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REITS:
BUILDING
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April 25, 2013

The Honorable Dave Camp
Chairman
Committee on Ways and Means
1102 Longworth House Office Building
Washington, D.C. 20515

The Honorable Sander Levin
Ranking Member
Committee on Ways and Means
1106 Longworth House Office Building
Washington, D.C. 20515

Re: Discussion Draft Provisions to Reform the Taxation of Financial Products

Dear Chairman Camp and Ranking Member Levin:

The National Association of Real Estate Investment Trusts[1] (NAREIT) welcomes the opportunity to provide comments on the discussion draft proposal with respect to provisions to reform the taxation of financial products (the Discussion Draft).[2] NAREIT looks forward to working with the Committee on Ways and Means (the Committee) on the Discussion Draft and appreciates the time the Committee's staff has already spent with NAREIT representatives.

EXECUTIVE SUMMARY

NAREIT understands that the Committee's goal is to update and rationalize the taxation of financial products, and NAREIT supports the Committee's goal and greatly appreciates your decision to proceed in "regular order" to obtain feedback from the public. However, we believe that the current proposal to mark-to-market "derivatives" is too broad and would apply mark-to-market accounting to many common commercial transactions. Accordingly, NAREIT believes the Discussion Draft should be amended to:

1) ensure that traditional investments, such as stock in mutual funds, exchange traded funds, and stock of corporations owning real estate such as REITs, would not be subject to mark-to-market accounting by clarifying that mark-to-market accounting would apply only to options, forward contracts, futures contracts, short positions, swaps, similar financial instruments, and notional principal contracts;

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[1]NAREIT®, the National Association of Real Estate Investment Trusts®, 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.

[2] http://waysandmeans.house.gov/uploadedfiles/leg_text_fin.pdf and http://waysandmeans.house.gov/uploadedfiles/final_financial_products_discussion_dated_tomorrow.pdf.

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2) expand the current exception for real property in the Discussion Draft so that derivatives with respect to real property held by investors, and not just dealers, would be clearly exempted from mark-to-market accounting;

3) add an exception for derivatives with respect to Government securities, which would: a) ensure that the market for "to be announced" (TBA) forward contracts to acquire mortgage-backed securities (MBS) guaranteed by Fannie Mae, Freddie Mac and Ginnie Mae (collectively, the Agencies) would not be disrupted in a way that could increase the interest rates borrowers pay on residential mortgage loans; and, b) allow REITs to continue to use derivatives with respect to Government securities to hedge fluctuations in the value of their investments in MBS and mortgage loans;

4) exclude from the definition of "derivative" the liquidity right held by minority holders of interests in the operating partnerships (OPs) through which many publicly traded REITs hold their properties, which would ensure that REITs could continue to acquire privately held real estate by offering the holders of that real estate a means to contribute their properties to the REIT's OP similar to the rules applicable to all partnership contributions;

5) clarify that a borrower's ability to prepay a loan will not cause a portion of the loan to be marked to market under the proposed definition of "embedded derivative component," which could: a) make mortgage loans and MBS less attractive investments; b) cause borrowers to pay higher interest rates on commercial and residential mortgage loans; and, c) subject them to taxation over the life of a mortgage on unrealized gains incurred due purely to interest rate movements;

6) clarify that a borrower's "rate-lock" is not a derivative that needs to be marked-to-market, which could affect mortgage lending activity around year-end;

7) allow REITs the ability to elect not to include market discount income currently, which would eliminate the possibility that the phantom income from market discount could cause a REIT to fail to satisfy the requirement that it distribute 90% of its taxable income each year (the 90% Distribution Requirement)[3]; and,

8) treat any mark-to-market income from "derivatives" and any market discount required to be recognized by a REIT in a manner consistent with the treatment of other "noncash income" for purposes of the 90% Distribution Requirement.

Finally, NAREIT believes the Committee could advance its goal of facilitating debt restructuring by providing in the Discussion Draft that a debt-for-debt exchange would be treated as a non-recognition event for the holder of the debt instrument. That change would eliminate the phantom

[3] I.R.C. § 857(a)(1).

income that is often recognized by debt holders that restructure distressed commercial and residential mortgage loans. In addition, the Committee could enable REITs to participate more fully in the market for distressed mortgage loans by conforming the treatment of interest income from mortgage loans with the treatment of rental income under the gross income tests applicable to REITs.

DISCUSSION

A. Background

1. REITs Generally

Congress created REITs in 1960 to provide all Americans the diversification and other benefits of professionally managed, income-producing real estate. Stock in publicly traded REITs is typically held by retail investors, either directly or indirectly through mutual funds, closed-end funds and exchange-traded funds. Investing in REITs gives all Americans access to, and the benefits of investing in, large scale real estate without the concentrated risks and much higher transaction costs associated with investing in individual properties. REITs have become widely accepted in today's investment landscape.

Modeled after mutual funds, a REIT is not subject to entity-level federal income tax on taxable income that it distributes to its shareholders each year.[4] However, to achieve that tax treatment, sections 856 through 860 of the Internal Revenue Code of 1986, as amended (the Code), require a REIT to satisfy several tests related to the nature of the REIT's assets, the sources of its income, its mandatory distributions to its shareholders, and the ownership of its stock.[5]

2. REIT Gross Income Tests and the 90% Distribution Requirement

a. 75% Gross Income Test

To ensure that a REIT derives substantially all of its income from real estate-related sources, a REIT is required to derive at least 75% of its gross income each year from, *inter alia*: 1) rents from real property; 2) interest on obligations secured by mortgages on real property or on interests in real property; and, 3) gain from the sale or other disposition of real property, including interests in real property and interest in mortgages on real property, that is not "dealer property" (*i.e.*, property held primarily for sale to customers in the ordinary course of business).[6]

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[4] I.R.C. § 857(b)(2)(B).

[5] References to "section" in this letter refer to sections of the Code. References to "Proposed Section" refer to the Code as it would be amended by the Discussion Draft.

[6] I.R.C. § 856(c)(3).

b. 95% Gross Income Test

To ensure that a REIT's income is almost exclusively passive, a REIT is also required to derive at least 95% of its gross income each year from passive sources, including, *inter alia*, any income that is qualifying for the 75% Gross Income Test plus interest, dividends, and gains from the sale or other disposition of stock, securities and real estate that is not "dealer property."[7]

Certain types of hedging income are ignored for purposes of the REIT gross income tests. Income and gain from a "hedging transaction," as defined in section 1221(b)(2)(A), is ignored for purposes of the 75% Gross Income Test and the 95% Gross Income Test.[8] However, that treatment is available only if the hedging transaction: 1) was properly identified for tax purposes; and, 2) was entered into in the normal course of the REIT's trade or business primarily to hedge any indebtedness incurred or to be incurred by the REIT to acquire or carry real estate assets.[9] Hedging transactions that produce disregarded income are commonly referred to as "qualified liability hedges." Income from other hedging transactions is either treated as non-qualifying income for both tests or, in the case of a hedging transaction that is treated as a disposition of a non-real estate "security," as qualifying income for the 95% Gross Income Test, but not the 75% Gross Income Test.

c. 90% Distribution Requirement

A REIT must also satisfy the 90% Distribution Requirement, which requires a REIT to distribute to its shareholders at least 90% of its REIT taxable income (excluding net capital gain) each year.[10] Like a mutual fund (called a regulated investment company in the Code) on which it is patterned, a REIT is allowed a dividends paid deduction in computing its taxable income because the taxable income so distributed is no longer available to the REIT.[11] Thus, to the extent a REIT distributes 100% of its taxable income, it will not pay corporate tax.

A limited exception from the 90% Distribution Requirement is available for certain types of "phantom" or "noncash" income recognized by a REIT. [12] A REIT is not required to distribute "excess noncash income," which is certain noncash income in excess of 5% of the REIT's taxable income (excluding net capital gains).[13] The potential sources of "excess noncash income" under section 857(e) include, *inter alia,* original issue discount (OID) and cancellation of indebtedness

[7] I.R.C. § 856(c)(2).

[8] I.R.C. § 856(c)(5)(G)(i). Certain income and gains from transactions that hedge foreign currency risk are also ignored for purposes of the REIT gross income tests. I.R.C. § 856(c)(5)(G)(ii).

[9] I.R.C. § 856(c)(5)(G).

[10] I.R.C. § 857(a)(1)(A).

[11] I.R.C. § 857(b)(2)(B).

[12] I.R.C. § 857(a)(1)(B).

[13] I.R.C. § 857(e)(1).

(COD) income.[14] A REIT, however, is required to pay corporate income tax on any "excess noncash income" that it does not distribute to its shareholders.

Notwithstanding the limited exception for excess noncash income, REITs are generally required to distribute phantom income. In order to raise the cash necessary to distribute phantom income as required by the 90% Distribution Requirement, a REIT may incur debt or sell assets it otherwise would hold long-term. Neither of those alternatives is typically in the best economic interests of the REIT's shareholders. Incurring debt to satisfy the 90% Distribution Requirement would necessarily increase the REIT's leverage beyond what it otherwise would have been, and that increased leverage may make it more difficult for the REIT to survive an economic downturn.

