Proposed Tax Amendments Remove Obstacle to Defeasance Transactions in Canada

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Over the past decade, the size of the Canadian commercial mortgage-backed securities (CMBS) market has grown at a dramatic rate. It has been reported that over $4.5 billion of Canadian CMBS were issued in 2006 alone.

As the size of the Canadian CMBS market has expanded, the prevalence of defeasance transactions has also increased. In 2006, 37 loans, totalling over $560 million, were defeased.

In the CMBS market, defeasance is the process by which a borrower replaces real property security in respect of a particular debt obligation with personal property security. The mortgage is discharged from the real property security and the borrower is free to sell or re-finance the property as it wishes. All obligations under the loan and the mortgage, other than those related to the use, operation or ownership of the original real property security remain in place, such as the obligation to continue to make payments under the loan. In exchange for a release of its security interest in the real property, a mortgagee receives a pledge of bonds from the borrower. The bonds are generally high-quality, triple-A rated, sovereign risk (such as Government of Canada bonds) and are purchased in such a combination that the proceeds from the maturity and coupons of the bonds match the future payments that will be due under the loan. Thus, provided an efficient portfolio of bonds has been assembled, each future payment under the loan is matched to a bond within the portfolio that comes due, or pays a coupon, on or prior to a payment date, such that the remaining payments under the loan are fully covered by the income stream from the bonds.

Defeasance Collateral in the United States

In the U.S., defeasance collateral must comply with the requirements of (1) real estate mortgage investment conduit (REMIC) regulations; and (2) the underlying loan and CMBS documentation. REMIC regulations generally require that defeasance collateral consist of "government securities," as that term is defined in the *Investment Company Act*. A "government security" is defined as "any security issued or guaranteed as to principal or interest by the United States, or by a person controlled or supervised by and acting as an instrumentality of the Government of the United States pursuant to the authority granted by the Congress of the United States."

U.S. Treasury obligations, as well as debt obligations of the Federal National Mortgage Association ("Fannie Mae") and the Federal Home Loan Mortgage Corporation ("Freddie Mac") are included within the scope of defeasance collateral that is permitted by REMIC regulations. Debt obligations issued by Fannie Mae and Freddie Mac receive favorable treatment under REMIC regulations since the issuers are agencies of the U.S. government. In addition, the underlying loan and CMBS documentation typically include provisions that address defeasance and which may require the borrower to deliver a specific type of government security as defeasance collateral. Such provisions will often specify the use of U.S. Treasury obligations as the defeasance collateral. Since U.S. Treasury obligations carry a higher perceived creditworthiness than other types of government securities (including agency paper), if the loan documentation requires U.S. Treasury obligations to be delivered as defeasance collateral, servicers may not allow a modification of those provisions to allow agency paper such as Fannie Mae or Freddie Mac obligations.

Defeasance Collateral in Canada

In Canada, there are no REMIC requirements that must be satisfied. However, there are generally other constraints imposed upon the personal property that a borrower can use as defeasance collateral in Canada, including those arising by virtue of (1) the desire to secure certain favourable characterizations under the *Income Tax Act* (Canada) (the "Tax Act"); and (2) the underlying loan and CMBS documentation.

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As a means of maximizing the marketability of particular CMBS offerings, certain CMBS are structured so as to permit Canadian registered retirement savings plans, registered retirement income funds, deferred profit sharing plans, and registered education savings plans (collectively, "Registered Plans") to validly acquire and hold the CMBS product without triggering harsh tax consequences.

The Tax Act generally provides that a Registered Plan may be subject to special Canadian tax liabilities if the plan holds property other than "qualified investments." In Canada, CMBS certificates are generally structured so that they constitute qualified investments for the purposes of the Tax Act, which significantly increases the number of potential investors of such CMBS product. The regulations to the Tax Act have historically provided that a certificate evidencing an undivided interest in one or more properties constitutes a qualified investment where (1) all or substantially all[1] of the fair market value of the certificate is attributable to property that is, or is incidental to, a debt obligation secured by a mortgage, charge, hypothec, or similar instrument in respect of real property situated in Canada; (2) the certificate has, at the time of its acquisition by the Registered Plan, an investment-grade rating with a bond rating agency that rates debt in the ordinary course of its business (the "Bond Rating Test"); and (3) the certificate is issued as part of an issue of certificates by the issuer for a total amount of at least $25,000,000 (the "Offering Test").

In order to preserve the qualified investment status of a CMBS certificate, the documentation governing the CMBS offering will frequently provide that no defeasance transactions will be permitted to be undertaken if the defeasance will compromise the status of the CMBS as a qualified investment for Canadian tax purposes (a "Qualified Investment Limitation"). Hence, to the extent that a borrower wished to undertake a defeasance transaction in respect of a CMBS that was encumbered by a Qualified Investment Limitation, concerns would arise if the real property security being released had a fair market value in excess of 10% of the fair market value of all of the property used to secure the operative debt obligation. Such concerns were particularly acute when dealing with debt obligations that were secured by a small number of sizeable Canadian real properties.

