Tax Considerations For REITs In A Coronavirus-Driven Market

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Decisions by state and local governments in the U.S. to control the spread of the COVID-19 virus through shelter-in-place orders and business closures have resulted in both a sharp increase in unemployment and a sharp contraction in business revenue and liquidity.

While the federal government and the Federal Reserve Bank have recently announced a number of programs that can be expected to help stabilize certain portions of the agency-backed mortgage, corporate credit, money market fund and asset-backed loan markets, the markets for nonagency commercial mortgage-backed securities, or CMBS, in general, and for commercial mortgage real estate investment trusts, or REITs, in particular, have yet to attract the same levels of attention and support.

Market participants in these two areas are already experiencing the knock-on effects of business closures, particularly as owner/operators of leveraged properties determine that conserving cash takes priority over mortgage payments and as commercial tenants begin to suspend the rental payments on which landlords rely to service their own mortgage obligations.

At this point, it appears inevitable that many commercial mortgage REITs will need to develop strategies to modify their capital structures, finance their operations and engage with distressed borrowers. This article highlights some key tax issues that commercial mortgage REITs should bear in mind as they develop those strategies.

Considerations Relating to the Trading of CDO Bonds by Commercial Mortgage REITs

Many commercial mortgage REITs have financed their mortgage portfolios by contributing mortgages to collateralized debt obligation or collateralized loan obligation securitization vehicles, collectively CDOs, in exchange for CDO bonds that are then sold into the market.

Typically, a CDO vehicle is structured to be classified for income tax purposes as a qualified REIT subsidiary, or QRS, of its sponsoring REIT, meaning that: (1) the CDO vehicle is disregarded as separate from the REIT for income tax purposes; (2) the REIT is treated as owning all of the mortgages and other assets held by, and earning all the income recognized by, the CDO vehicle; and (3) any CDO bonds held by outside investors are classified as debt of the sponsoring REIT.

In order for a CDO vehicle to maintain its status as a QRS for income tax purposes, the REIT must own 100% of the securities issued by the CDO vehicle that are classified as equity for income tax purposes.

If the REIT is found to own less than 100% of the equity of a CDO vehicle, then the vehicle would generally be classified as a stand-alone C corporation for income tax purposes, pursuant to the taxable mortgage pool rules.

In addition to triggering a default on the CDO bonds, this classification can create draconian results for the REIT, including loss of REIT status, and for the CDO bondholders, who may find themselves owning bonds of a fully taxable corporation that has less liquidity than they originally anticipated.

The tax classification of a CDO security as equity or debt for income tax purposes is determined by a facts-and-circumstances analysis under which certainty can be difficult to achieve. Because the consequences of losing QRS status are potentially catastrophic for both the sponsoring REIT and the CDO bondholders, a sponsoring REIT is typically required to retain all CDO bonds and other securities that could potentially be classified as equity for income tax purposes.

In order to achieve a high level of comfort on the classification of a CDO vehicle as a QRS, a REIT will typically sell to third-party investors only those CDO bonds for which a will-be-debt tax opinion has been received from securitization counsel. These opinions are customary in CDO offerings and are typically issued with respect to investment-grade CDO bonds.

If a REIT acquires its own CDO bond, it is generally treated for tax purposes as retiring that bond. This feature of the tax law presents at least three unique challenges for commercial mortgage REITs that intend to buy and sell their own CDO bonds, the first two of which are especially acute in situations where the credit quality of the CDO bonds has decreased since its original issuance.

First, if a REIT acquires its own CDO bond that is trading at a discount in the market, that acquisition will generally cause the REIT to recognize cancellation of debt income, or CODI. Although CODI is ignored for purposes of the REIT income tests and is generally exempt from the REIT distribution requirement, any undistributed CODI will result in the imposition of a corporate-level income tax on the REIT, without a credit for the REIT's shareholders.

