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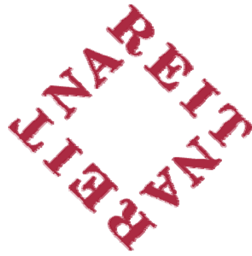

NATIONAL ASSOCIATION OF
REAL ESTATE INVESTMENT TRUSTS®

February 3, 2011

The Honorable Michael Mundaca
Assistant Secretary (Tax Policy)
U.S. Department of the Treasury
1500 Pennsylvania Avenue, N.W.
Room 3045
Washington, D.C. 20220

The Honorable Douglas Shulman
Commissioner
Internal Revenue Service
1111 Constitution Avenue, N.W.
Room 3000
Washington, D.C. 20224

Re: <u>Revenue Procedure 2011-16</u>

Dear Messrs. Mundaca and Shulman:

The National Association of Real Estate Investment Trusts (NAREIT)[1] appreciates the Department of the Treasury (Treasury) and the Internal Revenue Service (the Service) issuance of Revenue Procedure 2011-16, 2011-5 I.R.B. 1 (the Revenue Procedure). However, the application of the Revenue Procedure does leave a number of important issues unresolved or answered in a manner that effectively prohibits REITs from acquiring mortgages at below face value, an activity that other parts of the Administration have appropriately considered to be an essential component to working through the residue of the recent financial crisis. Accordingly, NAREIT is submitting this letter to request further clarification and, in some cases, changes to either the Revenue Procedure or the relevant regulations

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[1] NAREIT is the worldwide representative voice for real estate investment trusts (REITs) and publicly traded real estate companies with an interest in U.S. real estate and capital markets. NAREIT's members are REITs and other businesses throughout the world that own, operate and finance income-producing real estate, as well as those firms and individuals who advise, study and service those businesses.

1875 I Street, NW, Suite 600, Washington, DC 20006-5413
Phone 202-739-9400 Fax 202-739-9401 REIT.com

EXECUTIVE SUMMARY

The Revenue Procedure provides valuable guidance regarding the interpretation of Treas. Reg. § 1.856-5(c) (the Interest Apportionment Regulation)[2] with respect to distressed mortgage loans that REITs modify to avoid foreclosure. The Revenue Procedure will allow REITs greater flexibility to work out distressed mortgage loans without jeopardizing their REIT qualification. Consequently, the Revenue Procedure greatly decreases the chances that a borrower will suffer a foreclosure solely because its lender is a REIT.

The Revenue Procedure, however, leaves unresolved—and, in fact, exacerbates—certain issues faced by REITs seeking to invest in distressed mortgage loans and mortgage-backed securities. The problems relate to: 1) the application of the REIT asset test safe harbor in section 4.02 of the Revenue Procedure (the Asset Test Safe Harbor) when the value of the real property securing a distressed mortgage loan subsequently increases; and, 2) the treatment in section 5.01, Example 2 of the Revenue Procedure (Example Two) of a newly acquired distressed mortgage loan for purposes of the 75% gross income test applicable to REITs (the 75% Gross Income Test).[3] NAREIT requests that the Revenue Procedure be clarified and revised as follows.

> 1. The Asset Test Safe Harbor should be clarified so that a REIT will not be penalized when the value of the real property that secures a distressed mortgage loan later increases. The Asset Test Safe Harbor should be clarified to allow a REIT to treat a mortgage loan as a "real estate asset" under section 856(c)(4) based on the percentage of real property securing the loan determined as of the date the REIT committed to originate or acquire the loan; that ratio would remain fixed at each quarterly asset test date. Accordingly, the amount of a loan that the REIT could treat as a qualifying asset for purposes of the 75% asset test applicable to REITs (the 75% Asset Test)[4] at each quarterly asset testing date would be based on the value of the loan on that date multiplied by a fraction, the numerator of which is the value of the real property securing the loan on the date the REIT committed to originate or acquire the loan and the denominator of which is the fair market value the loan on the date the REIT committed to originate or acquire the loan.

[2] The Interest Apportionment Regulation generally addresses whether interest income on a mortgage loan will be treated as qualifying income for purposes of the 75% gross income test applicable to REITs when the loan is secured by both real property and other property. To the extent the "loan value of the real property" securing the loan exceeds the "amount of the loan," all of the interest income on the loan will be treated as qualifying income. To the extent the "amount of the loan" exceeds the "loan value of the real property," a portion of the interest income will be treated as nonqualifying. The "loan value of the real property" is generally the value of the real property securing the loan on the date the REIT committed to originate or acquire the mortgage loan. The "amount of the loan" is generally the highest principal amount of the loan during the applicable tax year.
[3] Section 856(c)(3). For purposes of this submission, "section" refers to the Internal Revenue Code of 1986, as amended (the Code), unless otherwise indicated.
[4] Section 856(c)(4)(A). Assets treated as "real estate assets" are qualifying assets for the 75% Asset Test and are not treated as securities for purposes of the other asset tests applicable to REITs under section 856(c)(4)(B).

This clarification would prevent a disproportionate amount of a distressed mortgage loan from being treated as a nonqualifying asset when the value of the real property securing the loan increases.