At the end of August 2006, the Canadian Department of Finance was asked to expand the applicable definition of a qualified investment to capture CMBS that were initially secured by Canadian real property, yet were subsequently fully defeased by the pledging of certain debt obligations as replacement security. On August 30, 2006, the Department of Finance issued a comfort letter confirming that the Department was prepared to recommend to the Minister of Finance that the regulations to the Tax Act be amended to allow for bonds secured by Canadian real property to be fully defeased with certain high-quality debt instruments without jeopardizing the status of a CMBS as a qualified investment for Canadian tax purposes.

On June 23, 2007, proposed amendments to the regulations under the Tax Act were published which, when enacted, will formally expand the scope of what validly constitutes a qualified investment for Canadian tax purposes. As noted in the "Regulatory Impact Analysis Statement" that accompanied the release of the proposed amendments, the definition of a qualified investment will be "amended to ensure that a mortgage certificate will not lose its qualified investment status if a mortgage that was registered in connection with the certificate is released in exchange for the provision of other high-quality substitute security." The new, expanded definition of a qualified investment is proposed to apply, with retroactive effect, after 2005.

Upon the enactment of the proposed amendments, a certificate that satisfies the Bond Rating Test and the Offering Test will be a qualified investment provided all or substantially all of the fair market value of the certificate is attributable to property that is, or is incidental to, a debt obligation secured by either (1) a mortgage, charge, hypothec, or similar instrument in respect of real or immovable property situated in Canada; or (2) certain bonds, debentures, notes, mortgages, hypothecary claims, or similar obligations of the Canadian or a provincial government, including bonds guaranteed by the Government of Canada, that were substituted for the security referred to in paragraph (a) under the terms of the debt obligation.

It is expected that the new, expanded definition of a qualified investment, when enacted, will remove a potential obstacle to defeasance transactions, particularly

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to generalize about something that's extremely market specific, we think that office fundamentals are likely to hold up better than retail over the coming year.

As far as multi-family is concerned, displaced homeowners could provide a boost to rental demand in several markets. But in the medium term, we think vacant homes are likely to be a drag on apartment rents, and multi-family prospects should be tied to the single family/condo market, as well as to the state of the economy and job creation. Hence, there is downside in a protracted housing slump and weak job market. All things considered, we would prefer pools that are office-heavy but without significant exposure to markets tied to the mortgage finance industry, such as Orange County, CA. ❑

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[1] *These are simplistic assumptions made for illustrative purposes. In reality, a premium property is expected to be larger and the NCF and value higher. While that would increase the scale, it does not alter the economics.*

[2] *In several cases, the leverage has been substantially higher—at 90%-95% of the purchase price. We did not attempt to model such high leverage because the economics are likely to be extremely sensitive to the inputs. In general, the all-in cost of debt in such cases is obviously higher, which should push up the required income growth. On the other hand, the higher leverage pushes down the required income growth. In most cases, we think the higher leverage effect would prevail, but of course, such an acquisition has much lower cushion from downside risk.*

[3] *The borrower would need to fund this DSCR reserve, which alters the overall economics a bit. But we have ignored this for the purpose of simplicity; we think the effect is not significant because this reserve is usually only a fraction of the value of the property or the size of the loan.*

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in respect of debt obligations that are secured against a small number of large pieces of Canadian real property. The amendments will clarify what is acceptable defeasance collateral in these circumstances and will specifically preserve the qualified investment status of CMBS certificates where a defeasance has taken place with the enumerated types of collateral. The amendments may also serve to limit the scope of interpretation of what constitutes acceptable defeasance collateral to those securities specifically identified in the proposed regulatory amendments. This, coupled with the fact that the provisions of the underlying loan and CMBS documentation often require the borrower to deliver a specific type of government security as defeasance collateral (such as Government of Canada treasury obligations, as is the case in U.S. transactions), means that while there will be greater certainty about what constitutes acceptable defeasance collateral, the universe of possible defeasance collateral has not been significantly expanded. In addition, since most defeasance transactions in Canada are reviewed by rating agencies, the rating agencies (as well as the servicer(s) and the custodian) also need to be comfortable with the substitute collateral that is being pledged. To the extent that securities specifically enumerated in the operative tax regulation are not used, it may be a challenge to obtain the necessary approvals from these parties. However, the benefit of the proposed amendments to the regulations under the Tax Act lies in the fact that there will be less ambiguity about the types of defeasance collateral that will be acceptable in certain circumstances for the purposes of preserving the qualified investment status of the CMBS certificates. And greater certainty in markets is always a good thing. ❑

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[1] *The Canada Revenue Agency generally asserts that the phrase "all or substantially all" represents 90% or more of a particular amount.*