

IRS Issues Guidance Concerning Modifications for CMBS Loans

As concerns have been raised about increasing securitized loan delinquencies, particularly in light of the estimated \$150 billion of commercial mortgage-backed securities (CMBS) loans maturing through 2012, many CMBS industry participants have focused on how to facilitate loan modifications. Favorable tax treatment for CMBS presumes that the loan pools are static. Accordingly, with certain exceptions, any modification to a loan jeopardizes the tax treatment for the pool of securities. In addition, the terms of pooling and servicing agreements (PSAs) that govern the relationship among the investors and the servicers for the pooled CMBS loans reflect both the tax rules and the expectations of investors that loans will not routinely be modified.

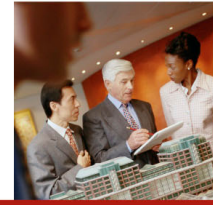
Last week the Internal Revenue Service (IRS) released changes to the tax rules (the “New Regulations”) that expand the list of permitted loan modifications and a Revenue Procedure that further attempts to facilitate loan modifications. These releases by the IRS respond to various requests that have been pending for several years for modernization of the laws governing real estate mortgage investment conduits (REMICs) and related CMBS loans, as well as more recent proposals for changes.

NEW REGULATIONS

The prior regulations (the “Prior Regulations”) permitted limited modifications to CMBS loans, including changes to a loan’s terms that are occasioned by default or a reasonably foreseeable default, without causing adverse tax consequences to investors in the CMBS. The Prior Regulations also permitted lien releases without adverse tax consequences in certain limited situations.

The New Regulations add three permitted types of loan modifications for certain qualifying loans: changes in collateral, including release of a lien; changes in guarantees and credit enhancement of an obligation; and changes to the recourse nature of an obligation. The New Regulations also clarify that a lien release that is not otherwise a prohibited modification (such as a lien release that is contemplated by the loan documents at origination or the release of a lien when the underlying loan is in default or default is reasonably foreseeable) will not jeopardize the REMIC’s tax-favored status.

In general, a CMBS loan held by a REMIC must be “principally secured” by an interest in real property. To meet this requirement, the value of the real property securing each mortgage loan at the time of origination or when the loan was contributed to the REMIC is required to be at least 80 percent of the value of the loan (the “80 Percent Test”). Under the New Regulations, in order to qualify for one of the new permitted loan modifications (including the expanded lien release rule), the value of the real property securing the loan to be modified must continue to meet the 80 Percent Test at the time of modification, or if the 80 Percent Test is not met, the fair market value of the



real property collateral immediately after the modification must equal at least the fair market value immediately prior to the loan modification (the “Alternative Test”). This re-testing requirement applies to all of the permitted loan modifications addressed by the New Regulations, but not to other permitted modifications.

In determining the value of the real property collateral securing the loan proposed to be modified, the New Regulations permit the servicer to rely on one of the following: a current appraisal performed by an independent appraiser; an update to an appraisal performed at origination; a substantially contemporaneous sales contract for the real property in which the buyer would have assumed the seller’s obligation under the loan; or some other commercially reasonable valuation method. The re-testing requirement may add quite a hurdle in the current environment, as it is widely believed that values of many commercial real estate assets have decreased, but the lack of current transactions in the markets means appraisers have a dearth of information upon which to base a valuation. However, the availability of the Alternative Test should be helpful in many situations, such as loan modifications that involve a credit enhancement.

The New Regulations are effective as of September 16, 2009 and consequently may impact modifications that are in progress.

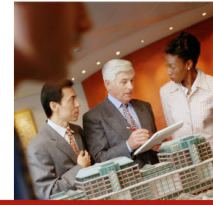
REVENUE PROCEDURE 2009-45

The Revenue Procedure establishes a safe harbor for certain loan modifications aimed at addressing maturity defaults, even in those situations in which a loan continues to be performing and no default is apparently imminent. By doing so, it endorses the commencement of loan modification discussions earlier than has been the common practice. The types of loan modifications facilitated by the Revenue Procedure include interest rate changes, principal forgiveness, extensions of the maturity date and alterations to the timing of interest rate resets and adjustments to amortization schedules.

The Revenue Procedure notes that “[t]he [IRS] 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.” This stated IRS understanding reflects both the Prior Regulations and that typically PSAs do not contemplate communications between the borrower and the special servicer (who is responsible for negotiating the type of loan modifications many borrowers currently are seeking, such as extensions of maturity dates) until after default has occurred or until a default is “imminent.”

To fall within the Revenue Procedure’s safe harbor, the servicer must have a reasonable belief that there is a significant risk of default upon maturity or at an earlier date and that the loan as proposed to be modified will present a substantially reduced risk of default, when compared with the pre-modification loan. The example given in the Revenue Procedure contemplates a modification that is approved 12 months before the maturity date.

Revenue Procedure 2009-45 is effective retroactive to January 1, 2008.



COMMENTS

The IRS's endorsement of earlier discussions between borrowers and servicers regarding loan modifications is welcome news to borrowers. Despite these efforts by the IRS to provide flexibility to borrowers and servicers, however, the application of the 80 Percent Test at the time of modification is likely to present challenges for borrowers and servicers. In addition, while the Revenue Procedure establishes a safe harbor that may be very helpful, it does not change the terms of PSAs governing contractual obligations of master servicers and special servicers, which could present conflicts both with the timetable for loan modifications permitted by this safe harbor and the requirement that servicers service the loans for the benefit of all investors in the CMBS pool. For example, although a loan modification of the type addressed by the IRS's actions may benefit the borrower, often it is not clear that these loan modifications will benefit all the CMBS investors. Furthermore, many investors have expressed concerns about regulatory efforts to encourage loan modifications. Accordingly, while the IRS's actions may facilitate earlier dialogue concerning loan modifications, it remains to be seen whether borrowers and servicers will find significant additional latitude for loan modifications due to the changes effected by the New Regulations and the guidance provided by the Revenue Procedure.

FOR MORE INFORMATION

If you have questions on this topic, please contact:

Marci P. Schmerler	404.541.2982	Marci.Schmerler@ThompsonHine.com
Linda A. Striefsky	216.566.5733	Linda.Striefsky@ThompsonHine.com

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