2. Consistent with NAREIT's previous submissions on this issue, the conclusion on the application of the 75% Gross Income Test to a distressed mortgage loan in Example Two should be reversed. The Revenue Procedure should be revised to include a safe harbor providing that, when a REIT acquires a mortgage loan with market discount, the REIT may use as the "amount of the loan," for purposes applying the Interest Apportionment Regulation, the REIT's highest adjusted tax basis in the mortgage loan during the taxable year. Example Two uses the face amount of the loan in Example Two as the "amount of the loan" for the Interest Apportionment Regulation, which is contrary to the treatment of market discount for federal income tax purposes generally and creates indefensible results.[5] If the Service believes that a regulatory change is needed to make this change, then NAREIT strongly urges that such a project be immediately initiated and then swiftly completed.

3. The Revenue Procedure should be modified to include a safe harbor pursuant to which the value of, and the interest income from, a mortgage loan would not be bifurcated into qualifying and nonqualifying portions for purposes of the 75% Gross Income Test or the 75% Asset Test if substantially all of the property securing the loan constitutes real property, determined as of the date the REIT committed to originate or acquire the loan. Such a safe harbor would mitigate many of the REIT qualification issues faced by REITs investing in distressed mortgage loans, as a REIT would not have to bifurcate a distressed mortgage loan when the value of the non-real property securing the loan is insubstantial.

If the Revenue Procedure is not clarified and revised as discussed herein, REITs will be significantly limited in their ability to invest in distressed mortgage loans and mortgage-backed securities.[6] As a result, there will be less liquidity in the market for those assets, and retail investors will have limited ability to participate in that market. NAREIT believes that a failure by the Service to clarify and revise the Revenue Procedure would undermine the government's efforts to address the continuing effects of the credit crisis on the mortgage market.

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[5] NAREIT proposed using the highest adjusted tax basis as the measure of the "amount of the loan" in its original submission on the issues with distressed mortgage loans. Letter from Tony M. Edwards, Executive Vice President & General Counsel, NAREIT, to the Honorable Michael Mundaca, Deputy Assistant Secretary, U.S. Department of Treasury, and the Honorable Douglas Shulman, Commissioner, Internal Revenue Service (Aug. 12, 2009), *available at* 2010 TNT 50-14 [hereinafter, the Original Submission].

6 As noted in the Original Submission, the issues with the Interest Apportionment Regulation and the asset tests apply also to mortgage-backed securities. Original Submission at 14-15. This submission will generally focus on the problems of distressed mortgage loans; however, the same problems exist with newly acquired distressed mortgage-backed securities and newly acquired mortgage-backed securities collateralized by distressed mortgage loans.

DISCUSSION

I. THE ASSET TEST SAFE HARBOR

The Asset Test Safe Harbor will be helpful to REITs when they acquire distressed mortgage loans or when real property values are decreasing. However, it will not assist REITs when the value of the real property securing a distressed mortgage loan later increases. As explained below, the Asset Test Safe Harbor could be read to cause a disproportionate amount of the value of a mortgage loan to be treated as a nonqualifying asset if the value of the real property securing the mortgage loan increases. NAREIT believes this result was not intended by the Service and that the Revenue Procedure can be easily clarified to avoid this result. We suggest a solution in part I.B. below to address this issue.

A. The Asset Test Safe Harbor Will Not Assist REITs When Real Property Values Increase

The Asset Test Safe Harbor provides that the Service will not challenge a REIT's treatment of a loan as being in part a "real estate asset" for purposes of the asset tests 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 Treas. Reg. § 1.856-3(a); or,

2) the loan value of the real property securing the loan as determined under the Interest Apportionment Regulation and the Revenue Procedure.

Treas. Reg. § 1.856-3(a) and the asset tests generally require that the "value" of the REIT's assets be determined as of the close of each quarter of the REIT's taxable year.[7] Thus, the "value" of a loan for purposes of Treas. Reg. § 1.856-3(a) will generally fluctuate depending on the fair value of the loan at the end of each quarter. Stated another way, the "value" of a loan under Treas. Reg. § 1.856-3(a) will "float" over time.

On the other hand, the loan value of the real property securing the loan under the Interest Apportionment Regulation and the Revenue Procedure generally is fixed as of the date the REIT commits to originate or acquire the loan.[8] As referred to above, section 4.01 of the Revenue Procedure provides a safe harbor under which a REIT, if certain requirements are satisfied, may treat a modification of a mortgage loan as not constituting a new commitment to originate or

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[7] Section 856(c)(4); Treas. Reg. § 1.856-3(a). Under Treas. Reg. § 1.856-3(a), the "value" of an asset is the fair value as determined in good faith by the REIT's board of directors or trustees, except in the case of a security for which market quotations are readily available, in which case the "value" is the market value of such securities.

