

## Part III

### Administrative, Procedural, and Miscellaneous

26 CFR 601.105: Examination of returns and claims for refund, credit or abatement; determination of correct tax liability.

(Also Part I, §§ 860D, 860F, 860G, 1001; 1.860G-2, 1.1001-3, 301.7701-2, 301.7701-3, 301.7701-4.)

Rev. Proc. 2009-45

#### SECTION 1. PURPOSE

This revenue procedure describes the conditions under which modifications to certain mortgage loans will not cause the Internal Revenue Service (Service) to challenge the tax status of certain securitization vehicles that hold the loans or to assert that those modifications give rise to prohibited transactions.

No inference should be drawn about whether similar consequences would obtain if a transaction falls outside the limited scope of this revenue procedure. Furthermore, there should be no inference that, in the absence of this revenue procedure, transactions within its scope would have impaired the tax status of securitization vehicles or would have given rise to prohibited transactions.

## SECTION 2. BACKGROUND—COMMERCIAL MORTGAGE LOANS

.01 Under the terms of many commercial mortgage loans, all or a large portion of the original stated principal is due at maturity. Typically, at the time of loan origination, both the borrower and the lender expected the borrower to obtain funds to satisfy the large payment at maturity by obtaining a new mortgage loan secured by the same underlying interest in real property.

.02 The current situation in the credit markets is affecting the availability of financing and refinancing for commercial real estate. In particular, borrowers under many of the commercial mortgage loans that will mature in the next few years are concerned that they will encounter great difficulty in obtaining refinancing for these loans. Because they had always anticipated using the proceeds from refinancing to satisfy the principal balance due at maturity, these borrowers are often at risk of defaulting when their loans mature. This may be true even for loans in which the underlying commercial real estate is providing more than enough cash flow to satisfy debt service before maturity.

.03 Many commercial mortgage loans are held in securitization vehicles such as investment trusts and real estate mortgage investment conduits (REMICS). Typically, these pools of loans are administered by servicers that handle the day-to-day operations of the mortgage loan pools and by special servicers that handle the modification and restructuring of defaulted loans, as well as foreclosure or similar conversion of defaulted mortgage loan property.

.04 Many loan pool administrators have developed and implemented procedures for monitoring both the status of the commercial properties securing the mortgage loans

and the likelihood of borrowers being able to refinance their mortgage loans or sell the mortgaged property as the loans mature. The personnel who implement these procedures are often experienced in negotiating with borrowers, restructuring troubled commercial loans, and foreclosing on commercial properties. It may be possible, therefore, to foresee impending difficulties for a mortgage loan well in advance of any actual payment default.

.05 Many industry participants have concluded that the monitoring procedures that have been adopted and the level of experience of those implementing the procedures make it possible to assess with substantial accuracy whether particular commercial mortgage loans present an unacceptably high risk of eventual foreclosure. It may be possible to foresee this risk of foreclosure even when no payment default has yet occurred and when the event of default may not occur until the maturity of the loan.

.06 Many industry participants have also concluded that it is possible to predict with a reasonable degree of accuracy whether proposed modifications will allow mortgage loans to continue to perform (and so avoid the necessity of property foreclosure). Modifications that may be considered include interest rate changes, principal forgiveness, extensions of maturity, and alterations in the timing of changes to an interest rate or to a principal amortization schedule. In many cases, modifications that include extensions of the maturity and, thus, postpone the need for refinancing, may reduce the risk of foreclosure.

.07 Often the complexity of the mortgage loans themselves and the consequent complexity of modifications to them necessitate a substantial period prior to any expected payment or maturity default for the negotiation of any such modifications.

### SECTION 3. BACKGROUND—REMICs

.01 REMICs are widely used securitization vehicles for mortgages. REMICs are governed by sections 860A through 860G of the Internal Revenue Code.

.02 For an entity to qualify as a REMIC, all of the interests in the entity must consist of one or more classes of regular interests and a single class of residual interests, see section 860D(a), and those interests must be issued on the startup day, within the meaning of § 1.860G–2(k) of the Income Tax Regulations.

.03 A regular interest is one that is designated as a regular interest and whose terms are fixed on the startup day. Section 860G(a)(1). In addition, a regular interest must (1) unconditionally entitle the holder to receive a specified principal amount (or other similar amount), and (2) provide that interest payments, if any, at or before maturity are based on a fixed rate (or to the extent provided in regulations, at a variable rate).

.04 An interest issued after the startup day does not qualify as a REMIC regular interest.

