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IRS Issues Guidance on Treatment of Distressed Mortgage Loans for REITs

On January 5, 2011, the Internal Revenue Service ("IRS") announced that it will publish Revenue Procedure 2011-16 (the "Revenue Procedure") addressing the treatment of distressed mortgage loans for purposes of the 75% gross income test (the "75% Gross Income Test") and the asset tests applicable to real estate investment trusts ("REITs"). The Revenue Procedure provides safe harbors clarifying how REITs may treat (1) distressed mortgage loans that are modified to avoid foreclosure and (2) newly acquired distressed mortgage loans. The Revenue Procedure resolves significant uncertainty regarding a REIT's ability to work-out distressed mortgage loans and should generally permit REITs to modify distressed mortgage loans without fear of endangering their REIT qualification. Unfortunately, the Revenue Procedure is less helpful for REITs seeking to acquire distressed mortgage loans. A link to the Revenue Procedure is provided at the end of this alert.

Hunton & Williams LLP tax partners actively participated in the lobbying effort that produced the Revenue Procedure and are available to provide more detailed analysis of the Revenue Procedure and strategies to modify and acquire distressed mortgage loans.

The Problematic Loan-to-Value Regulation

Treasury Regulations section 1.856-5(c) (the "Loan-to-Value Regulation") bifurcates the treatment of interest income for purposes of the 75% Gross Income Test when a loan is undersecured by real property and is also secured by other types of property. In that event, a portion of the interest income from the loan is treated as non-qualifying income if the "amount of the loan" (generally, the highest principal balance during any taxable year) exceeds the "loan value of the real property" (generally, the fair market value of the real property on the date the REIT acquired or committed to acquire the loan). The IRS has indicated that a similar bifurcation approach applies for purposes of the REIT asset tests.

The Loan-to-Value Regulation has historically caused problems for REITs seeking to modify distressed mortgage loans because the modifications often result in a new loan for tax purposes that is not fully secured by real estate as of the date of the modification. Similarly, the Loan-to-Value Regulation has caused problems in the case of newly acquired distressed mortgage loans since the value of the real property securing the loan at the time of acquisition is typically less than the principal balance of the loan.

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The Modification Safe Harbor

The Revenue Procedure provides that REITs will not have to re-test the value of the real property securing a modified loan for purposes of the Loan-to-Value Regulation if the modification satisfies certain conditions (the “Modification Safe Harbor”). As a result, modifying distressed mortgage loans within the confines of the Modification Safe Harbor should not change the character of the interest income from those loans for purposes of the 75% Gross Income Test or the proportion of those loans that are treated as qualifying assets for the REIT asset tests.

The following conditions must be met to qualify for the Modification Safe Harbor:

- the modification of the loan is occasioned by a borrower default; or
- the modification satisfies both of the following conditions:
  - based on all the facts and circumstances, the REIT or servicer of the loan reasonably believes that there is a significant risk of default of the pre-modified loan at or before maturity; and
  - based on all the facts and circumstances, the REIT or servicer reasonably believes that the modified loan presents a substantially reduced risk of default as compared with the pre-modified loan.

If those requirements are satisfied, for purposes of ascertaining the “loan value of the real property” securing that loan under the Loan-to-Value Regulation, a REIT may treat the modification as not resulting in the acquisition of a new loan. Consequently, the REIT is not required to re-test the value of the real estate securing the loan at the time of the modification. The Revenue Procedure further provides that a modification within the Modification Safe Harbor will not be treated as a dealer sale subject to the 100% “prohibited transaction” tax applicable to REITs.

When a loan is not in default, the key issue will be establishing that the belief of the REIT or the loan servicer regarding default risk (and the reduction of that risk by means of the loan modification) is reasonable. The Revenue Procedure provides that a reasonable belief regarding default risk must be based on a contemporaneous determination of that risk by the REIT or the loan servicer. That determination may take into account credible written factual representations made by the borrower as long as neither the REIT nor the servicer has reason to know that such representations are false. In determining the significance of the risk of default, the Revenue Procedure states that the estimated time of a future default and the past performance of the debtor are relevant factors. REITs that use the Modification Safe Harbor with respect to a loan that is not currently in default should carefully create and maintain sufficient contemporaneous documentation to clearly establish compliance with the safe harbor requirements.

