

## ***IRS Provides Safe Harbors for Distressed Real Estate Backed Debt Under the 75 Percent REIT Income and Asset Tests***



January 2011

*On January 5, 2011, the Internal Revenue Service (the “Service”) issued Revenue Procedure 2011-16, 2011-5 IRB (Rev. Proc. 2011-16). This revenue procedure provides a safe harbor for purposes of the REIT income test under section 856(c)(3)1 for certain kinds of modifications by REITs of distressed real estate backed debt. It also provides a safe harbor for distressed real estate backed debt for purposes of the 75 percent REIT asset test under section 856(c)(4). The revenue procedure is effective for all calendar quarters and all taxable years.*

### ***Background***

#### ***REIT 75 Percent Income and Asset Tests***

To qualify as a REIT, a REIT must meet certain annual income tests and quarterly asset tests. Specifically, at least 75 percent of a REIT's gross income for a taxable year must be derived from certain categories of real estate related income including, among other things, “interest on obligations secured by mortgages on real property or on interests in real property”<sup>2</sup> (the “75 percent income test”).<sup>3</sup> In addition, as of the end of each quarter of a taxable year, at least 75 percent of the value of a REIT's gross assets must consist of certain qualified real estate assets (the “75 percent asset test”). Qualified real estate assets for this purpose include, among other things, interests in mortgages on real property.<sup>4</sup>

If the property securing a mortgage loan consists of both real property and personal property, the Regulations provide special rules for apportioning the interest on the loan between interest on the portion of the loan treated as secured by real property (which qualifies under the 75 percent

income test) and interest on the portion of the loan that is not so secured (and which does not qualify under the 75 percent income test).<sup>5</sup> Pursuant to these regulations, if the “loan value of the real property” with respect to a mortgage loan exceeds the “amount of the loan,” then all of the interest income on the loan is deemed to be derived from the portion of the loan secured by real property.<sup>6</sup> Accordingly, all of such interest income is treated as qualified interest for purposes of the 75 percent income test.

By contrast, if the amount of the loan exceeds the loan value of the real property collateral, only a portion of the interest is treated as qualified interest on the real estate backed portion of the loan. Pursuant to the Regulations, interest income which is apportioned to the real property is equal to the product of the total interest income on a mortgage loan multiplied by a fraction the numerator of which is the loan value of the real property and the denominator is the amount of the loan.<sup>7</sup> The balance of the interest income is treated as nonqualified interest for purposes of the 75 percent income test.

<sup>1</sup> All section references herein are to the Internal Revenue Code of 1986, as amended (the “Code”), and the Treasury Department regulations issued thereunder (the “Regulations”).

<sup>2</sup> Section 856(c)(3)(B).

<sup>3</sup> Section 856(c)(4).

<sup>4</sup> Section 856(c)(5).

<sup>5</sup> See Treas. Reg. Section 1.856-5(c).

<sup>6</sup> Treas. Reg. Section 1.856-5(c)(1)(i).

<sup>7</sup> Treas. Reg. Section 1.856-5(c)(2)(ii).

The Regulations define the term “loan value of the real property” as the fair market value of real property collateral securing a loan on the date on which the REIT's commitment to make the loan becomes binding.<sup>8</sup> In the case of a mortgage loan purchased by a REIT, the loan value of the real property is the fair market value of the property as of the date on which the REIT's commitment to purchase the loan becomes binding.<sup>9</sup> The “amount of the loan” is defined as the highest principal of the loan outstanding during a taxable year.<sup>10</sup>

Neither the Code nor the Regulations provide a method for determining the portion of a mortgage that is to be treated as a “real estate asset” in cases in which the mortgage relates to both real and personal property.<sup>11</sup>

#### **Concerns Addressed by Rev. Proc. 2011-16**

Until the promulgation of Rev. Proc. 2011-16, the Service had not issued guidance addressing special concerns posed by distressed mortgage loans for REIT income and asset tests. In particular, the Regulations left unaddressed the circumstances in which REIT modifications of distressed mortgages that constitute “significant modifications” under section 1.1001-3 of the Regulations<sup>12</sup> are required to be treated as new “commitments” to acquire the modified mortgage loans, which could cause a portion of the interest received on the modified loans to fail to qualify under the 75 percent income test and a portion of the loans themselves to become nonqualified assets for purposes of the 75 percent asset test.<sup>13</sup> Similar uncertainty existed with respect

to the 75 percent income and asset test consequences of REIT acquisitions of distressed real estate mortgages at a discount. The safe harbors established by Rev. Proc. 2011-16 address these issues.

#### **Rev. Proc. 2011-16 Safe Harbors**

##### **Loan Modifications**

If a modification of a mortgage loan meets the criteria specified in Rev. Proc. 2011-16 (a “qualified modification”) for purposes of determining the “loan value of the real property” securing that loan under section 1.856-5(c)(2) of the Regulations, Rev. Proc. 2011-16 specifies that (1) a REIT may treat the modification as not being a new commitment to make or purchase a loan; and (2) the modification of the mortgage loan will not be treated as a prohibited transaction under section 857(b)(6).<sup>14</sup>

A modification of a mortgage loan is a qualified modification if:

- 1) The modification was occasioned by default; or
- 2) Based on all the facts and circumstances, the REIT or servicer of the loan reasonably believes that:
  - a. there is a significant risk of default of the pre-modified loan upon maturity of the loan or at an earlier date; and
  - b. the modified loan presents a substantially reduced risk of default, as compared with the pre-modified loan.

