

August 18, 2010

TO: The Commercial Real Estate
Finance Council

FROM: Scott A. Sinder
Philip R. West

RE: New Internal Revenue Service Revenue Procedure Addressing the Test for Real
Estate Mortgage Investment Conduit (“REMIC”) Qualified Mortgages in
Connection with Lien Releases

Overview

You have requested a brief analysis of Internal Revenue Service Revenue Procedure 2010-30, which was issued August 17, 2010 and addresses the test for REMIC qualified mortgages in connection with lien releases. Revenue Procedure 2010-30 sets forth two circumstances under which a lien release will not cause a mortgage to cease to be a qualified mortgage: a “grandfathered transaction” or a “qualified pay-down transaction.” Revenue Procedure 2010-30 should help REMICs avoid disqualification due to lien releases.

Background

Under Internal Revenue Code (“IRC”) section 860D(a)(4), an entity qualifies as a REMIC only if substantially all of its assets are “qualified mortgages” and permitted investments. A mortgage can be a “qualified mortgage” only if it is “principally secured” by an

interest in real property.¹ Treas. Reg. § 1.860G-1(a)(i) provides for a test, the “80-percent test,” that determines whether a mortgage is “principally secured.” Under the 80-percent test, a mortgage qualifies if the fair market value (“FMV”) of the interest in real property securing it was equal to 80 percent of the adjusted issue price of the mortgage when it was originated or at the time the mortgage was contributed to the REMIC.

A REMIC’s release of its lien on an interest in real property that secures a qualified mortgage is generally a modification that requires that the mortgage be retested. Upon retesting, either the 80-percent test must be met for the mortgage as modified by the lien release, or the FMV of the real property securing the mortgage after modification must equal or exceed the value before modification.² When there are significant declines in commercial real estate property values, borrowers may obtain lien releases in circumstances that do not satisfy either of the preceding tests, for example, because the release occurred under the terms of the mortgage or in the context of the borrower paying down the mortgage.

Impact of Revenue Procedure 2010-30

Revenue Procedure 2010-30 provides for two circumstances under which such a release will not cause the mortgage to cease to be a qualified mortgage: a “grandfathered transaction” or a “qualified pay-down transaction.” If the loan servicer reasonably believes that a transaction satisfies the “grandfathered transaction” or “qualified pay-down transaction” test as of the date of the lien release, then such test is deemed satisfied.

¹ IRC section 860G(a)(3)(A).

² Treas. Reg. § 1.860G-2(b)(7)(ii) and (iii).

In a grandfathered transaction, the lien release must have occurred by operation of the terms of the debt instrument (including a lien release pursuant to the exercise of a unilateral option of the borrower) and the terms of the release are contained in a contract executed no later than December 6, 2010.

In a qualified pay-down transaction, the lien is released in the context of a transaction in which the borrower makes a payment that reduces the adjusted issue price of the loan by a “qualified amount.” A qualified amount is equal to the lowest of (1) the amount the borrower would have received upon a sale or condemnation of the property, (2) the adjusted issue price of the mortgage when the lien was released, multiplied by a ratio equal to the FMV of the released interest/FMV of all the properties securing the loan, (3) the FMV of the property securing the loan, or (4) an amount that does not cause the ratio of the adjusted issue price of the loan to the FMV of the real properties securing the loan to increase.

In sum, Revenue Procedure 2010-30 relaxes the test for REMIC qualified mortgages in the context of certain types of lien releases, and should help REMICs avoid disqualification due to lien releases.

* * *