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Distressed Debt—REIT Considerations

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by Peter Ritter and David Lee, Washington National Tax*

Investors (including existing and newly formed mortgage real estate investment trusts ("REITs")) with liquidity may acquire distressed investments. Special considerations associated with REITs should be taken into account, however.

In recent weeks, due to the coronavirus (COVID-19) pandemic, there have been many temporary closures of businesses, either voluntarily or involuntarily, which undoubtedly will result in some mortgage loan defaults. At the same time, due to the turmoil in the financial markets, some borrowers that have entered into repos by "selling" mortgage-backed securities have announced the inability to meet future margin calls. Thus, there is a concern that some mortgage loans and mortgage-backed securities may become distressed similar to the 2008-2009 period following the financial crisis. While unfortunate, the present situation may present an opportunity for investors (including existing and newly formed mortgage REITs) with liquidity to acquire these distressed investments, to restructure or work them out, and to ultimately realize value as the economy recovers.

REIT Overview

For an entity to elect and qualify as a REIT it must comply with certain organizational, asset holding, income source, and distribution requirements set forth in the Code.¹ A REIT is taxed as a corporation

* Peter Ritter is a principal with the Financial Institutions and Products group of Washington National Tax ("WNT"). David Lee is a member of the REIT Services team and a partner in the Pass-throughs group of WNT.

¹ Unless otherwise indicated, section references are to the Internal Revenue Code of 1986, as amended (the "Code") or the applicable regulations promulgated pursuant to the Code (the "regulations").

but is not subject to a corporate level tax so long as it distributes all its earnings via a deduction for dividends paid to its shareholders. Thus, a REIT is often viewed as a tax-favored vehicle for certain tax sensitive investors because the activities conducted by a REIT typically are “blocked” and not attributed to its shareholders.

For example, investors looking for distressed debt investment opportunities are often U.S. tax-exempt organizations that are concerned with unrelated business taxable income (“UBTI”), as well as non-U.S. persons that wish to avoid U.S. trade or business (“USTB”) issues. For these investors, a REIT may be an ideal entity to “block” UBTI and/or USTB consequences. A REIT structure may also be beneficial for U.S. individuals because REIT dividends are either eligible for the 20 percent deduction under section 199A (even though interest income does not ordinarily qualify) or are treated as capital gains.

However, even if an entity qualifies as a REIT, it can be subject to a 100 percent tax on net income or gain derived from prohibited transactions, such as a sale or other disposition of property that is considered inventory or held primarily for sale to customers in the ordinary course of a trade or business other than foreclosure property (“dealer property”).

REITs and Distressed Debt

There are many special considerations when a REIT structure is used in the distressed debt space, however. These considerations are discussed in greater detail below.

REIT Gross Income Tests

With distressed debt, issues can arise with respect to the REIT gross income tests if the underlying real estate collateral supporting a mortgage loan has decreased in value, especially relative to any other collateral supporting the loan. In this case, care must be taken when a mortgage REIT acquires the distressed mortgage loan or modifies an existing loan in its portfolio in a material way.

By way of background, a REIT generally must derive at least 75 percent of its gross income from real-estate related sources, including, among other things: rents from real property, interest on obligations secured by mortgages on real property or on interests in real property, and gain from the sale or other disposition of real property (including interests in real property and interests in mortgages on real property) that is not dealer property (the “75 percent income test”). Additionally, a REIT generally must derive at least 95 percent of its gross income from sources qualifying for this 75 percent income test as well as dividends, interest, and gain from the sale or other disposition of stocks and securities that are not dealer property.

The applicable regulations specify that when a mortgage covers both real property and other property, interest income from the mortgage is apportioned entirely to real property (i.e., qualifying for the 75 percent income test) if the fair market value of the real property equals or exceeds the highest principal amount of the loan outstanding during the tax year. Otherwise, the interest income apportioned to the real property is based on a fraction, the numerator of which is the fair market value of the real property, and the denominator of which is the highest principal amount of the loan outstanding (“UPB”) during the

tax year. For this purpose, the fair market value is determined as of the date on which the REIT's commitment to make or acquire the loan becomes binding on the REIT (referred to as "REIT's loan commitment date").