Rev. Proc. 2011-16 specifies that the reasonable belief concerning the default risk of the pre-modified loan must be based on a diligent contemporaneous determination of that risk, which may take into account credible written factual representations made by the issuer of the loan, provided the REIT or servicer neither knows nor has reason to know that such representations are false. Factors which are relevant for the determination of default risk include

<sup>8</sup> Treas. Reg. Section 1.856-5(c)(2).

<sup>9</sup> Id.

<sup>10</sup> Treas. Reg. Section 1.856-5(c)(3).

<sup>11</sup> In PLR 199923006, the Office of Chief Counsel (IRS) concluded that the method set forth in Treas. Reg. Section 1.856-5(c) was a reasonable apportionment method for purposes of the asset test.

<sup>12</sup> Under section 1.1001-3 of the Regulations a modification of a debt instrument which meets the criteria of a “significant modification” is treated as triggering a deemed exchange of the original debt instrument for the modified debt instrument.

<sup>13</sup> See Letter from Tony M. Edwards, Executive Vice President & General Counsel of The National Association of Real Estate Investment Trusts, to Michael Mundaca, Deputy Assistant Secretary (International Tax Affairs) U.S. Department of the Treasury, and Douglas Shulman, Commissioner Internal Revenue Service, Re: Guidance Request With Respect to Treas. Reg. § 1.856-5(c), p. 2, 2010 TNT 50-14 (Aug. 12, 2009).

<sup>14</sup> Income of a REIT from prohibited transactions is subject to a confiscatory 100 percent excise tax. Section 857(b)(6).

past performance of the loan and whether a default is foreseeable at a future date. There is no maximum period, however, after which default is per se not foreseeable. For example, in appropriate circumstances, a REIT or servicer may reasonably believe that there is a significant risk of default even though the foreseen default is more than one year in the future. Similarly, although past performance is another relevant factor for assessing default risk, in appropriate circumstances, a REIT or servicer may reasonably believe that there is a significant risk of default even if the loan is performing.

### **The 75 Percent Asset Test**

Rev. Proc. 2011-16 specifies that the Service will not challenge a REIT's treatment of a loan as being in part a "real estate asset" for purposes of the 75 percent asset test if the REIT treats the loan as being a real estate asset in an amount equal to the lesser of:

- 1) The value of the loan as determined under section 1.856-3(a) of the Regulations, or
- 2) The loan value of the real property securing the loan as determined under § 1.856-5(c) and Rev. Proc. 2016-11.

Under section 1.856-3(a) of the Regulations, the term "value" is defined as, with respect to securities for which for which market quotations are not available, the fair value as determined in good faith by the trustees of the REIT.

### **Examples**

Rev. Proc. 2011-16 contains the following two examples that demonstrate the application of its provisions:

#### **Example 1.**

In 2007, X, a REIT, made a \$100 mortgage loan to A, secured by both real property and personal property. When X's commitment to make the loan became binding on X, the real property had a fair market value of \$115. At the end of the calendar

quarter in which X made the loan, the value of the loan as determined under section 1.856-3(a) of the Regulations was \$100. At all times through the end of 2010, under section 1.856-5(c)(3) of the Regulations, the amount of the loan continued to be \$100.

By the start of 2009, the fair market value of the real property had fallen to \$55 and the fair market value of the personal property was \$5. The values remained at these levels throughout 2009 and 2010. Throughout 2009 and 2010, the value of the loan was \$60.

During 2009, X and A modified the terms of the mortgage loan. The modification of the loan met the requirements of Rev. Proc. 2011-16 and was also a significant modification under section 1.1001-3 of the Regulations.

### **The 75 Percent Income Test Consequences**

When X made the mortgage loan in 2007, the loan value of the real property was its fair market value of \$115. Because this amount exceeded the amount of the loan for that year of \$100, all of the interest from the loan for that year was apportionable to the real property under section 1.856-5(c)(1) of the Regulations (and, thus, constituted qualified interest for purposes of the 75 percent income test).

Between the time that the loan was made and the time of the modification, the loan value of the real property under section 1.856-5(c)(2) of the Regulations continued to be \$115, notwithstanding changes in the fair market value of that real property. Similarly, the amount of the loan continued to be \$100. Accordingly, the loan value of the real property (\$115) continued to exceed the amount of the loan (\$100), and all of the interest on the loan continued to be apportioned to the real property. Accordingly, for such period, all of the interest was qualified interest for purposes of the 75 percent income test.

