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Legal Update
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REITs Provided Safe Harbors for Modifying Loans Secured by Distressed Real Estate

On January 5, 2011, the US Treasury Department published Revenue Procedure 2011-16 (the "Revenue Procedure"), providing guidance to real estate investment trusts (REITs) engaged in transactions involving debt secured by real estate that has declined in value. Specifically, the Revenue Procedure provides safe harbors for meeting the REIT income and asset tests in connection with the modification of loans secured by real estate, and it clarifies the treatment of mortgage loans acquired by a REIT through a secondary purchase.

Background

Under the Internal Revenue Code of 1986, as amended (the "Code"), a domestic corporation that is taxed as a REIT is entitled to a dividends paid deduction for distributions made to its shareholders (effectively eliminating corporate-level taxation). In order to maintain REIT status, at the close of each quarter of its taxable year, at least 75 percent of the value of a REIT's total assets must be represented by, among other items, real estate assets (including real estate mortgages). Additionally, at least 95 percent of a REIT's gross income must be derived from qualified income listed in section 856(c)(2) of the Code, and at least 75 percent of its gross income must be from qualifying income listed in section 856(c)(3). Interest income is generally qualifying income for purposes of the 95 percent gross income test, and interest income from obligations secured by real property is generally qualifying income for purposes of the 75 percent gross income test. If a mortgage loan is secured by both real property and other property, then Treasury Regulation section 1.856-5(c) provides that the interest income from such loan must be apportioned between interest income from an obligation secured by real property and interest income from an obligation that is not so secured.

Under the apportionment test, if the fair market value of the real property securing the loan equals or exceeds the principal amount of the loan, then all of the interest income is apportioned to the real property; if it does not, then only a proportionate amount of the interest income is apportioned to the real property. For these purposes, the fair market value of the real property is determined at the time the REIT's commitment to either make or purchase the loan becomes binding. Thus, subsequent declines in value will not affect the percentage of the interest income that is apportioned to the real property.

Certain modifications of a loan may, however, result in the deemed issuance of a new loan under Treasury Regulation section 1.1001-3. Consequently, if a REIT holds a loan secured by real property and that loan is significantly modified (as defined in Treasury Regulation section 1.1001-3), then Treasury Regulation section 1.856-5(c) could be read to require the REIT to use the property's fair market value at the time of the modification for purposes of apportioning the interest income earned in periods after such modification. If the fair market

value of the real property has declined since the loan was originally made or acquired, the use of the lower fair market value could reduce the portion of the interest income that will qualify under the 75 percent gross income test and, thus, may jeopardize the entity's ability to maintain REIT status.

Code section 857(b)(6) imposes a 100 percent tax on the net income derived by a REIT from any "prohibited transaction" (a sale or other disposition of property held as inventory or primarily for sale to customers in the ordinary course of a trade or business as described in Code section 1221(a)(1) that is not foreclosure property). There has been some concern that a deemed exchange of notes in connection with a significant modification of a loan could be viewed as a prohibited transaction.

New Guidance

The Revenue Procedure provides a safe harbor under which a REIT may treat a loan modification meeting the requirements of the Revenue Procedure as *not* being an exchange for a new debt instrument for purposes of the interest apportionment rule (although such modification may still give rise to a deemed exchange of notes under Treasury Regulation section 1.1001-3 for all other purposes of the Code). In other words, if the significant modification meets the requirements of the Revenue Procedure, the REIT may continue to apportion interest income from such loan based on the fair market value of the real property securing the loan at the time the REIT's original commitment to make or acquire the loan became binding. Further, such modification of the loan will not be treated as a prohibited transaction under Code section 857(b)(6).

To meet the requirements of the Revenue Procedure, the modification of a mortgage loan that is held by a REIT must either result from a default or satisfy two conditions: (i) the REIT or the loan servicer reasonably believes there is a significant risk of default of the pre-modified loan upon maturity or at an earlier date and (ii) the REIT or servicer reasonably believes that the modified loan presents a substantially reduced risk of default when compared with the pre-modified loan.

According to the Revenue Procedure, the determination must be based on a diligent, contemporaneous determination and may take into account credible written factual representations made by the loan issuer if neither the REIT nor the servicer knows or has a reason to know that such representations are false. In a determination of the significance of the risk of a default, one relevant factor is how far in the future the possible default may be. Past performance is also a relevant factor. However, there is not a maximum period making the default per se unforeseeable. Similarly, a REIT or servicer may reasonably believe there is a significant risk of default even if the loan is performing. As such, the analysis appears to be based on facts and circumstances.

Notably, the Revenue Procedure does not extend the safe harbor to encompass situations in which a REIT purchases from another party a mortgage loan that is secured by real property that has similarly declined in value. Without a safe harbor, Treasury Regulation 1.856-5(c)(2) and the Revenue Procedure state that the portion of the interest income that is apportioned to real property is determined based on the fair market value of the real property at the time the REIT makes a binding commitment to purchase the loan, not at the time the loan was originally made. Thus, where a REIT acquires a mortgage loan that is secured by real property that has declined in value to less than the principal amount of the loan, a portion of the interest income will not be qualifying income for purposes of the 75 percent gross income test even if the fair market value of the real property equals or exceeds the amount paid by the REIT to acquire the loan.

The Revenue Procedure also provides a safe harbor for the REIT asset tests. The Revenue Procedure stipulates that the Internal Revenue Service will not challenge the treatment of all or a portion of a loan as a real estate asset for purposes of the 75 percent asset test in an amount equal to the lesser of the value of the loan or the fair market value of the real property securing the loan as determined under Treasury Regulation section 1.856-5(c) and the Revenue Procedure. In other words, the REIT may treat the entire value of a loan as a real estate asset to the extent of the fair market value of the real property securing the loan at the time the REIT made a binding commitment to make or acquire the loan, and it is not required to "reset" the fair market value of the real property in connection with a significant modification of the loan that meets the requirements of the Revenue Procedure. However, in the case of a REIT that acquires a mortgage loan as a secondary purchaser, the REIT must use the fair market value of the real property securing the loan at the time the REIT made a binding commitment to acquire the loan rather the fair market value of the real property at the time the loan was originated.

For REITs seeking to modify the terms of their troubled loans, these safe harbors should provide comfort that the modification will not impair the REIT's ability to continue to satisfy the income and asset tests and that the modification will not be treated as a prohibited transaction. However, the Revenue Procedure provides no assistance to a REIT that acquires a troubled loan as a secondary purchaser, even where the value of the real property securing the loan equals or exceeds the amount paid by the REIT to acquire such loan.

The Revenue Procedure is effective for all calendar quarters and all taxable years.

For more information about the Revenue Procedure or any other matter raised in this Legal Update, please contact any of the attorneys listed below or any member of our Tax Transactions practice.

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