August 16, 2016

VIA E-MAIL: Financial_Products@finance.senate.gov

The Honorable Ron Wyden
Ranking Member
Senate Finance Committee
219 Dirksen Senate Office Building
Washington, D.C., 20510

Dear Ranking Member Wyden:

The undersigned organizations welcome the opportunity to provide comments on the Modernization of Derivatives Tax Act of 2016 (MODA), which, among other things, generally would require mark-to-market (MTM) and ordinary treatment for all derivatives.

As noted in a separate letter, (the Real Estate Organizations Letter), we appreciate that the current draft of MODA incorporates previous comments requesting an exception to ensure that common real estate transactions, *e.g.*, a sales contract to purchase real estate that is pending at year-end, would not be subject to MTM rules for income tax purposes. The Real Estate Organizations Letter also requests that MODA be modified to exempt "to be announced" (TBA) forward contracts to acquire mortgage-backed securities (MBS) guaranteed by Fannie Mae, Freddie Mac and Ginnie Mae (collectively, the Agencies) from the definition of "derivatives" requiring MTM treatment.

In addition to those requests, as further described below, we recommend that MODA be modified: (1) to treat MBS and mortgage loans held by a REIT as "ordinary property" for purposes of the definition of a "hedging transaction" and for federal income tax purposes generally, and (2) to exclude any instrument subject to the prepayment assumption calculation (PAC) method in section 1272(a)(6) from treatment as a "contract with an embedded derivative component."

EXECUTIVE SUMMARY

As currently proposed, MODA would cause a timing and character mismatch between, for example, losses on the sale/disposition of hedge assets and ordinary gains on marking-to-market hedges of such assets. The inability to offset fully gains from derivatives with losses on assets could increase the REIT's legal requirement to distribute at least 90% of its taxable income (the Distribution Requirement) [1] without the corresponding cash to satisfy such requirement. However, if MODA were amended to treat MBS and mortgage loans held by REITs as "ordinary property" for purposes of the definition of a "hedging transaction" and for federal income tax purposes generally, hedging of these assets would not be subject to MTM accounting, and ordinary income (or loss) recognized on an asset hedging transaction could be offset with ordinary loss (or income) from the disposition of the hedged MBS or mortgage loans. With that treatment, standard hedging transactions would not impair a REIT's ability to satisfy the

[1] Section 857(a)(1). Unless otherwise provided, all "section" references are to the Internal Revenue Code of 1986, as amended (the Code).

Distribution Requirement. We note that the treatment of MBS and mortgage loans of REITs as ordinary assets generally is similar to the treatment of debt instruments of "applicable insurance companies" under MODA.

Because hedging of outstanding MBS and mortgage loans are standard commercial real estate transactions and not speculative in nature, we recommend that MODA should treat MBS and mortgage loans as "ordinary property" for purposes of the definition of a "hedging transaction" and for federal income tax purposes generally.

In addition, we recommend that a "contract with an embedded derivative component" not include any instrument subject to the PAC method for calculating income inclusion under section 1272(a)(6). Mortgage REITs often invest in debt instruments that may be treated as having an embedded derivative component as a result of features that may accelerate the payment of principal. Those embedded derivative components would be difficult for the holder, *i.e.*, the mortgage REIT, to value. The PAC method already establishes an effective system for recognizing income on those instruments, and the administrative complexity of subjecting those instruments to MTM accounting on the embedded derivative component would not result in a more appropriate recognition of income.

DISCUSSION

A. The Hedging Exception to the Definition of "Derivative" Should Include Common Interest Rate Financial Hedges of MBS and Mortgage Loans, and MBS and Mortgage Loans held by REITs Should be Treated as Ordinary Property for Federal Income Tax Purposes Generally

We believe that the exception from MTM accounting in MODA for derivatives that are used in hedging transactions is too narrow to cover certain common commercial transactions that mitigate the risk of interest rate fluctuations.

1. Mortgage REIT Hedging of MBS and Mortgage Loans under Current Law: Generally

In general, mortgage REITs invest primarily in MBS and mortgage loans. In accordance with the requirements for REIT qualification, mortgage REITs typically hold those assets as investors, and their assets, accordingly, are treated as capital assets. The value of MBS and mortgage loans is sensitive to changes in interest rates. In an environment of rising interest rates or widening of the "spread" between interest rates on Treasury debt and other debt instruments, certain MBS and mortgage loans may decrease in value, and losses on their disposition would be treated as capital losses.

