Client Alert

Latham & Watkins
Tax Department

Revenue Procedure 2011-16 Provides Greater Flexibility for Real Estate Investment Trusts to Modify or Purchase Distressed Debt

"Revenue Procedure 2011-16, effective for all calendar quarters and all taxable years, provides REITs with helpful guidance on the treatment of both the modification and the purchase of distressed mortgage debt."

On January 5, 2011, the Internal Revenue Service (the Service) issued Revenue Procedure 2011-16, 2011-5 I.R.B., which provides guidance to real estate investment trusts (REITs) relating to the effect of the modification or purchase of distressed real estate debt on their qualification under certain income, asset and other tests applicable to REITs under the Internal Revenue Code of 1986, as amended, (the Code). This *Alert* provides a brief summary of the applicable tests under the Code and an overview of the effect of Revenue Procedure 2011-16 thereon.

REIT Income Tests

To qualify as a REIT, at least 95 percent of an entity's gross income must be derived from specified passive sources, which include dividends, interest and gains from certain property transactions. In addition, 75 percent of an entity's gross income must be derived from a more limited subset of real estate sources. Interest on obligations adequately secured by mortgages on real property generally qualifies for purposes of both the 75 and the 95 percent income tests, while interest on debt instruments that are not so secured qualifies for the 95 percent, but not the 75 percent, income test.

If the amount of a mortgage loan exceeds the value of the real property securing the loan, interest received must be apportioned between the portion of the loan that is secured by real property and that which is not. Under applicable Treasury regulations, this apportionment requires a comparison of the "loan value of the real property" to the "amount of the loan." Generally, the "loan value of the real property" for this purpose is the fair market value of the real property available to secure the loan on the date the REIT became committed to make or to purchase the loan, and the "amount of the loan" is the highest principal amount of the loan outstanding during the REIT's taxable year. If the "loan value of the real property" is equal to or greater than the "amount of the loan," all interest on the mortgage loan is apportioned to the real property and will generally constitute qualifying income for purposes of the 75 percent income test. If the "amount of the loan" exceeds the "loan value of the real property," only a fraction (the "loan value of the real property" divided by the "amount of the loan") of the interest received by the REIT will so qualify. This formula can lead to nonsensical results in the context of distressed debt acquisitions. For example, assume a REIT acquires a loan with a $10 principal amount for

$6, believing that the underlying real property collateral has a value of $6. In that case, the amount of the loan ($10) exceeds the loan value of the real property ($6), and only 60 percent of the interest on the loan would qualify under the 75 percent income test. The formula disregards the lower purchase price paid by the REIT for the loan.

Under applicable Treasury regulations, the modification of a debt instrument, if it is "significant," is treated for income tax purposes as an exchange of the pre-modification debt for a new debt instrument incorporating the terms of the modified debt. Such an exchange could have required a REIT lender to re-determine the "loan value of the real property" securing the debt for purposes of the interest allocation rules described in the preceding paragraph. If the fair market value of the real property serving as security for the debt declined substantially between the date the REIT committed to make or purchase the loan and the date of the modification, the modification might obligate the REIT to treat a greater portion of the interest received as nonqualifying income for purposes of the 75 percent income test.

REIT Asset Tests

In addition to the income tests described above, at the close of each calendar quarter, at least 75 percent of the value of a REIT's total assets must be represented by real estate assets, cash, cash items and certain Government securities. For this purpose, the term "real estate assets" includes a relatively broad range of real property interests including mortgages on real property. Neither the Code nor Treasury regulations address the extent to which a mortgage loan shall be treated as a real estate asset, and this has created some degree of uncertainty regarding this determination in the context of the modification or purchase of a distressed mortgage loan. A private letter ruling has concluded, however, that the income test allocation formula described above is a reasonable allocation method for purposes of the REIT asset tests. If such methodology is used for the acquisition of a distressed mortgage loan, nonsensical results, similar to those described above, may occur under the REIT asset tests.

Prohibited Transactions Tax

The Code imposes a 100 percent penalty tax on a REIT's income from certain "prohibited transactions." For this purpose, "prohibited transactions" are defined generally as sales (other than sales of foreclosure property) giving rise to ordinary income rather than capital gain (*i.e.*, sales to customers in the ordinary course of the REIT's business). If a REIT realized gain in a deemed exchange of a debt instrument arising from a significant modification, it was unclear whether or under what circumstances such gain might be subject to this 100 percent penalty tax.

Revenue Procedure 2011-16

Revenue Procedure 2011-16, effective for all calendar quarters and all taxable years, provides REITs with helpful guidance on the treatment of both the modification and the purchase of distressed mortgage debt.

The Revenue Procedure applies to the modification of a mortgage loan if:

- The modification is occasioned by a default; or
- Based on all of the facts and circumstances, the REIT or servicer of the loan reasonably believe that both:
  - There is a significant risk of default before or on the maturity of the loan; and
  - The modified loan presents a substantially reduced risk of default, as compared with the original loan.

A modification satisfying these requirements will not be considered a new commitment to make or purchase a loan by a REIT. As a result, a REIT will not be required to retest the modified loan and potentially reduce the "loan value of the real property." A qualifying modification will therefore allow a REIT to continue its prior approach to interest allocation without redetermining (and possibly reducing) the proportion of interest qualifying under the 75 percent interest test.

Revenue Procedure 2011-16 further specifies that modifications falling within the scope of the Revenue Procedure will not be treated by the IRS as prohibited transactions for purposes of the penalty tax discussed above.

In addition, Revenue Procedure 2011-16 provides that the Service will not challenge a REIT's treatment of all or a portion of a loan as a "real estate asset" qualifying under the 75 percent asset test if the REIT values the qualifying portion of the loan for this purpose in an amount equal to the lesser of:

- The fair market value of the loan as determined in good faith by the REIT; or
- The "loan value of the real property" as determined under the rules articulated in Revenue Procedure 2011-16.

Applying the Revenue Procedure to the example above, and assuming that the REIT believed in good faith that it purchased the loan for its fair market value of $6, the $10 principal amount loan would be treated as a $6 asset that fully qualified under the 75 percent asset test. In contrast to the Revenue Procedure's rules relating exclusively to the modification of real estate debt described above, this portion of the Revenue Procedure applies both to modified and to purchased debt instruments. Note, however, that the Revenue Procedure does not address the application of the REIT income tests to a debt instrument purchased by a REIT, and the formula in the regulations described above continues to apply for such purposes.

Conclusion

Revenue Procedure 2011-16 provides guidance on the application of the income and asset tests, and the prohibited transactions tax, to REITs that modify or purchase distressed debt. REITs engaged in such activities should consult their tax advisors to confirm the effect of the application of Revenue Procedure 2011-16 and to review the other tax consequences associated with such activities.

If you have any questions about this *Client Alert*, please contact the author listed below or the Latham attorney with whom you normally consult:

Michael J. Brody
+1.213.891.8724
michael.brody@lw.com
Los Angeles

David O. Kahn
+1.213.891.8675
david.kahn@lw.com
Los Angeles

Samuel T. Greenberg
+1.213.891.8587
samuel.greenberg@lw.com
Los Angeles