April 30, 2007

Hand Delivered

CC:PA:LPD:RU (Notice 2007-17)
Courier's Desk
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, DC 20224

Re: Modifications of Commercial Mortgage Loans Held by a REMIC

Ladies and Gentlemen:

The undersigned organizations, representing substantial segments of the commercial real estate industry, are pleased to respond to the request of the Internal Revenue Service and the Treasury Department in Notice 2007-17 for submissions regarding possible amendments to the real estate mortgage investment conduit ("REMIC") regulations that would expand the list of permitted loan modifications to include certain modifications incurred in connection with commercial mortgages.

As indicated in the Notice, the current REMIC regulations permit four specific types of loan modifications that can be made to loans held by a REMIC without disqualifying the REMIC. We believe that these regulations, adopted 15 years ago at a time when the mortgage-backed securities market involved mainly residential mortgage loans, do not address common situations that now arise with respect to commercial mortgage loans held by REMICs. Accordingly, we recommend that the Treasury Department and the IRS amend the REMIC regulations to include additional types of permitted loan modifications, described in this submission, that are responsive to situations that now regularly arise in the context of commercial mortgage loans.

As requested in Notice 2007-17, we are submitting herewith draft changes to the REMIC regulations and a policy memorandum responding to the specific questions the Notice raises. The attached draft changes to the REMIC regulations would add to the four types of loan modifications now permitted six additional types of permitted modifications. The additional permitted modifications we propose generally relate to: changes in loan collateral; changes in the time a loan can be prepaid; changes in the recourse/non-recourse nature of a loan; changes in the loan obligor(s); changes regarding prepayment penalties; and certain changes to the principal payment schedule of a loan. We also propose coordinating the REMIC regulations with the rules applicable to grantor trusts.

The existing REMIC loan modification rules pose an impediment to the use of REMICs in the commercial mortgage context. We believe that the amendments to the REMIC regulations we propose will remedy this situation and are consistent with the goal of Congress in enacting the REMIC rules – to provide a flexible vehicle for the issuance of securities backed by mortgage loans.

We very much appreciate the willingness of Treasury and the IRS to revisit the REMIC regulations in light of developments since the current regulations were issued in 1992. We also appreciate that the Treasury Department and the Internal Revenue Service have reached out to taxpayers, industry organizations, and other interested parties in advance of issuing proposed regulations because we believe that any proposed regulations that Treasury and IRS ultimately may decide to issue will benefit from these advance submissions.

We stand prepared to answer any questions you may have regarding our submission. Please direct any questions to Jennifer Williams of the Mortgage Bankers Association at (202) 557-2918 (jwilliams@mortgagebankers.org).

Sincerely,

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Attachments

Draft Changes to REMIC Regulations

(1) Treas. Reg. §1.860G-2(b)(3) is modified by striking "and" at the end of subparagraph (iii), deleting "mortgage." at the end of subparagraph (iv), and inserting in its place the following:

"mortgage;

(v) a modification that releases, adds, substitutes or otherwise alters any portion of the collateral for, a guarantee of, or other form of credit enhancement for the obligation, whether recourse or nonrecourse (other than an alteration that causes the obligation not to be principally secured by an interest in real property);

(vi) a change in the date on which the obligation may be prepaid or defeased in whole or in part, or addition of a defeasance provision that meets the requirements of paragraph (a)(8) of this section;

(vii) a change in the obligation from recourse (or substantially all recourse) to nonrecourse (or substantially all nonrecourse), or vice versa;

(viii) a substitution of a new obligor or addition or deletion of a co-obligor on the obligation;

(ix) an imposition or waiver of a prepayment penalty or other fee; and

(x) a change of the principal payment schedule of a loan following a voluntary or involuntary prepayment of principal."

(2) Treas. reg. §1.860G-2(b) is amended by adding at the end thereof the following new paragraph:

"(7) *Coordination with grantor trust rules*. A grantor shall not fail to be treated as the owner of any portion of a trust under sections 671 through 679 and the regulations thereunder solely because such portion includes one or more obligations with respect to which a modification described in paragraph (3) (or any other modification that is not a significant modification within the meaning of paragraph (2)) has been, or may be, made under the terms of such trust. The ability of a trust to make such modifications shall not be treated as a power to "vary the investment of the certificate holders" for purposes of §301.7701-4(c)."

Policy Memorandum re: Changes to REMIC Regulations

This Policy Memorandum responds to the questions posed in Notice 2007-17 regarding potential changes to the regulations (Treas. Reg. §1.860G-2(b)) regarding the types of modifications that are permitted with respect to loans held by real estate mortgage investment conduits ("REMICs"). Paragraph numbers below correspond to the numbered questions in Notice 2007-17

1. Evolution of market practices.

The market for the securitization of commercial mortgage loans[1] through REMICs was slow to get started, with $1.4 billion securitized per year, on average, in the 1980s and $5.6 billion in 1990. This market was fostered through the involvement of the government sponsored Resolution Trust Corporation ("RTC"), whose mandate was to liquidate the assets of failed thrift institutions. Over the period 1991-1993, the RTC sponsored $14.6 billion of the total of $40.7 billion of commercial mortgage-backed securities issued during that period.[2] As a government "deep pocket," the RTC helped standardize the features of these types of securities, helped develop a substantial investor base, enabled market participants to develop their analytical technologies, and helped create liquidity in the commercial real estate market by fostering the development of financing through the capital markets.[3] The foundation provided by the RTC transactions gave rise to "conduit" programs, in which investment banks, commercial banks and other mortgage originators securitize pools of small to medium sized commercial loans or portions of larger loans; "large loan" programs, in which a smaller number of relatively large loans are packaged and sold to investors; "stand-alone" deals, in which very large, individual loans are securitized; and "fusion" deals, in which multiple originators sell their loans to one of them as the sponsor of a joint securitization. As real property values and loan sizes have risen, many larger loans are often split into multiple notes or participations that are placed into separate securitizations. The commercial mortgage backed securities market has grown from $200.77 billion in 2000[4] to $631.1 billion of new issuances in 2006[5] and represents approximately 23.1% of all commercial mortgage loans originated in 2006[6]. Government Sponsored Enterprises ("GSEs"), such as Fannie

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[1] The term "commercial" mortgage loan is used in this memorandum to include multifamily mortgage loans.

