

Part III

Administrative, Procedural, and Miscellaneous

26 CFR 601.105.—Examination of returns and claims for refund, credit, or abatement; determination of correct tax liability.

(Also Part I, §§ 856(c); 1.856-3, 1.856-5.)

Rev. Proc. 2014-51

SECTION 1. PURPOSE

This revenue procedure provides guidance regarding aspects of a taxpayer's qualification as a real estate investment trust (REIT) in the context of transactions involving debt secured by real estate the fair market value of which has declined. This revenue procedure modifies and supersedes Rev. Proc. 2011-16, 2011-5 I.R.B. 440, to address situations in which there is a subsequent increase in the value of real property securing a loan addressed in Rev. Proc. 2011-16. Section 2.14(4) of this revenue procedure describes the modifications made by this revenue procedure to Rev. Proc. 2011-16.

SECTION 2. BACKGROUND

.01 For an entity to qualify as a REIT for a taxable year, section 856(c)(4)(A) of the Internal Revenue Code requires that at the close of each quarter of its taxable year at least 75 percent of the value of the entity's total assets must be represented by real estate assets, cash and cash items (including receivables), and Government securities (75% Asset Test). That is, the 75% Asset Test involves a fraction the denominator of which is the value of a REIT's total assets and the numerator of which is the value of the REIT's real estate assets, cash and cash items (including receivables), and Government securities.

.02 Under section 856(c)(5)(B), 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.

.03 Section 856(c)(5)(C) provides that 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, but does not include mineral, oil, or gas royalty interests.

.04 Section 1.856-3(a) of the Income Tax Regulations defines the term "value" to mean "with respect to securities for which market quotations are readily available, the market value of such securities; and with respect to other securities and assets, fair value as determined in good faith by the trustees of the real estate investment trust."

.05 For an entity to qualify as a REIT for a taxable year, it must also satisfy two gross income tests.

(1) First, at least 95 percent of the entity's gross income must be derived from the types of income listed in section 856(c)(2) (95% Income Test). All interest is included as qualifying income for the 95% Income Test.

(2) Second, at least 75 percent of the entity's gross income must be derived from the types of income listed in section 856(c)(3) (75% Income Test). Interest on obligations secured by mortgages on real property or on interests in real property is included as qualifying income for purposes of the 75% Income Test.

.06 If a mortgage loan is secured by both real property and other property, then, for purposes of the 75% Income Test, § 1.856-5(c) provides rules for apportioning the interest on the loan between interest on an obligation that is secured by real property (or by an interest in real property) and interest on an obligation that is not so secured.

.07 The regulations define two terms that are to be used in determining apportionment—

(1) Section 1.856-5(c)(3) defines the "amount of the loan" as the highest principal amount of the loan outstanding during the taxable year.

(2) Section 1.856-5(c)(2) generally defines the "loan value of the real property" that secures a loan as 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 the loan or to purchase the loan, as the case may be. (This definition, which focuses on the value of the real property collateral securing a loan, is different from the § 1.856-3(a) "value" of a loan as discussed in section 2.04 of this revenue procedure, which focuses on what a loan can be sold for (whether the loan is secured by real property or by other property)).

.08 To effect apportionment under § 1.856-5(c), 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.

(2) If the amount of the loan exceeds the loan value of the real property, then—

(a) 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; and

(b) 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.

.09 Section 1.1001-3(c)(1)(i) defines a “modification” of a debt instrument as any alteration, including any deletion or addition, in whole or in part, of a legal right or obligation of the issuer or holder of the debt instrument, whether the alteration is evidenced by an express agreement (oral or written), conduct of the parties, or otherwise. Section 1.1001-3(e) governs which modifications of debt instruments are “significant.” Under § 1.1001-3(b), for most federal income tax purposes, a significant modification produces a deemed exchange of the original debt instrument for a new debt instrument.

.10 Section 1.860G-2(b)(1) concerns modifications of mortgages held by real estate mortgage investment conduits (REMICs). Certain loan modifications are not significant for purposes of § 1.860G-2(b)(1) even if the modifications are significant under the rules in § 1.1001-3. In particular, under § 1.860G-2(b)(3)(i), if a change in the terms of an obligation is “occasioned by default or a reasonably foreseeable default,”

the change is not a significant modification for purposes of § 1.860G-2(b)(1), regardless of the modification's status under § 1.1001-3.

.11 Section 857(b)(6) imposes a tax equal to 100 percent of the net income derived from “prohibited transactions.” Section 857(b)(6)(B)(iii) defines the term “prohibited transaction” as a sale or other disposition of property that is described in section 1221(a)(1) and that is not foreclosure property.