[8] The Interest Apportionment Regulation states "the value of the real property is the fair market value of the property, *determined as of the date on which the commitment by the trust to make the loan becomes binding on the trust*. In the case of a loan purchased by the trust, the loan value of the real property is the fair market value of the property, *determined as of the date on which the commitment by the trust to purchase the loan becomes binding on the trust*." Treas. Reg. § 1.856-5(c) (emphasis added). The exceptions to that rule are re-testing that occurs: 1) in connection with a "significant modification" of a mortgage loan that does not qualify for the safe harbor in section 4.01 of the Revenue Procedure; and, 2) if a mortgage on real property is given as additional security (or as substitute for other security) for a loan after the REIT's commitment to originate or acquire the loan is binding, in which case the loan value of the new property that is provided as security, but not any other property securing the loan, is determined as of the date on which the property becomes security for the loan. Treas. Reg. § 1.856-5(c)(2).

acquire a loan for purposes of ascertaining the loan value of the real property securing the loan under the Interest Apportionment Regulation.[9] As a result, the REIT need not re-test the value of the real property securing the loan as of the modification date and may use the value on the date the REIT committed to originate or acquire the loan. Consequently, the Asset Test Safe Harbor appears to require that the loan value of the real property for purposes of the safe harbor be fixed as of the date the REIT commits to acquire a mortgage loan, including a distressed mortgage loan.

The Asset Test Safe Harbor operates well when the value of the mortgage loan and the real property decline after a REIT originates or purchases a loan. In that case, the REIT may treat a portion of the mortgage loan equal to the loan value of the real property at origination or purchase as a qualifying asset, but no more than 100% of the value of the loan will be ever be treated as a qualifying asset. When the value of the loan and the real property increase after the REIT originates or purchases the loan, however, the Asset Test Safe Harbor produces anomalous results. Because the Asset Test Safe Harbor applies to the *lesser* of the value of the loan under Treas. Reg. § 1.856-3(a) or the loan value of the real property securing the loan, the proportion of a distressed mortgage loan that is treated as a nonqualifying asset for the 75% Asset Test generally will increase as the value of the real property securing the loan increases as shown in the following example. For this purpose, we will use facts similar to those in Example Two.

> Example A (Distressed Mortgage Loan at Acquisition). A REIT purchased a mortgage loan for $60 in the first quarter of 2010. The stated face amount of the loan during the 2010 taxable year was $100. The loan value of the real property securing the loan on the date the REIT committed to purchase the loan was $55 and the value of the personal property securing the loan was $5. During every calendar quarter in 2010, the value of the loan (as determined under Treas. Reg. § 1.856-3(a)) was $60. Under the Asset Test Safe Harbor, in every calendar quarter in 2010, the REIT may treat $55 (out of $60) as the amount of the loan that is a qualifying asset and, accordingly, $5 of the value of the loan is treated as a nonqualifying asset. Thus, approximately 92% of the value of the loan ($55/$60) is a qualifying asset for every calendar quarter in 2010.

This treatment is logical and consistent with tax policy, because the amount of the loan that is treated as qualifying and nonqualifying is directly proportional to the value of the real property and the "other property" (*i.e.*, the personal property) securing the loan. A troubling result occurs if the value of the real property securing the loan increases.

> Example B (Distressed Mortgage Loan Appreciates). The REIT continues to own the loan in Example A. At the end of the fourth quarter of 2011, the value of the real property securing the loan has increased to $65, the value of the personal property remains $5, and the fair value of the loan has increased to $70 (reflecting the $10 increase in the value of the real property securing the loan since the REIT acquired the loan). The Asset Test Safe Harbor could be interpreted to mean that the portion of the loan that is treated as a qualifying asset is $55 and the portion that is a nonqualifying asset is $15. This would occur because the loan would be treated as a qualifying asset in an amount equal to the

[9] Rev. Proc. 2011-16, § 4.01(1).

> *lesser* of: 1) the value of the loan as of the end of the fourth quarter of 2011 (*i.e.*, $70); or, 2) the loan value of the real property securing the loan (*i.e.*, $55, the value of the real property securing the loan as of the date the REIT committed to acquire the loan). Although the value of the real property securing the loan has increased, the REIT may treat only $55 of the mortgage loan as a qualifying asset under the Asset Test Safe Harbor.

In Example B, the Asset Test Safe Harbor results in the REIT treating $15 of the loan as a nonqualifying asset even though only $5 of personal property secures the loan. Examining the relative percentages, 92% of the loan was treated as a qualifying asset when acquired by the REIT. That is equal to the percentage of the value of the property securing the loan attributable to real property on the date of acquisition. However, as of the end of the fourth quarter of 2011, 79% of the loan ($55/$70) will be a qualifying asset even though 93% of the value of the property securing the loan ($65/$70) is real property. Indeed, the proportion of the loan secured by the real property has increased, but the proportion of the loan that is treated as a qualifying asset has decreased.

B. Requested Clarification of the Asset Test Safe Harbor

NAREIT believes that to address the problem with the Asset Test Safe Harbor described above, the Service should clarify that it will not challenge a REIT's treatment of a loan as being in part a "real estate asset" for purposes of the asset tests if the REIT either treats the loan as a "real estate asset" based on:

> 1) the formula in the Asset Test Safe Harbor as currently drafted; or,
>
> 2) the percentage of the collateral securing the loan that was attributable to real property, determined as of the date the REIT committed to originate or acquire the loan. At each quarterly testing date, the portion of the loan that would be treated as a real estate asset would be based on the value of the loan on that date multiplied by a fraction, the numerator of which is the value of the real property securing the loan on the date the REIT committed to originate or acquire the loan and the denominator of which is the fair market value of the loan on the date the REIT committed to originate or acquire the loan.