[2] *See* M. Jungman, *The Contributions of Resolution Trust Corporation to the Securitization Process*, in A Primer on Securitization, p. 67-79 (L. Kendall and M. Fishman eds. 1996).

[3] Id. at 79.

[4] *MBA Commercial Real Estate/Multifamily Finance Quarterly Data Book, Fourth Quarter 2006,* page 56.

[5] Id.

[6] Id. at 37.

Mae, Freddie Mac and Ginnie Mae, also issue mortgage-backed securities backed by multifamily loans, which represent approximately 4.7% of all commercial mortgage loans originated in 2006[7].

2. Policy considerations affecting restrictions on modifications.

Because REMICs are intended to be the exclusive vehicle for multi-class issuance of securities backed by pools of mortgage loans, "[t]he Congress believed that the new vehicle provided by the [Tax Reform Act of 1986] . . . should be flexible enough to accommodate most legitimate business concerns while preserving the desired certainty of income tax treatment.[8] The Joint Committee's Blue Book explains that there should be relief from two levels of taxation where "an entity with multiple classes of interests holds only a pool of real estate mortgages and related assets, has no powers to vary the composition of its mortgage assets, and has other powers generally consistent with the preservation of trust status, provided that satisfactory rules are prescribed for the taxation of the multiple interests."[9]

We believe that the policies behind the REMIC rules (and, for that matter, the grantor trust rules) were not intended to prevent the normal loan administrative activities that would be performed by any lender in order to preserve the sound investment character of the loan and to maximize the ability to receive all amounts due on the loan. When the REMIC statutory provisions were adopted, and even when the primary regulations were adopted in December 1992, the predominant use of the REMIC vehicle was for residential mortgages. Residential mortgages do not require much administration unless their repayment is jeopardized. With the growth of commercial mortgage securitization, REMIC servicers have found that the existing rules treating "significantly modified" loans, within the meaning of section 1001 and the regulations thereunder, [10] as newly originated, and therefore as disqualified if they do not meet the definition of "qualified replacement mortgages," [11] impose undue burdens on the administration of these transactions and on borrowers. The regulations promulgated under Section 1001 define realization events based on a "hair trigger" approach, consistent with the approach of the Supreme Court decision that engendered them[12]. That approach is appropriate in that context; it is not logical when attempting to define the appropriate standard for limiting the activities of the exclusive statutory vehicle through which commercial mortgage loans may be securitized.

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[7] Id.

[8] Staff of the Joint Committee on Taxation, General Explanation of the Tax Reform Act of 1986 (H.R. 3838, 99th Congress; Public Law 99-514), May 4, 1987, at p. 411 ("Blue Book").

[9] Id. (footnote omitted).

[10] Section references are to the Internal Revenue Code of 1986, as amended. References herein to "Treas. Reg." are to the Income Tax Regulations or Procedure and Administration Regulations, as applicable, of the U.S. Department of the Treasury.

[11] Section 860G(a)(4).

[12] *See, Cottage Savings Ass'n* v. *Commissioner*, 499 U.S. 554 (1991).

We submit that the policy articulated by the Joint Committee on Taxation staff that a REMIC not vary the "composition" of its assets and generally have powers consistent with trust status is not violated by loan modifications (even though they may be deemed exchanges under section 1001), invariably made at the initiation of the borrower, that do not rise to the level of new loan origination activity. The Congressional intent to provide a pass-through vehicle that does not compete with corporate entities is not violated by a vehicle in which an existing pool of loans is administered, where there is no possibility to enter into new lending relationships or to act as a finance company with deposits and withdrawal of mortgage loans. The proposed modifications discussed below do not implicate corporate activities in originating loans. That is, because the proposed modifications do not include an increase in the principal balance of a mortgage loan, extension of loan maturity, or a change in interest rate,[13] they should not cause a REMIC to be seen as engaging in mortgage loan refinancing or origination activity.

3. Authority for amending the regulations.

Section 860G(e) provides that "[t]he Secretary shall prescribe such regulations as may be necessary or appropriate to carry out the purposes of this part," and then lists five specific areas that may be included. Those five are clearly given as examples and not by way of limitation. The current exceptions to section 1001 contained in Treas. Reg. §1.860G-2(b) are an example of the exercise of this authority, as would be the additional exceptions to that regulation proposed herein.

4. Relationship between section 1001 and REMIC modification rules.

The section 1001 modification rules are intended to identify the appropriate time for recognition of gain or loss when there is an "exchange of property for other property differing materially either in kind or in extent."[14] An exchange of one debt instrument for a different debt instrument is an example of such an exchange. The rules recognize that a lender and a borrower can enter into a new loan by amending existing loan documents as easily as they can by entering into new documents.[15]

The REMIC rules, on the other hand, are designed, in general, to identify qualified assets that form an essentially fixed pool and to prevent the REMIC from being used as a trading vehicle to realize gain through the disposition of assets. Thus, a REMIC may not exchange its qualified mortgages for other obligations after the first 90 days, unless the obligations are defective, in which case a 2-year replacement period is provided.[16]

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[13] Note that such modifications to the terms of an obligation would continue to be permitted under the current REMIC regulations when the obligation is in default or default is reasonably foreseeable. Treas. Reg. §1.860G-2(b)(3)(i).

[14] Treas. Reg. §1.1001-1(a).

[15] *See* Treas. Reg. §1.1001-3(a)(1).

[16] Section 860G(a)(4).

Similarly, it is a prohibited transaction, resulting in a 100% tax on any gain, to dispose of qualified mortgages except in limited circumstances.[17]

Treas. Reg. §1.860G-2(b)(1) draws the connection between section 1001 and the REMIC provisions by stating that a significant modification of a loan under section 1001 and the related regulations is, subject to the exceptions discussed below, treated as newly issued loan. This may cause the new loan not to be a qualified replacement mortgage, and the pre-modification loan to be disposed of in a prohibited transaction.[18]

The approach that the REMIC regulations adopt is one that at the time of their promulgation, when there were fewer commercial mortgage loan REMICs extant, accommodated all the issues then generally recognized to exist with respect to residential mortgage loans. Thus, when bringing the regulations under Section 1001 generally into the REMIC regulations by cross-reference, exceptions were made for "significant modifications" occurring in connection with circumstances regularly encountered at that time with respect to residential mortgage loans, viz.: defaults and reasonably foreseeable defaults; assumptions; waivers of due on sale or due on encumbrance provisions; and rate conversions under the terms of a convertible mortgage loans.[19] The regulations preserve the concerns of the period in which they were issued. It is past time to revisit them in light of developments in commercial mortgage loan securitization during the intervening fifteen years.

