of Information and Regulatory Affairs, Washington, DC 20503, with copies to the Internal Revenue Service, Attn: IRS Reports Clearance Officer, SE:W:CAR:MP:T:T:SP, Washington, DC 20224. Comments on the collection of information should be received by January 8, 2008.

Comments are specifically requested concerning:

Whether the proposed collection of information is necessary for the proper performance of the functions of the Internal Revenue Service, including whether the information will have practical utility;

The accuracy of the estimated burden associated with the proposed collection of information;

How the quality, utility, and clarity of the information to be collected may be enhanced;

How the burden of complying with the proposed collections of information may be minimized, including through the application of automated collection techniques or other forms of information technology; and

Estimates of capital or start-up costs and costs of operation, maintenance, and purchase of service to provide information.

The collection of information in this proposed regulation is in § 1.860G-2(b)(7). This information is required in order to show that modifications to mortgages permitted by the proposed regulation will not cause the modified mortgage to cease to be a qualified mortgage. The collection of information is voluntary to obtain a benefit. The likely respondents are businesses or other for-profit institutions.

Estimated total annual reporting burden: 3000 hours.

Estimated average annual burden hours per respondent: 8.

Estimated annual frequency of responses: 1.

An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a valid control number assigned by the Office of Management and Budget.

Books or records relating to a collection of information must be retained as long as their contents may become material in the administration of any internal revenue law. Generally, tax returns and tax return information are confidential, as required by 26 U.S.C. 6103.

Background

This document contains proposed amendments to 26 CFR part 1 under section 860G of the Internal Revenue Code (Code). The REMIC provisions under sections 860A through 860G provide for a pass-through vehicle that issues multiple classes of interests in pools of residential and commercial mortgage loans. All income from the mortgage loans in the REMIC is taxed to the holders of the regular and residual interests in the REMIC. Among the requirements for qualification are that the mortgage loans held by the REMIC must consist of "qualified mortgages" that are principally secured by an interest in real property. All loans must be acquired on the startup day of the REMIC or within three months thereafter, except that the REMIC may exchange a defective loan for a "qualified replacement mortgage" for up to two years.

Section 1.860G-2(b)(1) of the Income tax regulations (the regulations) provides that, subject to certain exceptions described in § 1.860G-2(b)(3), if an obligation is significantly modified, then the modified obligation is treated as one that was newly issued in exchange for the unmodified obligation that it replaced. If such a significant modification occurs after the obligation has been contributed to the REMIC and the modified obligation is not a qualified replacement mortgage, the modified obligation will not be a qualified mortgage and the deemed disposition of the unmodified obligation will be a prohibited transaction under section 860F(a)(2). Section 1.860G-2(b)(2) defines a "significant modification" as any change in the terms of an obligation that would be treated as an exchange of obligations under section 1001 and the related regulations. The treatment of specific loan modifications as deemed exchanges is addressed in § 1.1001-3. Section 1.1001-3 defines a loan modification and provides that a

modification that is significant will be treated as a deemed exchange of the original loan for a new loan.

Section 1.860G-2(b)(3) of the regulations sets forth four types of loan modifications that are expressly permitted without regard to the section 1001 modification rules. The four permitted modifications are: (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.

The present REMIC regulations were adopted in 1992 at a time when the mortgage-backed securities market involved primarily residential mortgage loans. Since that time, the securitization of commercial mortgage loans has become more common. The four types of modifications that are expressly permitted without regard to the section 1001 modification rules cover the most common changes affecting residential mortgage loans, but may not cover the range of likely changes in commercial mortgage loans.

In Notice 2007-17, IRB 2007-12, the IRS and Treasury Department solicited input on whether the present REMIC regulations should be amended to permit additional types of modifications incurred in connection with the commercial mortgage loans. In response to Notice 2007-17, the IRS and Treasury Department received three comments. See § 601.601(d)(2)(ii)(b).