To satisfy an increased distribution requirement caused by phantom income, a REIT may seek to make a distribution payable at a shareholder's election in cash or stock that is treated as a dividend under section 305(b)(1).[15] An elective cash/stock dividend, however, creates phantom income for the REIT's shareholders, which may be viewed negatively by shareholders. Ultimately, if the REIT's phantom income causes a failure of the 90% Distribution Requirement, the REIT will lose its REIT qualification, which would cause the REIT to be treated as a C corporation subject to regular corporate income tax for the year of the failure and for the following four years, unless the REIT obtains the consent of the IRS to maintain its REIT status.[16] The corporate income tax from a failure to satisfy the 90% Distribution Requirement would greatly reduce the distributions the REIT could pay its shareholders and would likely significantly reduce the value of the REIT's stock. In sum, phantom income can cause significant negative consequences for a REIT and its shareholders.

3. UPREITs

Like most other real estate owners, REITs conduct a substantial part of their business through entities treated as partnerships for federal income tax purposes. Many publicly traded REITs hold substantially all of their assets through an OP, the majority of the interests of which are held by the REIT. These REITs are known as umbrella partnership REITs or UPREITs.

An UPREIT generally consists of a publicly traded REIT that owns substantially all of its assets and conducts substantially all of its operations through an OP. As a general rule, the REIT will

[14] I.R.C. § 857(e)(2). Excess noncash income also includes: 1) "excess inclusion income," a type of phantom income recognized by a holder of a residual interest in a real estate mortgage investment conduit (REMIC) or a taxable mortgage pool; 2) gain from certain failed section 1031 "like-kind" exchanges; and, 3) rental income accelerated under section 467 (requiring accrual of rental income on level basis on certain leases with back loaded rent). I.R.C. § 857(e)(2)(A), (B), and (C). In the case of OID, excess inclusion income, and section 467 income, the "excess noncash income" is the amount in excess of the cash actually received on the related investment.

[15] *See* P.L.R. 201301007 (Oct. 2, 2012); P.L.R. 200618009 (Nov. 3, 2005); P.L.R. 200615024 (Jan. 10, 2005); P.L.R. 200406031 (Oct. 29, 2003); P.L.R. 200348020 (Aug. 26, 2003).

[16] I.R.C. § 856(g)(3) (prohibiting an entity that has failed to qualify as a REIT from electing REIT status for the next four taxable years).

own a number of "common units" in the OP equal to the number of shares of common stock that the REIT has outstanding.[17]

The limited partnership interests held by partners in the OP other than the REIT also are denominated as "units." Because the REIT owns substantially all of its assets and conducts substantially all of its operations through the OP, and because the REIT owns a number of OP units equal to the number of shares of common stock that it has outstanding, there is effectively an economic identity of interest between the units in the OP that are owned by the outside limited partners and the shares of common stock outstanding in the REIT.

The UPREIT structure was developed in the early 1990s during the previous real estate dislocation to facilitate the desire of real estate owners to be able to access the public capital markets through the partnership structure commonly used in the real estate industry while deferring the immediate recognition of taxable gain that would result if they were to transfer their properties or property-owning partnership interests directly to the REIT in exchange for REIT shares, rather than to the OP in exchange for units. Under section 351(e), a transfer of property to a REIT in exchange for REIT shares often will result in the recognition of gain for tax purposes.[18] This taxable gain can be deferred if the property owner instead receives OP units, rather than REIT shares. The Internal Revenue Service (IRS) has indicated that it does not consider the UPREIT structure abusive.[19]

In the typical UPREIT structure, the holder of OP units generally will have the right (usually after one year) to require the REIT or the OP to redeem all or some of its units for an amount of cash equal to the agreed upon "value" of those units. Under the typical partnership agreement for an UPREIT, the "value" of a unit is defined as equal to the value of a share of stock of the REIT so long as the stock of the REIT is publicly traded.[20]

Although the unit holder's liquidity right is typically expressed as the right to receive cash equal to the value of a REIT share, the OP and/or the REIT normally will have the right, in lieu of paying cash, to satisfy the redemption obligation with one share of REIT common stock for each OP unit that is redeemed. It is generally the parties' expectation that the REIT will elect to satisfy the redemption right with shares of REIT stock, rather than cash, but this does not always occur. An owner of OP units is typically required to hold the OP units for at least one year before exercising its liquidity right.

[17] In addition, if the REIT has preferred stock outstanding, the REIT will own "preferred units" in the OP that correspond to the shares of preferred stock that the REIT has outstanding.

[18] *But see* P.L.R. 200450018 (Aug. 17, 2004) (holding that the transfer of a diversified property portfolio to a newly-formed REIT, followed by an initial public offering, qualified as tax-deferred under section 351(a)).

[19] *See*, *e.g.*, Treas. Reg. § 1.701-2(d), Ex. 4 (the partnership anti-abuse regulations).

[20] Because the REIT generally does not own significant assets other than its interest in the OP, and because it owns a number of OP units equal to the number of shares of common stock that it has outstanding, the value of a share of the common stock is the best approximation of the value of an OP unit.

In the typical UPREIT, the common unit holder does not have the right to receive a fixed amount of cash but rather, only to receive cash in an amount (or at the election of the REIT, REIT shares with a value) equal to the agreed upon value of the OP units at the time the redemption right is exercised. The exercise of the redemption right is a taxable transaction, and its availability provides the OP unit holder with the flexibility of deferring taxation until such time that the unit holder has the cash or the liquid publicly traded company stock with which to pay the corresponding tax liability.[21]

4. TBA Market

Approximately 90% of residential mortgage loans are currently guaranteed by the Agencies.[22] Agencies guarantee mortgage loans by guaranteeing the payment of principal and interest on MBS, which are referred to as Agency MBS, in return for a guarantee fee paid by the borrower. A vital risk management component of the market for Agency MBS, and thus the market for residential mortgage loans, is the TBA market.

Today, most "conforming" mortgage loans are securitized through Agency MBS. A loan originator originates a pool of mortgage loans and then sells the mortgages to the Agencies in return for "pass-through" MBS, [23] which are collateralized by the transferred mortgage loans and carry an Agency guarantee. The loan originator then typically sells the Agency MBS through a forward commitment to market makers and uses the proceeds from the sale of the Agency MBS to originate new mortgage loans. The forward commitment guarantees the price at which the market maker will purchase the MBS, thereby allowing the loan originator to "lock in" mortgage rates for a fixed period of time for homebuyers.

Market makers often dispose of the Agency MBS acquired from loan originators through the TBA market. Under a TBA contract, one party agrees to purchase, and one party agrees to sell, a certain dollar amount of Agency "pass-through" MBS at a fixed price on a fixed settlement date in the future. When the TBA contract is entered into, the specific Agency MBS to be delivered at settlement is not stipulated. Instead, only six parameters are agreed to: issuer, coupon, maturity, price, par amount and settlement date.[24] Only Agency-guaranteed, residential, single-class MBS

[21] The discussion herein also applies to a parallel structure known as "Down REITs". A Down REIT is similar to an UPREIT except that in a Down REIT, the REIT may own property directly (in addition to an interest in other lower-tier partnerships), while in an UPREIT, virtually all of the REIT's holdings are through the OP.

[22] Written Statement of Thomas Hamilton, Managing Director, Barclays Capital, on behalf of The Securities Industry and Financial Markets Association, Hearing before the U.S. Senate Committee on Banking, Housing and Urban Affairs, Subcommittee on Securities, Insurance and Investment, at 2 (Aug. 3, 2011) [hereinafter *SIFMA Testimony*].

[23] In a "pass-through" structure, the underlying mortgage principal and interest payments are forwarded to security-holders on a pro rata basis, with no "tranching" or structuring of cash flows.

[24] Federal Reserve Bank of New York, Staff Report No. 468, *TBA Trading and Liquidity in the Agency MBS Market*, at 7 (2010) [hereinafter *Federal Reserve Report*].

are eligible to be traded in the TBA market. Settlement dates for TBA transactions are standardized and occur on four specified days each month, with different dates set for different types of MBS.[25] Most TBA trades are executed for settlement within one to three months. However, some trades may extend further forward from time to time. The unique structure of TBAs has created a standardized and liquid market for the forward trading of Agency MBS and the timely and efficient financing of homeownership.

Investors, such as mortgage REITs, may enter into TBAs to lock in prices of Agency MBS. However, rather than taking physical delivery at settlement, an investor may elect to "dollar roll" a TBA. A dollar roll is the combination of one TBA trade with a simultaneous offsetting TBA trade settling on a different (future) date. The ability to dollar roll TBAs allows investors and market makers flexibility in adjusting their positions for economic or operational reasons. For example, an investor who purchased a TBA but faces operational concerns with taking physical delivery on the scheduled settlement date could sell an offsetting TBA on that date and simultaneously buy another TBA due one month later, effectively avoiding the operational issue but retaining much of the economic exposure.[26]

The TBA market is what connects the residential mortgage borrower to the ultimate funders of residential mortgages, the secondary mortgage market. As investors enter into TBA purchase contracts to acquire Agency MBS in the future, loan originators enter into TBA sale contracts to sell loans (through the market makers) to investors. This enables a residential mortgage borrower to "lock in" a mortgage interest rate up to 30, 60 or 90 days in advance. By entering into a TBA sale contract, a loan originator can hedge the risk of its loan origination pipeline and "lock in" a price for the mortgage loans they are currently originating, which, in turn, allows borrowers the ability "lock in" interest rates on their mortgage loans up to 90 days in advance of closing on their home purchase. Although there are other means available, TBAs are a simple and low-cost way for originators to hedge loan production. Indeed, as a recent report from the Federal Reserve Bank of New York concluded, "[w]ithout TBAs, originators would have to engage in sophisticated trading strategies using a variety of derivatives to replicate the effect of a TBA."[27] The report further noted that, without TBAs, it would be more difficult for smaller loan originators to securitize loans through the Agencies.