5. Whether the existing and proposed exceptions are significant modifications.

The four existing exceptions for modifications of mortgage loans in REMICs are not treated as significant modifications, whether or not they would be so treated under section 1001.[20] They are:

(a) *Changes occasioned by a default or a reasonably foreseeable default.* This REMIC exception allows the broadest departure from section 1001, in that it applies to any change in a mortgage loan in order to work out the loan.

(b) *Assumption of the obligation.* This REMIC exception is not a departure from section 1001 with respect to nonrecourse loans; the section 1001 regulations allow a

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[17] Section 860F(a)(2)(A).

[18] Treas. Reg. §1.860G-2(b)(1)(i).

[19] The last of these accommodations reflects the chronology of the REMIC regulations and the Section 1001 regulations. In 1992, when the relevant REMIC regulations were finalized, it was unclear what the treatment of convertible mortgage loans would be under the Section 1001 regulations. When the section 1001 regulations ultimately were issued, the exception in the REMIC regulations became superfluous because the Section 1001 regulations treated the exercise of borrower's unilateral rate conversion option under a residential mortgage loan as not being a modification. On this point, the REMIC regulation became an anachronism, albeit an accommodating one.

[20] Treas. Reg. §1.1001-3(e)(4)(ii).

change in obligor without causing a significant modification.[21] However, it is a departure in the case of recourse loans, as to which the substitution of a new obligor is generally treated as a significant modification for purposes of section 1001.[22] While they are rarely seen anymore, and were vanishing even in 1992, there were still many residential loans outstanding at that time that could be assumed by the buyer of a residence. It appears that it was felt inappropriate to allow REMIC loan administration restrictions to interfere with such arrangements.

(c) *Waiver of a due-on-sale-clause or a due-on-encumbrance clause*. The status of this REMIC exception as a section 1001 modification is not clear. It is not one of the enumerated exceptions to a significant modification in Treas. Reg. §1.1001-3(e)(2) - (6), unless it is considered a change in a financial covenant that is not considered a significant modification under Treas. Reg. §1.1001-3(e)(6). If not covered there, then it would probably be tested under the general rule of Treas. Reg. §1.1001-3(e)(1) as to whether the degree to which the legal rights or obligations of the party that were altered are "economically significant." This test is notoriously difficult to apply, but the general view is that if there is no change in terms or consideration paid that benefits the party granting the waiver, then the change is not economically significant. Again, the history of this exception in the residential mortgage market is plain; the difficulty is that it does not translate well into the commercial mortgage market.

(d) *Conversion of an interest rate by a mortgagor pursuant to the terms of a convertible mortgage*. This REMIC exception is not a significant modification under Treas. Reg. §1.1001-3(c)(ii) and (iii), which provide that an alteration to the terms of a debt instrument occurring by the terms of a debt instrument, either automatically or pursuant to the exercise of a unilateral option, is not treated at a significant modification. An option granted to an obligor is considered unilateral if there is no corresponding right of the lender to terminate the instrument or put it to a related party, to consent to or approve the change or, with certain exceptions, require consideration for the change.[23] The exception in the REMIC regulations is, as previously noted, an accidental anachronism.

The changes for commercial mortgage loans[24] that are being proposed may or may not currently be significant modifications under the section 1001 regulations. Part of the reason the REMIC changes are needed is to remove impediments to the administration of REMICs due to the unclear nature of the section 1001 rules. The section 1001 rules, in focusing on maximizing the occurrence of realization events, were seemingly written with their regulatory, restrictive effects on REMICs in mind only on a secondary basis, if at all. The proposed exceptions are as follows:

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[21] Treas. Reg. §1.1001-3(e)(4)(ii).

[22] Treas. Reg. §1.1001-3(e)(4)(i)(A).

[23] Treas. Reg. §1.1001-3(c)(3).

[24] Although the need for these modifications was identified in connection with the servicing of commercial mortgage loans, there is no policy reason to preclude their application to residential mortgage loans to the extent such a change arises in connection with the servicing of such a loan.

(a) *A modification that releases, adds, substitutes or otherwise alters any portion of the collateral for, a guarantee of, or other form of credit enhancement for the obligation, whether recourse or nonrecourse*. Such a change in a recourse obligation would be a significant modification under Treas. Reg. §1.1001-3(e)(4)(iv)(A), unless there was no change in payment expectations.[25] In a nonrecourse obligation, such a change would be a significant modification if it involved a "substantial amount" of the collateral, a guarantee or any credit enhancement.

(b) *A change in the date on which the obligation may be prepaid or defeased in whole or in part, or the addition of a defeasance provision*. Treas. Reg. §1.1001-3(e)(3) governs changes in the timing of payments under a debt instrument. A safe harbor is provided for certain deferrals in scheduled payments.[26] However, the section 1001 regulation is silent on the acceleration of principal payments by agreement, such as a waiver by the lender of a lockout that prevents a borrower from voluntarily prepaying the loan. Such a change is usually viewed as an extinguishment of the loan, rather than a modification, but the proposed regulation would apply to partial prepayments, as well as allowing loans to be modified to waive a lockout without immediate prepayment. The proposal would not change the safe harbor for deferral of scheduled payments, including a final maturity date.

Allowing the addition of modification (such as the timing) of a defeasance provision could be a significant modification under Treas. Reg. § 1.1001-3(e)(4)(iv)(B), but would be consistent with the first exception above (allowing a substitution of collateral).

(c) *A change in an obligation from recourse (or substantially all recourse) to nonrecourse (or substantially all nonrecourse), or vice versa*. Because most commercial real property financings are done through special purpose entities that are disregarded for federal income tax purposes,[27] it is often difficult to tell whether the removal or activation of a "springing" guarantee by the borrower's parent under the terms of a loan (for example, if the borrower meets or fails to meet certain financial targets or suffers an improvement or a decline in performance) should be treated as a change in a guarantee or as a change from recourse to nonrecourse or vice-versa.[28] The distinction is critical, because a change in recourse nature cannot be considered as occurring pursuant to the terms of an instrument.[29] In the case of a change from recourse to nonrecourse, this may result in a significant modification unless a safe harbor is met,[30] while a change from

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[25] *See* Treas. Reg. §1.1001-3(e)(4)(vi).