Prior to 2016, so long as the collateral supporting a mortgage loan included *any* personal property (such as a dishwasher at a single family home that no investors would assign a value), a REIT acquiring the mortgage loan needed to apply the apportionment rule when the UPB was not fully supported by the value of the real property collateral. For example, assume a REIT paid \$60 to acquire a mortgage loan with the UPB of \$100 due to a significant decline in the collateral value. Because the highest principal amount (of \$100) exceeds the real property's fair market value (of \$60), only 60 percent of the interest income would have been apportioned to the real property (i.e., \$60 over \$100). If this loan were the sole asset, the REIT would have failed to satisfy the 75 percent income test. To alleviate the risk of failing the 75 percent income test and work within the interest apportionment rules, some REITs attempted to modify the acquired distressed debt by reducing the principal amount (i.e., the denominator of the fraction) while increasing the stated interest rate.

Effective for tax years beginning after December 31, 2015, however, the Code now provides that no such apportionment is required to be made (i.e., all interest qualifies for purposes of the 75 percent income test) if the fair market value of the personal property does not exceed 15 percent of the total fair market value of both real property and personal property. For this purpose, the value is similarly determined as of the REIT's loan commitment date. Thus, this new law effectively overrides the unfavorable result for the 75 percent income test under the above example. That is, because the personal property represents no more than 15 percent of the total value of personal property and real property determined as of the loan commitment date, the entire interest income is treated as qualifying for the 75 percent income test.

In addition, any gain on the sale or other disposition of such an obligation (if the 15 percent test is satisfied) is also treated as entirely qualifying for the 75 percent income test if not classified as dealer property.

REIT Asset Tests

In addition, mortgage REITs may encounter issues satisfying the various REIT asset test requirements set forth in the Code when investing in and modifying distressed debt.

These REIT asset tests provide generally that at the end of each quarter of each tax year, a REIT is required to have at least 75 percent of the value of its total assets represented by cash and cash items (including ordinary receivables), real estate assets, and U.S. government securities (the "75 percent asset test"). For these purposes, "real estate assets" generally include interests in real property, interests in mortgage loans secured by real property, interests in other REITs, and interests in real estate mortgage investment conduits (REMICs).

However, the REIT asset tests provide further that the “securities” of another issuer held by the REIT (other than securities of taxable REIT subsidiaries (“TRSs”) or those qualifying for the 75 percent asset test) must not represent (1) more than five percent of the value of REIT’s total assets, or (2) more than 10 percent of the total voting power or the total value of the outstanding securities of the issuer. The REIT also must not have more than 25 percent of the value of its total assets represented by nonqualified publicly offered REIT debt instruments. Finally, the value of securities of all TRSs held by the REIT must not represent more than 20 percent of the value of the REIT’s total assets.

The term “securities” for this purpose is not specifically defined in the REIT provisions of the Code, but according to the Investment Company Act of 1940 it includes “any note, stock... bond, debenture, evidence of indebtedness” However, securities that are considered real estate assets, such as interests in mortgages on real property, are not considered securities and, thus, not subject to the securities diversification requirements.

As with the 75 percent gross income test, a mortgage loan will qualify as a real estate asset for purposes of the asset tests only if adequately secured by real property or interests in real property. In particular, for tax years beginning after December 31, 2015, the Code provides that the term “real estate asset” includes an obligation secured by a mortgage on both real property and personal property if the fair market value of the personal property does not exceed 15 percent of the total fair market value of both real property and personal property. That is, if this 15 percent test is satisfied, the obligation is treated as a real estate asset and not a “security,” and, thus, no portion of the obligation will be subject to the securities diversification requirements.

For this purpose, the value is similarly determined as of the REIT’s loan commitment date. For example, assume a REIT agrees to make a loan of \$100 that is to be secured by a hotel building and furnishings, and as of REIT’s loan commitment date hotel’s real property and personal property is valued at \$110 and \$15, respectively. Because the value of the personal property does not exceed 15 percent of the total value, the entire loan is considered a real estate asset. The loan is treated so even if the value of the personal property subsequently represents more than 15 percent of the total for some reason because the value is determined only once (i.e., as of REIT’s loan commitment date).

