

Internal Revenue Service

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Department of the Treasury

Washington, DC 20224

Person to Contact:

Telephone Number:

Refer Reply To:

CC:FI&P:2 - PLR-140643-02

Date: February 14, 2003

Legend:

REMIC =

Borrower =

Lender =

Loan =

Mortgage =

Assignment =

Loan Documents =

Date A =

Date B =

Date C =

x =

y =

State =

Dear :

This responds to your request of July 9, 2002, submitted on behalf of REMIC, that the Internal Revenue Service rule that the Loan held by REMIC will continue to be a qualified mortgage within the meaning of section 860G(a)(3) of the Internal Revenue Code of 1986 if the real estate collateral that secures Borrower's obligation under the Loan is released from REMIC's lien pursuant to the defeasance transaction described below.

FACTS

Borrower is organized as a corporation under the laws of State. Borrower and Lender entered into a Loan as a nonrecourse obligation on Date A in an original face amount of \$x. On Date B, Borrower executed a Mortgage note evidencing the loan and an Assignment of leases and rents and security deposits in Lender's favor. The Mortgage provided for an interest rate of y percent and an original maturity date of Date C.

Under the terms of the Loan, Borrower has the right to prepay the principal after the expiration of a ten-year period from the date of issue, which period has not yet expired. Neither the Loan, Mortgage, nor Assignment (collectively, the "Loan Documents") executed by Borrower and Lender specifically provide the Borrower with any right to defease the Loan by the substitution of alternative collateral for the real property securing the Loan. The Loan Documents are also silent as to whether Borrower has the right to require REMIC to release its lien on the real estate collateral pursuant to a defeasance transaction.

On or about Date B, the startup day of REMIC, Lender transferred the Loan to REMIC. REMIC is a state law trust that has elected to be treated as a real estate mortgage investment conduit (REMIC) under §860D(b) of the Code.

Borrower's performance of its obligations under the terms of the Loan is secured by a mobile home park. Borrower now proposes to sell the mobile home park for an amount substantially in excess of the original face amount of the Loan. In order to complete this transaction, Borrower is required to deliver title to the mobile home park to its purchaser free and clear of REMIC's lien.

Borrower proposes to obtain release of REMIC's lien pursuant to a defeasance transaction. Under the terms of the proposed defeasance, Borrower would pledge government securities, as defined in §1.860G-2(a)(8)(i) of the Income Tax Regulations

(incorporating by reference section 2(a)(16) of the Investment Company Act of 1940, as amended (15 U.S.C. 80a-1)), in an amount necessary to make all payments of principal and interest due on the Loan throughout the ten-year period during which prepayment of the Loan is proscribed, and to pay off the Loan at the expiration of this period.

In support of its proposed plan of defeasance and release of REMIC's lien, the taxpayer cites an opinion of the highest court of State concluding that State's policy against restraints on the alienation of land supported a presumption in favor of a right of prepayment in a case involving a mortgage note that was silent as to the right of prepayment. The court also took note of the policy against restraints on alienation in stating that, where a mortgagor provides a mortgagee with the benefit of its bargain under the terms of the mortgage, a mortgagor is entitled to the release of its land following the substitution of security or other arrangement. The taxpayer therefore maintains that, although the matter is not free from doubt, REMIC would be required to release its lien under this authority in the event that Borrower provided REMIC with the benefit of its bargain under the terms of the Loan.

LAW AND ANALYSIS

Section 860D(a)(4) of the Code defines a REMIC in pertinent part as an entity substantially all of the assets of which consist of qualified mortgages and permitted investments as of the close of the third month beginning after the startup day and at all times thereafter. Section 860G(a)(3)(A) requires that an obligation be principally secured by an interest in real property to be considered a qualified mortgage. Section 860G(a)(3)(A) also requires that an obligation be transferred to the REMIC on the startup day in exchange for regular or residual interests in the REMIC or be purchased by the REMIC within the 3-month period beginning on the startup day to be considered a qualified mortgage.

Section 1.860G-2(a)(8) of the regulations provides that a mortgage ceases to be a qualified mortgage if a REMIC releases its lien on real property that secures it unless certain requirements are met. The requirements set forth are: (i) the mortgagor must pledge substitute collateral that consists solely of government securities (as defined in section 2(a)(16) of the Investment Company Act of 1940 as amended (15 U.S.C. 80a-1)); (ii) the mortgage documents must allow such a substitution; (iii) the lien must be 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 (iv) the release must not be within 2 years of the startup day.

The proposed defeasance transaction satisfies the requirements of clauses (i), (iii), and (iv) of §1.860G-2(a)(8) of the regulations as follows. Borrower, the mortgagor, proposes to pledge substitute collateral that consists solely of government securities (as defined in section 2(a)(16) of the Investment Company Act of 1940, as amended); the proposed release of the mortgage lien will facilitate the disposition of the property, and will not form part of an arrangement to collateralize a REMIC offering with obligations

that are not real estate mortgages; and the proposed release of the mortgage lien will not fall within 2 years of the startup day.

