Part III - Administrative, Procedural, and Miscellaneous

Modifications of Commercial Mortgage Loans Held by an Investment Trust

Notice 2009-79

In TD 9463, the Internal Revenue Service (IRS) and the Treasury Department issued final regulations relating to permitted modifications of commercial mortgage loans held by a real estate mortgage investment conduit (REMIC). See TD 9463, 74 FR (No. 178, September 16, 2009), (amending § 1.860G-2(b)(3) of the Income Tax Regulations). In response to a request for comments in Notice 2007-17, 2007-1 C.B. 748 (March 19, 2007), and in response to proposed regulations published in the Federal Register (72 FR 63523) on November 9, 2007, several commentators recommended that the scope of the regulations project be expanded to include a rule that would permit investment trusts to modify commercial mortgage loans to the same extent that REMICs can modify those loans under § 1.860G–2(b)(3) (taking into account the anticipated amendments to that rule). The commentators, however, did not provide detailed explanations for why those changes were needed or whether there are alternative ways of dealing with investment trust interests held by REMICs.

The scope of the final regulations remained focused on § 1.860G-2(b)(3) and was not expanded to include modifications of commercial mortgage loans held by investment trusts. The IRS and the Treasury Department note that, although REMICs and investment trusts are often used to securitize mortgages, the requirements for classification as a REMIC are not identical to the requirements for classification as a trust. The IRS and the Treasury Department continue to study the commentators' recommendation and in this notice solicit input concerning whether additional guidance may be appropriate.

Background

Section 301.7701-1(b) of the Procedure and Administration Regulations provides that the classification of organizations that are recognized as separate entities is determined under §§ 301.7701-2, 301.7701-3, and 301.7701-4, unless a provision of the Internal Revenue Code (Code) (such as section 860A addressing Real Estate Mortgage Investment Conduits (REMICs)) provides for special treatment of that organization.

Section 301.7701-2(a) provides that a "business entity" is an entity recognized for federal tax purposes that is not properly classified as a trust under § 301.7701-4 or otherwise subject to special treatment under the Code.

Section 301.7701-4(a) provides that, in general, an arrangement is treated as a trust if it can be shown that the purpose of the arrangement is to vest in trustees responsibility for the protection and conservation of property for beneficiaries who cannot share in the discharge of this responsibility and, therefore, are not associates in a joint enterprise for the conduct of business for profit.

Section 301.7701-4(b) provides that there are arrangements that are known as trusts, because legal title to property is conveyed to trustees for the benefit of beneficiaries, but that are not classified as trusts for purposes of the Code because they are not simply arrangements to protect or conserve the property for the beneficiaries. The beneficiaries generally create these trusts, which are often known as business or commercial trusts, simply as a device to carry on a profit-making business. Such a business normally would have been carried on through business organizations that the Code classifies as corporations or partnerships (business entities).

Section 301.7701-4(c) provides that an "investment" trust is not classified as a trust if there is a power under the trust agreement to vary the investment of the certificate holders. See Comm'r v. North American Bond Trust, 122 F.2d 545 (2d Cir. 1941), *cert. denied*, 314 U.S. 701 (1942). An investment trust with a single class of ownership interests representing undivided beneficial interests in the assets of the trust is classified as a trust if there is no power to vary the investment of the certificate holders.

A power to vary the investment of the certificate holders exists where there is a managerial power, under the trust instrument, that enables a trust to take advantage of variations in the market to improve the investment of the investors. See North American Bond Trust, 122 F.2d at 546.

In previous published guidance, the IRS and the Treasury Department have identified situations in which a power to vary is determined not to be present. For example, in Rev. Rul. 73-460, 1973-2 C.B. 424, a sponsor establishes an investment trust to hold municipal bonds. The sponsor has the power, under certain conditions,

such as a default by a bond issuer or substantial decline in the market value of certain bonds, to direct the trustee to sell the affected bonds to preserve the sound investment character of the trust. Except in case of default or probable default, the trustee is not permitted to accept any new or substitute bonds from an obligor who is refunding or refinancing bonds held by the investment trust. The trust agreement also requires that moneys in the interest and principal accounts must be distributed to certificate holders. Rev. Rul. 73-460 concludes that a power to vary is not necessarily present if there is a power to dispose of trust assets to preserve the value of the trust in situations where, for example default has occurred or there is a substantial decline in the value of the assets provided that the proceeds of the sale are distributed to certificate holders and are not reinvested in additional assets. Rev. Rul. 73-460 also concludes that a power to accept an issuer's offer to exchange or substitute existing obligations held by the investment trust pursuant to a plan for the refunding or refinancing of such obligations in situations where the issuer has already defaulted or the occurrence of default is probable is not a power to vary.