The TBA market is the mechanism through which the vast majority of Agency MBS trading occurs, [28] and only the market for trading in Treasury securities is larger than the Agency MBS market.[29] According to the Securities Industry and Financial Markets Association, the TBA

[25] *SIFMA Testimony* at 12.

[26] *Federal Reserve Report* at 13.

[27] *Id.* at 14.

[28] *Federal Reserve Report* at 2.

[29] *SIFMA Testimony* at 14.

market is the most liquid and most important secondary market for mortgage loans.[30] Moreover, TBAs are the means through which many newly issued Agency MBS are distributed to investors.

The liquidity of the TBA market reduces risk management costs, thereby raising MBS prices and improving market functioning, which ultimately lowers the interest rates paid by borrowers for residential mortgage loans and enhances the availability and reliability of mortgage credit.[31] This liquidity helps mortgage originators manage risk, as it allows them to "lock in" mortgage rates in the TBA market before originating a mortgage loan.[32] This ability to sell mortgages forward through the TBA market allows loan originators the ability to offer borrowers fixed-rate loan terms well in advance of an actual mortgage closing, and is an important feature of labor market mobility in the United States. This, in turn, greatly facilitates the final negotiations of home purchases and the overall viability of the fixed-rate, 30-year residential mortgage loan.

B. Proposed Sections 485 & 486: Marking-to-Market Derivatives

NAREIT believes that certain provisions of Proposed Sections 485 and 486 would subject common commercial transactions to mark-to-market accounting, which would have significant unintended consequences on the markets for real estate and MBS. In addition, we anticipate that Proposed Sections 485 and 486 could significantly impair the ability of many REITs to satisfy the 90% Distribution Requirement.

Proposed Section 485 would require taxpayers to mark to market for federal income tax purposes any "derivative" held at the close of a taxable year.[33] All items of income, loss, and deduction from any "derivative" would be treated as ordinary income.[34] NAREIT understands that the Discussion Draft intends to apply mark-to-market accounting to speculative financial activities, but not to business hedging against common risks. NAREIT believes that the current definition of "derivative" is too broad and should be revised as proposed below.

1. The Definition of "Derivative" Should be Revised to Exclude Beneficial Ownership of Assets

NAREIT believes that the inclusion of the phrase "any evidence of an interest in" in the definition of "derivative" would require taxpayers to mark to market investments that are not commonly thought of as "derivatives." Proposed Section 486(a) defines "derivative" to include, *inter alia*, "any evidence of an interest in (or any derivative financial instrument with respect to)" an

[30] *Id.* at 13.

[31] *Federal Reserve Report* at 1; *SIFMA Testimony* at 2.

[32] *Federal Reserve Report* at 1; Securities Industry and Financial Markets Association, *TBA Market Fact Sheet* at 1 (2011).

[33] Proposed Section 485(a)(1).

[34] Proposed Section 485(b)(1).

enumerated list of assets, including: 1) any share of stock in a corporation; 2) any partnership or beneficial ownership interest in a partnership or trust; 3) any note, bond, debenture or other evidence of indebtedness; 4) any real property (subject to a limited exception described below); 5) any commodity which is actively traded; or, 6) any currency.

Although appreciating the Committee's desire to craft a definition of "derivative" that is sufficiently broad, NAREIT notes that the phrase "any evidence of an interest in" may cause beneficial ownership of many ordinary investments to be subject to mark-to-market accounting. For example, it is not clear whether stock in a mutual fund, exchange traded fund, or a corporation owning real estate such as a REIT (or for that matter, any corporation owning their own headquarters, factories, etc.) would be treated as "any evidence of an interest in" the real estate, debt instruments, or stock held by those entities. NAREIT believes it would not be appropriate to require retail investors to mark to market their investments in stocks such as REITs and mutual funds.

In addition, it is not clear whether beneficial ownership of an interest in an MBS would be subject to mark-to-market accounting, because it could be viewed as representing an "evidence of an interest in" the mortgage loans that collateralize the MBS. Similarly, ownership of a commercial mortgage loan is often divided between two or more owners through participation agreements, pursuant to which two or more investors divide interest and principal payments on the commercial mortgage loan. NAREIT believes that common participation interests in commercial mortgage loans could be treated as "evidence of an interest in" a mortgage loan that would be required to be marked to market under the Discussion Draft, even though direct ownership of the commercial mortgage loan would not.

NAREIT believes the uncertainties regarding which investments would be unintentionally included in the definition of "any evidence of an interest in" warrant removing that language from Proposed Section 486(a)(1). NAREIT believes that the definitions of "derivative financial instrument" (*i.e.*, any option, forward contract, futures contract, short position, swap, or similar financial instrument) and "notional principal contract," which are currently components of the definition of "derivative," are sufficiently broad to encompass the range of financial instruments that should be treated as "derivatives."

2. The Real Property Exception to the Definition of "Derivative" Should Be Expanded and an Exception for Government Securities Should be Added

NAREIT believes that the current exemption in the Discussion Draft from the definition of "derivative" for real property is too narrow. Unless that definition is broadened as proposed below, NAREIT believes that common commercial transactions entered into by investors in real estate, MBS, and mortgage loans could be subject to mark-to-market accounting, which could cause some REITs to fail to satisfy the 90% Distribution Requirement or be subject to corporate tax on any undistributed phantom income. In addition, NAREIT encourages the Committee to include an exception from the definition of "derivative" with respect to Government securities, which would help ensure that the Discussion Draft does not disrupt the TBA market or impair

the ability of REITs to hedge fluctuations in the value of their assets.

a. Issues with the Current Real Estate Exception

i. Investors in Real Property

The current exception for real property in Proposed Section 486(e) applies only to an interest or instrument: 1) with respect to a "tract of real property" as defined in section 1237(c); or, 2) real property that would be inventory in the hands of the taxpayer if held directly by the taxpayer (*i.e.*, property held by a "dealer").[35] The exception for "dealer" property will not apply to REITs and other long-term investors in real estate. Indeed, REITs are subject to a 100% prohibited transaction tax on the gain from the sale of "dealer" property. Moreover, the meaning of "tract of real property" as used in Proposed Section 486(e)(1)(A) is not entirely clear, and NAREIT is concerned that it applies only to undeveloped land. [36] The phrase "tract of real property" is borrowed from section 1237, which generally provides that a taxpayer other than a C corporation will not be treated as a dealer with respect to a "tract of real property" solely because the taxpayer subdivided the tract.[37] One of the requirements of section 1237 is that no improvement that substantially enhances the value of the tract is made by the taxpayer on the tract while held by the taxpayer or is made pursuant to a contract of sale entered into between the taxpayer and the buyer.[38] NAREIT has found no authorities that address solely the definition of "tract of real property" in section 1237(c), and the limited authorities under section 1237 generally address undeveloped land.[39]

NAREIT notes that any issues regarding the scope of the phrase "tract of real property" are magnified by the exception for "real property" held by dealers in Proposed Section 486(e)(1)(B). "Real property" is not defined for purposes of the dealer exception in Proposed Section 486(e)(1)(B). If "tract of real property" included more than undeveloped land, then arguably the exception for "real property" held by dealers is unnecessary. A court could limit "tract of real

[35] Proposed Section 486(e)(2) grants the Secretary the authority to prescribe regulations or other guidance to treat multiple tracts of real property as a single tract.

[36] *Cf.* Rev. Rul. 80-216, 1980-2 C.B. 239 (holding that the benefits of section 1237 do not apply to conversion of rental units in apartment condominiums because section 1237 does not apply to the subdivision and sale of improvements).

[37] I.R.C. § 1237(a).

[38] I.R.C. § 1237(a)(2).

[39] There are some rulings addressing the sale of fee interests in lots in which development occurred on the lots via lease development agreements, pursuant to which a developer leases a tract under long-term leases, develops homes on the tract, and assigns leases to the ultimate tenants of the developed property. *E.g.*, Rev. Rul. 77-338, 1977-2 C.B. 312 (involving sales of fee interest in land to ultimate tenants of houses constructed under lease development agreements; leases allowed the tenants the option of removing the constructed homes at the end of the lease term); P.L.R. 8630712 (June 2, 1986) (same); P.L.R. 8038196 (June 30, 1980) (prior ruling related to P.L.R. 8630712).

property" to undeveloped land in the context of Proposed Section 486(e)(1)(A) because any other interpretation would make the exception for "real property" held by dealers in Proposed Section 486(e)(1)(B) superfluous.

Moreover, it is unclear why dealers of real property, but not investors in real property, are clearly protected by the real property exception. NAREIT believes it is important that the real property exception clearly encompasses developed real estate and buildings held by an investor. Because of the issues discussed above, NAREIT observes that the current real property exception would not apply to numerous situations in which "financial derivative instruments" are used in common real estate transactions.