.12 Section 4.01 of Rev. Proc. 2011-16 provided a safe harbor to allow REITs to treat certain loan modifications occasioned by default or reasonably foreseeable default as not being a new commitment to make or purchase a loan for purposes of the 75% Income Test.

.13 Section 4.02 of Rev. Proc. 2011-16 also provided a safe harbor (the Asset Test Safe Harbor) for determining the extent to which a REIT may treat certain loans as real estate assets for purposes of the 75% Asset Test. Under this safe harbor, the Internal Revenue Service (Service) will not challenge a REIT’s treatment of a loan as being in part 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—

(1) The value of the loan as determined under § 1.856-3(a) (see section 2.04 of this revenue procedure); or

(2) The loan value of the real property securing the loan as determined under § 1.856-5(c) and section 4.01 of Rev. Proc. 2011-16 (see section 2.07(2) of this revenue procedure).

.14 The Service has become aware that when the value of the real property securing the loan (and, thus, generally the value of the loan as well) increases after the

REIT originates or acquires the loan, the Asset Test Safe Harbor may produce anomalous results.

(1) The Asset Test Safe Harbor addresses the numerator of the 75% Asset Test (the value of a REIT's real estate assets, cash and cash items, and Government securities, see section 2.01 and 2.02 of this revenue procedure). As is described in section 2.13 of this revenue procedure, under this safe harbor, the numerator is the *lesser* of the value of the loan (under § 1.856-3(a)) or the loan value of the real property securing the loan (under § 1.856-5(c) and section 4.01 of Rev. Proc. 2011-16).

Although the "value of the loan" generally rises with increases in the value of the real property securing a distressed loan, the "loan value of the real property securing the loan" is fixed as of the date that the REIT commits to make or purchase the loan. The loan value of the real property securing the loan, therefore, does not vary with changes in the value of the loan's real property collateral. Thus, the numerator (the *lesser* of the value of the loan or the loan value of real property securing the loan) will generally not vary with increases in the value of the real property collateral.

(2) On the other hand, if there is an increase in the value of the real property collateral, that increase often results in a corresponding increase in the value of the loan and thus in the denominator of the 75% Asset Test (the value of the REIT's total assets, see section 2.01 of this revenue procedure).

(3) Thus, when the value of the real property collateral increases, the portion of a distressed mortgage loan that is treated as a qualifying asset for the 75% Asset Test is the generally constant numerator described above, divided by an increasing denominator. Under the formula in section 4.02 of Rev. Proc. 2011-16, therefore, the

portion of a mortgage loan that is treated as a qualifying asset for this purpose generally *decreases* as the value of the real property securing the loan *increases*.

(4) To prevent this anomaly, this revenue procedure modifies the Asset Test Safe Harbor in section 4.02 of Rev. Proc. 2011-16. This revenue procedure also modifies section 5 of Rev. Proc. 2011-16 by amending Examples 1 and 2 and adding a new Example 3 to illustrate the modified Asset Test Safe Harbor.

SECTION 3. SCOPE

.01 Section 4.01 of this revenue procedure applies to a modification of a mortgage loan which (or an interest in which) is held by a REIT if—

- (1) The modification was occasioned by default; or
- (2) The modification satisfies the following two conditions:

(a) Based on all the facts and circumstances, the REIT or servicer of the loan (the “pre-modified loan”) reasonably believes that there is a significant risk of default of the pre-modified loan upon maturity of the loan or at an earlier date. This reasonable belief must be based on a diligent contemporaneous determination of that risk, which may take into account credible written factual representations made by the issuer of the loan if the REIT or servicer neither knows nor has reason to know that such representations are false. In a determination of the significance of the risk of a default, one relevant factor is how far in the future the possible default may be. There is no maximum period, however, after which default is *per se* not foreseeable. For example, in appropriate circumstances, a REIT or servicer may reasonably believe that there is a significant risk of default even though the foreseen default is more than one

year in the future. Similarly, although past performance is another relevant factor for assessing default risk, in appropriate circumstances, a REIT or servicer may reasonably believe that there is a significant risk of default even if the loan is performing.

(b) 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.

.02 Section 4.02 of this revenue procedure applies to any corporation that has elected to be taxed as a REIT.

SECTION 4. APPLICATION

.01 *Modifications.* If a modification of a mortgage loan is described in section 3.01 of this revenue procedure—

(1) For purposes of ascertaining under § 1.856-5(c)(2) the loan value of the real property securing that loan, a REIT may treat the modification as not being a new commitment to make or purchase a loan; and

(2) The modification of the mortgage loan is not treated as a prohibited transaction under section 857(b)(6).

