

IRS ISSUES REVENUE PROCEDURE 2003-65 AND ESTABLISHES SAFE HARBOR FOR REITS ACQUIRING MEZZANINE LOANS

A real estate investment trust (“REIT”) must satisfy a number of income and asset tests to qualify as a REIT for tax purposes. Satisfaction of these tests may depend on whether debt obligations owned by the REIT qualify as “real estate assets,” defined to include interests in real property and “interests in mortgages on real property.”

A typical loan directly and adequately secured by a mortgage on real property is a straightforward example of a loan that qualifies as a “real estate asset,” but under many circumstances, first mortgage lenders will prohibit encumbering the mortgaged property with any subordinated mortgage lien. In such situations, a lender may be willing to lend to the owner of the entity owning the real property, thereby avoiding borrowing limits on the property owner itself and structurally subordinating the loan to all indebtedness of the property-owning entity. The loan will not be secured by a direct pledge of the real estate, but will typically be secured by a pledge of interests in the entity (e.g., limited partnership or LLC interests), and the borrowing entity would be organized as a special purpose entity or SPE. In some cases, the lender may expect the loan to default, and might be making the loan as a means to acquire a controlling interest in an entity owning real estate that the lender desires to own and manage.

Prior to the creation of the safe harbor by Revenue Procedure 2003-65, it was not clear that loans secured by a pledge of entity interests would qualify as “real estate assets” and this uncertainty constrained some REITs from making such loans. Some comfort might be derived from the rule in Treasury Regulation Section 1.856-3(g) stating that a REIT owning a partnership interest is treated as owning its proportionate share of the assets of the underlying partnership, and from the fact that the applicable income/assets tests allow a 25% “bad basket.” Also, Revenue Ruling 77-459 provides some support for treating a pledge of entity interests as real property, although in the ruling, the REIT held both a mortgage in real property and a beneficial interest in an Illinois land trust. Of note, although the Revenue Procedure cites both Treasury Regulation Section 1.856-3(g) and Revenue Ruling 77-459, it appears to have placed greater reliance on the Regulation, since the Revenue Procedure allows a pledge of less than 100% of the outstanding partnership or LLC interests, whereas the Ruling describes a pledge of 100% of the beneficial interests in the land trust.

The Revenue Procedure is effective August 11, 2003 and classifies loans not directly secured by a real estate mortgage as “real estate assets” if eight criteria are met. To ensure satisfaction of these criteria, the lender will need to insist on appropriate protections via negative covenants and provisions in the partnership or LLC agreement:

- (i) the borrower must be a partner in a partnership (or a member of an entity treated as a partnership for tax purposes, such as an LLC) or the owner of interests in a disregarded entity (e.g., an LLC or partnership owned 100% by the borrower);
- (ii) the loan must be nonrecourse and secured only by the borrower's interest in the entity;
- (iii) the security interest in the entity must be senior to any other pledge of interests in the entity;
- (iv) upon foreclosure, the lender must replace the borrower as partner of the partnership or member of the LLC, and the other partners or members (if any) must agree not to oppose unreasonably admission of the lender as partner or member;
- (v) on the date the lender commits to make the loan, the entity must own real property, and the loan must become due upon a sale or disposition of the real property;
- (vi) on each testing date, the value of the real property held by the entity must be at least 85% of the value of all assets of the entity. For this purpose, a "testing date" means the close of the first quarter after the loan commitment is made, and the close of any subsequent quarter during which the entity acquires assets other than real estate assets, cash items and government securities and reasonable quantities of maintenance supplies;
- (vii) the value of the real property held by the entity, net of liens encumbering it, must equal or exceed the amount of the loan, determined as of the date the REIT enters into a binding commitment to make the loan. It would be an unusual case where the lender would not insist on such a condition to making the loan, although this requirement does disregard the value of any personal property in valuing the collateral;
- (viii) interest on the loan must qualify as interest for REIT qualification purposes; e.g., interest may not depend on profits and must be for the use of money and not a fee for services provided by the lender.

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July 21, 2003

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