[26] Treas. Reg. §1.1001-3(e)(3)(ii).

[27] *See* Treas. Reg. §301.7701-3(a).

[28] A change in a debt from recourse to nonrecourse could also occur if a debtor changes form and becomes a disregarded entity, unless the rights of the debtor and creditor under state law are unaffected by the change. *See* Pvt. Ltr. Rul. 200315001 (Sept. 19, 2002); Pvt. Ltr. Rul. 200630002 (April 24, 2006).

[29] Treas. Reg. §1.1001-3(c)(2)(i).

[30] Treas. Reg. §1.1001-3(e)(5)(ii)(B).

nonrecourse to recourse will always be treated as significant.[31] The question is whether, if a contingency or circumstance occurs that causes there to be recourse liability on a theretofore nonrecourse loan[32], there has been a "change" under the terms of the instrument. Or is recourse liability under circumstances defined in the loan agreement not a "change"? It is one thing to deal with questions such as these in the context of whether there has been a realization event under section 1001; it is quite another to do so in the context of whether a REMIC will remain qualified.

(d) *A substitution of a new obligor or the addition or deletion of a co-obligor*. This exception is intended to cover any change in an obligor not involving an assumption (such as the acquisition of a disregarded entity) or the addition of a guarantor on a recourse obligation. It is intended to cover these situations where Treas. Reg. §1.1001-3(e)(4)(iii) would result in a significant modification and that are not otherwise covered under exceptions (a) and (c) above.

(e) *An imposition or waiver of a prepayment penalty or other fee*. Servicers in commercial mortgage loan REMICs charge fees for their services in the case of assumptions, defeasances, releases or substitutions of collateral and other modifications requiring administrative processing. Often the loans provide for a specific fee, but in other cases compensation is provided for, but the amount is not specified, or else the borrower simply agrees to pay a fee at the time of the change. The imposition of such a fee could prevent a borrower option from being unilateral,[33] or could constitute a change in yield under Treas. Reg. §1.1001-3(e)(2).

(f) *A change in the principal payment schedule of a loan following a voluntary or involuntary prepayment of principal*. Mortgage loans frequently provide for a reamortization or other adjustment of a principal payment schedule (but not a delay in the final maturity) after a partial principal payment on a loan. However, some loans are silent on this point and may limit the servicer's flexibility to make these adjustments if they would involve a material deferral of scheduled payments.[34] This change may or may not be a section 1001 modification, depending on how rescheduled payments are measured.

6. The purpose and background of four existing exceptions.

Although the final REMIC regulations sharpen the focus on "significant" modifications as causing a change in qualified mortgage status or a prohibited transaction, the

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[31] Treas. Reg. §1.1001-3(e)(5)(ii)(A).

[32] The clauses ordinarily found in commercial mortgage loans imposing personal liability for malfeasance might even be included in theory as subject to question here, but provision for recourse liability if a promised improvement is not timely completed, or if particular occupancy levels are not timely achieved, would appear to be included, unless they are viewed as a guarantee and not a recourse feature.

[33] Treas. Reg. §1.1001-3(c)(3)(iii).

[34] Treas. Reg. §1.1001-3(e)(3).

preambles to neither the final regulations[35] nor the proposed regulations[36] provide any rationale for the four listed exceptions. It is apparent that the exception for mortgage loans as to which default has occurred or is reasonably foreseeable was derived from the similar rule for grantor trusts.[37] The rationale for this exception is that it is consistent with trust status to be able to preserve the capital of the beneficiaries by modifying a loan in jeopardy in order to maximize the ability to collect amounts due.

We believe that the other three exceptions are practical responses to potential problems with alterations of residential mortgage loans that had been identified by REMIC sponsors even prior to the issuance of the proposed regulations. For example, because residential mortgage loans are almost exclusively recourse, assumptions of those loans where the mortgaged property is transferred would have been a common disqualifying event for REMICs. Thus, not to allow an exception would have imposed undue burdens on servicers, and would have restricted transferability of properties and potentially the collection of the related mortgage loan. It is also worth noting that a consented assumption almost always occurs in conjunction with a waiver of a due-on-sale clause, hence the addition of the third exception in the proposed and final regulations. The rationale for the addition of a waiver of a due-on-encumbrance clause in the final regulations is less clear, especially when it is not apparent that this would have been a significant modification in any event. However, the rationale may be similar to that for the fourth exception, a change in interest rate on a convertible mortgage, which also does not appear to be a significant modification. In 1991, when these regulations were proposed, the real estate market was in a depressed state, and both of these exceptions would have assisted in any recovery in property values and related refinancings. It is therefore possible that market participants asked Treasury to make these changes so that servicers would not have to speculate whether such modifications would be allowed. It is highly likely that the addition of the exceptions for due-on-sale and due-on-encumbrance waivers, as well as fostering the use of convertible mortgages, promoted a variety of residential housing acquisitions, including those financed through municipal programs (tax-exempt housing bonds) as well as government guarantee programs (VA insurance and FHA guarantee programs).

7. Examples of common changes.

The following are examples of loan modification issues that arise with some frequency in commercial mortgage loan securitizations. Common to all the examples is the requirement that the servicer make a determination based on sound loan administration principles and the collective protection of investors. All of the examples assume that the degree of change exceeds the various thresholds for a significant modification under Treas. Reg. §1.1001-3.

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[35] T.D. 8458, 1993-1C.B. 147.

[36] FI-88-86, 1991-2C.B. 926. The final regulations added the waiver of a due-on-encumbrance clause to the waiver of a due-on-sale-clause, but did not otherwise change the exceptions.

[37] *See, e.g.*, Rev. Rul. 73-460, 1973-2 C.B. 424.

(a) The borrower seeks the servicer's permission for an assumption of the loan in connection with a sale of the mortgaged property (currently allowed by Treas. Reg. §1.860G-2(b)(3)(ii)). Either because the mortgaged property's performance has deteriorated or the new borrower's owners are not as financially secure as the old borrower's, the servicer wishes to condition its approval on the posting of a letter of credit by the new borrower, a new debt service or other reserve account, or the provision of a new guarantee or other recourse feature by the parent of the new borrower or a related party.