The requirement of clause (ii) of §1.860G-2(a)(8) of the regulations that the mortgage documents must allow a substitution of collateral as described in clause (i) of that regulation is satisfied where, as here represented by the taxpayer, the highest court of the State having jurisdiction over the real property and contractual obligations with respect to that property has held that a right to obtain a release of a mortgagee's lien upon property exists if a mortgagor provides a mortgagee with the benefit of its bargain.

Section 1.860G-2(b)(1) of the regulations provides that if an obligation is significantly modified in a manner or under circumstances other than those described in paragraph (b)(3), then the modified obligation is treated as one that was newly issued in exchange for the modified obligation that it replaced. Consequently, 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. A "significant modification" is defined under paragraph (b)(2) of §1.860G-2 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.

Section 1001(c) of the Code provides that the entire amount of gain or loss on the sale or exchange of property shall be recognized, except as otherwise provided. Section 1.1001-1(a) of the regulations states in pertinent part that the gain or loss realized from the exchange of property for other property differing materially either in kind or in extent is treated as income or as loss sustained.

Section 1.1001-3 of the regulations provides rules for determining whether a modification of the terms of a debt instrument results in an exchange for purposes of §1.1001-1(a). Under the general rule set forth in §1.1001-3(b), a significant modification of a debt instrument results in an exchange of the original debt instrument for a modified instrument that differs materially either in kind or in extent from the original debt instrument.

Section 1.1001-3(c)(1)(i) of the regulations defines a modification as any alteration, including any deletion or addition, in whole or in part, of a legal right or obligation of the holder or issuer of a debt instrument, whether the alteration is evidenced by an express agreement (oral or written), conduct of the parties, or otherwise.

Section 1.1001-3(c)(2)(iii)(A) of the regulations provides that an alteration that results from the exercise of an option provided to an issuer or a holder to change a term of a debt instrument is a modification unless the option is unilateral. Section 1.1001-3(c)(3) provides that an option is unilateral only if, under the terms of an instrument or under applicable law, (i) there does not exist, at the time the option is exercised, or as a result of the exercise, a right of the other party to alter or terminate the instrument or put the instrument to a person who is related to the issuer; (ii) the exercise of the option

does not require the consent or the approval of the other party, a related party, or a court or arbitrator; and (iii) the exercise of the option does not require consideration, except as further described therein.

Borrower holds a unilateral option to defease the Loan under applicable law where, as here represented by the taxpayer, the highest court of the State having jurisdiction over the real property and contractual obligations with respect to that property has held that a mortgagor has a right to obtain a release of a mortgagee's lien upon property if a mortgagor provides a mortgagee with the benefit of its bargain.

Accordingly, the tendering of the benefit of the mortgagee's bargain pursuant to the proposed plan of defeasance will not constitute a significant modification of the Loan within the meaning of §1.1001-3(c)(2)(iii)(A) of the regulations, and will not cause the Loan to cease to be a qualified mortgage within the meaning of section 860G(a)(3) of the Code and §1.860G-2(b)(2) of the regulations.

CONCLUSIONS

Based on the facts as represented, we rule as follows:

(1) That the requirement of clause (ii) of §1.860G-2(a)(8) of the regulations that the mortgage documents must allow a substitution of collateral is satisfied where, as here represented by the taxpayer, the highest court of the State having jurisdiction over the real property and contractual obligations with respect to that property has held that a right to obtain a release of a mortgagor's lien upon property exists if a mortgagor provides a mortgagee with the benefit of its bargain; and

(2) That the Borrower holds a unilateral option to defease the Loan under applicable law where, as here represented by the taxpayer, the highest court of the State having jurisdiction over the real property and contractual obligations with respect to that property has held that a mortgagor has a right to obtain a release of a mortgagor's lien upon property if a mortgagor provides a mortgagee with the benefit of its bargain. Accordingly, the tendering of the benefit of the mortgagee's bargain pursuant to the proposed plan of defeasance will not constitute a significant modification of the Loan within the meaning of §1.1001-3(c)(2)(iii)(A) of the regulations, and will not cause the Loan to cease to be a qualified mortgage under section 860G(a)(3) of the Code and §1.860G-2(b)(2) of the regulations.

Except as specifically ruled upon above, no opinion is expressed or implied regarding the federal tax consequences of the described transaction. No opinion is expressed as to whether REMIC otherwise qualifies as a REMIC under sections 860A through 860G of the Code.

This ruling is directed only to the taxpayer who requested it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

A copy of this letter should be attached to the federal income tax return of REMIC for the taxable year in which the proposed plan of defeasance and release of REMIC's mortgage lien is executed

Sincerely,

William E. Coppersmith
William E. Coppersmith
Chief, Branch 2
Office of Associate Chief Counsel
(Financial Institutions & Products)

Enclosure: section 6110 copy