In Rev. Rul. 90-63, 1990-2 C.B. 270, a trustee has the power to consent to changes in the credit support of debt obligations held by the trust, but the power is exercisable only if the trustee reasonably believes that the changes are needed to maintain the value of the trust assets by preserving the credit rating of the obligations. Rev. Rul. 90-63 concludes that this power to change the credit support, exercisable only if needed to preserve the value of the trust assets, is not a power to vary.

A "power to vary" was found to be present, however, in Rev. Rul. 78-149, 1978-1 C.B. 448. Rev. Rul. 78-149 involves a municipal bond trust in which the trustee has a

limited power to reinvest in certain types of municipal bonds. The trust agreement provides that in the case of early redemption by a bond issuer, the trustee is permitted to reinvest the proceeds in similarly rated bonds that mature no later than the last maturity date of municipal bonds originally deposited in the trust. The trustee may also choose to distribute the proceeds to the trust certificate holders. In holding that the trust is an association taxable as a corporation for federal tax purposes, Rev. Rul. 78-149 concludes that "the power in the trust agreement permitting reinvestment of the proceeds of obligations redeemed prior to maturity, even though limited to reinvestment of the proceeds of redemptions over which the trust has no control, is a managerial power that enables the trust to take advantage of variations in the market to improve the investment of the investors."

A power to vary does not exist as a result of reinvestments that occur outside of the original investment trust. In Rev. Rul. 81-238, 1981-2 C.B. 248, the sponsor of the initial investment trust, prior to each semiannual distribution, creates a new investment trust in which certificate holders can invest their distributions. With regard to each specific investment trust, neither the trustee nor any other person has a power to vary the investments of the trust. Certificate holders in the original investment trust may choose to have all of their distributions invested in the newly-created investment trusts under an automatic reinvestment plan or may choose to receive cash. Further, certificate holders may choose to participate in or terminate the reinvestment plan at any time, may withdraw from the reinvestment plan with respect to particular distributions, or may withdraw from the reinvestment plan with respect to only some of the certificates they own. Rev. Rul. 81-238 concludes that the reinvestment plan does

not create a power to vary, because there is no change in, or addition to, the assets of the original trust and the investment of each certificate holder in the original trust remains fixed.

Request for Comments

The IRS and the Treasury Department welcome further comments regarding what additional guidance, if any, is needed regarding modifications of commercial mortgage loans held by investment trusts. To be most useful, the comments should also analyze the extent to which the modifications at issue are consistent with existing case law and administrative pronouncements that govern whether an investment trust is classified as a trust for federal income tax purposes. Answers to the following questions would be particularly helpful:

1. Is it common business practice to hold commercial mortgage loans through an investment trust? If so, please describe the structure of an investment trust that holds commercial mortgage loans. Also, if commercial mortgages are held by a REMIC through an investment trust, please explain the utility of this structure and its business purpose.

2. Are there fact patterns which are not described in § 1.860G-2(b)(3)(i) and in which one or more modifications permitted to REMICs under § 1.860G-2(b)(3)(ii) through (vi) would be consistent with the case law and prior administrative pronouncements if carried out by an investment trust?

3. Are there alternative structures that would be consistent with the case law and prior administrative pronouncements and would allow the modified mortgage loans

to be held by an investment trust? Are there any changes or additions to the REMIC rules that would be needed to facilitate these alternative structures?

Interested parties are invited to submit comments on this notice by November 14, 2009. Comments should be submitted in writing, and should include a reference to Notice 2009-79. Send submissions to: CC:PA:LPD:PR (Notice 2009-79), Room 5203, Internal Revenue Service, PO Box 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand delivered Monday through Friday between the hours of 8 a.m. and 4 p.m. to CC:PA:LPD:PR (Notice 2009-79), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC. Alternatively, comments may be submitted electronically directly to the IRS via the following e-mail address: *Notice.comments@irscounsel.treas.gov.* Please include "Notice 2009-79" in the subject line of any electronic communication. All materials submitted will be available for public inspection and copying.

Drafting Information

The principal author of this notice is Pamela Lew of the Office of Associate Chief Counsel (Financial Institutions & Products). For further information regarding this notice contact Pamela Lew on (202) 622-3950 (not a toll-free call).