Loan Workouts

Issues can arise when the terms of a distressed mortgage are modified, e.g., through a workout. For U.S. federal income tax purposes, the modification of a mortgage may be treated as a deemed taxable exchange of the pre-modified mortgage for the modified mortgage. This can occur when, for example, the modification of a mortgage results in a change in its yield, a material deferral of scheduled payments, a change in the collateral or the addition or removal of a co-obligor, and the change is considered to be a “significant modification” (as defined for tax purposes).

A REIT may recognize gain on a mortgage that is acquired at a discount and subsequently modified if the modification is treated as a deemed exchange (under the rules discussed above). In that case, the amount of gain recognized by the REIT on the exchange will generally be equal to the excess of the

stated principal amount of the modified mortgage over the amount originally paid by the REIT to acquire the pre-modified mortgage. This gain would be “phantom income or gain” (i.e., taxable income or gain without any corresponding cash flow), and the REIT may need to take the phantom income into account for purposes of determining compliance with the REIT distribution requirement. For example, suppose a REIT acquires a mortgage for \$60 and modifies the mortgage in a manner that results in a deemed exchange for tax purposes. If the stated principal amount of the modified mortgage is \$100, the REIT may recognize \$40 of tax gain (\$100 amount realized—\$60 basis) as a result of the modification, even though economically there may be no gain or profit.

If a REIT modifies too many loans, while it may seem nonsensical, it is conceivable that the REIT could be treated as a “dealer” for purposes of the prohibited transaction rules, on account of each modification resulting in a taxable disposition of the loan. If the modification is treated as a “prohibited transaction,” a 100 percent tax on this phantom income or gain could apply (as is further discussed below). However, IRS guidance provides that in certain distressed mortgage scenarios these prohibited transaction tax should not apply. If the mortgage is held by a TRS at the time of modification, the prohibited transaction tax generally should not apply, but the TRS may have a corporate tax liability as a result of the modification. In addition, a portion of any gain realized may be characterized as ordinary (and not capital) gain under the market discount rules (discussed below). Some have explored the use of a mark-to-market election, under which a TRS, if eligible, may minimize its taxable income.

If a REIT modifies a mortgage loan as part of a loan modification program or other workout and the modification is treated as a deemed taxable exchange of the pre-modified mortgage for a new one, difficulties satisfying the assets and gross income tests discussed above likewise can arise. In particular, if the modification results in a deemed taxable exchange, the REIT will be treated as originating a new loan for tax purposes, with the result that the value of the real estate securing the loan may need to be retested.

Again, however, if the mortgage loan in question is secured by both real property and other (personal) property, and if at the time of the deemed exchange the fair market value of the personal property does not exceed the 15 percent thresholds mentioned above, then it appears that the mortgage loan should be treated as a qualifying asset and producing qualifying income in its entirety.

However, if this is not the case then problems can arise. For example, assume that a REIT originated a mortgage loan seven years ago with a principal balance of \$100, which at the time was secured by real estate with a value of \$100 and personal property of \$15. In 2020, when the value of the real estate was worth only \$60 and the personal property \$15, the loan is modified (e.g., interest rate lowered and/or the term extended) with those modifications resulting in a deemed taxable exchange of the loan. If the deemed exchange results in a new loan for tax purposes, then after applying the special “apportionment” rule (discussed above) only 60 percent of the interest on the “new” mortgage would qualify as qualifying income for purposes of the 75 percent income test.

However, and in an effort to facilitate loan workouts and avoid this result, the IRS has issued guidance whereby if certain conditions are met (i.e., the modification was occasioned by a default or a significant

risk of default, etc.), then the REIT does *not* need to treat the new modified loan as triggering a re-testing of the value of the real estate for purposes of the 75 percent income test. So, in the example above and if all the IRS requirements set forth in this guidance are met, then the mortgage loan could continue to generate qualifying interest income in its entirety, even post modification and notwithstanding the fact that the loan is secured by personal property in excess of the 15 percent threshold. It should be noted that this special rule applies only in the context of distressed loan modifications (and not purchases).

