

Corporate & Financial Weekly Digest

Posted at 12:03 PM on January 7, 2011 by [Anna-Liza Harris](#)

New Guidance on Loan Modifications: IRS Finalizes Rules on Issuer's Credit Quality and Provides a Safe Harbor for REITs

Co-authored by [Brandon D. Hadley](#)

On January 6, the Internal Revenue Service issued final regulations (T.D. 9513) under U.S. Treasury Department Regulation Section 1.1001-3 clarifying that a change in the issuer's credit quality between the issue date and the modification date of a debt instrument is not considered in determining the nature of the instrument or property that results from modification of the debt instrument. For example, a decrease in the fair market value of a debt instrument between the issue date and modification date is not taken into account if it is attributable to the deterioration of the obligor's financial condition and not to a modification of the instrument's terms. This rule does not apply if the modification includes the substitution of a new obligor or the addition or deletion of a co-obligor.

On January 5, the IRS released Revenue Procedure 2011-16 with respect to modifications of mortgage loans held by a real estate investment trust (REIT). If a mortgage loan modification qualifies for the safe harbor described below, then (1) the REIT is not required to treat it as a new commitment to make or purchase a loan for purposes of ascertaining the loan value of the real property; (2) the modification is not a prohibited transaction; and (3) the IRS will not challenge the REIT's treatment of a loan as a real estate asset if the REIT computes the loan value using one of the acceptable methods provided by Revenue Procedure 2011-16.

The new safe harbor applies to a mortgage loan modification which (or an interest in which) is held by an REIT if either (1) the modification was occasioned by default, or (2) the modification satisfies both of the following conditions based on all of the facts and circumstances: (A) the REIT or servicer of the pre-modified loan, after a diligent contemporaneous determination of the risk, 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; and (B) the REIT or servicer reasonably believes that the modified loan presents a substantially reduced risk of default, as compared with the pre-modified loan.

Click [here](#) for a copy of the final regulations, and [here](#) for a copy of the REIT guidance.