NAREIT anticipates that the current formulation of the real property exception would cause liquidity problems for long-term investors in real property, including REITs that invest in real property. For example, it is not uncommon for an owner of a commercial office building to possess an option to acquire an adjoining building or parcel of land for future expansion. Under the Discussion Draft, that "option" would be treated as a "financial derivative instrument."[40] Unless the property were treated as a "tract of real property," the investor in the commercial office building would have to mark to market that option each year, with any mark-to-market gain treated as ordinary income. It is not apparent why an investor holding an option should recognize this phantom income, but a dealer of property would not. A dealer of property would presumably have greater cash flow from sales of inventory than would an investor in real property, which would make it easier for a dealer to manage the liquidity issues caused by phantom income.

Similarly, it is not uncommon for a contract to acquire a commercial property to specify that closing will occur three to six months after signing. A delayed closing is often needed to allow the purchaser time to conduct due diligence and obtain financing. Again, unless the property subject to purchase contract qualified as a "tract of real property," the purchaser could be required to mark the property to market if the closing does not occur before the end of the purchaser's taxable year. Finally, a tenant in a commercial office building that has an option to extend its lease would also appear to have a "financial derivative instrument" subject to mark-to-market accounting under the Discussion Draft. NAREIT believes these types of results were unintended and could be addressed by a broader real property exemption, as proposed below.

ii. UPREITs

NAREIT also notes that the redemption right in a typical UPREIT structure could be viewed as an "option" to acquire REIT stock under the current definition of a "derivative financial instrument."[41] Although the redemption right is not currently treated as an "option" for purposes

[40] Proposed Section 486(b) (defining "derivative financial instrument" to include an "option").

[41] Although the definition of "embedded derivative instrument" in Proposed Section 486(d) specifically addresses derivatives embedded in a debt instrument, it does not appear that any provision of Proposed Sections 485 and 485 would exclude from the definition of "derivative" a "derivative financial instrument" embedded in an equity interest, such as a partnership interest or share of stock.

of the constructive ownership rules in section 318,[42] the scope of the "option" definition in the Discussion Draft is unclear. If an UPREIT redemption right were treated as a "derivative financial instrument," holders of the OP units would be required to mark to market the redemption right. NAREIT believes that would be inappropriate as OP units are acquired and held as long-term investments.

Moreover, the "option" of holders of OP units to receive a fair market value price for their OP units, paid either in cash or REIT stock, is no different than the "option" of any holder of publicly traded stock to sell their stock on the market for its fair market value. If holders of OP units are required to mark to market the value of the redemption right inherent in their OP units, REITs may be unintentionally limited in their ability to acquire privately held property for OP units. The phantom income from marking to market the redemption right would likely make OP units unattractive to potential contributors of property, who are generally seeking to transfer property on a tax-deferred basis. Those holders of real property may be less likely to transfer property to a REIT's OP, which would limit the ability of a REIT's retail investors to invest in real estate that is currently held outside of the public real estate markets.

iii. Preferred Stock

Preferred stock, although not unique to REITs, also presents similar issues. It appears that under the Discussion Draft, a holder of convertible preferred stock could be treated as having an "option" to acquire the common stock received upon conversion. If holders of convertible preferred stock are required to mark to market the value of the conversion right inherent in the preferred stock and treat any income therefrom as ordinary, then convertible preferred stock may become a less attractive investment. In addition, preferred stock is often redeemable at the issuer's option. If the issuer's redemption right were treated as an "option" under Proposed Sections 485 and 486, a corporation could have ordinary mark-to-market income as a result of issuing preferred stock with market terms.[43] The Code already encourages corporations to incur debt because interest payments, unlike dividends, are generally deductible. NAREIT sees no policy reason for making convertible and redeemable preferred stock even less attractive by causing holders and issuers of preferred stock to have ordinary phantom income.

iv. TBA Market and Interest Rate Locks

NAREIT also believes that the effect of Proposed Sections 485 and 486 on the TBA market is unwarranted. The definition of "derivative financial instrument" would include TBAs, as that phrase includes a "forward contract."[44] As discussed above, the TBA market is vital to the

[42] *See* Rev. Rul. 68-601, 1968-2 C.B. 124 (holding that, to be treated as an option for purposes of section 318, the option must give the holder the unconditional right to acquire stock at the holder's election).

[43] With that said, it is possible that section 1032 ("[n]o gain or loss shall be recognized by a corporation with respect to any … acquisition of an option . . . to buy or sell its stock") may prevent such recognition.

[44] Proposed Section 486(b).

efficiency of the residential mortgage market. Because of the TBA market, loan originators can allow borrowers to lock-in interest rates on a cost-effective basis. The TBA market also provides a means for loan originators to sell new Agency MBS to market makers and for market makers, in turn, to distribute those Agency MBS to investors.

NAREIT believes that requiring mark-to-market accounting of TBAs could disrupt the TBA market. Investors in new Agency MBS may avoid acquiring TBAs near the end of their taxable year so they do not have to recognize ordinary mark-to-market income. Any disruption to the TBA market would ripple through the markets for Agency MBS and residential mortgage loans, likely increasing the interest rate paid by borrowers under standard fixed-rate, 30-year residential mortgage loans. Not only would the avoidance of TBAs have the effect of reducing the availability of mortgage credit over year-end, but it may also force market participants to reduce their prudent interest rate risk management by reducing their TBA hedging activity.

For REITs, marking to market TBAs may make it difficult for some mortgage REITs to satisfy the 90% Distribution Requirement. Under current law, a REIT seeking to acquire a new Agency MBS through a TBA would not have an income event as a result of entering into a TBA and taking delivery of the TBA. Under the Discussion Draft, the same REIT would have ordinary income if the TBA was "in the money" at the end of its taxable year. Although the REIT would have no income from the TBA (indeed, the REIT would have to pay for the Agency MBS subject to the TBA), the REIT would have an increased distribution requirement as a result of using the TBA to invest in new Agency MBS. REITs would either have to reduce their participation in the TBA market, which could contribute to difficulties in arranging f home financings, or potentially face difficult issues satisfying the 90% Distribution Requirement.

Finally, NAREIT believes there is a risk that borrowers who have "locked in" a mortgage interest rate prior to closing could be treated as having an "option" to acquire a mortgage loan at a specified interest rate. If interest rates increase after the borrower "locks in" the interest rate and the lock extends over the end of the borrower's taxable year, the borrower would have phantom ordinary income. Clearly, a rate lock is not a speculation on the part of the borrower since an unrealized gain in the value of the rate lock could not be realized by selling or trading it. Nevertheless, borrowers could avoid "locking in" interest rates on residential mortgage loans if they knew they could potentially pay a derivatives tax as the Discussion Draft contemplates in its current form.

b. Issues Related to Derivatives with respect to Government Securities and Definition of "Hedging Transactions"

NAREIT notes that the Discussion Draft may 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. In particular, under the Discussion Draft, the gain or loss on a "derivative" would be ordinary income, but the gain or loss on the hedged MBS would be capital. Because a mortgage REIT could not use any capital loss recognized on a hedged MBS or

mortgage loan to offset the ordinary income from the hedging transaction, the mortgage REIT may not be able to satisfy the 90% Distribution Requirement.

Proposed Section 485(b) requires ordinary treatment on all items of income or loss with respect to a "derivative." Proposed Section 486(f) excludes from mark-to-market accounting under Proposed Section 485 any "hedging transaction," as defined in Proposed Section 1221(c). The definition of "hedging transaction" under Proposed Section 1221(c) is generally consistent with the current definition of "hedging transaction" in section 1221(b)(2), except Proposed Section 1221(c) includes some helpful changes to the hedge identification requirement. Under Proposed Section 1221(c) (and section 1221(b)(2)), a hedging transaction includes only transactions entered into in the ordinary course of the taxpayer's trade or business primarily to manage: 1) risk of price changes or currency fluctuations with respect to *ordinary* property which is held or to be held by the taxpayer; or, 2) risk of interest rate or price changes or currency fluctuations with respect to borrowings made or to be made, or ordinary obligations incurred or to be incurred by the taxpayer. A transaction that hedges a capital asset of a taxpayer could not be a "hedging transaction" under Proposed Section 1221(c) (and section 1221(b)(2)). Accordingly, a hedge of a capital asset would be subject to mark-to-market accounting under Proposed Sections 485 and 486.

Some mortgage REITs enter into transactions to hedge the decreases in the value of their assets, but those transactions are not, or cannot be, treated as "hedging transactions" for purposes of Proposed Section 1221(c) (and section 1221(b)(2)). 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.

Mortgage REITs may enter into hedging transactions using Treasury bonds, Treasury bond futures or TBAs to reduce exposure to the effect of rising interest rates on their investment portfolio. Such transactions may also be used to hedge the interest rate risk on the mortgage REIT's short-term, 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.[45]

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 those cases, the transactions economically hedge fluctuations in the value of the REIT's assets. We will refer

[45] I.R.C. § 856(c)(5)(G).

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. However, asset hedging transactions may produce qualifying income for the 95% Gross Income Test when they give rise to gain from the sale of "securities."[46]

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. 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.