This situation frequently arises when the borrower has the opportunity to sell a mortgaged property at a profit. The object of the added credit enhancement is to maintain the sound investment character of the loan.

(b) The borrower seeks the servicer's approval for a transfer of a 51% ownership interest in the borrower. The servicer wishes to condition its approval on the provision by the old and/or new owners of an indemnity against potential environmental problems and a covenant that the loan will become recourse if the owners permit the borrower to become subject to a bankruptcy proceeding.

When the owner of a borrower wishes to transfer all or a majority of its ownership interest, which generally requires the lender's consent, the servicer often identifies provisions that are commonly present for the protection of the lender but are missing in the loan in question. The borrower is typically willing to grant this protection as a condition to the transfer.

(c) The borrower requests that the servicer permit the release of a portion of the mortgaged property or the substitution of a new mortgaged property. Either (a) the loan contemplates such a release or substitution but the borrower requests a variance from one or more of the criteria in the loan, or (b) the loan contains no release or substitution provisions, but the servicer wishes to apply commercially reasonably criteria, including, where appropriate, a partial paydown of the loan or the posting of a reserve or other credit enhancement. In no event will the release or substitution cause the loan to fail to be principally secured by an interest in real property (as required for loans contributed to a REMIC on the startup day). Other changes to the real property may include the acquisition or granting of easements or the release of air rights or development rights.

Borrowers frequently reposition their portfolios of real property. Trying to make the change unilateral by specifying criteria in the loan arguably reduces the servicer's control over the sound investment character of the loan, while allowing a servicer discretion would be consistent with its general obligation to investors to maximize recoveries on the securitized loans.

(d) A loan contains a provision allowing the real property to be defeased with Treasury securities four years after the loan closing date. The borrower asks the servicer to allow the loan to be defeased at an earlier date, but more than two years after the loan is included in a REMIC and to allow the use of securities other than Treasury obligations that meet the definition of "government securities" (in compliance with Treas. Reg. §1.860G-2(a)(8)).

The borrower has the opportunity to sell the property at a gain or to refinance it favorably with another lender, but the loan is locked out from prepayment.

(e) The borrower requests permission to demolish all or a portion of a building on the mortgaged property preparatory to renovating or constructing an improvement to suit a new tenant or to replace an obsolete structure. The borrower may post a completion bond or letter of credit in connection with the demolition and rebuilding. Even taking into account the demolition, the loan would be principally secured by real property if it were contributed on the startup day.

Although Treas. Reg. §1.1001-3(e)(4)(iv)(B) allows improvements to the real property, there has been some debate as to whether demolition is covered by this provision. This situation arises with some frequency.

(f) Three related borrowers enter into loans, and their three properties are cross-collateralized with each other. Two of the borrowers wish to sell their properties to purchasers who will assume their loans, but require a release of the cross-collateralization. The servicer is willing to release the cross-collateralization based on reasonable commercial criteria, and after the release each of the three loans would be principally secured by an interest in real property if they were contributed on the startup day.

This is a common commercial transaction where the opportunity arises to sell a property at a gain.

(g) The borrower's property has shown a decline in performance, but the borrower is able to find a buyer for the property in an amount sufficient to pay off the loan in whole or in allocable part. However, the loan is locked out from prepayment for another three years. The servicer is willing to allow prepayment on the basis that it is the most likely way to ensure that the loan will be paid in full, and may require the borrower to pay a prepayment premium in connection with the prepayment.

Borrowers often agree to lockouts and then change their view when a sale opportunity arises. Servicers will generally agree to allow a prepayment that pays investors earlier than expected only if it is in the best interests of all classes of investors.

(h) Following a casualty or condemnation, a portion of the insurance or purchase proceeds is used to pay down the principal balance of the loan. The borrower requests that its monthly payment be reduced and that the loan be reamortized over the period to its original maturity date. This has the effect of deferring payments of principal within the original term of the loan. The servicer is willing to make the change because the property's income-producing capacity has been reduced.

This is an obvious response to a principal paydown, but under current regulations would have to be tested for the materiality of the deferral, absent a reasonably foreseeable default.

(i) The borrower wishes to add collateral to the loan, such as the acquisition of an adjacent parcel as part of an expansion of existing buildings, or the posting of a tenant improvement reserve or capital improvement reserve in connection with the renovation or expansion of a building.

This is another case where borrowers are trying to manage their business operations at the mortgaged property. Additions to the collateral may be sought by the borrower or may be required by the servicer as a condition to activity at the property.

(j) A variety of situations may arise in which the borrower wishes (or the servicer requires the borrower) to add a reserve or impound; to move money from one reserve account to another; to release a reserve when it is no longer economically necessary; to change a reserve to a letter of credit; to add a guarantee or other form of credit enhancement; or to change or add a guarantee or interest rate cap or swap contract that is or will become part of the collateral.

These are further examples of property administration that do not affect the identity of the loan but must currently be tested for materiality. In each case, the lender will make a determination of the effect of the change on the soundness of the loan.

8. Explanation of proposed exceptions for commercial mortgages.

(a) *Changes in collateral, guarantees and credit enhancement*. An undue amount of attention is given by servicers to whether changes in collateral are "unilateral" options of the borrower under Treas. Reg. §1.1001-3(c)(3), and if not, whether the amount of collateral involved is "substantial." This issue arises frequently in the drafting of loans as well as in their administration. Some modifications under the proposed exception would be "significant" and others would not. However, the proposed rule would not permit an alteration that causes the obligation not to be principally secured by an interest in real property. Since this basic REMIC policy is protected, this change would permit REMIC servicers to allow changes in collateral that preserve the sound investment character of the pooled loans without engaging in refinancing or other business activity (since no changes would be permitted in the maturity date, loan principal balance or interest rate).

