Major New Opportunity to Modify CMBS Loans Created by New Tax Rule - Special Servicer's Hands Untied

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A lynchpin of the entire loan securitization industry is the pass-through or transparent tax status of the entity holding the commercial real estate loan, i.e., no double taxation as with corporate income. Preserving this tax status has been a major impediment to obtaining modifications of securitized loans. Borrowers on securitized commercial loans can now immediately seek modifications by taking advantage of a new tax rule and more lenient regulations issued by the Treasury Department and Internal Revenue Service (IRS) with respect to commercial loans held by real estate mortgage investment conduits (REMICs) or investment trusts.

As background, for income tax purposes, a REMIC is treated as a pass-through entity, whereby the purchasers of commercial mortgage-backed securities (CMBS) pay taxes on the income that they receive, but the REMIC is not taxed provided that it continues to qualify as a REMIC. Maintaining REMIC status is therefore the number one goal of every CMBS transaction and drives the REMIC's decision making process. That goal, however, has often prohibited the modification of distressed commercial loans held by a REMIC because the tax rules and regulations, as opposed to traditional lender considerations, have been driving the REMIC's responses to borrowers' requests for loan modifications. And more often than not under the tax rules and regulations, a loan modification would result in an event that would cause the loss of the holder's REMIC status. Negotiations were therefore dead before they even began.

On September 15, 2009, the IRS issued a tax rule (Revenue Procedure 2009-45) permitting holders and special servicers to modify loans held by REMICs or investment trusts prior to a default without jeopardizing the securitization vehicle's tax status. The tax rule also opens the door for holders and special servicers to discuss modifications with borrowers long before a default has occurred without triggering adverse tax consequences.

Under prior regulations, a "significant" modification of such loans could have resulted in a prohibited transaction that could jeopardize a REMIC's tax status. Under the new tax rule, if the holder or special servicer "reasonably believes" there is a "significant risk of default" on the loan, and modifying the loan will result in a "substantially reduced risk of default," then the holder or special servicer may negotiate and/or modify the loan without tax penalty. The IRS explained that one relevant factor in determining the significance of the risk of default is how far in the future the default may occur. Holders or servicers could find that a loan posed a significant risk of default even though such default may not occur until a year or more in the future. Similarly, in appropriate circumstances, a performing loan could also be found to pose a significant risk of default. There is no maximum period after which default is no longer considered foreseeable. The new tax rule applies to loan modifications effected on or after January 1, 2008.

The IRS cited lack of liquidity in the current credit market and the concern that borrowers would not be able to refinance the commercial real estate loans that will mature in the next few years as the basis for the new tax rule. According to press reports, more than $150 billion of loans bundled into CMBS will mature between now and 2012.

The IRS and Treasury also made it easier to modify loans held by REMICs by expanding the list of permitted modifications that will not be considered "significant" modifications to an obligation held by a REMIC. These new regulations, effective September 16, 2009, permit holders and special servicers to make changes in collateral, guarantees, and credit enhancement of obligations, and changes to the recourse nature of an obligation, so long as the obligations continue to be principally secured by an interest in real property. Although the new exceptions to "significant" modifications apply only to REMICs, the Treasury Department has solicited input concerning whether additional guidance is appropriate for investment trusts.

The new tax rule and final regulations are positive steps to help staving off a further deepening of the credit crisis in the commercial real estate market by easing the disincentives to modifying commercial loans held by REMICs without tax penalty. Luce Forward has attorneys who can immediately assist you with analyzing the potential impact of the new tax rule and final regulations on your CMBS loans and in developing a strategy for negotiating modifications to such loans with the special servicer.

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