In addition, pursuant to the guidance, for purposes of the 75 percent assets test the REIT may treat the loan as being in part a “real estate asset” in amount equal to the lesser of (1) the value of the loan (and not the *amount* of the loan), and (2) the greater of current value of the real property securing the loan or the “loan value” of the real property securing it (as used for purposes of the 75 percent income test). Unlike the special rule for the 75 percent income test, this special asset test rule applies regardless of whether the modification was occasioned by default or significant risk of default. In addition, this special asset test rule appears to apply to not only loan modifications but purchases as well.

Other Distressed Debt Considerations

When a mortgage REIT (or one of its TRSs) holds a non-performing loan, it is possible that the REIT (or TRS) may need to accrue (and report) interest income on the loan notwithstanding the fact that no interest is actually being paid. In this case, the REIT may need to consider the phantom income accruals for purposes of determining compliance with the REIT distribution requirement, and if the loan is held by a TRS, the TRS may need to fund corresponding tax payments with cash from other sources. However, in certain cases a lender may be able to cease accruing interest income under the so-called “doubtful collectability” doctrine.

Consideration should also be given to the “market discount” rules of the Code. In general, under the tax law a mortgage loan will be treated as acquired with “market discount” if the loan is purchased in the secondary market for an amount less than its issue price (which, in the case of most mortgages, generally is equal to its principal amount). Under these rules, any payment of principal (as well as any gain upon a later disposition of a loan) is generally required to be treated as “ordinary income” to the extent of any market discount that has accrued on the loan since its purchase. Any market discount is considered to accrue ratably during the period from the date of acquisition of the loan, unless the taxpayer elects to accrue on a constant yield method. In addition, a taxpayer can also elect to include market discount in income currently as it accrues (on either a ratable or constant yield basis).

Accordingly, because most mortgages provide for monthly principal payments, a mortgage REIT (or TRS if it holds mortgages) may be required to report accrued market discount (as ordinary income) as these payments are made.

In addition, if the REIT (or TRS) subsequently disposes of a mortgage loan (directly, or indirectly on account of a deemed taxable exchange resulting from a loan modification), a portion of any gain may be characterized as ordinary (and not capital) gain. It appears that any such market discount is treated

as qualifying interest income for REIT purposes, assuming the underlying mortgage otherwise produces qualifying interest income. In the distressed mortgage market environment, the market discount may reflect doubts as to collectability rather than changes solely with respect to interest rates. To the extent a mortgage REIT (or TRS) included market discount in income with respect to (monthly) principal payments, but eventually collected less on the mortgage than the amount paid for the mortgage plus the market discount previously included in income, the REIT or TRS may be entitled to a bad debt deduction.

Given the risks involved with distressed mortgages and satisfying the various REIT asset and gross income requirements, it may be necessary in certain cases for a REIT to hold certain distressed mortgages (for purposes of workouts, modifications, foreclosures and sales) in a TRS.

Minimum Distribution Requirement

Generally speaking, a REIT is required to distribute at least 90 percent of its “ordinary” taxable income. However, as mentioned above, in certain cases a mortgage REIT may have taxable income without any corresponding cash flow, e.g., interest accruals for debt in default, or on account of original issue discount. The Code provides that certain phantom income can be excluded from this 90 percent distribution requirement to the extent this income exceeds five percent of the REIT’s “ordinary” taxable income. However, a REIT that relies on this rule will be subject to a corporate level tax on the amount of income not distributed, even if it is phantom income.

