

Part III - Administrative, Procedural and Miscellaneous

Modifications of Commercial Mortgage Loans Held by a REMIC

Notice 2007-17

I. PURPOSE

The Internal Revenue Service (IRS) and the Department of the Treasury (Treasury) receive many requests from the public to resolve issues through published guidance. Available resources limit the number of issues that can be addressed. As a result, publication of guidance on many important tax issues is often delayed. Illustrative of the requests for guidance received by the IRS and Treasury is a recent request for an expansion of the permitted types of modifications to loan obligations held by a real estate mortgage investment conduit ("REMIC"). This request relates to guidance in a narrow, technical area of the tax law, where the need for guidance is driven by market changes with which taxpayers may be more familiar than are the IRS and Treasury.

The IRS and Treasury have made, and continue to make, efforts to develop ways of publishing guidance in a more timely and efficient manner. As part of this effort, the IRS and Treasury anticipate the launch of a pilot program to

solicit greater input from the public in the initial development of certain guidance projects.

Under this pilot program, the IRS and Treasury would publish a notice for each guidance project selected for the program. The notice would identify research, background documents, drafts of proposed guidance and other work products, and ask interested parties to provide them. These written submissions from the public will help the IRS and Treasury determine whether it is appropriate to publish guidance. If so, the IRS and Treasury expect that increased public participation in the preliminary stages of certain guidance development would provide a significant benefit to taxpayers by permitting IRS and Treasury to hasten the publication of a greater number of guidance projects. It is anticipated that notices issued under the pilot program would follow the model of this notice, relating to modifications of commercial loan obligations held by a REMIC.

As this and additional projects are completed, the IRS and Treasury will review and evaluate the pilot program. Comments on the program may be solicited, and IRS and Treasury will consider publishing guidelines for future projects.

As a model for the pilot program, the IRS and Treasury solicit input, in the specific format described below, on whether it is appropriate to amend existing income tax regulations to permit certain modifications to securitized commercial mortgage loans.

II. BACKGROUND

The REMIC provisions contained in Part IV of subchapter M of Chapter 1 of the Internal Revenue Code (sections 860A - 860G) provide for a pass-through vehicle that issues multiple classes of interests in pools of residential and commercial mortgage loans. All of the income from the mortgage loans in the REMIC is taxed to the holders of the regular and residual interests in the REMIC. Among the requirements for qualification are that the mortgage loans held by the REMIC must consist of "qualified mortgages" that are principally secured by an interest in real property. All of a REMIC's loans must be acquired on the startup day of the REMIC or within three months thereafter, except that the REMIC may exchange a defective loan for a "qualified replacement mortgage" for up to two years.

Section 1.860G-2(b)(1) of the Income Tax Regulations provides that, subject to certain exceptions described in section 1.860G-2(b)(3), if an obligation is significantly modified, then the modified obligation is treated as one that was newly issued in exchange for the unmodified obligation that it replaced. If such a significant modification occurs after the obligation has been contributed to the REMIC and the modified obligation is not a qualified replacement mortgage, the modified obligation will not be a qualified mortgage and the deemed disposition of the unmodified obligation will be a prohibited transaction under section 860F(a)(2). Section 1.860G-2(b)(2) defines a "significant modification" as any change in the terms of an obligation that would be treated as an exchange of obligations under section 1001 and the related regulations. The treatment of specific loan modifications as deemed exchanges is addressed in section

1.1001-3. Section 1.1001-3 defines a loan modification and provides that a modification that is significant will be treated as a deemed exchange of the original loan for a new loan.

Section 1.860G-2(b)(3) sets forth four types of loan modifications that are expressly permitted without regard to the section 1001 modification rules. The four permitted modifications are: (i) changes in the terms of the obligation occasioned by default or a reasonably foreseeable default; (ii) assumption of the obligation; (iii) waiver of a due-on-sale clause or a due on encumbrance clause; and (iv) conversion of an interest rate by a mortgagor pursuant to the terms of a convertible mortgage.

The present REMIC regulations were adopted in 1992 at a time when the mortgage-backed securities market involved primarily residential mortgage loans. Since the adoption of the REMIC regulations, the securitization of commercial real estate mortgages has become more common. The four types of modifications that are expressly permitted without regard to the section 1001 modification rules cover the most common changes affecting residential mortgage loans, but may not cover the range of likely changes in commercial mortgage loans.

To accommodate commercial mortgage loans, the IRS and Treasury are considering whether the present REMIC regulations should be amended to reflect the evolution of market practices in the mortgage-backed securities industry. In particular, the IRS and Treasury are considering whether the regulations should be amended to provide exceptions for certain modifications of

commercial mortgage loans. In doing so, the IRS and Treasury are considering whether such changes would be consistent with the policy underlying existing regulatory provisions and Congressional intent in enacting the REMIC rules.

III. REQUEST FOR SUBMISSIONS

A. In General

The determination of whether to amend the REMIC rules requires extensive legal and policy analysis, as well as a better understanding of commercial mortgage securities industry practices. Consequently, the IRS and Treasury are requesting written submissions from taxpayers, industry associations, and other interested parties to aid the IRS and Treasury in determining whether it is appropriate to amend the REMIC regulations by expanding the list of permitted loan modifications to include certain modifications incurred in connection with commercial mortgages.