The first comment set forth a proposal to add six new types of permissible modifications: (1) A modification that releases, adds, substitutes or otherwise alters any portion of the collateral for, a guarantee of, or other form of credit enhancement for the obligation, whether recourse or nonrecourse (other than an alteration that causes the obligation not to be principally secured by an interest in real property); (2) a change in the obligation from recourse (or substantially all recourse) to nonrecourse (or substantially all nonrecourse), or vice versa; (3) a change in the date on which the obligation may be prepaid or defeased in whole or in part, or addition of a defeasance provision; (4) substitution of a new obligor or addition or deletion of a co-obligor on the obligation; (5) imposition or waiver of a prepayment penalty or other fee; and (6) a change of the principal payment schedule of a loan following a voluntary or involuntary prepayment of principal. The second comment set forth a proposal to add two new types of permissible modifications

relating to changes in collateral and defeasance that are substantially similar to proposals (1) and (3) of the first comment. In addition, the second comment set forth a proposal to revise the existing exception for assumptions of the obligation to include any substitution of a guarantor for a guarantee on, or other form of credit enhancement for, an obligation. The first and second comments also set forth examples of the most common changes to commercial loans requested by commercial borrowers to assist the IRS and Treasury Department in understanding the particular business need served by each proposed modification.

Finally, the third comment requested that the IRS and Treasury Department consider a prior proposal advocating a new standard to measure materiality for modifications to loans held by a REMIC. Rather than adding specific types of loan modifications to the list of permitted modifications, the prior proposal recommended that the REMIC regulations be revised to provide that any change in the terms of a qualified mortgage will not cause it to cease to be a qualified mortgage so long as the change does not increase the principal amount or extend the maturity of the mortgage.

IRS and Treasury Department personnel, including personnel from Large & Mid-Size Business (LMSB) and LMSB Division Counsel, reviewed all comments and met with certain of the submitting parties to explore the proposals and the analysis supporting those proposals. After consideration of all comments received, the IRS and Treasury Department believe that it is appropriate at this time to propose amendments to the REMIC regulations to permit certain additional types of modifications to commercial mortgages.

Explanation of Provisions

1. General

The proposed regulations are intended to address the concerns raised by the commercial real estate industry that the existing REMIC regulations do not adequately accommodate legitimate business practices existing in the commercial mortgage securitization market. Submitting parties have indicated that the real property that secures a commercial mortgage loan is typically an active, income-generating, business property of the commercial loan borrower. Thus, in contrast to residential mortgage loans, there is a greater need to make ongoing changes to the terms of a commercial mortgage loan. For example, a borrower may

request a release of a parcel of land from the lien of the mortgage to either sell or develop the land. Although the mortgage continues to be principally secured by an interest in real property following the release, such a change under the existing REMIC regulations might cause the mortgage to cease to be a qualified mortgage.

The legislative history indicates that REMICs “should be flexible enough to accommodate most legitimate business concerns while preserving the desired certainty of income tax treatment.” S. Rep. No. 99–313, 99th Cong., 2d Sess., at 792. The legislative history also indicates that a REMIC, to preserve its tax status, 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.” S. Rep. No. 99–313, 99th Cong., 2d Sess., at 791–792. Accordingly, the proposed regulations are intended to strike a balance between accommodating the legitimate business concerns of the commercial real estate industry with the requirement that a REMIC remain a substantially fixed pool of mortgages and not be engaged in an active lending business.

In weighing the business needs of the industry against Congressional intent that a REMIC consist of a fixed pool of qualified mortgages that are principally secured by real property and whose income can be accurately calculated as of the startup day, the IRS and Treasury Department applied four core concepts to each of the proposed modifications. First, to minimize changes to REMIC cash flows after the startup day, the IRS and Treasury Department analyzed whether a particular modification would be likely to produce any significant gain or loss to the REMIC. Second, the IRS and Treasury Department considered whether a mortgage loan, if permitted to be modified as requested by submitting parties, would remain principally secured by real property after the modification. Third, the IRS and Treasury Department examined the ability of the IRS to review and administer compliance with the requirements of a particular modification. Finally, the IRS and Treasury Department considered the business needs indicated by the industry for a borrower requesting a particular modification to the terms of the loan and whether that business need was adequately addressed by the current regulations.