Mortgage REITs may enter into hedging transactions using Treasury bonds, Treasury bond futures or TBAs[2] to hedge the interest rate risk on the mortgage REIT's short-term,

[2] As noted above, hedging through TBAs specifically is discussed separately in the Real Estate Organizations Letter.

floating rate borrowing. If the mortgage REIT designates those transactions as "hedging transactions" with respect to its short-term, floating rate borrowing, they are treated as qualified liability hedges, and the income from those transactions is ignored for purposes of the REIT gross income tests.[3]

2. Gains and Losses of Hedging of MBS and Mortgage Loans and Hedged MBS and Mortgage Loans Offset One Another Under Current Law

Some mortgage REITs, however, do not designate all of those types of transactions as "hedging transactions" or may not have sufficient borrowings to be able to designate all of those transactions as "hedging transactions" under the definition of section 1221(b)(2). In addition, some mortgage REITs use those types of transactions to reduce exposure to the effect of rising interest rates on their investment portfolio, rather than on the liabilities used to finance their investment portfolio. In those cases, the transactions economically hedge fluctuations in the value of the REIT's assets. We will refer to transactions that hedge asset values as "asset hedging transactions." An asset hedging transaction would not be treated as a qualified liability hedge, the income from which is ignored for purposes of the REIT gross income tests.[4] However, asset hedging transactions may produce qualifying income for the 95% gross income test applicable to REITs when they give rise to gain from the sale of "securities."[5]

Under current law, the failure of an asset hedging transaction to be treated as a "hedging transaction" under section 1221(b)(2) does not generally affect the ability of a mortgage REIT to satisfy the 90% Distribution Requirement or cause the REIT to incur corporate income taxes. The gain or loss on an asset hedging transaction is capital, as is the gain or loss on the hedged MBS and mortgage loans. Thus, the gains and losses from the asset hedging transaction and the hedged items can offset each other, subject to the limitations on offsetting short-term and long-term gains and losses. Moreover, a mortgage REIT can control the timing of the recognition of the gain or loss on the asset hedging transaction with the gain or loss on the hedged MBS and mortgage loans, so there is not a timing mismatch between the recognition of the income from the related transactions.

3. MODA's Character and Timing Mismatch Could Affect Negatively a REIT's Ability to Satisfy the Distribution Requirement

The asset hedging transactions that mortgage REITs use would, under the current draft of MODA, be subject to MTM accounting, and the income from those transactions would be ordinary income, whereas the gain from the hedged MBS and mortgage loans would be capital gain. MODA does exclude "hedging transactions" from MTM treatment. However, MBS or

[3] Section 856(c)(5)(G).
[4] Section 856(c)(5)(G).
[5] Section 856(c)(2)(D) (treating gain from the sale of "securities" as qualifying income for the 95% gross income test applicable to REITs).

mortgage loans in the hands of a mortgage REIT are capital assets[6] and, therefore, are not eligible to be treated as part of a "hedging transaction" under Proposed section 493(b)(2).[7]

Although MODA provides integrated timing and character treatment for "investment hedging units," MBS and mortgage loans and their related asset hedging transactions used by mortgage REITs would not be eligible to be included in the definition of "investment hedging unit," which is the correct result in light of the intended purpose for the "investment hedging unit" concept.[8] An "underlying investment" can be included as part of an "investment hedging unit" only if the value of the derivative "is determined directly or indirectly" by "reference to" the "underlying investment."[9] The value of the asset hedging transactions used by mortgage REITs, such as futures Treasury futures, are determined by reference to interest rates or assets the mortgage REIT does not intend to hold, but not to the MBS and mortgages that REITs use those transactions to hedge. Accordingly, the typical asset hedging transaction would not be included in an "investment hedging unit."

Moreover, the undersigned do not believe it would be appropriate to treat a typical asset hedging transaction and the related MBS and mortgage loan as an "investment hedging unit." The "investment hedging unit" concept appears intended to address straddle-like structures, and the asset hedging transactions engaged in by mortgage REITs are not similar to straddle-like structures. Furthermore, if an asset hedging transaction was treated as part of an "investment hedging unit," REITs would still have phantom income as a result of the MTM accounting of an "investment hedging unit," which would present the same problems with the Distribution Test and the tax on "excess noncash income" that are discussed below.

Because an asset hedging transaction could not be included in a general hedging transaction and appropriately is not included in the definition of an "investment hedging unit," MODA could harm mortgage REITs that use "derivatives" with respect to Government securities to hedge fluctuations in the value of their MBS and mortgage loans caused by interest rate changes. Under MODA, the derivative, but not the hedged MBS or mortgage loan, would be marked to market, and the gain on the MBS or mortgage loan would not be recognized until the instrument was sold. This would create a timing mismatch. Moreover, MODA generally treats derivative transactions as ordinary assets,[10] whereas the hedged MBS and mortgage loans

---

[6] If the mortgage REIT originated the mortgage loan, it would be treated as an ordinary asset. *See Burbank Liquidating v. Comm'r*, 39 TC 999 (1955), *aff'd*, 335 F.2d 125 (9th Cir. 1964) (holding that mortgage loans made in the ordinary course of business are excluded from treatment as capital gains assets). Most mortgage REITs, especially mortgage REITs owning residential mortgage loans, do not originate the mortgage loans in their portfolios.

[7] Proposed Section 493(b)(2)(A) (excluding from the definition of "derivative" "any contract which is part of a hedging transaction (as defined in section 1221(b)"); Section 1221(b) (defining "hedging transaction" to include a transaction entered into in the normal course of the taxpayer's trade or business primarily (1) to manage risk of price changes or currency fluctuations with respect to ordinary property or (2) to manage interest rate or price currency fluctuations with respect to borrowings made or to be made, or ordinary obligations incurred to be incurred, by the taxpayer).