This solution would preserve the valuable assistance the Service has provided in down-market scenarios, but would also prevent the illogical result described in Example B when distressed real property (and, thus, distressed mortgage loans secured by that property) increase in value. The following example illustrates this proposal.

> Example C (Distressed Mortgage Loan Appreciates—NAREIT Proposal). Using the facts from Example B and applying the proposed solution, the REIT would be allowed to treat the distressed mortgage loan as a qualifying asset based on the relative percentage of the real property versus the fair market value of the loan at acquisition (*i.e.*, 92%) for purposes of all future asset testing dates. At the end of the fourth quarter of 2011, the REIT would be able to treat $64.15 (92% of $70) of the value of the loan as a "real estate asset," rather that $55 under the current version of the Asset Test Safe Harbor.

Even under this solution, a slightly disproportionate amount of the mortgage loan is treated as a nonqualifying asset. In Example C above, at the end of 2011, 93% of the fair market value of the property securing the loan would be real property ($65/$70), even though only 92% of the loan would be treated as a qualifying asset. NAREIT believes that this slight distortion is preferable to the extreme distortion that could occur under the current version of the Asset Test Safe Harbor, under which only 79% of the loan would be a qualifying asset.

NAREIT encourages the Service to adopt the proposed solution outlined above as means of ensuring that REITs can hold distressed mortgage loans, not only during an economic downturn, but also during a recovery.

II. EXAMPLE TWO'S 75% GROSS INCOME TEST ANALYSIS

A. Example Two Inappropriately Treats a Disproportionate Amount of the Interest Income on a Distressed Mortgage Loan As Nonqualifying Income

The 75% Gross Income Test analysis in Example Two is incorrect as a matter of law, is not supported by tax policy, and will undermine the government's efforts to address the continuing effects of the credit crisis on the mortgage market. NAREIT strongly recommends that the Revenue Procedure be revised or that the underlying regulations be amended as soon as possible to reverse the conclusion reached in Example Two. The Service should establish a safe harbor providing that, when a loan is acquired with market discount, a REIT may treat its highest adjusted tax basis in the loan for the year (initially its purchase price) as the "amount of the loan" for purposes of the Interest Apportionment Regulation. This is the same guidance NAREIT requested in the Original Submission.

Example Two addresses a distressed mortgage loan acquired by a REIT for $60. The loan value of the real property securing the loan, determined as of the time the REIT acquired the loan, was $55. The loan was secured by personal property with a value of $5, and the face amount of the loan at all times during the year was $100. Example Two concludes:

> 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 [the REIT's] loan is apportioned to the real property securing 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.[10]

We do not believe that this conclusion is appropriate or reasonable. Forty-five percent of the interest income on the loan is "apportioned to the other property" even though the other property securing the loan represents only 8% ($5/$60) of the value of the property securing the loan. NAREIT has difficulty understanding why the Service concluded that this was the correct treatment of a distressed mortgage loan under the 75% Gross Income Test. Further, this treatment will make it extremely difficult for a REIT to invest a significant amount of its capital

[10] Rev. Proc. 2011-16, § 5.02(1).

in distressed mortgage loans and satisfy the 75% Gross Income Test, which will result in less liquidity in the market for distressed mortgage loans.

Example Two treats the face amount of a loan acquired at a discount as the principal amount of the loan for purposes of the Interest Apportionment Regulation. This ignores the treatment of market discount for federal income tax purposes generally. When a taxpayer acquires a bond with more than a *de minimis* amount of market discount, the taxpayer generally includes the accrued market discount in income as ordinary income upon a disposition or retirement of the bond and upon a receipt of a partial principal payment.[11] The Code could not be clearer that market discount is treated as interest—not principal (*i.e.*, a tax-free return of capital)—for federal income tax purposes generally. Section 1276(a)(4) provides that "any amount treated as ordinary income [under the market discount rules] *shall be treated as interest for purposes of this title*."[12] If market discount is treated as interest for nearly all purposes of the Code, it is difficult to understand how it could be treated as "principal" for purposes of the Interest Apportionment Regulation.

Admittedly, the Interest Apportionment Regulation does not reference the market discount rules in section 1276. That is understandable, as section 1276 was enacted in 1984, three years after the promulgation of the Interest Apportionment Regulation.[13] On the other hand, it makes little sense for Example Two to treat market discount as "principal" for purposes of the Interest Apportionment Regulation when it has been treated for almost 27 years as interest for nearly all purposes of the Code. Given Congress' command in section 1276 to treat market discount as interest, we believe that the conclusion in Example Two is incorrect as a matter of law. NAREIT is perplexed by the Service's failure to interpret the Interest Apportionment Regulation in light of Congress' treatment of market discount.

Moreover, we cannot discern any substantive tax policy that supports the conclusion in Example Two. The 75% Gross Income Test is intended to ensure that a substantial portion of a REIT's income is derived from real estate related sources.[14] The REIT in Example Two made an investment that is almost exclusively backed by real property. Only 8% of the security backing the loan is attributable to personal property. Yet, Example Two requires the REIT to treat 45% of the interest income from the loan as nonqualifying income for purposes of the 75% Gross Income Test. The distressed mortgage loan in Example Two is an investment principally backed by real property, and the income from that investment should be accretive to the REIT's compliance with the 75% Gross Income Test. Instead, Example Two would make the loan a drag on the REIT's compliance with the 75% Gross Income Test.