2. Proposed Modifications

In applying the four core concepts, the IRS and Treasury Department

determined that proposals relating to changes in collateral, guarantees and credit enhancement of an obligation and changes to the recourse nature of an obligation should be added to the list of permitted exceptions under section 860G to the section 1001 modification rules. These changes would be permitted so long as the obligation continues to be principally secured by an interest in real property. The proposed regulations also would clarify that a release of a lien on real property collateral securing a mortgage does not disqualify a mortgage so long as the mortgage continues to be principally secured by an interest in real property after giving effect to any releases, substitutions, additions or other alterations to the collateral.

Section 1.860G–2(a)(1) of the current regulations provides that an obligation is principally secured by an interest in real property if the fair market value of the real property that secures the obligation equals at least 80 percent of the adjusted issue price of the obligation. The current regulations require the 80-percent test to be satisfied either at the time the obligation was originated or at the time the sponsor contributes the obligation to the REMIC. To ensure that a modified mortgage loan continues to be principally secured by an interest in real property, the proposed regulations require the 80-percent test to be satisfied at the time the mortgage loan is modified as determined by an appraisal performed by an independent appraiser.

To support their proposals, commentators provided examples of loan modification requests that arise with some frequency in commercial mortgage loan securitizations. The majority of those examples involved requests to change the security or credit enhancement of an obligation.

Accordingly, the IRS and Treasury Department expect that, by permitting changes to collateral and changes to the recourse nature of an obligation without regard to the section 1001 modification rules, the proposed regulations will resolve many of the industry’s business concerns arising from borrower requests to modify commercial mortgage loans.

3. Other Modifications

In balancing the competing interests noted in the preceding discussion, however, the IRS and Treasury Department determined that the remainder of the changes requested by commentators to accommodate business needs of the industry could not be adopted in the proposed regulations. First, commentators set forth a proposal to permit changes to the date on which

a commercial mortgage loan may be defeased and to permit the addition of a defeasance provision where the original terms of the mortgage loan do not otherwise provide. By defeasing a commercial mortgage loan, the borrower replaces the underlying real property collateral securing the mortgage with government securities whose payments match the mortgage's payments. Section 1.860G-2(a)(8) of the current regulations permits defeasance of a mortgage loan, under certain conditions, including the condition that the defeasance not occur within 2 years of the startup date of the REMIC. These conditions are intended to ensure that the defeasance transaction is undertaken as part of a customary commercial transaction and not as part of an arrangement to collateralize a REMIC with obligations that are not real estate mortgages.

Commentators indicated that while defeasance is currently the preferred means by which a borrower can obtain an early release from liability on a commercial mortgage, the original terms of commercial loan documents do not always satisfy the current defeasance exception. Submitting parties maintain that expanding the borrower's ability to defease does not violate the policy against replacing real property securing a commercial mortgage with other collateral so long as the defeasance does not occur within two years of the startup date. The IRS and Treasury Department believe, however, 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. Expanding the defeasance exception is not warranted given Congress' intent that REMICs consist of a substantially fixed pool of real estate mortgages and related assets.

Second, commentators set forth a proposal to expand the existing exception for assumptions of the obligation such that any changes to the obligor on a commercial mortgage loan, including the addition or deletion of a co-obligor, would be permitted. In general, a change to the obligor on a nonrecourse debt instrument is not a significant modification for purposes of the section 1001 modification rules. The submitting parties indicated that the vast majority of commercial mortgage loans are nonrecourse. As a result, permitting a borrower to make changes to the obligor on a commercial mortgage would not generally cause the mortgage to cease to be a qualified mortgage. For this reason, the IRS and Treasury Department do not believe that expanding the existing exception for

assumptions of the obligation is necessary to address a business need of the industry that was not already addressed by the current regulations.