Accordingly, unless the REIT has other tax attributes available to offset the CODI, it may need to consider alternative strategies for satisfying the distribution requirement with respect to the CODI.[1]

The second challenge is more surprising, and potentially more serious. Because the acquired bond is treated as having been repaid and goes out of existence for income tax purposes, if the REIT resells that bond at a later date, the sale is treated as a brand-new issuance of a CDO bond and must be retested at that time as debt or equity for tax purposes.

Unless that bond is subject to its own will-be-debt tax opinion at the time of the resale transaction, the resale can jeopardize the status of the CDO vehicle as a QRS and thus the status of the REIT as a REIT.

Third, even in situations where the REIT obtains a new will-be-debt tax opinion prior to reselling the CDO bond into the market, the REIT may face withholding and capital market fungibility challenges if the bond is resold at a discount to the original issue price.

For example, assume that: (1) on Date 1, the REIT sells $1,000 of CDO bonds into the market at par; (2) on Date 2, the REIT buys $100 (face amount) of those bonds for $75; and (3) on Date 3, the REIT sells the $100 (face amount) of bonds that it purchased on Date 2 for $85. From an economic perspective, the REIT made a $10 profit trading in its own bonds.

From the perspective of the tax law, however, the results are much more complex: (1) The REIT recognized $25 of CODI on Date 2; (2) the REIT issued a new $85 bond on Date 3, which must be retested under a debt-equity analysis; and (3) assuming that the resold bond continues to qualify as debt for tax purposes, the bond will be treated as having been issued with $15 of original issue discount.

In that event, the REIT must manage its CODI; may have a difficult time obtaining a "will be debt" opinion on Date 3, which could jeopardize its REIT status (or, as a practical matter, prohibit the REIT from reselling the bond altogether); and will have issued a bond that is not tax fungible with the other CDO bonds of the same class, which would generally prevent the reissued bond from trading under the same CUSIP number as the bonds which were issued on Date 1.

There are multiple strategies that allow a REIT to trade in its own CDO bonds without raising the concerns described above. These strategies do, however, pose their own unique challenges and require careful tax and corporate planning at the early stages of a trade.

Restructuring or Modifying CDO Bonds

Any time the terms of an outstanding CDO bond are modified, the tax treatment of the modification must be carefully analyzed. Because debt modifications can produce unexpected tax results (including those discussed in the section above titled "Considerations Relating to the Trading of CDO Bonds by Commercial Mortgage REITs") it is critical to bear in mind the following:

- Depending on the nature and extent of the bond modification, the REIT may need to obtain a new will-be-debt tax opinion for the modified bonds.

- If the principal amount of a CDO bond is written down in connection with a modification, the REIT generally will recognize CODI, with the results described above.

- Under regulations addressing the issue price of traded bonds, modifications of discounted CDO bonds can result in the recognition of CODI, even where the principal amount of the debt is unchanged. These rules apply to, among other things, debt instruments for which broker quotations are readily available.

- The modified debt instrument could become subject to other adverse rules that did not apply premodification, such as the applicable high-yield discount obligation provisions, a punitive set of rules that defer and even wholly disallow a significant portion of a debtor's interest deductions.

  If the applicable high-yield discount obligation rules come into play, the REIT may find itself in a situation where it is earning interest income on the bonds inside the

> CDO vehicle without a sufficiently high interest deduction in respect of payments on CDO bonds. This situation could create an unexpectedly high REIT distribution requirement, which may pose liquidity challenges for the REIT that need to be addressed through alternate strategies of their own.

A borrower wishing to modify its debt without triggering CODI can do so through a modification that satisfies one of the safe harbors set out in the regulations. These safe harbors include, among other things, modifications of financial covenants, certain forbearance agreements and extensions, and modifications that do not change the yield of the instrument by more than a specified threshold.

