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# New IRS rules for lenders may help troubled commercial borrowers

## Tax Law

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A recently issued IRS procedure could ease restrictions on modifying certain securitized commercial loans.

From the late 1990s until last year, securitized loans were all the rage for financing commercial investment real estate. These securitized loans were issued by lenders known as Real Estate Mortgage Investment Conduits (REMIC).

They offered low interest rates, high loan-to-value ratios, long amortization schedules, seven- to 10-year maturities, and non-recourse terms, which made securitized loans the ideal financing vehicle for real estate.

This, in spite of the fact that the loan originators were often inflexible in their loan terms, and expensive in loan underwriting, documentation and fees.

But as the economy ground to a halt late last year, the hidden face of the REMIC loan began to assert itself: The "loan servicers" were unwilling — indeed, incapable — of responding to the issues, problems and special needs of its borrowers.

Borrowers who were accustomed to "relationship banking" found themselves hamstrung by the faceless bureaucracy of the loan servicer.

Indeed, absent an "imminent loan default," loan servicers have refused to entertain any discussions concerning loan modifications, in some cases due to fear that such modifications could cause the IRS to challenge the tax status of certain securitization vehicles that hold such loans in securitization pools.

In fact, REMIC paralysis appeared to stem in large part from IRS rules that imposed a tax of 100 percent of net income derived from "prohibited transactions."

Since modification or other "disposition" of a qualified mortgage could be deemed a prohibited transaction, the tax consequences of amending a Commercial Mortgage Backed Securities (CMBS) loan could be disastrous to the note holder and its entire CMBS pool of loans.

Until now, the only way borrowers could get a servicer to discuss their situation was to default!

On Sept. 16, 2009, however, and with retroactive effect to loan modifications made on or after Jan. 1, 2008, the IRS issued Revenue Procedure 2009-45.

This Revenue Procedure provides new tax guidance that will allow pre-default modifications of loans held by REMIC's or investment trusts, without adverse tax consequences to the lender — provided that the holder or loan 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."

Such belief may even take into account "credible written factual representations" made by the borrower, even if the foreseeable default is "more than one year in the future."

This Revenue Procedure is especially intended to assist borrowers with notes that will balloon in the relatively near future, where the underlying real estate has provided sufficient cash flow to satisfy debt service before maturity, but where sufficient capital to refinance balloon payments is not anticipated to be readily available.

This situation is being faced by many borrowers right now, and is only expected to worsen in the very near future as literally thousands of securitized loans come due in the next few years.

Estimates are that $300 billion to $500 billion in commercial real estate loans will come due this year, and, on average, $400 billion of loans will mature each year over the next decade.

A substantial percentage of maturing loans will be REMIC loans. Loan modifications that may be considered include:

- Interest rate changes;
- Principal forgiveness;
- Extension of maturity;
- Alterations in the timing of interest rate changes; and
- Alterations to principal amortization schedules.

In fact, it is the ability to extend maturity dates that may have the greatest positive effect in reducing the number of foreclosures, as these loans continue to mature into an environment where credit markets remain frozen.

However, collateral value will have to be retested, and modifications can only proceed if loan-to-value ratios hold up.

Nothing in this new Revenue Procedure requires note holders or loan servicers to cooperate with borrowers, and offer loan modifications.

However, the excuse that IRS regulations prohibit them from helping is substantially mitigated now.

Let's hope that note holders and loan servicers will use Revenue Procedure 2009-45 to help their borrowers (and ultimately themselves) avoid the same kind of catastrophe as crippled the economy during the sub-prime residential mortgage crisis last year.

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