In Example Two, the Service treats the face amount of the loan as the key determining factor for the characterization of the distressed mortgage loan for the 75% Gross Income Test. However, the face amount of a distressed mortgage loan represents merely a contract right held by the

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[11] Section 1276. A taxpayer may elect to include market discount in income as it accrues. Section 1278(b).
[12] (Emphasis added). The only exceptions to this general rule apply to tax-exempt bonds and with respect to certain withholding and reporting purposes.
[13] T.D. 7767 (Feb. 3, 1981) (promulgating the Interest Apportionment Regulation); P.L. 98-369, 98 Stat. 494 (1984) (enacting the market discount rules codified in section 1276).
[14] *See* H.R. Rep. No. 2020, 86th Cong., 2d Sess. 4 (1960), 1960-2 C.B. 819, 822.

REIT to receive additional value if the value of the real property securing the loan improves. This is a contract right to which neither the buyer nor the seller in Example Two attributed any economic value. In Example Two, the $60 value of the REIT's investment in the loan and the $60 purchase price for the loan are driven solely by the value of the real and personal property securing the loan, $60. The REIT's speculative ability to recover the difference between the value of the property securing the loan, $60, and the face amount of the loan, $100, had no effect on the purchase price, $60.

In both the facts in Example Two and in the market for distressed mortgage loans, buyers and sellers of distressed mortgage loans set the prices for the loans by reference to the value of the property securing the loans at the time of purchase, not the speculative ability of the holder of the loan to receive the full face amount of the loan.[15] But the analysis in Example Two accords to the full face amount of the loan an importance for REIT qualification purposes that is completely divorced from economic realty. Example Two's application of the Interest Apportionment Regulation without regard to the REIT's actual investment (which is almost exclusively secured by real property) and by reference to a feature of the distressed mortgage loan (*i.e.*, the face amount of the loan in excess of the REIT's purchase price) that has been attributed no market value by the parties is highly distortive. NAREIT believes that basing the treatment of distressed mortgage loans for the 75% Gross Income Test on a economically irrelevant feature of the loans advances no sound tax policy objective.

The treatment of the distressed mortgage loan in Example Two is especially difficult to understand given the treatment of oversecured mortgage loans under the Interest Apportionment Regulation. Under the Interest Apportionment Regulation, if a newly originated loan with a principal amount of $100 is secured by $100 of real property and $400 of personal property, 100% of the interest income on the loan will be qualifying income. Even though only 20% of the collateral securing the loan is attributable to real property, all of the interest income is treated as real estate related sources for the 75% Gross Income Test. The liberal, and appropriate, treatment of oversecured mortgage loans under the Interest Apportionment Regulation cannot be reconciled with the treatment of the distressed mortgage loan in Example Two.

Moreover, the result in Example Two is in no way dictated by the Code. Congress has not prescribed how "mixed collateral loans" (*i.e.*, loans secured by both real and personal property) should be treated for 75% Gross Income Test. Section 856(c)(3)(B) includes as qualifying income for the 75% Gross Income Tests "interest on obligations secured by mortgage on real property or interests in real property."[16] Treasury and the Service have wide latitude under section 856(c)(3)(B) to address interest on mixed collateral loans and, presumably, could have decided to treat all interest on any loan that provides for a mortgage on real property as qualifying income. No plausible claim can be made that section 856(c)(3)(B) compelled the unsupportable conclusion reached in Example Two.

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[15] In the market for distressed mortgage loans, the buyers typically purchase distressed mortgage loans at a discount to the value of the real property securing the loan, in part, because of the transaction costs involved in any possible foreclosure on the loan and sale of the property.
[16] Similarly, section 856(c)(5)(B) includes "interests in mortgages on real property" in the definition of a "real estate asset" for purposes of the asset tests.

The conclusion reached in Example Two is also inconsistent with Congress' treatment of rental income from leases of real and personal property. The only area in which section 856 specifically addresses the treatment of income from a mixed source of real and personal property is in the context of rental income from leases of both real and personal property. When a lease covers both real and personal property, 100% of the rental income will be treated as qualifying "rents from real property" so long as the rent attributable to the personal property for the taxable year does not exceed 15% of the total rent for the taxable year attributable to both real and personal property subject to the lease (the 15% Personal Property Test).[17]

Contrast that treatment with Example Two, in which 45% of the interest income on the distressed mortgage loan is treated as nonqualifying income even though only 8% of the collateral securing the loan is personal property. The 15% Personal Property Test evidences Congress' determination that income may appropriately be treated as qualifying income even if a significant part of the property creating that income is attributable to personal property. In light of Congress' treatment of mixed collateral leases, NAREIT does not think that the Service's conclusion is correct when it decided that 45% of the interest income on a distressed mortgage loan is appropriately treated as nonqualifying income when only 8% of the collateral backing the loan is attributable to personal property.

The inappropriate result reached in Example Two is solely a consequence of guidance issued by Treasury and the Service. Absent additional administrative action, any future distortive treatment of distressed mortgage loans for REIT qualification purposes will be caused by the Interest Appointment Regulation and the misguided analysis in the Example Two.

