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Client Alert

August 2014

IRS Revises Distressed Mortgage Loan Guidance for REITs

On August 22, 2014, the Internal Revenue Service (“IRS”) issued Revenue Procedure 2014-51 (the “New Revenue Procedure”), which allows real estate investment trusts (“REITs”) that purchase distressed mortgage loans to treat a greater proportion of such loans as a qualifying asset for the REIT 75% asset test (the “75% Asset Test”) when there is post-acquisition appreciation in the value of the related real property. Unfortunately, the IRS also reaffirmed its less favorable position on the proportion of the interest income on distressed mortgage loans that is treated as qualifying income under the REIT 75% gross income test (the “75% Gross Income Test”).

The Revised Asset Test Safe Harbor for Distressed Loans

The New Revenue Procedure supersedes Revenue Procedure 2011-16 (the “Old Revenue Procedure”). The Old Revenue Procedure established a safe harbor for the treatment of distressed mortgage loans under the 75% Asset Test (the “Old Safe Harbor”). Under the Old Safe Harbor, a post-acquisition increase in the value of a distressed mortgage loan—which would typically occur because of a rise in the value of the real property securing the loan—would result in a higher proportion of the loan being treated as a non-qualifying asset for the 75% Asset Test. Specifically, the Old Safe Harbor provided that a REIT could treat a mortgage loan as a qualifying asset in an amount equal to the *lesser* of:

- the current value of the loan; or
- the fair market value of the real property securing the loan on the date the REIT acquired (or committed to acquire) the loan (the “Acquisition Date Value”).

The effect of the Old Safe Harbor was to cap the amount of a distressed mortgage loan that a REIT could treat as a qualifying asset at the Acquisition Date Value. Consequently, under the Old Safe Harbor, an increase in the value of the loan (presumably based on a rise in the value of the underlying real estate) had the counterintuitive result of reducing the percentage of the loan that could be classified as a qualifying asset under the 75% Asset Test.

The New Revenue Procedure provides a revised safe harbor (the “New Safe Harbor”) under which the amount of a mortgage loan that a REIT may treat as a qualifying asset is limited to the *greater* of (i) the current value of the real property securing the loan; or (ii) its Acquisition Date Value. This change has the effect of allowing the amount of a distressed mortgage loan that can be treated as a qualifying asset to float up as the value of the underlying real estate rises.

The following example shows the different consequences under the two safe harbors. Assume a REIT purchases for $60 a mortgage loan with a principal amount of $100, which is secured by $55 of real property and $5 of personal property. At acquisition, both safe harbors would allow the REIT to treat $55 worth of the loan (i.e., the Acquisition Date Value) as a qualifying asset and $5 as a non-qualifying asset. Under the Old Safe Harbor, if the value of the property subsequently increased to $65, and the value of the loan to $70, the REIT still could treat only $55 of the loan (i.e., the Acquisition Date Value) as a qualifying asset and would have to treat the remaining $15 of value as a non-qualifying asset. The New Safe Harbor avoids that counterintuitive result by taking into account increases in the value of the real property securing the loan. In this example, the REIT would be able to treat $65 (i.e., the current value of the real property) of the loan as a qualifying asset and would continue to treat $5 as a non-qualifying asset.

Continuing Gross Income Test Issues with Distressed Loans

Although the New Revenue Procedure resolves an important issue with respect to the application of the 75% Asset Test to distressed mortgage loans that are purchased by a REIT, it does not fix a related problem under the 75% Gross Income Test. The New Revenue Procedure continues to determine the percentage of the interest on a purchased loan that is qualifying income under the 75% Gross Income Test based on the ratio of the Acquisition Date Value of the real property securing the loan to the unpaid principal amount of the loan (not the value or purchase price of the loan). Thus, in the above example, the IRS would treat only 55% of the interest income from the mortgage loan as qualifying income, even though $55 of the $60 loan value is attributable to real property. In addition, no increase in this percentage would be permitted as a result of post-acquisition appreciation in the value of the related real property. The IRS's failure to adopt a more favorable position with respect to the 75% Gross Income Test will limit the ability of REITs to invest in distressed mortgage loans that are secured by both real and other property.

Effective Date

The Revenue Procedure is effective for all calendar quarters and all taxable years, including those prior to 2014.

Please click here for a copy of the Revenue Procedure.

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; or Christopher Mangin, Jr. at (804) 787-8188 or cmangin@hunton.com.