



Commercial Mortgage Securities Association™ (CMSA)

Position Paper

Subject: REMIC Reform

Issue: Modification of underlying mortgage loans can cost a Real Estate Mortgage Investment Conduit (REMIC) its tax-exempt status. Under Internal Revenue Service (IRS) rules, certain loan modifications may be made without affecting a REMIC's tax status. The IRS has issued proposed regulations that would incorporate additional permissible modifications that reflect common modifications to commercial loans.

Background: At the crux of the commercial mortgage-backed securities (CMBS) is a trust that holds a pool of secured commercial mortgage loans. That trust is structured as a statutorily-created holding entity (or "pass through" vehicle) known as a "Real Estate Mortgage Investment Conduit (REMIC)." REMICs, which have become the principal vehicle for CMBS, were authorized by Congress in the "Tax Reform Act of 1986" to allow trusts that satisfy the REMIC requirements to issue multiple classes of securities backed by the trust assets (here, commercial mortgage loans) without any adverse tax consequences to the trust. The REMIC framework enables the trust to hold the loans that are secured by real property without the regulatory, accounting, and economic obstacles that exist in other forms of mortgage-backed securities. REMICs are analogous to limited partnerships or limited liability corporations in that they are created to allow an entity to "pass through" its income and its liabilities directly to its investor beneficiaries. The REMIC trust itself generally pays no tax on the income generated by the trust assets; instead, taxes are paid only by the individual investor(s) holding the residual interest(s) in the REMIC, which avoids double taxation.

To qualify for the REMIC treatment, all mortgage loans held by the REMIC must be "qualified mortgages" that are principally secured by an interest in real property. As a result, the applicable rules require the REMIC to operate as a holding entity for an unchanging (or "static") pool of loans, except when a loan is in default. If modifications are made to a securitized loan that is not in default, the REMIC runs the risk of being viewed as a business entity rather than a holding entity, and thus may be required, for example, to pay entity-level taxes.

Specifically, Section 1001 of the Internal Revenue Code requires that the pool of loans comprising a REMIC must be static. That is, if a loan is exchanged – or deemed exchanged – for a new loan, the REMIC will lose its tax-exempt status, triggering adverse tax consequences for investors. A loan will be "deemed exchanged" for a new loan if a significant modification is made to the original loan after the obligation has been contributed to the REMIC, and the modification is not one of the four types expressly permitted under section 1.860G-2(b)(3) of the regulation. If the modification does not fall into one of the four categories, the modified obligation will not be a qualified mortgage and the REMIC will lose its tax-exempt status.

The four types of loan modifications expressly permitted under section 1.860G-2(b)(3) are: (1) changes in the terms of the obligation occasioned by default or a reasonably foreseeable default; (2) assumption of the obligation; (3) waiver of a due-on-sale clause or a due on encumbrance clause; and (4) conversion of an interest rate by a mortgagor pursuant to the terms of a convertible mortgage.

As such, maintaining REMIC's ongoing tax-exempt status can require REMIC borrowers to obtain costly tax opinions to make basic real estate management decisions aimed at benefiting both the property and REMIC investors. Some examples of common loan document revisions include: tenant expansions or replacements of insolvent tenants; releases of tenant escrows or lease termination payments for re-tenanting or paying debt service shortfalls; collateral substitutions of equal or greater value; and collateral additions.

The REMIC rules were first developed in 1992, at a time when the mortgage-backed securities market involved primarily residential mortgage loans, and the four permissible types of loan modifications discussed above cover the most common changes affecting residential mortgage loans. However, they do not address common situations that now arise with respect to commercial mortgage loans held by REMICs. As a result, commercial property owners have found that borrowing through a REMIC can make it more difficult to modify performing loans in order to meet reasonable requests for managing the underlying collateral.

In early 2007, the IRS and the Treasury Department issued a request for submissions regarding possible amendments to the REMIC regulations to expand the list of permitted loan modifications to include certain modifications incurred in connection with commercial mortgages. In response, CMSA and several other trade organizations suggested the addition of six new types of loan modifications to those currently permitted under the REMIC regulations. The six proposed loan modifications include: (1) changes in loan collateral; (2) changes in the time a loan can be prepaid; (3) changes in the recourse/non-recourse nature of a loan; (4)

changes in the loan obligor(s); (5) changes regarding prepayment penalties; and (6) certain changes to the principal payment schedule of a loan.

On November 9, 2007, the IRS published proposed rules on modifications of commercial mortgage loans held by a REMIC. Although they do not address all six issues proposed by CMSA and the other industry groups, the proposed rules add two additional types of loan modifications to the list of permitted loan modifications: (1) changes in collateral, guarantees and credit enhancement of an obligation; and (2) changes to the recourse nature of an obligation. 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.

CMSA Position: REMIC is critical to the current and future capital and liquidity that fuels CMBS and the overall commercial real estate sector. For the past several years, CMSA along with its industry coalition partners have been seeking modernization of the REMIC rules to keep pace with current transactional needs and reflect current market realities. CMSA believes that revising the rules to address commercial loan modifications will help ease the legal burden on the industry in connection with securing tax opinions and will, in the long run, protect investor value.

Status: The comment period for the proposed rule will close on February 7, 2008. Final rules will be issued at a subsequent date. CMSA, as a part of the REMIC industry coalition, will submit specific comments on the proposed rule prior to the close of the comment period.