B. <u>The Conclusion in Example Two on the 75% Gross Income Test Must Be Reversed, Either Through Administrative Guidance or Regulatory Amendment</u>

The treatment of distressed mortgage loans under the analysis in Example Two presents significant hurdles for REITs seeking to create value for their shareholders by investing a significant amount of their capital in distressed mortgage loans. The consequences of those hurdles will be less investment by REITs in distressed mortgage loans and less liquidity in the market for distressed mortgage loans. Because we believe that the 75% Gross Income Test analysis in Example Two is incorrect as a matter of law and is not supported by appropriate tax policy rationale, NAREIT strongly urges that the Revenue Procedure be modified. The Service should allow a REIT to use as the "amount of the loan" the highest tax basis for the taxable year when a mortgage loan is acquired with market discount. The following example shows how that rule would apply to the same facts as Example Two.

> <u>Example D (75% Gross Income Test Treatment of Distressed Mortgage Loan—NAREIT Proposal)</u>. The REIT acquires a mortgage loan on January 1, 2011 for \$60. The face amount of the mortgage loan is \$100. At the time of acquisition, the loan is secured by real property with a value of \$55 and personal property with a value of \$5. The REIT does not elect to accrue market discount currently and no principal payments are made on the loan during 2011. Under the proposed safe harbor, the amount of the interest income

[17] Section 856(d)(1)(C).

> that is treated as qualifying income would be determined by multiplying the amount of interest by a fraction, the numerator of which is $55 (the loan value of the real property) and the denominator of which is $60 (the REIT's highest adjusted tax basis in the mortgage loan during 2011). Accordingly, 92% of the interest income would be qualifying income.

Under our proposed safe harbor, 92% of the interest income would be treated as qualifying income—the same percentage of real property securing the loan at acquisition. NAREIT believes this result would be more in accord with the market discount rules and the tax policy behind the REIT provisions of the Code than the illogical result in the Example Two.

It is possible that the 75% Gross Income Test analysis in Example Two is attributable to a concern that the literal language of the Interest Apportionment Regulation required treating the face amount of the loan as the principal amount. As described above, NAREIT believes that reading is inconsistent with existing law and with a sound administration of the Code. Nevertheless, if the government feels that the literal language of the Interest Apportionment Regulation prevented reaching a sensible result, then Treasury and the Service should amend the regulation, which is within their power to accomplish.[18]

NAREIT urges the Service to reverse the 75% Gross Income Test conclusion in Example Two. NAREIT believes that the treatment of distressed mortgage loans described in the Original Submission could be provided by adding a new safe harbor to the Revenue Procedure or through a revenue ruling. If there were a concern that the Interest Apportionment Regulation needs to be amended, NAREIT urges that such a regulatory project be initiated and completed as soon as possible. The pressing need for REITs to have clarity on this issue could be addressed by a notice stating that: 1) the Interest Apportionment Regulation will be revised; and, 2) pending issuance of the revised regulation in final form, a REIT may treat the "amount of the loan" for a market discount loan as the REIT's highest adjusted tax basis in the loan for the taxable year. The Service has made similar statements regarding reliance on to-be-issued regulations in connection with other regulatory projects,[19] and NAREIT believes it would be appropriate to apply the same

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[18] Besides the general regulatory afforded the Secretary under section 7805, in 2008 Congress expressly provided the Service authority to include any item of income as qualifying income under the 75% Gross Income Test or to exclude any item from the calculation entirely. *See* section 856(c)(4)(J).

[19] *E.g.*, Notice 2010-38, 2010-20 I.R.B. 682 (announcing guidance on tax treatment of health coverage for children under 27 years of age upon which taxpayers may rely pending the issuance of amended regulations); Notice 2009-1, 2009-2 I.R.B. 248 (announcing rules allowing investments in a section 529 account to be changed more frequently pending the issuance of final regulations under section 529); Notice 2006-6, 2006-1 C.B. 385 (announcing a future change to the categories of reportable transactions under the treasury regulations and providing that taxpayers may rely on the notice until such regulations are issued); Notice 2003-65, 2003-2 C.B. 747 (announcing safe harbors for calculation of built-in gain under section 382 pending issuance of regulations on the topic); Notice 2002-8, 2002-1 C.B. 398 (providing interim guidance on split-dollar life insurance upon which taxpayers could rely pending the publication of final regulations); Notice 2001-81; 2001-2 C.B. 617 (providing guidance on recordkeeping, reporting, and other requirements under section 529 that section 529 programs could rely upon pending the issuance of final regulations); Notice 2000-1, 2000-1 C.B. 288 (announcing a change to the proposed effective date of proposed regulations under section 368(a)(1)(C) and providing that taxpayers may rely upon the notice until final regulations are issued).

procedure to allow REITs to invest in distressed mortgage loans while the Interest Apportionment Regulation is being revised.

III. SAFE HARBOR FOR LOANS SUBSTANTIALLY ALL OF THE SECURITY FOR WHICH CONSTITUTES REAL PROPERTY

Many of the issues associated with applying the 75% Gross Income Test and the asset tests to newly acquired distressed mortgage loans could be mitigated if REITs were not required to bifurcate a mortgage loan when real property comprises substantially all of the value of the property securing the loan.