Third, the commentators set forth a proposal to allow for the imposition or waiver of a prepayment penalty. The imposition or waiver of a prepayment penalty generally results in a change in yield on an obligation and can further result in a significant modification under § 1.1001-3(e)(2) of the regulations if the annual yield of the modified obligation varies from the unmodified obligation by more than the greater of 25 basis points or 5 percent of the yield of the unmodified instrument. Commentators indicated that although there is an administrative burden imposed on the servicer because the yield change computations are complicated and are performed frequently due to borrower requests, the change in yield resulting from an imposition or waiver of a prepayment penalty does not generally cause a significant modification and does not cause the mortgage to cease to be a qualified mortgage. Accordingly, the IRS and Treasury Department do not believe that adoption of this proposal is necessary to address a business need of the industry that was not already addressed by the current regulations.

Fourth, commentators set forth a proposal to permit changes in the principal payment schedule following a partial prepayment of a mortgage. Commentators indicated that loan documents do not always provide for a reamortization or other adjustment of a principal payment schedule after a partial principal payment on a loan. In general, a material deferral of scheduled principal payments is a significant modification under the section 1001 modification rules. Section 1.1001-3(e)(3)(ii) of the regulations, however, provides a safe harbor period that begins on the original due date of the first deferred payment and extends for a period equal to the lesser of 5 years or 50 percent of the original term of the obligation. In addition, a pro rata prepayment of all of the remaining payments on an obligation does not result in a modification of the portion of the obligation that remains outstanding.

In light of the safe harbor and the rule for pro rata prepayments, it is not clear to the IRS and Treasury Department whether permitting changes to the timing of principal payments is necessary. In addition, it is not clear whether a change in the principal payment schedule of a commercial mortgage loan could result in a change in yield more than the greater of 25

basis points or 5 percent of the yield of the unmodified loan.

Finally, one commentator advocated a new standard to measure materiality for modifications to loans held by a REMIC that departs from the standards set forth under section 1001. The IRS and Treasury Department continue to believe that the section 1001 standard should generally govern modifications of mortgage loans held by a REMIC. The IRS and Treasury Department further believe that adding to the list of exceptions expressly permitted without regard to the section 1001 modifications strikes the appropriate balance between accommodating the business needs of the industry with the requirement that a REMIC remain a substantially fixed pool of mortgages.

4. Interaction With Section 1001

The additional types of modifications permitted by the proposed regulations will exempt the modified obligation from deemed exchange treatment for purposes of § 1.860G-2(b)(1) of the regulations only. For example, a commercial mortgage loan that is modified from nonrecourse to recourse and continues to be principally secured by an interest in real property will continue to be a qualified mortgage and will not be subject to the prohibited transaction tax under section 860F(a)(2). Such a modification, however, is significant under § 1.1001-3 and will be treated as a deemed exchange of the original mortgage loan for a new mortgage loan for purposes of section 1001. Accordingly, any resulting gain or loss under section 1001 must be included in the computation of the REMIC's taxable income.

Effective Date

These regulations are proposed to apply to modifications made to the terms of an obligation on or after publication of this document in the **Federal Register** as a Treasury decision.

Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It has also been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to this regulation.

It is hereby certified that the collection of information requirement in this regulation will not have a significant economic impact on a substantial number of small business entities. This certification is based on the fact that the REMICs affected by this

regulation will not be classified as small business entities. According to the Small Business Administration definition of a "small business," 13 CFR 121.201, a REMIC is classified under Sector 52 (Finance and Insurance), Subsector 525 (Funds, Trusts and Other Financial Vehicles) under the category "Other Financial Vehicle", NAICS code 525990, and is only considered a small business entity if it accumulates less than 6.5 million dollars in annual receipts. REMICs affected by this regulation generally hold pools of commercial mortgage loans with an average loan size of 18.1 million dollars, and have greater than 6.5 million dollars in annual receipts. Therefore, a Regulatory Flexibility Analysis under the Regulatory Flexibility Act (5 U.S.C. chapter 6) is not required.