Repo Financing on Retained CDO Bonds

In situations where selling CDO bonds into the market proves challenging, a REIT may consider selling those bonds to a financial counterparty under a repo line. Any time the REIT transfers a CDO bond to a third party, it must analyze whether and when the bond has come into existence for tax purposes and, if the bond has come into existence for tax purposes, whether the bond satisfies the will-be-debt standard at the time it comes into existence.

In the case of a repo transaction done under a standard International Swaps and Derivatives Association form contract, it may not be clear whether the transaction results in the bond coming into existence for tax purposes and, if so, at what point in time. For a REIT that will only transfer CDO bonds if it can be certain that the transfer will not jeopardize the QRS status of the CDO vehicle, the lack of clarity surrounding the tax implications of the repo transaction on the CDO vehicle poses a problem.

To avoid this problem, the REIT should consider either modifying the terms of the repo agreement to ensure that the repo is treated as a borrowing by the REIT or pursue an alternative corporate structure in order to execute the repo transaction in a way that achieves certainty on its impact on the CDO vehicle.

Again, while these strategies can mitigate or eliminate the tax risk associated with the loss of QRS status, they do require careful planning, as the initial documentation will influence the tax analysis.

Acquiring Market Discount Bonds

The secondary market acquisition of loans and bonds at a discount can present income tax challenges that are unique to commercial mortgage REITs. These challenges include the potential recognition of phantom income in connection with debt modifications and the distribution requirement challenges posed by the potential inability to deduct interest incurred in connection with a leveraged acquisition of discounted bonds.

In certain situations, these challenges can be overcome through either changing the structure of the acquisition or pre-acquisition contractual provisions among the buyer, seller and borrower.

Debt-for-Equity Recapitalizations of Troubled Borrowers

Certain commercial mortgage REITs may soon find themselves in discussions with borrowers about modifying the terms of an outstanding mortgage issued by the borrower to the REIT, or a CDO vehicle sponsored by the REIT.

If this cycle plays out similarly to the 2008 financial crisis, some of these borrowers may seek to issue their own equity in full or partial repayment of a mortgage debt held by the REIT or its CDO vehicle.

Before undertaking that type of debt-for-equity recapitalization, the REIT would need to evaluate the impact of holding borrower equity on the REIT's income and asset test compliance, particularly in situations where the borrower is a corporate entity that is ineligible to be a taxable REIT subsidiary of the REIT (e.g., because the borrower is in the business of operating or managing a health care or lodging facility) or where the borrower is a pass-through entity that is engaged in non-REIT-compliant businesses.

In addition, if a mortgage held by a CDO vehicle is converted into borrower equity, the REIT would need to determine whether the operative documents permit the vehicle to hold nonmortgage securities.

De-REITing

If a commercial mortgage REIT is considering a conversion to C corporation status — e.g., to facilitate the acquisition of nonreal estate assets or expand a non-REITable business such as loan servicing or special servicing — care must be taken to assess the impact of the C-corporation conversion on any CDO vehicles sponsored by the REIT.

During the last cycle, commercial mortgage REITs were surprised to learn that the loss of REIT status would trigger mass defaults on their sponsored CDO bonds absent careful structuring and precise planning as to the time REIT status is terminated.

For any commercial mortgage REIT that has issued CDO bonds and is contemplating a C-corporation conversion, now is the time to start analyzing how to achieve the conversion as quickly as possible without triggering defaults on outstanding CDO bonds.

Conclusion

The REIT vehicle has a well-deserved reputation for complexity, and nowhere is that reputation more deserved than the commercial mortgage REIT space. That complexity notwithstanding, commercial mortgage REITs possess a number of creative solutions to what can at first appear to be intractable problems at the intersection of tax law and finance. As alluded to above, preparation and careful tax planning are some of the keys to obtaining good results in a challenging financial market.

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[1] See, for example, the cash/stock dividend strategy described in our March 19, 2020, client alert, "REIT and RIC Cash Management Strategies for Uncertain Times."