By its terms, the Interest Apportionment Regulation does not apply to a mortgage loan that is secured solely by real property and a similar rule should apply for the asset tests.[20] REITs often face situations in which "other property" secures the loan, but the "other property" has no value or a value that is economically insignificant. A REIT may reasonably believe that the value of the "other property" securing the newly acquired distressed mortgage loan is zero, but the consequences of that conclusion being successfully challenged appear to be disastrous. Because the Interest Apportionment Regulation appears to apply even if the loan is secured by a peppercorn's worth of "other property," unsupportable consequences result—especially under the unreasonable 75% Gross Income Test analysis in Example Two. As illustrated in the examples below, a distressed mortgage loan secured by no "other property" will produce 100% qualifying income, while a distressed mortgage loan secured by an insignificant amount of "other property" will produce a significant amount of nonqualifying income.

> Example E (Distressed Mortgage Loan Not Secured by Other Property). A REIT acquires a non-recourse mortgage loan on undeveloped land for $60,000. At the time of acquisition, the face amount of the loan is $100,000 and the value of the real property securing the loan is $65,000.[21] Because no "other property" secures the mortgage loan, the Interest Apportionment Regulation does not apply. Accordingly, 100% of the interest income from the loan is treated as qualifying income. A similar result should apply for the 75% Asset Test.
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> Example F (Distressed Mortgage Loan Secured by A *De Minimis* Amount of Personal Property). The REIT acquires the non-recourse mortgage loan described in Example E, except that, prior to the REIT's acquisition of the loan, the owner of the property erected a temporary fence to deter squatters. The owner paid $500 for the fence, but the fence could be sold in a used condition for only $100. Because the temporary fence is "other property" securing the loan,[22] the loan is subject to the Interest Apportionment Regulation. Based on Example Two, 45% of the interest income on the mortgage loan would be nonqualifying income for purposes of the 75% Gross Income Test. Also, if the

[20] Treas. Reg. § 1.856-5(c)(1) ("Where a mortgage covers both real property and other property, an apportionment of the interest income must be made for purposes of the 75-percent requirement in section 856(c)(3).").
[21] Typically, the purchase price of a distressed mortgage loan will be less than the value of the real property securing the loan, in part, because of the transaction costs involved in any possible foreclosure and sale of the real property.
[22] Only property that is permanently affixed to real property is treated as real property REIT purposes. *See* Treas. Reg. § 1.856-3(d).

> value of the loan increased to $80 and the value of the real property increased to $85, the REIT would, under the Asset Test Safe Harbor, only be able to treat the loan as being a qualifying asset in an amount equal to $65 (the loan value of the real property at acquisition).

As we have indicated in prior submissions, there is no sound tax policy reason for reaching the disparate results illustrated above solely based on a distressed mortgage loan being secured by a miniscule amount of "other property." In both instances, the value of the loan is derived entirely by the real property securing the loan, yet the two distressed mortgage loans receive grossly disparate treatment. In Example F, 45% of the interest income on the distressed mortgage loan is treated as nonqualifying merely because 0.001% of the property securing the loan is "other property."

If a REIT determines that the "other property" securing a loan has no value and the Service successfully challenges that position, the consequences for REIT status could be dire. This is a particular concern in the residential mortgage loan context. Residential mortgage loans typically grant the lender a security interest in the real and personal property at the home and, in some states, a recourse guarantee from the borrower. In practice, buyers of distressed residential mortgage loans place little or no value on the security interest in the personal property or the recourse guarantee. At foreclosure, the personal property is typically thrown away because the lender would receive no value, net of transaction costs, from selling that property. Similarly, the recourse guarantee from a residential borrower on a distressed mortgage loan has little or no value because the borrower typically has few assets and the legal costs of enforcing the guarantee will exceed any recovery. Although a REIT may believe that the "other property" and the recourse guarantee have a zero value, there is a risk the Service may determine that an economically insignificant amount of "other property" secures the loan, which would require the REIT to bifurcate the loan.

A similar issue arises in the commercial mortgage loan context. Commercial borrowers often provide significant cash reserves for costs such as interest, property taxes, and maintenance expenses. The cash reserves are part of the security for the loan. Cash, even though treated as a qualifying asset for purposes of the 75% Asset Test,[23] is not "real property" and appears to be treated as "other property" for purposes of the Interest Apportionment Regulation. Thus, a distressed commercial mortgage loan that is not secured by personal property may be subject to the Interest Apportionment Regulation because of the cash reserves, even though those cash reserves would be a qualifying asset if held directly by the REIT. Also, as in the residential mortgage context, the value of any "other property" securing a distressed commercial mortgage loan may be economically insignificant, but the existence of the "other property" requires bifurcation.