.02 *Asset test.* The Service will not challenge a REIT's treatment of a loan as being in part a "real estate asset" for purposes of section 856(c)(4) if the REIT treats the loan as being a real estate asset in an amount equal to the lesser of—

(1) The value of the loan as determined under § 1.856-3(a) (see section 2.04 of this revenue procedure); or

- (2) The greater of—
- (a) The current value of the real property securing the loan; or
 - (b) The loan value of the real property securing the loan as determined under § 1.856-5(c) and, if applicable, section 4.01 of this revenue procedure (see section 2.07(2) of this revenue procedure).

SECTION 5. EXAMPLES

.01 *Example 1.* In 2007, X, a REIT, made a \$100 mortgage loan to A. X's loan to A was secured by both real property and personal property. When X's commitment to make the loan became binding on X, the real property had a fair market value of \$115. At the end of the calendar quarter in which X made the loan, the value of the loan as determined under § 1.856-3(a) was \$100. At all times through the end of 2010, under § 1.856-5(c)(3), the amount of the loan continued to be \$100.

By the start of 2009, the fair market value of the real property securing the loan had fallen to \$55 and the fair market value of the personal property was \$5. The values remained at these levels throughout 2009 and 2010. Throughout 2009 and 2010, the value of the loan, as determined under § 1.856-3(a), was \$60.

During 2009, X and A modified the terms of the mortgage loan. The modification of the loan is described in section 3.01 of this revenue procedure and is a significant modification under § 1.1001-3.

(1) *Income Test.* When X made the mortgage loan in 2007, the loan value of the real property for purposes of § 1.856-5(c) was its fair market value (\$115) determined as of the date on which the commitment to make the loan became binding on X. This amount exceeded the amount of the loan for that year (\$100). Accordingly, in the year that the loan was made, all of the interest from the loan was apportioned to the real property. See § 1.856-5(c)(1).

Between the time that the loan was made and the time of the modification, the loan value of the real property continued to be \$115, notwithstanding changes in the fair market value of that real property. See § 1.856-5(c)(2). Similarly, the amount of the loan continued to be \$100. Accordingly, the loan value of the real property (\$115) continued to exceed the amount of the loan (\$100), and all of the interest on the loan continued to be apportioned to the real property.

The fair market value of the real property that secured the mortgage loan had fallen to \$55 by the time that X and A modified the loan in 2009. That modification, however, is described in section 3.01 of this revenue procedure, and X chose to treat the modification as not being a new commitment to make or purchase a loan.

Therefore, the loan value of the real property (\$115) does not change. Because the loan value of the real property (\$115) continued through the end of 2010 to exceed the amount of the loan (\$100), all of the interest from the loan during that year is apportioned to real property.

(2) *Asset Test*. In 2007, at the end of the calendar quarter in which X made the mortgage loan, the current value of the real property securing the loan was \$100, the value of the loan (as determined under § 1.856-3(a)) was \$100, and the loan value of the real property securing the loan (as determined under § 1.856-5(c)(2)) was \$115. For this calendar quarter, in determining the amount of the loan that is a real estate asset for purposes of the 75% Asset Test, X may use the safe harbor in section 4.02 of this revenue procedure. If X does so, the amount of the loan that is a real estate asset for purposes of the 75% Asset Test is the lesser of—

- The value of the loan as determined under § 1.856-3(a) (see section 2.04 of this revenue procedure) (\$100); or
- The greater of—
 - The current value of the real property securing the loan (\$100); or
 - The loan value of the real property securing the loan as determined under § 1.856-5(c) and, if applicable, section 4.01 of this revenue procedure (in this case, section 4.01 is not applicable) (\$115).

Accordingly, X may treat \$100 of the loan as a qualifying asset.

At the end of the calendar quarter immediately preceding the quarter in 2009 in which X modified the mortgage loan, the current value of the real property securing the loan was \$55, the value of the loan (as determined under § 1.856-3(a)) was \$60, and the loan value of the real property securing the loan (as determined under § 1.856-5(c)(2)) was \$115. As described earlier in this section 5.01, beginning with the calendar quarter in which the loan was modified, X may use the safe harbor in section 4.01 of this revenue procedure to treat the modification as not being a new commitment to make or purchase the loan. In addition, in determining the amount of the loan that is a real estate asset for purposes of the 75% Asset Test, X may use the safe harbor in section 4.02 of this revenue procedure. If X does so, the amount of the loan that is a real estate asset for purposes of the 75% Asset Test is the lesser of—

- The value of the loan as determined under § 1.856-3(a) (see section 2.04 of this revenue procedure) (\$60); or
- The greater of—
 - The current value of the real property securing the loan (\$55); or
 - The loan value of the real property securing the loan as determined under § 1.856-5(c) and, if applicable, section 4.01 of this revenue procedure (in this case, section 4.01 is applicable) (\$115).