Under Proposed Section 485, however, all items of income or loss with respect to a "derivative" would be ordinary income regardless of whether the derivative has been, or could be, designated as a "hedging transaction" under section 1221. Under the Discussion Draft, a mortgage REIT's investments in MBS and mortgage loans would continue to be treated as capital assets. As a result, there would be a character "mismatch" between the ordinary income and loss from asset hedging transactions and the capital gains and losses from the REIT's investments. Because of the character mismatch, a mortgage REIT may not have economic income or may even have an economic loss, but may still have a higher distribution requirement as a result of asset hedging transaction-generated ordinary income at the same time the hedged assets generated capital losses. The effect of the character mismatch could, in certain interest rate environments, significantly impair to a REIT's ability to satisfy the 90% Distribution Requirement.

c. NAREIT's Suggested Expanded Real Estate and Government Securities Exception

NAREIT believes the Discussion Draft should include an expanded real estate and Government securities exception that would address the issues discussed above with real estate transactions, TBAs, the redemption right in a typical OP unit, and asset hedging transactions.

To ensure that standard commercial transactions involving real estate are not subject to mark-to-market accounting, NAREIT suggests replacing the definition of "real property" in Proposed Section 486(e) with an exception for "real estate," with a definition of "real estate" that is similar to the one used in Treasury Regulations section 1.856-3(b) for purposes of the provisions of the Code applicable to REIT qualification. Specifically, NAREIT recommends that "real estate" be defined as "real property, interests in mortgages on real property (including interests in mortgages on leaseholds of land or improvements thereon), and interests in a real estate mortgage investment

[46] I.R.C. § 856(c)(2)(D) (treating gain from the sale of "securities" as qualifying income for the 95% Gross Income Test).

conduit."[47] NAREIT believes an appropriate definition of "real property" for purpose of the Discussion Draft could use the definition of "real property" and "interest in real property" from Treasury Regulations section 1.856-3(c) and (d).[48] The proposed real estate exemption would clearly cover investors in all types of real estate assets.[49] Finally, by including interests in mortgage loans in the definition of "real estate," the proposed exemption would eliminate the concern that borrowers under residential mortgage loans would have mark-to-market income from "locking in" an interest rate.

To address the issues raised above regarding TBAs and asset hedging transactions, NAREIT recommends that the Discussion Draft also exempt from the definition of "derivatives," any derivative with respect to a Government security, defined as "any security issued or guaranteed as to principal or interest by the United States, or by a person controlled or supervised by and acting as an instrumentality of the Government of the United States pursuant to any authority granted by the Congress of the United States, or any certificate of deposit for any of the foregoing." This is

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[47] This is generally the same definition of "real estate assets" in Treasury Regulations section 1.856-3(b)(1), except that it does not include stock in a REIT and does not apply the "look-through" rule in Treasury Regulations section 1.856-3(b)(2) to interests in a REMIC when less than 95% of the REMIC's assets are real estate assets.

[48] Treasury Regulations section 1.856-3(d) provides the following definition of "real property":

> The term "real property" means land or improvements thereon, such as buildings or other inherently permanent structures thereon (including items which are structural components of such buildings or structures). In addition, the term "real property" includes interests in real property. Local law definitions will not be controlling for purposes of determining the meaning of the term "real property" as used in section 856 and the regulations thereunder. The term includes, for example, the wiring in a building, plumbing systems, central heating, or central air-conditioning machinery, pipes or ducts, elevators or escalators installed in the building, or other items which are structural components of a building or other permanent structure. The term does not include assets accessory to the operation of a business, such as machinery, printing press, transportation equipment which is not a structural component of the building, office equipment, refrigerators, individual air-conditioning units, grocery counters, furnishings of a motel, hotel, or office building, etc., even though such items may be termed fixtures under local law.

Treasury Regulations section 1.856-3(c) provides the following definition of "interest in real property" (a phrase used in the definition of "real property"):

> The term "interests in real property" includes fee ownership and co-ownership of land or improvements thereon, leaseholds of land or improvements thereon, options to acquire land or improvements thereon, and options to acquire leaseholds of land or improvements thereon. The term also includes timeshare interests that represent an undivided fractional fee interest, or undivided leasehold interest, in real property, and that entitle the holders of the interests to the use and enjoyment of the property for a specified period of time each year. The term also includes stock held by a person as a tenant-stockholder in a cooperative housing corporation (as those terms are defined in section 216). Such term does not, however, include mineral, oil, or gas royalty interests, such as a retained economic interest in coal or iron ore with respect to which the special provisions of section 681(c) apply.

[49] Moreover, the rules of Treasury Regulations section 1.856-3(g) (a REIT that holds an interest in a partnership is deemed to own its proportionate share, based on its capital interest in the partnership, of each of the assets of the partnership and will be deemed to be entitled to the income of the partnership attributable to such share.) and Rev. Proc. 2003-65, 2003-2 C.B. 336 (mezzanine loans, *i.e.*, loans secured by interests in pass-through entities that own primarily real estate, if they meet certain criteria, are "real estate assets") should be applicable.

the same definition of "Government securities" that is used for purposes of the Investment Company Act of 1940, [50] and that is incorporated into the rules for REITs and regulated investment companies.[51] NAREIT believes an exception for derivatives on Government securities would ensure that the TBA market is not disrupted by strategies to avoid mark-to-market accounting. In addition, a Government securities exception would allow mortgage REITs to use derivatives on Government securities as asset hedging transactions without endangering their ability to satisfy the 90% Distribution Requirement.

If an exception for Government securities is not adopted, NAREIT recommends that, at a minimum, the concerns with TBAs and asset hedging transactions be addressed by: 1) including forward contracts to acquire MBS in the definition of "real estate" proposed above, which would cause those transactions to be excluded from mark-to-market accounting; and, 2) adding a provision that would allow a taxpayer the ability to integrate an asset hedging transaction with the associated asset so there is no "mismatch" between the character of the income from those two transaction.[52]

To address the issues raised above regarding the redemption right in the typical OP unit, NAREIT recommends that the definition of "derivative" exclude an interest in a partnership that would otherwise be treated as a "derivative" solely because the partnership interest may be exchanged, at the option of someone other than the partner, for stock of a REIT pursuant to the terms of the partnership's organizational documents. By adding that exception, the Committee will help ensure that REITs could continue to use OP units to acquire privately held real estate, which would broaden the base of real estate that retail investors can own indirectly through REITs.

Finally, NAREIT believes that any mark-to-market income recognized by a REIT as result of Proposed Section 485 should be treated as a potential source of "excess noncash income" under section 857(e). NAREIT believes that the exceptions proposed above should address most, but not all, of the situations in which Proposed Section 485 would require REITs to mark-to-market income. Nevertheless, there may be situations in which a REIT would have to recognize income under Proposed Section 485 and would not have cash from the transaction to satisfy the 90% Distribution Requirement.

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[50] Investment Company Act of 1940, 15 U.S.C. § 80a-2(a)(16) (2012).

[51] I.R.C. §§ 851(c)(6) (using the definitions of terms in the Investment Company Act of 1940 for purposes of the rules for regulated investment companies); 856(c)(5)(F) (using the definitions of terms in the Investment Company Act of 1940 for purposes of the REIT rules); G.C.M. 39700 (Mar. 7, 1988) (applying the definition of "Government securities" from the Investment Company Act of 1940 for purposes of the rules for regulated investment companies).

[52] The integration provision would be similar to the integrated treatment that section 988(d) offers to taxpayers in the area of foreign currency hedging. The integrated treatment should provide taxpayers an option to elect to treat a qualifying asset hedging transaction and the asset being hedged as one transaction for purposes of determining the character of the combined income or loss. The determination should be solely based on the character of income or loss with respect to the asset being hedged. As to the timing of income or loss recognition, we would recommend that the hedging gain or loss be recognized when realized. This proposed recognition method should meet the general matching principal of Treasury Regulations section 1.446-4(b) applicable to hedging transactions.

To help mitigate the possibility that Proposed Section 485 could cause a REIT to lose its REIT qualification or require it to engage in transactions that would not otherwise be in the best interests of its shareholders, NAREIT believes that any income recognized by a REIT under Proposed Section 485 should be a potential source of "excess noncash income." With that treatment, a REIT would not be required to distribute mark-to-market income to the extent that income and other noncash income specified in section 857(e) exceeded 5% of the REIT's gross income. The REIT would still be required to pay corporate income tax on the undistributed "excess noncash income," which could cause liquidity issues for REITs. Nevertheless, the liquidity issues with paying corporate tax on mark-to-market income recognized under Proposed Section 485 would be significantly less than the issues raised by requiring REITs to distribute 90% of that income to their shareholders. Moreover, treating mark-to-market income under Proposed Section 485 as potential source of "excess noncash income" would conform the treatment of mark-to-market income for a REIT with the treatment of other noncash income, such as OID and COD income.[53]

3. Definition of "Embedded Derivative Component" Should be Clarified to Exclude a Borrower's Prepayment Right

NAREIT points out that the definition of "embedded derivative component" in Proposed Section 486(d)(2) may inadvertently treat a borrower's right to prepay a debt instrument as a "derivative." A borrower's prepayment right is a common component of residential mortgage loans and many commercial mortgage loans. NAREIT does not believe that the Committee's goals would be advanced by treating a prepayment right as a "derivative" subject to mark-to-market accounting.

Proposed Section 486(d) includes in the definition of "derivative" any "embedded derivative component," which is defined as "any terms of a debt instrument that affect some or all of the cash flows or the value of other payments required by the instrument in a manner similar to a derivative."[54] Contingent payment debt instruments, variable rate debt instruments, and debt instruments with alternative payment schedules are excluded from the definition of "embedded derivative component."[55] If a debt instrument has an embedded derivative component, the component is treated as an instrument separate from the debt instrument and is subject to mark-to-market accounting.