Foreclosure Property

In 1975, Congress enacted special foreclosure property rules for REITs in response to the then economic problems and to prevent a REIT from being disqualified or having to take action not economically sensible to remain qualified in “a situation where a REIT, inadvertently, as the result of an unanticipated default of its debtor, takes over real property under existing mortgages or leases that yielded nonqualified income.” Pursuant to these foreclosure property rules, a REIT may elect to treat real property (including interests in real property) and any personal property incident to the real property, as “foreclosure property” if the real property is acquired as a result of the REIT having bid on the property at foreclosure, or having otherwise reduced the property to ownership or possession by agreement or process of law, after there was default (or default was imminent) on an indebtedness that the property secured. Upon election, income and gain derived from foreclosure property are treated as qualifying income for purposes of the 75 percent and 95 percent income tests. Further, the sale of a foreclosure property, even if being held primarily for sale by the REIT, is not considered dealer property the gain on which could be subject to a 100 percent tax.

Under the applicable regulations, property does not qualify as foreclosure property if the loan with respect to which default occurs was acquired by the REIT with an intent to foreclose, or when the REIT knew or had reason to know that default would occur (i.e., improper knowledge). However, it is worth noting that the mere fact that a payment is late for an insubstantial amount of time or a minor covenant to a loan agreement is breached is usually insufficient to cause a loan to fail the improper knowledge

test. It should be noted also that to the extent a REIT recognizes a gain on a foreclosure property and makes a distribution that is attributable to this gain, the distribution may result in a non-U.S. shareholder's realization of income effectively connected with a USTB and being obligated to U.S. tax filings unless the stock of the REIT is regularly traded in the United States. Thus, many U.S. debt funds cause a TRS to be formed by the REIT to hold and dispose of the foreclosure property to avoid the adverse tax consequences to certain non-U.S. investors.

Prohibited Transactions

Ordinarily, whether a property is considered a dealer property is based on a facts-and-circumstances analysis. In light of the punitive 100 percent tax risk, the Code provides a safe harbor. A sale of property, which is a real estate asset, is not a prohibited transaction if:

1. The REIT has held the property for not less than two years;
2. The aggregate expenditures made by the REIT or any partner thereof during the two-year period preceding the date of sale and includable in the basis of the property do not exceed 30 percent of the property's net selling price;
3. During the tax year, other than sales of foreclosure property or involuntary conversion, (a) the REIT does not make more than seven sales of property; (b) the REIT does not sell more than 10 percent of total assets as of the beginning of the tax year (based on either fair market value or adjusted earnings and profits bases); or (c) the REIT does not sell more than 20 percent of total assets as of the beginning of the tax year (based on either fair market value or adjusted earnings and profits bases) provided that the REIT does not sell more than 10 percent on a three-year averaging basis;
4. In the case of property that consists of land or improvements, not acquired through foreclosure (or deed in lieu of foreclosure) or lease termination, the REIT has held the property for not less than two years for production of rental income; and
5. If the REIT has made more than seven sales of property during the tax year, substantially all of the marketing and development expenditures with respect to the property were made through an independent contractor from whom the REIT itself does not derive or receive any income or a taxable REIT subsidiary.

A mortgage REIT's reliance on the safe harbor has not always been easy for the following reasons. First, and as mentioned above, for U.S. federal income tax purposes a significant modification of a debt instrument results in a deemed exchange of the original debt for a modified debt. Further, for U.S. federal income tax purposes, amounts received by the holder on retirement of a debt instrument are generally considered as amounts received in exchange therefor. Thus, these could potentially be taken into account for condition number 3 above. However, based on court cases, to be a dealer with respect to securities, one must have "customers" and function similar to a merchant that purchases his stock in trade "with the expectation of reselling at a profit . . . because [he has or hopes] to find a market of buyers who will purchase from [him] at a price in excess of their cost." Neither a significant

modification nor a loan repayment seems to fit within this definition. Also, the guidance mentioned above allows REITs to treat certain loan modifications occasioned by default or reasonably foreseeable default not as prohibited transactions.

However, as discussed above if a REIT modifies too many loans, it is conceivable that the REIT could be treated as a “dealer” for purposes of these prohibited transaction rules, on account of each modification resulting in a taxable deemed exchange or disposition of the loan. Thus, if the risk is meaningful (e.g., not eligible for the safe harbor under the guidance), it may be prudent to consider the use of a TRS.



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