Accordingly, X may treat \$60 of the loan as a qualifying asset.

.02 *Example 2*. The facts include all of the facts in Example 1. Additionally, during the first quarter of 2010, Y, a REIT, committed to purchase, and purchased, the mortgage loan from X for \$60.

(1) *Income Test.* Under § 1.856-5(c)(2), the loan value of the real property securing the loan is the fair market value of the real property determined as of the date on which Y's commitment to purchase the loan became binding on Y (\$55). This value is compared to the amount of the loan for the year (\$100). Because 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 (\$55) and the denominator of which is the amount of the loan (\$100). Therefore, 55 percent of the interest income from Y's loan is apportioned to the real property securing the loan. Interest income apportioned to the other property is the excess of the total interest income over the interest income apportioned to the real property. See § 1.856-5(c)(2).

(2) *Asset Test.* At the end of every calendar quarter during 2010, the current value of the real property securing the loan was \$55, the value of the loan (as determined under § 1.856-3(a)) was \$60, and the loan value of the real property securing the loan (as determined under § 1.856-5(c)(2)) was \$55. For every calendar quarter during 2010, in determining the amount of the loan that is a real estate asset for purposes of the 75% Asset Test, Y may use the safe harbor in section 4.02 of this revenue procedure. If Y does so, the amount of the loan that is a real estate asset for purposes of 75% Asset Test is the lesser of—

- The value of the loan as determined under § 1.856-3(a) (see section 2.04 of this revenue procedure) (\$60); or
- The greater of—
 - The current value of the real property securing the loan (\$55); or
 - The loan value of the real property securing the loan as determined under § 1.856-5(c) and, if applicable, section 4.01 of this revenue procedure (in this case, section 4.01 is not applicable) (\$55).

Accordingly, X may treat \$55 of the loan as a qualifying asset.

.03 *Example 3.* On January 1, 2011, Z, a REIT, purchased for \$60 a distressed mortgage loan with a principal amount due of \$100. During the taxable year 2011, the amount of the loan under § 1.856-5(c)(2) was \$100. The value of the real property securing the loan on the date Z committed to purchase the loan was \$55 and the value of the personal property securing the loan was \$5. At the end of the first calendar quarter in 2011, the current value of the real property securing the loan was \$55, and the value of the loan (as determined under § 1.856-3(a)) was \$60.

Asset Test. Under section 4.02 of this revenue procedure, Z may treat \$55 of the loan as a “real estate asset” for purposes of the 75% Asset Test. This amount is the lesser of—

- The value of the loan as determined under § 1.856-3(a) (see section 2.04 of this revenue procedure) (\$60); or
- The greater of—
 - The current value of the real property securing the loan (\$55); or

- The loan value of the real property securing the loan as determined under § 1.856-5(c) and, if applicable, section 4.01 of this revenue procedure (in this case, section 4.01 is not applicable) (\$55).

At the end of the second calendar quarter of 2011, the current value of the real property securing the loan had increased to \$65, and the value of the loan (as determined under § 1.856-3(a)) had increased to \$70. Accordingly, at the end of the second quarter of 2011, under section 4.02 of this revenue procedure, Z may treat \$65 of the loan as a “real estate asset” for purposes of the 75% Asset Test. This amount is the lesser of—

- The value of the loan as determined under § 1.856-3(a) (see section 2.04 of this revenue procedure) (\$70); or
- The greater of—
 - The current value of the real property securing the loan (\$65); or
 - The loan value of the real property securing the loan as determined under § 1.856-5(c) and, if applicable, section 4.01 of this revenue procedure (in this case, section 4.01 is not applicable) (\$55).

SECTION 6. EFFECTIVE DATE

This revenue procedure is effective for all calendar quarters and all taxable years.

SECTION 7. EFFECT ON OTHER DOCUMENTS

Rev. Proc. 2011-16 is modified and superseded.

SECTION 8. DRAFTING INFORMATION

The principal author of this revenue procedure is Jonathan D. Silver of the Office of Associate Chief Counsel (Financial Institutions & Products). For further information regarding this revenue procedure, contact Mr. Silver at (202) 317-4413 (not a toll-free call).