NAREIT also notes that a borrower's right to prepay a mortgage could be viewed as an "embedded derivative component." A prepayment right may be viewed as "affect[ing] some or all of the cash flows or the value of other payments" on the mortgage loan. NAREIT suspects that the Committee did not intend to treat a prepayment right as an "embedded derivative component." Indeed, it would seem inconsistent to exclude contingent payment debt instruments from the

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[53] I.R.C. § 857(e)(2).

[54] Proposed Section 486(d)(2)(A).

[55] Proposed Section 486(d)(2)(B)(iii).

definition of "embedded derivative component," but include a typical fixed-rate, 30-year residential mortgage loan. Valuation of this prepayment right would be particularly difficult for a typical homeowner. In addition, as a practical matter, it would be difficult for the average residential mortgage borrower to derive the change in value of his or her right to prepay a mortgage, and there is no way to realize this value unless the borrower actually refinances. In a market in which current mortgage rates are significantly higher than a borrower's existing rate, the exercise itself is not very meaningful.

Moreover, NAREIT believes some mortgage REITs could face difficulties satisfying the 90% Distribution Requirement if they were required to mark to market the portion of the value of their mortgage loans that are attributable to the borrower's prepayment right. NAREIT recommends that this issue be addressed by specifying in Proposed Section 485(d)(2)(B) that a debt instrument is not treated as having an "embedded derivative component" merely because the borrower has the right to prepay the debt instrument.

C. Proposed Section 1278: Current Inclusion of Deemed Interest Component of Market Discount

NAREIT supports the Committee's efforts to limit income inclusions under the market discount rules to the discount attributable to fluctuations in interest rates, rather than the discount attributable to credit risk. That issue is important to many mortgage REITs, and NAREIT appreciates the Committee's efforts to address the issue.[56]

Although it supports generally the Committee's effort to reform the market discount rules, NAREIT notes that the requirement to include market discount in income currently could make it difficult for some REITs to satisfy the 90% Distribution Requirement. Under the Discussion Draft, REITs would be required to include a portion of the accrued market discount in income even if the taxpayer did not receive any cash payment in respect of the debt instrument. This could present problems for mortgage REITs that invest in loans that do not require the borrower to make significant principal payments prior to maturity. For example, commercial mortgage loans typically require a single "bullet" principal payment at maturity. REITs that invest in commercial mortgage loans would be required by the Discussion Draft to include in income market discount, even though they would not receive any cash that could be used to satisfy the 90% Distribution Requirement.

NAREIT believes this issue could be solved by allowing REITs the ability to elect to: 1) include market discount in income under Proposed Section 1278; or, 2) be subject to the current rules for the recognition of market discount in section 1276. Under current law, unless a taxpayer elects under section 1278(b) to include market discount into income as it accrues, market discount is

[56] NAREIT understands that the Committee is working to refine the limitation in Proposed Section 1278(b)(2) on the amount of the market discount that would be included in income currently. NAREIT supports efforts to ensure that the limitation, to the extent possible, does not cause taxpayers to have to include in income market discount attributable to credit risk.

included in income under section 1276 only if the taxpayer has received a principal payment or disposes of the debt instrument. In those cases, the taxpayer generally has cash from the debt instrument in an amount equal to or in excess of the market discount included in income.[57] As a result, the recognition rules in section 1276 do not generally make it difficult for a REIT to comply with the 90% Distribution Requirement.

NAREIT believes that the flexibility under current law regarding recognition of market discount should be retained for REITs. Otherwise, REITs may be reluctant to acquire debt instruments with market discount, because acquiring those instruments may make it difficult for the REIT to satisfy the 90% Distribution Requirement.

If REITs are not allowed to retain the flexibility allowed under current law, NAREIT requests that, at a minimum, any market discount that is required to be included in income be treated as a potential source of "excess noncash income" for REITs under section 857(e)(2). That change would conform the treatment of market discount with OID, which is eligible to be treated as "excess noncash income" under section 857(e)(2). Market discount is currently not treated as "excess noncash income." The current treatment of market discount is understandable because, as explained above, market discount does not generally cause noncash income, unless a REIT elects under section 1278(b) to include market discount in income as it accrues. As a result, a REIT can, under current law, avoid the issues with satisfaction of the 90% Distribution Requirement described in the previous paragraph.

NAREIT believes that the problems of compliance with the 90% Distribution Requirement caused by Proposed Section 1278 could be mitigated – but not solved – by treating the market discount that is required to be included in income as a potential source of "excess noncash income." NAREIT believes that change would be consistent with the Committee's goal of treating the market discount attributable to interest rate changes in a manner similar to OID. However, even if this change to the excess noncash income rules is accepted, market discount could still create liquidity issues for a REIT because the REIT would be required to pay corporate tax on any undistributed market discount. Accordingly, the best means to avoid those potential liquidity issues for a REIT would be to allow the REIT the ability to elect whether to include market discount income on a current basis, as proposed above.

D. <u>Debt Restructuring Proposals</u>

NAREIT understands that one of the Committee's goals is to reform the tax rules to encourage debt restructurings. To advance that objective, NAREIT encourages the Committee to include two additional proposals in the Discussion Draft. The first proposal would eliminate the phantom income that holders of non-publicly traded debt recognize in a debt restructuring by treating debt-for-debt exchanges as non-recognition transactions for all debt holders. The second proposal

[57] I.R.C. § 1276(a).

would allow REITs greater ability to invest in distressed debt that is likely to be restructured by conforming the treatment of loans and leases under the 75% Gross Income Test.

1. The Discussion Draft Should Treat a Debt Restructuring as a Non-Recognition Transaction for the Holder of the Debt Instrument

NAREIT believes that redefining "issue price" for "specified debt modifications" as provided for in Proposed Section 1274B would be helpful to REITs and other issuers of publicly traded debt when they need to restructure that debt. NAREIT understands that Proposed Section 1274B is based on a similar proposal in the report entitled "Options for Tax Reform in the Financial Transactions Tax Provisions of the Internal Revenue Code" issued by the Tax Section of the American Bar Association (the "ABA Report").[58] Although the Discussion Draft will help issuers of publicly traded debt avoid COD income from a debt-for-debt exchange, the Discussion Draft does not address the phantom income that is often recognized by holders of non-publicly traded debt as a result of a debt-for-debt exchange. NAREIT encourages the Committee to also include in the Discussion Draft the ABA Report's proposal to treat all debt-for-debt exchanges as non-recognition transactions for federal income tax purposes. NAREIT believes the ABA Report's proposal would eliminate a significant impediment to restructuring of residential and commercial mortgage loans.

As discussed in detail in the ABA Report, under current law the tax consequences for the holders of debt that is modified depend on whether the exchange is treated as a "reorganization" within the meaning of section 368(a). Reorganization status is available only if: 1) the debtor is a corporation; and, 2) the debt qualifies as "security" for purposes of reorganization rules.[59] If the debt-for-debt exchange qualifies as a reorganization, the holder does not recognize gain or loss on the transaction and takes a carryover basis in the exchanged debt. Otherwise, the debt-for-debt exchange causes the holder to recognize gain or loss. If the debt is not publicly traded, then the issue price of the modified debt is based on its principal or imputed principal amount.[60] If the debt was acquired while it was "distressed," the holder's tax basis in the debt may be significantly below the principal amount.

As a result, a holder of non-publicly traded debt that purchased the debt at a discount to its principal amount may recognize phantom income if the debt is restructured and the principal amount is not reduced. Moreover, the amount of phantom income that the holder must recognize is artificially high. Causing the holder of a modified debt to be treated as if it received a new obligation with a deemed value equal to the principal or imputed principal amount typically grossly overstates the value of the new obligation. It is usually the case that the actual fair market

[58] American Bar Association, Section on Taxation, *Options for Tax Reform in the Financial Transactions Tax Provision of the Internal Revenue Code*, Dec. 2, 2011, *available at* 2011 TNT 234-25 [hereinafter *ABA Report*].

[59] I.R.C. § 354(a).

[60] I.R.C. § 1274(a); Treas. Reg. § 1.1274-2(b).

value of the modified debt is far closer to the price the holder paid for the debt instrument rather than its principal or imputed principal amount.

The current treatment of holders of non-publicly traded debt presents a significant impediment to the acquisition and restructuring of residential and commercial mortgage loans by REITs and other investors. Non-recognition treatment is generally not available for debt-for-debt exchanges of mortgage loans. Because residential loans are almost always issued by individuals, a restructuring of a residential mortgage loan will not qualify as a reorganization. Similarly, commercial mortgage debt is often issued by entities treated as partnerships for federal income tax purposes, and commercial mortgage loans often do not qualify as a "security."[61] Thus, the non-recognition treatment accorded to reorganizations is often not available when residential and commercial mortgage loans are restructured.

Under the current rules, there is a tax incentive for the purchaser of distressed mortgage loans to foreclose rather than restructure the debt. We understand that one of the main objectives of Proposed Section 1274B is to eliminate the COD income currently recognized by issuers of publicly traded debt as a result of a debt restructuring. In light of that objective, it seems inconsistent to retain the current tax incentives that encourage foreclosures on distressed mortgage loans and other non-publicly traded debt, which results in the borrower's recognizing either COD income or gain on the sale of the property.