NAREIT believes that many of the issues with the 75% Gross Income Test and the asset tests for newly acquired distressed loans would be mitigated if the Service adopted a safe harbor under which a REIT would not be required to bifurcate a mortgage loan for purposes of the 75% Gross Income Test or the 75% Asset Test so long as substantially all of the property securing the loan

[23] Section 856(c)(4)(A).

constituted real property, determined as of the date the REIT committed to originate or acquire the loan. When substantially all of the property securing a mortgage loan is real property, the loan should be treated as a qualifying asset producing qualifying income. A safe harbor that allows that result would be consistent with the policy behind the 75% Gross Income Test and the 75% Asset Test.[24]

Indeed, the Service has utilized a similar approach with respect to REITs in Revenue Procedure 2003-65, 2003-2 C.B. 336 (Revenue Procedure 2003-65), which provides a safe harbor for the treatment of mezzanine loans by REITs.[25] In order to ensure that substantially all of the ultimate security for a mezzanine loan constituted real property, the Service required in Revenue Procedure 2003-65 that on each "testing date,"[26] the value of the real property held by the partnership or disregarded entity (the interest in which was pledged as security for the loan) was at least 85% of the value of all of the assets of the partnership or disregarded entity.[27] Mezzanine loans that satisfy the requirements of the safe harbor in Revenue Procedure 2003-65 are treated as 100% qualifying assets producing 100% qualifying income.[28] Similarly, in the context of mixed collateral leases, the Code treats all of the rental income from the lease as qualifying income when substantially all of the leased property is real property. As with Revenue Procedure 2003-65, an 85% threshold is applied under the 15% Personal Property Test (*i.e.*, a mixed collateral lease produces 100% qualifying income so long as 85% of the value of the leased property is real property).

Both Revenue Procedure 2003-65 and the 15% Personal Property Test evidence a policy determination that an investment that is substantially backed by real property should be treated as qualifying asset producing qualifying income. In the context of mixed collateral mortgage loans, NAREIT believes that a safe harbor using a similar "substantially all" threshold should apply.

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[24] There should be no concern about Treasury and the Service's ability to treat 100% of the interest income and 100% of the value of a mixed collateral loan as qualifying for purposes of the 75% Gross Income Test and the 75% Asset Test when less than all of the property securing the loan is real property. As noted above in part II.A., section 856 provides wide latitude to address the treatment of mixed collateral loans, and the Interest Apportionment Regulation already treats 100% of the interest income on an oversecured mortgage loan as qualifying income, regardless of the amount of personal property securing the loan. In addition, Treasury has broad authority under section 856(c)(5)(J) to determine categories of income which are qualifying income, or disregarded income, for purposes of the gross income tests.

[25] Rev. Proc. 2003-65, § 4. A mezzanine loan is a loan secured by an interest in a partnership or disregarded entity that owns real property. *Id.* §§ 3.02, 3.05.

[26] A "testing date" is the close of the first quarter of the lender's taxable year following the date on which the commitment by the lender to make the loan becomes binding on the lender, and the close of each subsequent quarter in which the partnership or disregarded entity (the ownership interests in which serve as security for the loan) acquires any assets other than real estate assets, cash and cash items (including receivables), or government securities, or reasonable quantities of equipment and materials customarily used for the maintenance and repair of real property. Rev. Proc. 2003-65, § 3.06.

[27] Rev. Proc. 2003-65, § 3.06.

[28] Revenue Procedure 2003-65 also contains a requirement that the loan value of the real property owned by the partnership or disregarded entity (the ownership interests in which serve as security for the loan) equals or exceeds the amount of the loan, as determined under the Interest Apportionment Regulation. The loan value is reduced by any liens encumbering the real property, as well as by any other liabilities of the partnership or disregarded entity on the date the commitment by the lender to make the loan becomes binding on the lender. Rev. Proc. 2003-65, § 3.07.

Under such a safe harbor, a REIT would not be required to bifurcate a mortgage loan so long as substantially all of the value of the property securing the loan is real property.

NAREIT believes that the safe harbor described above would significantly reduce the uncertainty for REITs investing in newly acquired distressed mortgage loans and would be consistent with the Service's treatment of mezzanine loans in Revenue Procedure 2003-65 and the Code's treatment of mixed collateral leases under the 15% Personal Property Test.

IV. POLICY IMPLICATION OF THE REVENUE PROCEDURE'S TREATMENT OF NEWLY ACQUIRED DISTRESSED MORTGAGE LOANS

If the Revenue Procedure is not clarified and revised as proposed above, REITs will continue to face significant impediments to investing in distressed mortgage loans and mortgage-backed securities. REITs are the best avenue for "retail" investors to participate in the market for distressed mortgage loans and mortgage-backed securities. Without further guidance, NAREIT is concerned that the market for distressed mortgage loans and mortgage-backed securities could become the exclusive preserve of hedge funds, private equity funds, and institutional investors. Without the capital from REITs and their retail investors, there will be less liquidity in the market for distressed mortgage loans and mortgage-backed securities.

Accordingly, NAREIT encourages the Service to clarify and revise the application of the Revenue Procedure as described above. The requested guidance would enable REITs to participate actively in the market for distressed mortgage loans and mortgage-backed securities without jeopardizing their REIT qualification, thereby furthering the government's response to the credit crisis by clearing a barrier to liquidity to that market.

Thank you for your consideration. Please contact me at (202) 739-9408 or Dara Bernstein, NAREIT's Senior Tax Counsel at (202) 739-9446, if we can provide you with any additional information.

Respectfully submitted,

Tony M. Edwards
Executive Vice President & General Counsel

cc: William J. Wilkins, Esq.
Clarissa C. Potter, Esq.
Jeffrey Van Hove, Esq.
Michael S. Novey, Esq.
Stephen R. Larson, Esq.