Although the fair market value of the real property securing the mortgage loan declined to \$55 by the

time that X and A modified the loan in 2009, that modification qualified under Rev. Proc. 2011-16 and X chose to treat the modification as not being a new commitment to make or purchase a loan. Therefore, the loan value of the real property (\$115) did not change and all of the interest on the loan for 2009 continues to be qualified interest for purposes of the 75 percent income test.

### **The 75 Percent Asset Test Consequences**

In 2007, at the end of the calendar quarter in which X made the mortgage loan, the value of the loan was \$100, and the loan value of the real property securing the loan was \$115. For this calendar quarter, pursuant to the second safe harbor established by Rev. Proc. 2011-16, X may treat the lesser of these two values (\$100) as the amount of the loan that is a real estate asset for purposes of the 75 percent asset test. Thus, in 2007, X may treat the full amount of the loan as a real estate asset for purposes of the 75 percent asset test.

In 2009, at the end of the calendar quarter in which X modified the mortgage loan, the value of the loan was \$60, and, for the reasons described above, the loan value of the real property securing the loan was \$115. For this calendar quarter, pursuant to the asset test safe harbor established by Rev. Proc. 2011-16, X may treat the lesser of these two values (\$60) as the amount of the loan that is a real estate asset for purposes of the 75 percent asset test.

### **Example 2.**

The facts are the same as in Example 1. Additionally, during the first quarter of 2010 another REIT, Y, committed to purchase, and purchased, the mortgage loan from X for \$60.

### **The 75 Percent Income Test Consequences**

Under section 1.856-5(c)(2) of the Regulations, the loan value of the real property securing the loan is the fair market value of the real property determined as of the date on which Y's commitment to purchase the loan became binding on Y (\$55). This value is

compared to the amount of the loan for the year (\$100). Because the amount of the loan exceeds the loan value of the real property, the interest income apportioned to the real property is an amount equal to the interest income multiplied by a fraction the numerator of which is the loan value of the real property (\$55) and the denominator of which is the amount of the loan (\$100). Therefore, 55 percent of the interest income from Y's loan is apportioned to the real property securing the loan and the balance of the interest income (45 percent) is treated as nonqualified income for purposes of the 75 percent income test.

### **The 75 Percent Asset Test Consequences**

At the end of every calendar quarter during 2010, the value of the loan was \$60, and the loan value of the real property securing the loan was \$55. Accordingly, for every calendar quarter during 2010, pursuant to the asset test safe harbor of Rev. Proc. 2011-16, Y may treat the lesser of these two values (\$55) as the amount of the loan that is a qualified real estate asset for purposes of the 75 percent asset test.

*For additional information concerning this issue, please contact:*

**Dmitriy Shamrakov**  
646-471-8561  
dmitriy.shamrakov@us.pwc.com

**James Guiry**  
646-471-3620  
james.m.guiry@us.pwc.com

**Kelly Nobis**  
703-918-3104  
kelly.s.nobis@us.pwc.com

*For more information, please contact your local PwC real estate tax service provider or one of the contacts below.*

### **Nationally**

**Gary Cutson**  
US REIT Tax Leader  
New York  
646-471-8805  
gary.cutson@us.pwc.com

**Paul Ryan**  
US Real Estate Tax Leader  
New York  
646-471-8419  
paul.ryan@us.pwc.com

### **Regionally**

#### **Atlanta**

**Dennis Goginsky**  
678-419-8528  
dennis.goginsky@us.pwc.com

#### **Boston**

**Timothy Egan**  
617-530-7120  
timothy.s.egan@us.pwc.com

#### **Laura Hewitt**

617-530-5331  
laura.a.hewitt@us.pwc.com

#### **Chicago**

**Jill Loftus**  
312-298-3294  
jill.h.loftus@us.pwc.com

#### **Alan Naragon**

312.298.3228  
alan.naragon@us.pwc.com

#### **Dallas**

#### **Colin Stevenson**

214-756-1752  
philip.c.sutton@us.pwc.com

#### **Los Angeles**

#### **Adam Handler**

213-356-6499  
adam.handler@us.pwc.com

#### **Phil Sutton**

213-830-8245  
philip.c.sutton@us.pwc.com

#### **New York**

#### **Martin Doran**

646.471.8010  
martin.doran@us.pwc.com

#### **Joni Geuther**

646.471.4526  
joni.geuther@us.pwc.com

#### **James Guiry**

646.471.3620  
james.m.guiry@us.pwc.com

#### **Jill Hemphill**

646.471.8080  
jill.hemphill@us.pwc.com

#### **Christine Lattanzio**

646.471.8463  
christine.a.lattanzio@us.pwc.com

#### **James Oswald**

646.471.4671  
james.a.oswald@us.pwc.com

#### **Steve Tyler**

646.471.7904  
steve.tyler@us.pwc.com

#### **David Voss**

646.471.7462  
david.m.voss@us.pwc.com

#### **San Francisco**

#### **Neil Rosenberg**

415-498-6222  
neil.rosenberg@us.pwc.com

#### **Washington DC**

#### **Kelly Nobis**

703-918-3104  
kelly.s.nobis@us.pwc.com

#### **Tim Trifilo**

703-918-3338  
timothy.j.trifilo@us.pwc.com