The ABA Report concluded that the "distinctions between corporate and non-corporate debtors and between securities and non-securities are arbitrary, and give rise to divergent tax consequences for no apparent policy reason."[62] NAREIT concurs and encourages the Committee to include in the Discussion Draft the ABA Report's recommendation that all debt-for-debt exchanges should be treated from the holder's perspective as a non-recognition transaction.[63] That proposal would, as the ABA Report stated, "rationalize the tax consequences of similar transactions."[64] NAREIT believes that allowing general non-recognition treatment for debt-for-debt exchanges is the correct treatment from a policy perspective and will encourage the acquisition and restructuring of distressed mortgage loans by REITs and other investors.

The phantom income issues currently faced by holders of non-publicly traded debt would also apply to purchasers of distressed publicly traded debt under Proposed Section 1274B. Under Proposed Section 1274B, the issue price of debt that undergoes a "specified debt modification" would be the lesser of the issue price of the existing debt or the principal amount (or imputed principal amount) of the modified debt.[65] Taxpayers that purchase publicly traded debt would

[61] Rev. Rul. 2004-78, 2004-2 C.B. 108 ("Under case law, an instrument with a term of less than five years generally is not a security.").

[62] *ABA Report* at 19.

[63] *Id.* at 20.

[64] *Id.* at 19.

[65] Proposed Section 1274B(a).

typically have a tax basis significantly below both the issue price of the existing debt and the principal amount (or imputed principal amount) of the modified debt. As a result, under Proposed Section 1274B, a purchaser of distressed publicly traded debt could recognize significant phantom income on a restructuring, unless the restructuring qualifies as a tax-deferred reorganization. Under current law, the issue price of publicly traded debt that is restructured is its fair market value.[66] As a result, purchasers of distressed publicly traded debt typically do not recognize significant phantom income on a debt restructuring.

If enacted in its current form, Proposed Section 1274B would create a new tax incentive for taxpayers to avoid purchasing publicly traded debt that is trading at a discount. In addition, those taxpayers that do purchase publicly traded debt at discount would be incentivized by Proposed Section 1274B to object to any debt restructuring, unless the restructuring qualifies as a reorganization. It does not appear those results are consistent with the Committee's goal of eliminating impediments to debt restructuring.

2. The Discussion Draft Should Encourage REITs to Acquire and Restructure Distressed Mortgage Loans by Conforming the Treatment of Income from Leases and Loans under the 75% Gross Income Test

REITs are also limited in their ability to invest in distressed mortgage loans by the IRS' current position on what portion of the interest income from those loans will be treated as qualifying income for the 75% Gross Income Test. According to current IRS regulations, a significant portion of the interest income on a distressed mortgage loan must be treated as non-qualifying income for the 75% Gross Income Test if there is *any* property other than real property securing the loan.[67]

For example, assume a REIT acquires a mortgage loan with a face amount of $100 for $60. Further assume that, as of the date of acquisition of the mortgage loan, the loan was secured by real property with a value of $55 and personal property of $5. According to the current regulations, 40% of the interest income on that loan is treated as non-qualifying income for the 75% Gross Income Test.[68] However, if the loan was not secured by any property other than real property, then all of the interest income would be qualifying income for the 75% Gross Income Test. The current regulations on treatment of interest income from distressed mortgage loans for

[66] I.R.C. § 1273(b)(3).

[67] Treas. Reg. § 1.856-5(c) (requiring a REIT to treat a portion of the interest on a mortgage loan as bad income for purposes of the 75% gross income test if (1) the loan is secured by real property "and other property" and (2) the principal amount of the loan exceeds the value of the real property securing the loan on the date the REIT acquired the loan); Rev. Proc. 2011-16, 2011-5 I.R.B. 440.

[68] Rev. Proc. 2011-16, Example 2(1).

purposes of the 75% Gross Income Test prevents REITs from being more active investors in distressed mortgage loans.[69]

Under current law, leases and loans that are backed by both real property and other property are treated differently. In the case of rental income, a lease will produce 100% qualifying income for the 75% Gross Income Test so long as no more than 15% of the leased property is treated as personal property.[70] However, under the current regulations, a distressed loan backed by any personal property could produce a significant amount of bad income. NAREIT believes that no valid policy objective is advanced by the disparate treatment of the income from leases and loans under the 75% Gross Income Test.

NAREIT believes that REITs would be able to more fully participate in the market for distressed mortgage loans if the treatment of interest income was conformed to the treatment of rental income. Specifically, NAREIT recommends that section 856 be amended to provide that 100% of the interest income from a mortgage loan would be treated as qualifying income for the 75% Gross Income Test so long as no more than 15% of the security for the loan consists of personal or other non-real estate property. NAREIT anticipates that REITs would be able to acquire and restructure more distressed mortgage loans if the Committee conformed the treatment of income from leases and loans under the 75% Gross Income Test.

* * * *

To provide clarity on NAREIT's suggestions, attached with this letter is a black-lined version of the Discussion Draft showing suggested legislative language that would implement the recommendations discussed above. Please contact me at (202) 739-9408 or tedwards@nareit.com or Dara Bernstein, NAREIT's Senior Tax Counsel, at (202) 739-9446 or dbernstein@nareit.com if you like to discuss this letter in greater detail.

Respectfully submitted,

Tony M. Edwards
Executive Vice President & General Counsel

Attachment

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[69] For a more detailed discussion of NAREIT's concerns with the IRS's position on the treatment of distressed mortgage loans, *see* Letter from Tony M. Edwards, Executive Vice President & General Counsel, NAREIT, to the Honorable Michael Mundaca, Assistant Secretary (Tax Policy), U.S. Department of Treasury, and the Honorable Douglas Shulman, Commissioner, Internal Revenue Service (Feb. 3, 2011), *available at* 2011 TNT 38-21.

[70] I.R.C. § 856(d)(1)(C).

[WAYS AND MEANS DISCUSSION DRAFT]

JANUARY 23, 2013

113TH CONGRESS
1ST SESSION

H. R. ______

To amend the Internal Revenue Code of 1986 to provide for comprehensive income tax reform.

IN THE HOUSE OF REPRESENTATIVES

M__. ______________introduced the following bill, which was referred to the Committee on ______________________

A BILL

To amend the Internal Revenue Code of 1986 to provide for comprehensive income tax reform.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. SHORT TITLE; ETC.

(a) Short Title.—This Act may be cited as the "Tax Reform Act of 2013".

(b) Amendment of 1986 Code.—Except as otherwise expressly provided, whenever in this Act an amendment or repeal is expressed in terms of an amendment to, or repeal of, a section or other provision, the reference shall be considered to be made to a section or other provision of the Internal Revenue Code of 1986.

(c) Table of Contents.—The table of contents of this Act is as follows:

Sec. 1. Short title; etc.

TITLE I—TAX REFORM FOR INDIVIDUALS

Sec. 101. [to be provided].

TITLE II—TAX REFORM FOR BUSINESSES

Sec. 201. [to be provided].

TITLE III—PARTICIPATION EXEMPTION SYSTEM FOR THE TAXATION OF FOREIGN INCOME

Sec. 301. [to be provided].

TITLE IV—OTHER REFORMS

Subtitle A—Financial Instruments

PART 1—DERIVATIVES AND HEDGES

Sec. 401. Treatment of derivatives.
Sec. 402. Treatment of hedges identified for financial accounting purposes.

PART 2—TREATMENT OF DISCOUNT AND PREMIUM

Sec. 411. Determination of issue price in the case of specified debt modifications.
Sec. 412. Deduction for amortizable bond premium allowed in determining adjusted gross income.
Sec. 413. Current inclusion in income of market discount.
Sec. 414. Rules regarding certain government debt.
Sec. 415. Specified debt modifications.
Sec. 416. REIT asset and income test clarification regarding ancillary personal property.

PART 3—CERTAIN RULES FOR DETERMINING GAIN AND LOSS

Sec. 421. Cost basis of specified securities determined in accordance with average basis method.
Sec. 422. Wash sales by related parties.

Subtitle B—[additional Reforms to Be Provided]

TITLE I—TAX REFORM FOR INDIVIDUALS

SEC. 101. [TO BE PROVIDED].

TITLE II—TAX REFORM FOR BUSINESSES

SEC. 201. [TO BE PROVIDED].

TITLE III—PARTICIPATION EXEMPTION SYSTEM FOR THE TAXATION OF FOREIGN INCOME

SEC. 301. [TO BE PROVIDED].

TITLE IV—OTHER REFORMS

Subtitle A—Financial Instruments

PART 1—DERIVATIVES AND HEDGES

SEC. 401. TREATMENT OF DERIVATIVES.

(a) IN GENERAL.—Subchapter E of chapter 1 is amended by adding at the end the following new part:

"PART IV—DERIVATIVES

"Sec. 485. Treatment of derivatives.
"Sec. 486. Derivative defined.

"SEC. 485. TREATMENT OF DERIVATIVES.

"(a) GENERAL RULE.—For purposes of this subtitle—

"(1) any derivative held by a taxpayer at the close of the taxable year shall be treated as sold for its fair market value and the last business day of

such taxable year (and any gain or loss shall be taken into account for the taxable year), and

"(2) proper adjustment shall be made in the amount of any gain or loss subsequently realized for gain or loss taken into account by reason of paragraph (1).