The Asset Test Safe Harbor

The Revenue Procedure also provides a safe harbor for purposes of the REIT asset tests (the “Asset Test Safe Harbor”). The Revenue Procedure provides that for purposes of the REIT asset tests, the portion of a mortgage loan that a REIT may treat as a qualifying asset is equal to the lesser of:

- the value of the loan as determined for REIT asset test purposes generally (i.e., the value determined by the REIT’s board of directors in good faith or, if market quotations are readily available, the market price); or
- the “loan value of the real property” securing the loan (as determined under the Loan-to-Value Regulation and the Revenue Procedure).

Thus, if a REIT acquires for $60 a loan with a principal amount of $100, which is secured by $55 of real property and $5 of personal property, the REIT may treat $55 worth of the loan (i.e., the “loan value of the real property”) as a qualifying asset and $5 as a non-qualifying asset. The Asset Test Safe Harbor does not apply for purposes of the 75% Gross Income Test.

Continuing Issues with Newly Acquired Distressed Mortgage Loans

Although the Revenue Procedure provides substantial relief to REITs modifying distressed mortgage loans, the Revenue Procedure does not provide much comfort for REITs seeking to acquire distressed mortgage loans.

First, an example in the Revenue Procedure clarifies that the IRS will apply a strict interpretation of the Loan-to-Value Regulation in the case of newly acquired distressed debt for purposes of the 75% Gross Income Test. Under that interpretation, the portion of the interest income that will be treated as qualifying income will be based on the ratio of real property securing the loan to the principal amount of the loan (not the purchase price of the loan). In the example above, in which the "loan value of the real property" was $55 and the principal amount of the loan was $100, the IRS would treat 55% of the interest income from the mortgage loan as qualifying income and 45% of the income non-qualifying income—even though only $5 of the $60 fair market value of the loan is attributable to personal property. Thus, for purpose of the 75% Gross Income Test, a disproportionate amount of the interest income from the distressed mortgage loan potentially will be treated as non-qualifying income. It appears that the IRS will apply this strict interpretation of the 75% Gross Income Test even if the REIT is not attempting to qualify for one of the safe harbors in the Revenue Procedure.

Second, the Asset Test Safe Harbor will help REITs comply with the asset tests immediately following the acquisition of a distressed mortgage loan. However, that assistance will diminish as the value of the loan increases. The Asset Test Safe Harbor provides that a REIT may treat such a loan as a qualifying asset in an amount equal to the *lesser* of (1) the value of the loan or (2) the "loan value of the real property" securing the loan. In the example above, if the value of the loan increases to $70, the Asset Test Safe Harbor would prescribe that the value of the real estate asset will be limited to $55 (i.e., "the loan value of the real property") and the remaining $15 of value would constitute a non-qualifying asset. Accordingly, the Asset Test Safe Harbor may help asset test compliance for REITs acquiring distressed debt during an economic downturn, but will provide little assistance as values increase during a recovery.

Effective Date

The Revenue Procedure is effective for all calendar quarters and all taxable years, including those prior to 2011.

A copy of the Revenue Procedure is available here.

Hunton & Williams LLP REIT Tax Practice

Hunton & Williams LLP attorneys are available to provide more information about the Revenue Procedure and the tax aspects of investments in distressed mortgage loans generally. If you would like to receive more information, please contact George C. Howell, III at (804) 788-8793 or ghowell@hunton.com, Mark C. Van Deusen at (804) 788-8349 or mvandeusen@hunton.com, Cameron N. Cosby at (804) 788-8604 or ccosby@hunton.com or Christopher Mangin, Jr. at (804) 787-8188 or cmangin@hunton.com.