# IRS Publishes Guidance to REITs Holding Distressed Debt

Last week, the IRS issued Revenue Procedure 2011-16 (the "Revenue Procedure") providing guidance on the qualification of a "real estate investment trust" (a "REIT") holding distressed debt secured by real estate that has declined in value. Maintenance of REIT status requires compliance with an intricate set of rules regarding the type of income earned, and the type of assets held, by the entity seeking to qualify as a REIT, as well as the number and type of REIT shareholders. The Revenue Procedure provides safe harbors for the treatment of interest on distressed debt under the REIT income tests, and the treatment of mortgage loans under the REIT asset test.

In order to qualify as a REIT for any taxable year, an entity must meet a 95% gross income test and a 75% gross income test, as well as a 75% asset test. All interest is "qualifying income" for purposes of the 95% income test, but only interest on obligations secured by mortgages on real property or on interests in real property is "qualifying income" for purposes of the 75% income test. Furthermore, at the end of each quarter, at least 75% of the value of the REIT assets must be represented by "real estate assets," cash and cash items (such as receivables), and government securities. The term "real estate assets" includes interests in real property and interests in mortgages on real property.

In addition to the foregoing, a REIT is subject to a 100% tax on the net income derived from "prohibited transactions," defined to include gain from the sale or other disposition of property treated as inventory or as held primarily for sale to customers in the ordinary course of a trade or business (so-called "dealer property"), other than property for which an election has been made to treat as "foreclosure property" and subject to a specific safe harbor.

If a mortgage loan is secured both by real property and other property, certain rules apply to apportion the interest on the loan between the real property and the other property for purposes of the REIT 75% income test. Under these rules, the "loan value" of the real property is compared to the "amount of the loan." For this purpose, "loan value" means the fair market value of the real property, determined as of the date on which the commitment by the REIT to make the loan becomes binding on the REIT or, in the case of a loan purchased by a REIT, on the date on which the commitment by the REIT to purchase the loan becomes binding on the REIT. The "amount of the loan" means the highest principal amount of the loan outstanding during the taxable year, regardless of the amount the REIT may have paid for such loan on the secondary market. If the loan value equals or exceeds the amount of the loan, then all of the interest from the mortgage loan is apportioned to the real property. If the amount of the loan exceeds the loan value, only a *pro rata* portion of the interest is apportioned to the real property.

The Treasury Regulations under Section 1001 of the U.S. Internal Revenue Code provide rules for determining when a modification of a debt instrument is treated as a "significant modification" that produces a deemed exchange of the original debt instrument for a new debt instrument. If distressed debt held by a REIT is modified resulting in such a deemed exchange, under the interest apportionment rules described above, the loan value of the real property would be required to be retested. Assuming the fair market value of the real property has declined below the amount of the loan, this retesting could cause a portion of the interest on the mortgage loan to no longer be treated as "qualifying income" for purposes of the REIT 75% income test (even in the absence of any "other" property securing the mortgage loan).

Similar apportionment rules apply to mortgage loans under the REIT asset test. Although interests in mortgages on real property constitute "real estate assets" for purposes of the REIT asset test, if a mortgage loan held by a REIT is collateralized by both real property and other property, the IRS has held that an apportionment of the loan is necessary because only the portion of the loan secured by real property is included for purposes of the REIT asset test. An apportionment methodology similar to that described above applies, with the result that the qualifying portion of the loan is limited to the "amount of the loan" 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."

To address these issues, the Revenue Procedure provides that certain modifications of a mortgage loan will not be treated as a new commitment to make or purchase the loan for purposes of determining the loan value of the underlying real property, and will not be treated as prohibited transactions. This safe harbor applies to modifications resulting from a default *or* if the modification satisfies both of the following conditions: (1) the REIT (or loan servicer) reasonably believes that there is a significant risk of default of the pre-modified mortgage loan based on all the facts and circumstances and (2) the REIT (or loan servicer) reasonably believes that the modified loan presents a substantially reduced risk of default, as compared with the pre-modified loan.

The Revenue Procedure also provides that the IRS will not challenge a REIT's treatment of a mortgage loan as a real estate asset for purposes of the REIT asset test if the REIT treats the loan as a "real estate asset" in an amount equal to the lesser of (1) the fair market value of the loan or (2) the "loan value" of the real property securing the loan (as defined above).

The Revenue Procedure is effective for all calendar quarters and all taxable years. Although the safe harbors provided by the Revenue Procedure are quite favorable with respect to the modification of existing debt held by a REIT, they unfortunately do not address the acquisition of new distressed debt by a REIT. For example, if distressed mortgage debt is purchased by a REIT at a discount, because the fair market value of the property (*i.e.*, the "loan value") may be significantly less than the principal amount of the loan (*i.e.*, the "amount of the loan") then, only a portion of the loan will constitute a "real estate asset" for purpose of the REIT asset test, and only a portion of the interest paid on the loan will be treated as "qualifying income" for purposes of the REIT 75% income test. This may significantly limit the acquisition of distressed debt by REITs until further IRS guidance is provided.

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