(b) *Changes in prepayment date or defeasance date*. These changes are requested by borrowers frequently. Commercial mortgage loan securitizations require predictability of cash flows; hence, prepayments in cash are limited and defeasance within the REMIC rules is the norm when a borrower wishes to dispose of a property. For whatever reason, defeasance provisions in loans are occasionally drafted to postpone the permitted date beyond two years after the REMIC's startup day. In some cases, borrowers find a buyer for their property prior to the permitted defeasance date. The proposed change would remove uncertainty in the rules as to cash prepayments, but would preserve the REMIC defeasance policy of not transferring a loan to a REMIC with the intention of exchanging the real property collateral for government securities. The proposed exception would extend to amending a defeasance provision in other ways, such as a change in the type of government securities that may be used, or even the addition of a defeasance provision. Because these changes occur after the REMIC's startup day and in no event violate the two-year rule, they do not violate the policy against intending to replace real property with other collateral. This change to the regulations would remove any doubts that such a defeasance is pursuant to the terms of the loan agreement.[38]

(c) *Changes in recourse or nonrecourse nature*. This issue arises frequently in connection with loan assumptions or transfers of ownership interests in borrowers. It also may occur by the terms of a loan if performance or financial targets are met or not met. These changes do not violate the basic REMIC policy requiring that qualified mortgages be principally secured by an interest in real property. They have no more impact on whether a refinancing is occurring than the addition or removal of a guarantee, since substantially all commercial mortgage loans in a securitization are secured by property owned by special purpose entities that hold only the mortgaged property in question.

(d) *Substitution of a new obligor or the addition or deletion of a co-obligor*. The rationale for this exception is the same as for that in 8(c) immediately above and is consistent with the current exception for assumptions. It is included to cover any fact pattern involving transfers of a mortgaged property, transfers of ownership interests in the borrower, or the addition of a new co-signer of a loan not already covered by the other exceptions.

(e) *The imposition or waiver of prepayment penalty or other fee*. Commercial mortgage loans in securitizations are serviced by professional servicers for compensation. Borrowers understand, whether the loan terms so provide or not, that requests for modifications entitle the servicer to recovery of third party expenses as well as a "processing fee" to compensate the servicer for the additional administrative efforts. A change in yield that does not involve a change in the interest rate of an obligation does <u>not</u> implicate any REMIC policy against origination of new loans. Making this explicit in the regulations would allow servicers to charge commercially reasonable compensation without having to test such fees in every situation for a change in yield. Similar considerations apply to the imposition of a prepayment penalty. This change goes hand in hand with the exception in 8(b) above allowing waivers of prepayment lockouts. Although under the section 1001 regulations prepayment penalties are not tested for a change in yield if the prepayment is a "pro rata prepayment",[39] including it within the proposed exception would remove doubts as to whether this rule applies only to prepayment penalties stated in the loan or also covers penalties added by amendment.

(f) *Change in principal payment schedule following prepayment*. This change was proposed by servicers faced with the uncertainty of the materiality of a deferral of principal payments in partial prepayment situations. Such a change has no impact on the

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[38] Treas. Reg. §1.860G-2(a)(8)(ii).

[39] Treas. Reg. §1.1001-3(e)(2)(iii)(B).

identity of the loan and the exception is proposed in order to avoid having to address this issue where it has no relation to an actual refinancing.

9. Examples of exceptions.

(a) *Changes in collateral, guarantees and credit enhancement*. Examples of this exception are provided in 7(a), (c), (e), (f), (i) and (j) above.

(b) *Changes in prepayment date or defeasance provision.* Examples of this exception are provided in 7(d) and (g) above.

(c) *Changes in recourse or nonrecourse nature*. An example of this exception is given in 7(b) above.

(d) *Substitution of a new obligor or the addition or deletion of a co-obligor*. Example 7(b) above also illustrates this exception, but instead of providing a springing recourse provision, the 51% transferee owner co-signs the mortgage note.

(e) *The imposition of or waiver of a prepayment penalty or other fee*. This exception is also illustrated by 7(g) above.

(f) *Change in principal payment schedule following prepayment*. An example of this exception is provided in 7(h) above.

10. Alternatives to resolving issues.

The commercial mortgage loan industry has already made many accommodations in the drafting of documents in order to avoid the significant modification rules. For example, collateral release, substitution and addition provisions are drafted to qualify as "unilateral options" within the meaning of Treas. Reg. §1.1001-3(c)(3). However, from a business standpoint, these provisions are probably not as effective in protecting investors as some amount of lender discretion would be. Furthermore, despite the best efforts of borrowers and lenders, situations often arise that were not foreseen when the loan was originated. We believe that the main industry issues with the significant modification rules – that they add uncertainty to the servicer's duties, add significant time and expense to the administration of transactions, and in many cases prevent sound administration of a REMIC's assets – can only be remedied through the proposed amendment of the regulations.

11. Types of taxpayers and other interested persons directly and indirectly affected by an inability to modify commercial mortgage loans.

Developers of commercial real estate (borrowers) are directly affected by an inability to modify commercial mortgage loans once the loans are placed in a REMIC. Borrowers must incur significant costs and administrative burdens in order to assess whether requested modifications to commercial mortgage loans meet the current REMIC regulations. Lenders and servicers and their advisors are currently limited in executing borrowers' requests for loan modifications given the limited nature of the current regulations to commercial mortgage loans. The following sections highlight the types of costs and delays typically incurred by borrowers when requesting loan modifications, examples of common transactions borrowers are unable to complete under the current REMIC regulations, and the increasing unwillingness of borrowers to securitize commercial mortgage loans in order to avoid these administrative burdens.

A. Types of Costs Incurred for Loan Modifications Under the Current REMIC Regulations

Borrower requests for modifications affecting their collateral come in a number of forms. For a servicer to grant consent, the servicer typically must obtain an opinion of counsel that the proposed transaction will not (i) cause the REMIC to fail to qualify as a REMIC for purposes of the Code, or (ii) cause the REMIC to be subject to any tax under the REMIC provisions. In general, to issue these opinions, counsel must be comfortable that the proposed modification is not a "significant modification" pursuant to Treas. Reg. §1.1001-3. Accordingly, counsel must be able to conclude, for example:

- that the modification does not result in a "material change" to the debt instrument;[40]

- that the modification does not release, substitute, add or otherwise alter a "substantial" amount of the collateral for, a guarantee on or other form of credit enhancement for a nonrecourse debt instrument;[41] or

- that the modification is pursuant to a unilateral option of the issuer or holder.[42]

The additional cost to the borrower, regardless of the size of the loan, can be:

- the cost of the "will opinion" ($2,000 or more depending on the complexity of the analysis); and

- costs of appraisals and other third party analyses to support the opinion.

