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CLIENT ALERT

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Contacts

Richmond Office
Riverfront Plaza, East Tower
951 East Byrd Street
Richmond, Virginia 23219-4074

George C. Howell, III
(804) 788-8793
ghowell@hunton.com

Cecelia Philipps Horner
(804) 788-7394
chorner@hunton.com

Kendal A. Sibley
(804) 788-8697
ksibley@hunton.com

IRS Provides Guidance on Lien Releases for Commercial Mortgage Loans Held by REMICs

On August 17, 2010, the Internal Revenue Service ("IRS") issued Revenue Procedure 2010-30 (the "Revenue Procedure"), which provides that certain lien releases will not cause a mortgage loan to fail to be a "qualified mortgage" for federal income tax purposes. Treasury regulations applicable to real estate mortgage investment conduits ("REMICs") issued on September 16, 2009 (the "Modification Treasury Regulations") require mortgage loans held by REMICs to meet a principally secured test (the "Principally Secured Requirement") after a lien release, even for releases occasioned by default or condemnation or pursuant to the original loan terms. The Principally Secured Requirement can be difficult to satisfy in the context of partial releases, which are common in the case of commercial mortgage loans that are secured by multiple parcels of property. As described below, the Revenue Procedure provides that the IRS will not challenge a mortgage loan's status as a qualified mortgage for failure to meet the Principally Secured Requirement in two situations: a "grandfathered transaction" or a "qualified pay-down transaction." The Revenue Procedure is effective for lien releases on or after September 16, 2009, the date of the Modification Treasury Regulations.

Modification Treasury Regulations

In general, mortgage loans held by a REMIC must be qualified mortgages. A qualified mortgage must be principally secured by real property. The Modification Treasury Regulations provide that if a REMIC releases its lien on an interest in real property that secures a qualified mortgage, the mortgage loan generally ceases to be a qualified mortgage on the date the lien is released unless (1) the mortgage loan is defeased with government securities in the manner described in the Treasury regulations applicable to REMICs or (2) the lien is released in a modification that satisfies both of the following criteria:

> (1) the modification either is not a significant modification or is not treated as a significant modification for REMIC purposes; and
>
> (2) following the modification, the mortgage loan satisfies the Principally Secured Requirement.

The Modification Treasury Regulations provide that a mortgage loan meets the Principally Secured Requirement after a modification only if (1) after the modification, the fair market value of the interest in real property securing the mortgage loan is at least 80 percent of the adjusted issue price of the modified mortgage loan or, alternatively, (2) the fair market value of the interest in real property that secures the mortgage loan immediately after the modification equals or exceeds the fair market value of the interest in real property that secured the mortgage loan immediately before the modification. Because of the decreases in real property values over the last several years, the fair market value of real property securing a mortgage loan is often less

than 80 percent of the principal balance of the mortgage loan. For many modifications, the alternative test is easily satisfied, if the modification does not affect the real property. However, prior to the Revenue Procedure, it appeared that partial lien releases could not satisfy the alternative test.

Revenue Procedure

The Revenue Procedure applies to a release of a lien on an interest in real property that secures a mortgage loan held by a REMIC in circumstances in which the Principally Secured Requirement may not be satisfied. The Revenue Procedure provides that any lien release that qualifies as either a "grandfathered transaction" or a "qualified pay-down transaction" need not meet the Principally Secured Requirement.

- A "grandfathered transaction" is any release of a lien on an interest in real property that satisfies the following two criteria:

  (1) the lien release is not a modification for federal income tax purposes because it 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

  (2) the terms providing for the lien release are contained in a contract that was executed no later than December 6, 2010.

- A "qualified pay-down transaction" is a transaction in which a lien is released on an interest in real property and the borrower makes a payment that reduces the adjusted issue price of the mortgage loan by a "qualified amount." In general, a "qualified amount" is an amount that is equal to or greater than at least one of the following:

  (1) the net proceeds available to the borrower from an arm's-length sale of the released real property to an unrelated party or from a condemnation proceeding, including any insurance or tort settlement related to the property;

  (2) an amount determined under the loan agreement that equals or exceeds the released interest's proportionate part of the adjusted issue price of the mortgage loan, based on the relative fair market value of the interests in real property securing the loan at the time of origination;

  (3) the fair market value (at the time of the transaction) of the released interest, including any insurance or tort settlement related to the property; or

  (4) an amount such that, immediately after the transaction, the loan-to-value ratio is no greater than what the ratio was immediately before the transaction.

For the criteria in (3) and (4) above, if the servicer reasonably believes that the transaction satisfies one of these criteria, based on a current appraisal, original (and updated) appraisal, sales price in an arm's-length transaction or other commercially reasonable valuation method, then the criterion is deemed to be satisfied.

Implications

The Revenue Procedure provides comfort to lenders and servicers that they can comply with the terms of mortgage loan documents executed prior to December 6, 2010, that permit lien releases at the unilateral option of the borrower without endangering the status of the REMIC holding the mortgage loan. The Revenue Procedure also provides comfort in situations beyond the lender's and borrower's control, such as condemnations. Finally, the Revenue Procedure permits partial lien releases where there is an appropriate pay-down of the related loan, as described above. Whether a pay-down fits within the requirements of the Revenue Procedure will depend on the particular facts and circumstances surrounding the lien release, but it is expected that most partial lien release provisions will meet at least one of the four pay-down criteria. For mortgage loan documents executed on or after December 6, 2010, the Principally Secured Requirement and the definition of "qualified amount," as described above, should be taken into account.

A copy of the Revenue Procedure is available here. If you would like to receive more information about the Revenue Procedure, please contact George C. Howell III at (804) 788-8793 or ghowell@hunton.com, Cecelia Philipps Horner at (804) 788-7394 or chorner@hunton.com, or Kendal A. Sibley at (804) 788-8697 or ksibley@hunton.com.

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