B. Format of Submissions

Submissions should include draft changes to the REMIC regulations and a policy memorandum. It is anticipated that the draft amendment will include proposed exceptions for new types of permissible loan modifications that reflect routine industry practices in connection with commercial mortgage loans.

The policy memorandum should discuss:

1. the evolution of market practices in the securitization of commercial mortgages in REMIC form;
2. the relevant REMIC policy considerations affecting restrictions on mortgage loan modifications;

3. the authority under current law for amending the regulations to include exceptions for commercial mortgages;
4. the relationship between the section 1001 modification rules and the separate REMIC modification rules;
5. an analysis of the extent to which the four existing exceptions for mortgages and any proposed exceptions for commercial mortgages constitute departures from the section 1001 modification rules;
6. the purpose and background of the four existing exceptions for modifications of mortgages in the REMIC modification rules (including policies that might favor allowing assumptions and waivers of due on sale clauses in programs intending to assist residential housing acquisitions (e.g., tax-exempt single family housing bonds, VA & FHA insured mortgages));
7. examples of what are considered to be common changes requested by borrowers to the terms of commercial mortgages and an explanation of why such changes are requested by borrowers;
8. an explanation of each proposed exception for commercial mortgages, including (i) how each proposed exception is consistent with the underlying existing regulatory provisions and Congressional intent in enacting the REMIC rules, (ii) whether the proposed exception relates to a common change; and (iii) how each proposed exception would accommodate a legitimate business concern;
9. each proposed exception illustrated by one or more examples;

10. whether there are alternatives to resolve industry issues related to commercial mortgage loan modifications other than through amending the regulations and the feasibility of such alternatives (e.g., drafting documents to permit certain changes to the terms of the commercial mortgage loan to avoid triggering a significant modification under section 1.1001-3);

11. identification of the types of taxpayers and other interested persons who are affected by the inability to modify commercial mortgage loans once the loan is placed in a REMIC and how they are affected;

12. an estimate of how many taxpayers and other interested persons are directly and indirectly affected by an inability to modify commercial mortgage loans;

13. potential consequences to the industry if changes are not made to the regulations to permit certain changes to the terms of the commercial mortgage loans; and

14. because some or all of the proposed exceptions for commercial mortgage loans will likely constitute a significant modification under section 1.1001-3, a discussion of the resulting tax consequences to the REMIC of deemed exchange treatment under section 1001 (e.g., how would the existing REMIC rules treat a gain or loss from a deemed exchange).

C. Communication with Submitting Parties during the Drafting Process

Written submissions should fully develop the issues set forth in part III., B., above. A dialogue between submitting parties and IRS and Treasury personnel during the drafting process may help ensure that submissions are as

comprehensive as possible. Consequently, the IRS and Treasury encourage submitting parties to contact or meet with IRS and Treasury personnel during the initial development of their submissions.

IV. IRS AND TREASURY REVIEW OF SUBMISSIONS

A. Meetings with a Submitting Party

A submitting party may be asked to meet informally with personnel from IRS and Treasury. These meetings are intended to be used to explore the proposals and the analysis supporting those proposals set forth in a written submission and to gather additional facts and information. Discussions at these meetings may focus on the legal and policy justifications for each proposal, relevant industry practices, and any other issues of concern raised by IRS and Treasury personnel. At the end of these meetings, the IRS and Treasury may request a submitting party to provide additional factual development or legal research. The IRS and Treasury may also request additional meetings to the extent necessary to clarify any remaining issues.

Any solicitation of input from interested persons will be done within the requirements of the Federal Advisory Committee Act. The IRS does not intend to form advisory committees during this process. Although input is welcome, interested parties will not be invited to enter into negotiations or to participate in the decision-making process with respect to the proposed resolution of any issue.

B. IRS and Treasury Review and Decision-Making

After IRS and Treasury personnel have met with submitting parties and have been provided with any additional information requested, IRS and Treasury personnel will further review all submitted material, and develop any additional legal and policy analysis. After the review process is completed, the IRS and Treasury will decide whether it is appropriate to publish guidance that permits certain modifications to commercial real estate loans. If guidance is appropriate, the IRS and Treasury intend to publish proposed amendments to the REMIC regulations permitting additional types of modifications to commercial real estate loans.

V. DEADLINE AND ADDRESS FOR SUBMISSIONS

Written submissions should be submitted no later than Monday, April 30, 2007, to Internal Revenue Service, CC:PA:LPD:RU (Notice 2007-17), room 5203, P.O. Box 7604, Ben Franklin Station, Washington, DC 20044.

Submissions may be hand delivered between the hours of 8 a.m. and 4 p.m. to CC:PA:LPD:RU (Notice 2007-17), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue NW, Washington, DC 20224. Alternatively, submissions may be submitted via the Internet at

Notice.Comments@irsounsel.treas.gov (Notice 2007-17). All submissions will be available for public inspection and copying in their entirety. Therefore, submissions received by the IRS and Treasury should not include taxpayer-specific information of a confidential nature. Submissions should include the name and telephone number of a person to contact.

VI. DRAFTING INFORMATION

The principal author of this notice is Diana Imholtz of the Office of Associate Chief Counsel (Financial Institutions and Products). For further information regarding this notice, contact Ms. Imholtz at 202-622-3930 (not a toll-free call).