Additional, less definable costs include:

- structuring costs and additional transaction costs where the original request does not meet REMIC standards; and

- the costs of time delay while the transaction is held up for REMIC analysis.

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[40] Treas. Reg. §1.1001-3(c)(2)(iii).

[41] Treas. Reg. §1.1001-3(e)(4)(iv)(B).

[42] Treas. Reg. §1.1001-3(c)(2)(iii).

Using the above examples, the costs of these opinions are frequently increased by the complicated fact patterns involved. For example, in determining whether an "alteration" is an alteration of a "substantial" amount of the collateral, counsel is required to review the actual change and determine whether the modification to the collateral is "substantial". Very little authority exists as to what is in fact an alteration of a "substantial" amount of the collateral. REMIC counsel have different thresholds as to how much of an alteration is "substantial" for opinion purposes.

What actually constitutes an alteration is a separate question. As noted above, when making an improvement which involves not only expansion of the collateral but a demolition of a portion of the existing building, REMIC counsel must determine whether or not the transaction fits into the "improvement" exception and, if not, what portion of the activity constitutes an alteration that must meet the "not substantial" threshold. The more complicated the facts are, the more difficult and expensive the opinion is to give.

To support a tax opinion, counsel must frequently rely on independent analysis. Using the alteration of collateral as the example, an independent analysis might include appraisal information before and after the alteration and a revenue analysis of the impacted collateral (i.e., the percentage of rents that are impacted by the change). The amount of these costs bears no relationship to the size of the loan. An alteration of collateral is just one of many types of seemingly routine transactions that can lead to burdensome and expensive analysis under the REMIC regulations (which, as discussed below, can also result in unnecessary delays). Accordingly, what appears to be a borrower's simple and reasonable request can, in the context of a REMIC, have an unanticipated and built in transaction cost of $5,000 to $10,000 or more just because of the legal analysis. When the costs for third party reports from appraisers and other experts supporting the REMIC opinion are considered, the extra costs can easily derail the entire project.

B. Delays to the Commercial Real Estate Industry Under Current REMIC Regulations

Negotiating the technical and sometimes uncertain requirements of the current REMIC regulations may result in unnecessary delays in transactions with respect to securitized loans. These delays do not exist outside the securitization context and therefore may result in the disparate treatment of economically similar transactions. Although delays may not cause transactions to be abandoned, they do result in additional cost and complexity that could easily be eliminated by providing clarity in the regulations, without compromising their purpose.

As noted above, alterations and modifications of collateral or the substitution of a "carve-out guarantor" (i.e., a guarantee on a nonrecourse loan applicable only in the case of fraud or misrepresentation by the borrower), although immaterial from a credit perspective, may nevertheless require opinions of counsel, which can slow the transaction process. Similarly, where a defeasance lock-out period provided for by the loan documents exceeds the 2-year lockout period required by the current regulations, the defeasance may be delayed because it is uncertain whether a waiver of the lock-out period is a significant modification. Obtaining the required opinion may be time consuming, as additional facts, documentation and analysis may be necessary. We note that the private letter ruling process is not a viable option in these cases because of the four to six months (or more) required to obtain a ruling, an unrealistic timeframe for typical commercial real estate transactions.

C. Types of Commercial Mortgage Transactions That Are Restricted or Significantly Limited Under the Current REMIC Regulations

The types of commercial mortgage transactions discussed in the following paragraphs expand on previous examples of what are considered to be common changes requested by borrowers, as described above in response to Item 7:

1. Release of Collateral. As set forth above, the release of a substantial amount of collateral secured by a nonrecourse debt instrument constitutes a significant modification. In a variety of situations, this restriction can be a roadblock to an otherwise typical industry- acceptable modification to a loan arrangement. For example, when a borrower wishes to develop a previously undeveloped parcel of land that has been pledged as collateral (in conjunction with the originally developed land), releasing the undeveloped land to facilitate development may not be allowed by the REMIC rules. Similarly, when a loan is secured by multiple properties, a borrower might want to release one of the properties. In each of these cases, where the loan is well secured by the remaining real property after giving effect to the release, the release might be acceptable to a servicer (especially if there is a partial prepayment associated with the release). In the REMIC context, however, this release might be considered a release of a substantial amount of collateral and unavailable to the borrower (assuming a unilateral option is not provided in the loan documents).

2. No Defeasance During a Lock-out Period that is After Two Years from the REMIC's Startup Day. If a REMIC releases its lien on real property that secures a qualified mortgage, that mortgage ceases to be a qualified mortgage on the date the lien is released unless (1) the borrower pledges substitute collateral that consists solely of government securities as defined in section 2(a)(16) of the Investment Company Act of 1940; (2) the loan documents allow such substitution; (3) the lien is released to facilitate the disposition of the property or any other customary commercial transaction, and not as part of an arrangement to collateralize a REMIC offering with obligations that are not real estate mortgages; and (4) the release is not within two years of the startup day.[43] Some loan documents do not allow a defeasance transaction during a lock-out period that is well beyond the initial two-year statutory time restriction (or do not allow a defeasance transaction at all). Since the loan documents do not "allow for such substitution," a defeasance transaction is not available until after the lock-out period has expired (or not at all if the loan documents do not allow a defeasance).

3. Change in Obligor. The addition or deletion of a co-obligor on a debt instrument is a significant modification if the addition or deletion of the co-obligor results

[43] Treas. Reg. §1.860G-2(a)(8).

in a change in payment expectations.[44] A change in payment expectations occurs as a result of a transaction when (1) there is a substantial enhancement of the obligor's capacity to meet the payment obligations under a debt instrument and that capacity was primarily speculative prior to the modification and is adequate after the modification, or (2) there is a substantial impairment of the borrower's capacity to meet the payment expectations under a debt instrument and that capacity was adequate prior to the modification and is primarily speculative after the modification.[45] This standard is very difficult to interpret, but one that comes up often. It can arise if one borrower buys out another, in the estate context or other routine reorganizations.