Pursuant to section 7805(f) of the Internal Revenue Code, this regulation has been submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Comments and Requests for Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written (a signed original and 8 copies) or electronic comments that are submitted timely to the IRS. The IRS and Treasury Department request comments on the clarity of the proposed rules and how they can be made easier to understand. All comments will be available for public inspection and copying. A public hearing will be scheduled if requested in writing by any person that timely submits written comments. If a public hearing is scheduled, notice of the date, time, and place for the public hearing will be published in the **Federal Register**.

Drafting Information

The principal author of these proposed regulations is Diana Imholtz of the Office of Associate Chief Counsel (Financial Institutions and Products). Other personnel from the IRS and Treasury Department participated, however, in their development.

List of Subjects in 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

Proposed Amendments to the Regulations

Accordingly, 26 CFR part 1 is proposed to be amended as follows:

PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 is amended by adding entries in numerical order to read in part as follows:

Authority: 26 U.S.C. 7805 * * *

Section 1.860A-0 also issued under 26 U.S.C. 860G(e).

Section 1.860A-1 also issued under 26 U.S.C. 860G(e).

Section 1.860G-2 also issued under 26 U.S.C. 860G(e). * * *

Par. 2. Section 1.860A-0 is amended by adding an entry for § 1.860G-2(b)(7) to read as follows:

§ 1.860A-0 Outline of REMIC provisions.
* * * * *

§ 1.860G-2 Other rules.
* * * * *

(b) * * *

(7) Principally secured test; appraisal requirement.

* * * * *

Par. 3. Section 1.860A-1 is amended by adding paragraph (b)(6) to read as follows:

§ 1.860A-1 Effective dates and transition rules.
* * * * *

(b) * * *

(6) *Exceptions for certain modified obligations.* Paragraphs (b)(3)(v), (b)(3)(vi) and (b)(7) of § 1.860G-2 apply to modifications made to the terms of an obligation on or after the date of publication of this document in the **Federal Register** as a Treasury decision.

Par. 4. Section 1.860G-2 is amended by:

1. Revising paragraphs (a)(8), (b)(3)(iii) and (b)(3)(iv).

2. Adding paragraphs (b)(3)(v), (b)(3)(vi) and (b)(7).

The additions and revisions read as follows:

§ 1.860G-2 Other rules.

(a) * * *

(8) *Release of interest in real property securing a qualified mortgage; defeasance.* If a REMIC releases its lien on real property that secures a qualified mortgage, that mortgage ceases to be a qualified mortgage on the date the lien is released unless—

(i) The REMIC releases its lien pursuant to a modification described in paragraph (b)(3)(v) of this section addressing changes to the collateral for, guarantees on, or other form of credit enhancement on a mortgage; or

(ii) The mortgage is defeased in the following manner—

(A) The mortgagor pledges substitute collateral that consists solely of

government securities (as defined in section 2(a)(16) of the Investment Company Act of 1940 as amended (15 U.S.C. 80a-1));

(B) The mortgage documents allow such a substitution;

(C) 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

(D) The release is not within 2 years of the startup day.

* * * * *

(b) * * *

(3) * * *

(iii) Waiver of a due-on-sale clause or a due on encumbrance clause;

(iv) Conversion of an interest rate by a mortgagor pursuant to the terms of a convertible mortgage;

(v) 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, so long as the obligation continues to be principally secured by an interest in real property following such release, substitution, addition or other alteration; and

(vi) A change in the nature of the obligation from recourse (or substantially all recourse) to nonrecourse (or substantially all nonrecourse), so long as the obligation continues to be principally secured by an interest in real property following such a change.

* * * * *

(7) *Principally secured test; appraisal requirement.* For purposes of paragraph (b)(3)(v) and (vi) of this section, in determining whether an obligation continues to be principally secured by an interest in real property, the fair market value of the interest in real property securing the obligation, determined as of the date of the modification, must be equal to at least 80 percent of the adjusted issue price of the modified obligation, determined as of the date of the modification. For purposes of this test, the fair market value of the interest in real property securing the obligation must be determined by an appraisal performed by an independent appraiser.

* * * * *

Linda E. Stiff,

Deputy Commissioner for Services and Enforcement.

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