[8] Proposed Section 492.

[9] Proposed Section 492(e)(1)(A)(ii).

[10] MODA, Section 4(a)(1) (striking provisions of the Code that treat certain derivative transactions as capital assets).

would still be treated as capital assets. This would create a character mismatch. The timing and character mismatch could impair the REIT's ability to satisfy the Distribution Requirement or, to the extent the REIT has phantom income from the derivative transaction, require the REIT to pay the corporate income tax liability on "excess noncash income."[11]

We recommend that MODA include an expansion to the exception for hedging transactions that would address the issues discussed above with hedges of outstanding MBS and mortgage loans which—like TBAs and interest rate locks—are standard commercial real estate transactions and not speculative in nature. Specifically, to ensure that these asset hedging transactions are not subject to MTM accounting, we suggest treating MBS and mortgage loans held by REITs as ordinary property for the purpose of determining whether the exception for hedging transactions applies to a derivative that hedges these assets. By treating MBS and mortgage loans as ordinary property, the asset hedging transactions would satisfy the definition of a "hedging transaction" under Proposed section 493(b)(2) for this purpose, and they would not be subject to MTM accounting. This change would prevent a timing mismatch.

In addition, we recommend that MODA treat MBS and mortgage loans held by REITs be treated as ordinary income assets generally. This would be similar to the ordinary treatment MODA affords to bonds, debentures, notes and certificates or other evidence of indebtedness held by an "applicable insurance company" under Proposed section 1221(a)(9).[12] If REITs were able to treat MBS and mortgage loans as ordinary income assets, then they would be able to offset the ordinary income from the asset hedging transaction with any ordinary income recognized on an ultimate disposition of the hedged MBS or mortgage. Conforming the character of the income from the asset hedging transaction with the hedged MBS and mortgage loan would address the problems with the Distribution Requirement caused by a character mismatch.

---

[11] Section 857(e). A REIT is not required to distribute "excess noncash income," which is certain noncash income, or phantom income, in excess of 5% of the REIT's taxable income (excluding net capital gains). However, a REIT is required to distribute noncash income that does not exceed 5% of the REIT's taxable income (the 5% Basket). A REIT is required to pay corporate income tax on any "excess noncash income" that it does not distribute to its shareholders. The current draft of MODA would treat MTM income as "excess noncash income." MODA, Section 4(b)(3). Thus, a REIT would be required to distribute any MTM income included in the 5% Basket, and the REIT would either have to distribute to its shareholders, or pay corporate tax on, any MTM income in excess of the 5% Basket.

[12] It would be important that any legislation implementing this proposal does not treat MBS and mortgage loans held by REITs as property described under section 1221(a)(1). REITs are subject to a 100% tax on any "prohibited transaction," which is defined to include the sale or other disposition of any property described in section 1221(a)(1), other than "foreclosure property." Section 857(b)(6)(A), (B)(iii). Although treating MBS and mortgage loans as ordinary assets would address some on the issues with the Distribution Requirement, the gains from the sale of those assets should not be subject to the 100% prohibited transaction tax. That unwarranted result could be avoided by creating a separate subsection under section 1221(a)(1) that would address the treatment of MBS and mortgage loans for REITs.

B. "Contracts with an Embedded Derivative Component" Should Not Include Instruments Subject to the PAC Method under Section 1272(a)(6)

Proposed section 493(c) treats the derivative component of a contract that has a derivative and nonderivative component as a derivative subject to MTM accounting. If the derivative component cannot be separately valued, then the entire contract shall be treated as a derivative and subject to MTM accounting.

Mortgage REITs often invest in instruments that are primarily debt instruments, but may have a component that could be treated as a derivative as a result of features that could cause the acceleration of the principal amount on the debt instrument. As a practical matter, a mortgage REIT would have no ability to determine the value of the component that could potentially be treated as a derivative, resulting in the risk that the entire transaction would be subject to MTM accounting under MODA. We anticipates that most of the instruments that would have hard-to-value derivative components would be subject to the PAC method in section 1272(a)(6), which establishes a method for recognizing income on debt instruments in which principal is subject to acceleration. Because section 1272(a)(6) already establishes an appropriate mechanism for calculating income from such a debt instrument, we believe there is no reason to add an additional regulatory regime to their taxation. Accordingly, we request that the instruments subject to the PAC method section 1272(a)(6) be excluded from treatment as a "contract with an embedded derivative component" in Proposed section 493(c).

We look forward to continuing to work with you and your staff on these issues and the TBA issue described in the Real Estate Organizations Letter. If you would like to discuss these issues in greater detail, feel free to contact Brad Cheney, Associate VP of Legislative Affairs, Mortgage Bankers Association, at (202) 557-2913, or BCheney@mba.org, or Dara Bernstein, VP & Senior Tax Counsel, at (202) 739-9446 or dbernstein@nareit.com.

Respectfully submitted,

CRE Finance Council
Mortgage Bankers Association
National Association of Real Estate Investment Trusts
The Real Estate Roundtable