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New REIT Safe Harbor with Respect to Certain Modifications of Troubled Mortgage Loans

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Recognizing that the widespread decline in real estate values could adversely affect the ability of a real estate investment trust ("REIT") to maintain its status for federal income tax purposes, on January 5, 2011 the Internal Revenue Service issued a new safe harbor for REITs with respect to certain mortgage loan modifications. The new guidance is contained in Revenue Procedure 2011-16 (the "Rev. Proc.") which gives relief in a situation where declines in the value of real estate securing a loan might have otherwise created non-qualifying income or assets for REIT qualification purposes.

BACKGROUND

In order to qualify as a REIT, an entity must meet two annual income tests (among other requirements). First, at least 75% of the entity's gross income must consist of real estate related income, including, in particular, rents from real property and mortgage interest (the "75% income test"). Second, at least 95% of the entity's gross income must consist of items that meet the 75% income test plus other passive income, including interest and dividends (the "95% income test").

A REIT must also meet an asset test each quarter. Thus, at the close of each quarter of an entity's taxable year, at least 75% of the value of the entity's total assets must consist of "real estate assets," cash and cash items (including receivables) and Government securities (the "75% of asset test"). The term "real estate assets" includes real property (including interests in real property and interests in mortgages on real property) and shares (or transferable certificates of beneficial interest) in other REITs. The term "interests in real property" includes fee ownership and co-ownership of land or improvements thereon, leaseholds of land or improvements thereon, options to acquire land or improvements thereon, and options to acquire leaseholds of land or improvements thereon.

If a mortgage loan is secured by both real property and other property, an apportionment test is used to determine how much of the interest on such loan is treated as "good" real estate related interest for purposes of the 75% income test. Under this apportionment test, the "loan value of the real property" is compared to the "amount of the loan."¹ If the loan value of the real property is equal to or exceeds the amount of the loan, then all of the interest income from the loan is apportioned to the real property. If 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 and the denominator of which is the amount of the loan. The interest income apportioned to the other property is the excess of the total interest income over the interest income apportioned to the real property. For purposes of the apportionment test, the "loan value of real property" that secures a loan is the fair market value of the real property, determined as of the date on which a commitment became binding on the REIT either to make or to purchase the loan.

¹ The "amount of the loan" is the highest principal amount of the loan outstanding during the taxable year.

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In addition, a REIT is subject to a 100% tax on net income derived from prohibited transactions, generally defined as a sale or other disposition of property described in Code Section 1221(a)(1) (i.e., property held primarily for sale to customers in the ordinary course of a trade or business, commonly referred to as “dealer property”), which is not foreclosure property.²

A substantial modification of a debt instrument for federal income tax purposes can result in a deemed issuance of a new loan for federal income tax purposes.³ The fear was that the new loan would have to be retested under the REIT income test (i.e., running a new apportionment test) and the REIT asset test at a time when the real property securing the loan was worth much less than the loan face amount. There was also concern that the deemed exchange of the old loan for a new loan could result in a 100% prohibited transactions tax.

REVENUE PROCEDURE 2011-16

The Rev. Proc. provides REITs with relief from potential violations of the REIT qualification requirements that are due to certain modifications of mortgage loans. Specifically, for purposes of the REIT’s income tests, “qualifying” modifications of mortgage loans (i) may be treated as not being new commitments to make or purchase a loan for purposes of ascertaining the “loan value of the real property” and (ii) will not be treated as prohibited transactions.

Qualifying mortgage loan modifications include modifications that (A) were occasioned by default or (B) based on all the facts and circumstances, (1) the REIT (or servicer of the loan) reasonably believes that there is a significant risk of default of the unmodified loan and (2) the REIT (or servicer of the loan) reasonably believes that the modified loan presents a substantially reduced risk of default (as compared to the unmodified loan). For purposes of determining whether the REIT reasonably believes there is a significant risk of default (i) the reasonable belief may be based on credible written factual representations made by the loan issuer (so long as the REIT does not know, or have reason to believe, they are false), (ii) the default may be at maturity or at an earlier date, (iii) there is no maximum period after which default is *per se* not foreseeable (e.g., the foreseen default may be more than one year in the future), and (iv) the REIT may reasonably believe there is a significant risk of default even if the loan is performing. This new standard follows similar guidance issued in 2009 with respect to real estate mortgage investment conduits (“REMIC”s).⁴

In addition, the Rev. Proc. provides that the IRS will not challenge a REIT’s treatment of a loan as being part of a “real estate asset” for purposes of the 75% asset test if the REIT treats the loan as being a real estate asset in an amount equal to the lesser of (i) the market value of the loan (if quotations are readily available for such loan) or the fair value of the loan (as determined in good faith by the REIT’s trustees) or (ii) the loan value of the real property securing the loan as determined under the apportionment test described above.

The favorable rules in the Rev. Proc. do not apply to a REIT that buys the loan after the real estate securing the loan has declined in value. An example in the Rev. Proc. makes clear that the purchasing REIT must retest the loan at the time of its acquisition for purposes of the income and asset tests. Moreover, if the purchasing REIT buys the loan at a substantial discount because the underlying real estate has depreciated, the example makes it clear that the retest could result in a

² In general, foreclosure property is any real property (including interests in real property), and any personal property incident to such real property, acquired by a REIT as the result of such REIT having bid on such property at foreclosure, or having otherwise reduced such property to ownership or possession by agreement or process of law, after there was default (or default was imminent) on a lease of such property or on an indebtedness which such property secured.

³ Code Section 1001; Treas. Reg. Section 1.1001-3.

⁴ See Rev. Proc. 2009-45, 2009-40 I.R.B. 471.

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significant amount of income not qualifying under the 75% income test.⁵

The real estate industry had also requested that, for newly acquired distressed mortgage loans, the “amount of the loan” should be the REIT’s highest adjusted tax basis in the mortgage loan for the taxable year.⁶ However, this provision was not included in the Rev. Proc.

Acknowledging the extreme duress that the real estate market has been under for several years, the Rev. Proc. is effective for all calendar quarters and all taxable years.

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⁵ Thus, in the example, the purchasing REIT buys a \$100 face amount mortgage for \$60 at a time when the underlying real estate is worth \$55. The interest apportioned to the real estate is 55/100 or 55% of the total interest. The remainder of the interest is apportioned to the other property.

⁶ See Letter from NAREIT to The Honorable Michael Mundaca and The Honorable Douglas Shulman (August 12, 2009) available at http://www.reit.com/PolicyPolitics/InternalRevenueServiceIssues/~/_/media/Portals/0/PDF/NAREITRequestforDistressedDebtGuidance081209.ashx.