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), 1001; 1.856–3, 1.856–5, 1.1001–3.)

Rev. Proc. 2011-16

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.

SECTION 2. BACKGROUND

.01 To qualify as a REIT for a taxable year, at least 95 percent of an entity's gross income must be derived from the types of qualifying income listed in section 856(c)(2) of the Internal Revenue Code, and at least 75 percent of its gross

income must be derived from the types of qualifying income listed in section 856(c)(3). Specifically, all interest is qualifying income for the 95 percent income test under section 856(c)(2); and interest on obligations secured by mortgages on real property or on interests in real property is qualifying income for purposes of the 75 percent income test under section 856(c)(3).

.02 Section 856(c)(4)(A) provides that at the close of each quarter of its taxable year, at least 75 percent of the value of a REIT's total assets must be represented by real estate assets, cash and cash items (including receivables), and Government securities.

.03 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.

.04 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.

.05 If a mortgage loan is secured by both real property and other property, then, for purposes of section 856(c)(3), § 1.856–5(c) of the Income Tax Regulations 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. Under this apportionment test, the “loan value of the real

property” is compared to the “amount of the loan.” 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. If 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 and the denominator of which is the amount of the loan. 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.

.06 For purposes of the apportionment test, § 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.
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.

.07 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.

.08 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.

.09 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.

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 both of the following 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, and

(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 will not be 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), or

(2) The loan value of the real property securing the loan as determined under § 1.856–5(c) and 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 had fallen to $55 and the fair market value of the personal property was $5. They 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, 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 to exceed the amount of the loan for the year of modification ($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 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, under section 4.02 of this revenue procedure, *X* may treat the lesser of these two values ($100) as the amount of the loan that is a real estate asset for purposes of section 856(c)(4).

In 2009, at the end of the calendar quarter in which *X* modified the mortgage loan, 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) and section 4.01 of this revenue procedure) was $115. For this calendar quarter, under section 4.02 of this revenue procedure, *X* may treat the lesser of these two values ($60) as the amount of the loan that is a real estate asset for purposes of section 856(c)(4).

.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 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) and this revenue procedure) was $55. For every calendar quarter during 2010, under section 4.02 of this

revenue procedure, *Y* may treat the lesser of these two values ($55) as the amount of the loan that is a real estate asset for purposes of section 856(c)(4).

SECTION 6. EFFECTIVE DATE

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

SECTION 7. 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 Jonathan D. Silver on (202) 622-3930 (not a toll free call).