4. Change in Recourse Nature of Loan. A typical provision in a loan document where the general rule would be troubling is where the loan might change from nonrecourse to recourse if an objective test is not met (e.g., debt service coverage ratio of at least 1.10) since any change from nonrecourse to recourse constitutes a significant modification (despite this likely being in the best interests of the REMIC interest holders).

D. Unwillingness to Complete REMIC Transactions by Borrowers

Many borrowers have a negative feeling about securitized loans. They do not fully understand the complex and often counterintuitive restrictions created by the REMIC rules. The inability to release or develop relatively valueless out parcels or the complexity or complete inability to make material modifications or improvements to properties has created frustration with securitized loans after origination. This has driven many borrowers away from the securitized loan market and into higher interest rate non-securitized loans.

In February 2005, the Mortgage Bankers Association (MBA) and the Commercial Mortgage Securities Association (CMSA) conducted a joint survey assessing commercial/multifamily borrowers' expectations and experiences with different capital sources.[46] When borrowers in the survey were asked to rate various aspects of different types of loans, average levels of satisfaction were lowest for the ability to restructure their securitized loans as well as with post-closing service. Borrowers' frustrations are, in large part, due to the current restrictions placed on commercial mortgage loans employing a REMIC execution, which accounts for a growing proportion of commercial mortgage loans.

Unfortunately, the borrowers most frequently driven from the securitized loan market into the more expensive non-securitized loan market by the complexity of the REMIC rules are the smaller business borrowers who cannot afford, or cannot justify, the cost of

[44] Treas. Reg. §1.1001-3(e)(4)(iii).

[45] Treas. Reg. §1.1001-3(e)(4)(vi).

[46] MBA Research Data Notes, April 2006.

hiring sophisticated counsel or financial professionals to work through all of the REMIC requirements and restrictions.

12. Estimated number of taxpayers affected by inability to modify commercial mortgage loans.

It is difficult to estimate with precision the number of taxpayers directly or indirectly affected by the lack of REMIC guidance permitting commonly requested modifications to commercial mortgage loans. While the absence of needed guidance may not ultimately block most transactions with respect to which a commercial mortgage loan modification is sought, the lack of guidance nonetheless affects numerous participants at various levels.

At one level, the current rules may discourage the contribution of specific commercial mortgage loans to REMICs, thus affecting both the borrowers and the lenders in these transactions (perhaps through interest rates and transaction costs on the loan). At another level, sophisticated potential borrowers may incur significant costs in negotiating non-standard loan terms that would permit future actions otherwise requiring REMIC trustees to modify the loan agreements. At still another level, borrowers seeking modifications may be required to undertake a costly analysis, including seeking legal opinions, in order to give REMIC trustees sufficient comfort to approve the modifications. The need to undertake this analysis and to await trustee consideration causes delay in the transactions related to the modifications (e.g., sale of the real property securing the loan). At the level of REMIC interest holders, the current lack of guidance may affect their tax risk (with respect to modifications approved) and/or their investment returns.

The number of potentially affected taxpayers can be discerned somewhat from industry statistics. As noted above, the commercial mortgage securities market has grown to $631.1 billion in 2006[47] and represented approximately 23.1% of all commercial mortgage loans originated in 2006.[48] These vehicles held approximately 70,000 commercial mortgage loans.[49] In 2006 alone, there were 102 collateralized mortgage-backed securities transactions that utilized a REMIC structure.[50]

While not every commercial mortgage loan held by a REMIC will require a possible modification during its term, REMIC servicers and lawyers advising REMICs estimate that as many as 20% to 40% of all commercial mortgage loans held by REMICs will be the subject of modification requests during their terms. Extrapolating from this estimate, the lack of REMIC guidance permitting commonly-requested commercial mortgage loans

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[47] *MBA Commercial Real Estate/Multifamily Finance Quarterly Data Book, Fourth Quarter 2006,* page 56.

[48] Id. at 37.

[49] MBA Year-end Survey of Commercial/Multifamily Mortgage Servicing Volume, as of December 31, 2006.

[50] Commercial Mortgage Alert CMBS Database.

could directly or indirectly affect thousands of borrowers each year, and could also affect numerous REMICs.

13. See <u>Item 11</u> for a description of how the commercial real estate industry is currently affected by the limited ability to permit certain modifications to commercial mortgage loans.

14. REMIC income or loss from deemed exchange.

It is anticipated that deemed exchanges arising from significant modifications of mortgage loans would have the same results as actual sales of mortgage loans (for example, a sale of a defective loan or a sale pursuant to a qualified liquidation) currently do. That is, gain or loss would be measured by the difference between the issue price of the "new" obligation and the basis of the "old" obligation. In the case of a debt instrument exchanged for another debt instrument, in the general case where the new instrument has adequate stated interest, its issue price is its stated principal amount.[51] REMIC tax return preparers would determine the basis of the pre-modification mortgage loan in the same manner that they currently do for mortgage loan sales. This could result in a gain or a loss to the REMIC, which would be taken into account in computing the net income or net loss of the REMIC reportable by a residual holder.[52]

15. Grantor trust exception.

Although not specifically requested in Notice 2007-17, the proposed amendment to the REMIC regulations would add a provision coordinating the rules for grantor trusts holding mortgage loans. Under this coordination provision, a grantor would not fail to be treated as the owner of any portion of a trust under sections 671 through 679 and the regulations thereunder solely because such portion includes one or more obligations with respect to which one or more modifications that would be permissible for a REMIC have occurred or may occur under the terms of the trust. The power of the trust to make such modifications would not be treated as a power to "vary the investment of the certificate holders" for purposes of Treas. Reg. §301.7701-4(c). Under their governing documents, REMIC transactions are frequently paired with grantor trusts for some portion of the mortgage loans held by the trust, or where a portion of the trust's assets may not be held by the REMIC itself.[53] It is also not uncommon for a single, large commercial mortgage loan to be securitized through a grantor trust rather than a REMIC. Without the proposed addition to the regulations, the additional efficiency being sought in the REMIC proposal would be incomplete, and there would be inconsistency between these two common securitization vehicles. Because the grantor trust policy relating to "varying the investment" also underlies the REMIC modification rules, these two sets of rules should be coordinated.

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[51] Section 1274(a)(1) and Treas. Reg. §1.1274-2(b)(1).

[52] Section 860C(a)(1).

[53] *See* Treas. Reg. §1.860G-2(i).