.05 Under section 860D(a)(4), an entity qualifies as a REMIC only if, among other things, as of the close of the third month beginning after the startup day and at all times thereafter, substantially all of its assets consist of qualified mortgages and permitted investments. This asset test is satisfied if the entity owns no more than a *de minimis* amount of other assets. See § 1.860D–1(b)(3)(i). As a safe harbor, the amount of assets other than qualified mortgages and permitted investments is *de minimis* if the aggregate of the adjusted bases of those assets is less than one percent of the aggregate of the adjusted bases of all of the entity's assets. § 1.860D–1(b)(3)(ii).

.06 With limited exceptions, a mortgage loan is not a qualified mortgage unless it is transferred to the REMIC on the startup day in exchange for regular or residual interests in the REMIC. See section 860G(a)(3)(A)(i).

.07 The legislative history of the REMIC provisions indicates that Congress intended the provisions to apply only to an entity that holds a substantially fixed pool of real estate mortgages and related assets and that “has no powers to vary the composition of its mortgage assets.” S. Rep. No. 99–313, 99<sup>th</sup> Cong., 2<sup>d</sup> Sess. 791–92, 1986–3 (Vol. 3) C.B. 791–92.

.08 Section 1.1001–3(c)(1)(i) defines a “modification” of a debt instrument as any alteration, including any deletion or addition, in whole or in part, of a legal right or obligation of the issuer or holder of a debt instrument, whether the alteration is evidenced by an express agreement (oral or written), conduct of the parties, or otherwise. Section 1.1001–3(e) governs which modifications of debt instruments are “significant.” Under § 1.1001–3(b), for most federal income tax purposes, a significant modification produces a deemed exchange of the original debt instrument for a new debt instrument.

.09 Under § 1.860G–2(b), related rules apply to determine REMIC qualification. Except as specifically provided in § 1.860G–2(b)(3), if there is a significant modification of an obligation that is held by a REMIC, then the modified obligation is treated as one that was newly issued in exchange for the unmodified obligation that it replaced. See § 1.860G-2(b)(1). For this purpose, the rules in § 1.1001–3(e) determine whether a modification is “significant.” See § 1.860G-2(b)(2). Thus, even if an entity initially qualifies as a REMIC, one or more significant modifications of loans held by the entity

may terminate the qualification if the modifications cause less than substantially all of the entity's assets to be qualified mortgages.

.10 Certain loan modifications, however, are not significant for purposes of § 1.860G-2(b)(1), even if the modifications are significant under the rules in § 1.1001-3. In particular, under § 1.860G-2(b)(3)(i), if a change in the terms of an obligation is “occasioned by default or a reasonably foreseeable default,” the change is not a significant modification for purposes of § 1.860G-2(b)(1), regardless of the modification's status under § 1.1001-3.

.11 Discussions between a holder or servicer and a borrower concerning a possible modification of a loan may occur at any time and need not begin only after the loan is in default or there is a reasonably foreseeable default.

.12 The Service understands that many industry participants believe that a loan modification necessarily fails to be “occasioned by default or a reasonably foreseeable default” unless the loan is not performing or default is imminent.

.13 Section 860F(a)(1) imposes a tax on REMICs equal to 100 percent of the net income derived from “prohibited transactions.” The disposition of a qualified mortgage is a prohibited transaction unless the “disposition [is] pursuant to—(i) the substitution of a qualified replacement mortgage for a qualified mortgage . . . , (ii) a disposition incident to the foreclosure, default, or imminent default of the mortgage, (iii) the bankruptcy or insolvency of the REMIC, or (iv) a qualified liquidation.” Section 860F(a)(2)(A).

.14 Under section 860C(b)(1), “The taxable income of a REMIC shall be determined under an accrual method of accounting . . . except that— . . . (C) there shall

not be taken into account any item of income, gain, loss, or deduction allocable to a prohibited transaction, . . . .”

#### SECTION 4. BACKGROUND—TRUSTS

.01 Section 301.7701–2(a) of the Procedure and Administration Regulations defines a “business entity” as any entity recognized for federal tax purposes (including an entity with a single owner that may be disregarded as an entity separate from its owner under § 301.7701–3) that is not properly classified as a trust under § 301.7701–4 or otherwise subject to special treatment under the Code.

.02 Section 301.7701–4(a) provides that an arrangement is treated as a trust if the purpose of the arrangement is to vest in trustees responsibility for the protection and conservation of property for beneficiaries who cannot share in the discharge of this responsibility and, therefore, are not associates in a joint enterprise for the conduct of business for profit.

.03 Section 301.7701–4(c) provides that an “investment” trust is not classified as a trust if there is a power under the trust agreement to vary the investment of the certificate holders.

#### SECTION 5. SCOPE

This revenue procedure applies to a modification (including an actual exchange to which § 1.1001-3 applies) of a mortgage loan (the “pre-modification loan”) that is held by a REMIC, or by an investment trust, if all of the following conditions are satisfied:

.01 The pre-modification loan is not secured by a residence that contains fewer than five dwelling units and that is the principal residence of the issuer of the loan.

.02 Either—(1) If a REMIC holds the pre-modification loan, then as of the end of the 3-month period beginning on the startup day, no more than ten percent of the stated principal of the total assets of the REMIC was represented by loans fitting the following description: At the time of contribution to the REMIC, the payments on the loan were then overdue by at least 30 days or a default on the loan was reasonably foreseeable; or

(2) If an investment trust holds the pre-modification loan, then as of all dates when assets were contributed to the trust, no more than ten percent of the stated principal of all the debt instruments then held by the trust was represented by instruments the payments on which were then overdue by 30 days or more or for which default was reasonably foreseeable.

.03 Based on all the facts and circumstances, the holder or servicer reasonably believes that there is a significant risk of default of the pre-modification loan upon maturity of the loan or at an earlier date. This reasonable belief must be based on a diligent contemporaneous determination of that risk, which may take into account credible written factual representations made by the issuer of the loan if the holder or servicer neither knows nor has reason to know that such representations are false. In a determination of the significance of the risk of a default, one relevant factor is how far in the future the possible default may be. There is no maximum period, however, after which default is per se not foreseeable. For example, in appropriate circumstances, a holder or servicer may reasonably believe that there is a significant risk of default even though the foreseen default is more than one year in the future. Similarly, although past performance is another relevant factor for assessing default risk, in appropriate

circumstances, a holder or servicer may reasonably believe that there is a significant risk of default even if the loan is performing.

.04 Based on all the facts and circumstances, the holder or servicer reasonably believes that the modified loan presents a substantially reduced risk of default, as compared with the pre-modification loan.

## SECTION 6. APPLICATION

If one or more modifications of pre-modification loans are within the scope of Section 5 of this revenue procedure—

.01 The Service will not challenge a securitization vehicle's qualification as a REMIC on the grounds that the modifications are not among the exceptions listed in § 1.860G-2(b)(3);

.02 The Service will not contend that the modifications are prohibited transactions under section 860F(a)(2) on the grounds that the modifications result in one or more dispositions of qualified mortgages and that the dispositions are not among the exceptions listed in section 860F(a)(2)(A)(i)–(iv);

.03 The Service will not challenge a securitization vehicle's classification as a trust under § 301.7701-4(c) on the grounds that the modifications manifest a power to vary the investment of the certificate holders; and

.04 The Service will not challenge a securitization vehicle's qualification as a REMIC on the grounds that the modifications result in a deemed reissuance of the REMIC regular interests.

## SECTION 7. EXAMPLE

The following example illustrates the application of this revenue procedure:

.01 Facts. As part of its business, S services mortgage loans that are held by R, a REMIC that is described in Section 5.02(1) of this revenue procedure. Borrower B is the issuer of one of the mortgage loans held by R. B's mortgage loan is non-amortizing, and thus the entire principal amount is due upon maturity. The real property securing B's mortgage loan is an office building. All of B's required payments on the mortgage loan have been timely, and the loan is not scheduled to mature for another 12 months. B expects that in order to repay the loan when it matures, B will have to refinance the maturing mortgage loan into a newly issued mortgage loan. There are factors, however, that indicate that refinancing options may be unavailable to B at the time the mortgage loan matures. These factors include either or both of the following: current economic conditions in the relevant credit markets, and the current market value of the real property securing the loan. B provides a written factual representation to S showing that B will probably not be able to repay or refinance the mortgage loan at maturity. S neither knows, nor has reason to know, that the representation is false.

Based on all the facts and circumstances and a diligent contemporaneous determination, S reasonably believes that, if the loan to B is not modified, there is a significant risk of default by B upon maturity of the mortgage loan. Therefore, S and B agree to modify the mortgage loan by extending its maturity and increasing the interest rate. S reasonably believes that this modification reduces the risk of default. The modification is a significant modification under § 1.1001-3(e). The modification occurs after the effective date of this revenue procedure.

.02 Analysis. S reasonably believed that the pre-modification loan presented a significant risk of default and that the modification substantially reduced that risk.

Accordingly, the modification is within the scope of this revenue procedure.

#### SECTION 8. EFFECTIVE DATE

This revenue procedure applies to loan modifications effected on or after January 1, 2008.

#### SECTION 9. DRAFTING INFORMATION

The principal author of this revenue procedure is Diana Imholtz of the Office of Associate Chief Counsel (Financial Institutions and Products). For further information, contact Ms. Imholtz on (202) 622–3930 (not a toll-free call).