"(b) TREATMENT AS ORDINARY INCOME OR LOSS; ALLOWANCE AS NET OPERATING LOSS.—All items of income, gain, loss, and deduction with respect to such derivative—

"(1) shall be treated as ordinary income or loss, and

"(2) shall be treated for purposes of section 172(d)(4) as attributable to a trade or business of the taxpayer.

"(c) MARK TO MARKET OF ALL POSITIONS IN MIXED STRADDLES.—

"(1) IN GENERAL.—In the case of any straddle which includes any derivative to which subsection (a) applies, subsections (a) and (b) shall apply to all positions in such straddle in the same manner as such subsections apply to such derivative.

"(2) SPECIAL RULES FOR BUILT-IN GAIN POSITIONS.—

"(A) IN GENERAL.—IN the case of any built-in gain position to which paragraph (1) applies—

"(i) in addition to any other time at which such position is treated as sold under subsection (a)(1), such position shall be

treated as sold as provided in subsection (a)(1) at the time that the straddle is established with respect to such position, and

"(ii) subsection (b) shall not apply to any gain taken into account by reason of clause (i).

"(B) BUILT-IN GAIN POSITION.—For purposes of subparagraph (A), the term 'built-in gain position' means any position (other than a derivative to which subsection (a) applies) with respect to which a gain would be realized if such position were sold for its fair market value at the time that the straddle is established with respect to such position.

"(3) SPECIAL RULES FOR BUILT-IN LOSS POSITIONS.—

"(A) IN GENERAL.—In the case of any built-in loss position to which paragraph (1) applies, any gain or loss realized under subsection (a)(1) shall be properly adjusted so as not to take into account the loss referred to in subparagraph (B) with respect to such position.

"(B) BUILT-IN LOSS POSITION.—For purposes of subparagraph (A), the term 'built-in loss position' means any position (other than a derivative to which subsection (a) applies) with respect to which a loss would be realized if such position were sold for its fair market value at the time that the straddle is established with respect to such position.

"(4) SUSPENSION OF HOLDING PERIODS FOR NON-DERIVATIVES.—In the case of any position to which paragraph (1) applies, the holding period of such

position shall not include any period during which such position is part of such straddle.

"(5) STRADDLE.—For purposes of this section—

"(A) the term 'straddle' has the meaning given such term by section 1092(c) applied without regard to paragraph (2)(B) thereof and by treating all offsetting positions as being with respect to personal property, and

"(B) the term 'position' includes any derivative.

"(d) TERMINATIONS, ETC.—

"(1) IN GENERAL.—The rules of subsections (a) and (b) shall also apply to the termination (or transfer) during the taxable year of the taxpayer's obligation (or rights) with respect to a derivative by offsetting, by taking or making delivery, by exercise or being exercised, by assignment or being assigned, by lapse, by expiration, by settlement, or otherwise.

"(2) SPECIAL RULE FOR STRADDLES.—If paragraph (1) applies with respect to any position which is part of a straddle, the rules of subsections (a) and (b) shall apply to every position which is part of such straddle.

"(e) DETERMINATION OF FAIR MARKET VALUE.— For purposes of this section—

"(1) FAIR MARKET VALUE NOT READILY ASCERTAINABLE.—To the extent provided in regulations prescribed by the Secretary, where there is no readily

ascertainable fair market value, fair market value shall be determined under the method used for the purpose of a report or statement—

"(A) to shareholders, partners, or other proprietors, to beneficiaries, or to such other persons as the Secretary may specify in such regulations, or

"(B) for credit purposes.

"(2) TERMINATIONS, ETC..—For purposes of subsection (d), fair market value shall be determined at the time of the termination (or transfer).

"(3) CONVERTIBLE INSTRUMENTS WITH EMBEDDED DERIVATIVE COMPONENTS.—The fair market value of an embedded derivative component (as defined in section 486) shall be the excess of—

"(A) the fair market value of the debt instrument including such component, over

"(B) the fair market value of the debt instrument not including such component.

"(4) BLOCKAGE FACTOR NOT TAKEN INTO ACCOUNT.—To the extent provided in regulations prescribed by the Secretary, fair market value shall be determined without regard to any premium or discount based on the proportion of the total available trading units which are held.

"SEC. 486. DERIVATIVE DEFINED.

"(a) IN GENERAL.—For purposes of this part, except as otherwise provided in this section, the term 'derivative' means—

"(1) ~~any evidence of an interest in (or~~ any derivative financial instrument with respect to~~)~~—

"(A) except as provided in subsection (g), any share of stock in a corporation,

"(B) any partnership or beneficial ownership interest in a partnership or trust,

"(C) except as provided in subsections (e) and (h), any note, bond, debenture, or other evidence of indebtedness,

"(D) except as provided in subsection (e), any real property,

"(E) any commodity which is actively traded (within the meaning of section 1092(d)(1)), or

"(F) any currency,

"(2) any notional principal contact, and

"(3) any derivative financial instrument with respect to any interest or instrument described in paragraph (1) or (2) (or this paragraph).

"(b) DERIVATIVE FINANCIAL INSTRUMENT.—For purposes of this section, the term 'derivative financial instrument' includes any option, forward contract, futures contract, short position, swap, or similar financial instrument.

"(c) NOTIONAL PRINCIPAL CONTRACT.—For purposes of this section—

"(1) IN GENERAL.—Except as otherwise provided by the Secretary, the term 'notional principal contract' means any financial instrument which requires two or more payments at specified intervals calculated by reference to a specified index upon one or more notional principal amounts. An amount shall not fail to be treated as a payment described in the preceding sentence merely because such amount is fixed on one date and paid or otherwise taken into account on a different date.

"(2) SPECIFIED INDEX.—For purposes of this subsection, the term 'specified index' means any one or more of (or any combination of)—

"(A) a rate, price, or amount (whether fixed or variable),

"(B) any index based on any information (including the occurrence or nonoccurrence of any event) which is not within the control of any of the parties to the instrument and is not unique to any of the parties' circumstances, and

"(C) any other index as the Secretary may prescribe.

"(d) DEBT INSTRUMENTS HAVING EMBEDDED DERIVATIVE COMPONENTS.—

"(1) IN GENERAL.—For purposes of this part, the term 'derivative' includes any embedded derivative component.

"(2) EMBEDDED DERIVATIVE COMPONENT.—For purposes of this section—

"(A) IN GENERAL.—The term 'embedded derivative component' means any terms of a debt instrument that affect some or all of the cash flows or the value of other payments required by the instrument in a manner similar to a derivative. Such component and the debt instrument shall be treated as two separate instruments for purposes of this part.

"(B) EXCEPTIONS.—A debt instrument shall not be treated as having an embedded derivative component merely because—

"(i) such debt instrument is denominated in a nonfunctional currency (as defined in section 988(c)(1)(C)(ii)),

"(ii) payments with respect to such debt instrument are determined by reference to the value of a nonfunctional currency (as so defined), ~~or~~

"(iii) such debt instrument is a contingent payment debt instrument, variable rate debt instrument, or a debt instrument with alternative payment schedules~~.~~, or

"(iv) the borrower under such debt instrument has the right to prepay, in whole or in part, principal prior to the scheduled payment dates set by the terms of the debt instrument.

"(e) EXCEPTION FOR CERTAIN REAL PROPERTY.—

"(1) IN GENERAL.—An interest or instrument shall not be treated as described in ~~subsection~~subsections (a)(1)(C) or (D) if~~—~~ ~~"(A)~~ such interest or instrument is with respect to ~~a tract of~~real property, interests in mortgages on real property (~~as defined in section 1237(c)), or~~including interests in mortgages on leaseholds of land or improvements thereon), or interests in a REMIC.

"(2) DEFINITIONS.—For purposes of this subsection,

~~"(B) such interest or instrument is with respect to only real property which would be inventory in the hands of the taxpayer if held directly by the taxpayer.~~

~~"(2) REGULATIONS.—The Secretary shall prescribe regulations or other guidance under which multiple tracts of real property may be treated as a single tract of real property for purposes of paragraph (1)(A) if the interest or instrument is of a type which is designed to facilitate the acquisition or disposition of such real property.~~

(A) The term "real property" means land or improvements thereon, such as buildings or other inherently permanent structures thereon (including items which are structural components of such buildings or structures and manufactured housing treated as a single family residence under section 25(e)(10)). In addition, the term "real property" includes interests in real property. Local law definitions will not be controlling for purposes of determining the meaning of the term "real property" as used in

section 485. The term includes, for example, the wiring in a building, plumbing systems, central heating, or central air-conditioning machinery, pipes or ducts, elevators or escalators installed in the building, or other items which are structural components of a building or other permanent structure. The term does not include assets accessory to the operation of a business, such as machinery, printing press, transportation equipment which is not a structural component of the building, office equipment, refrigerators, individual air-conditioning units, grocery counters, furnishings of a motel, hotel, or office building, etc., even though such items may be termed fixtures under local law.

(B) The term "interests in real property" includes fee ownership and co-ownership of land or improvements thereon, leaseholds of land or improvements thereon, contracts or options to acquire land or improvements thereon, and contracts or options to acquire leaseholds of land or improvements thereon. The term also includes timeshare interests that represent an undivided fractional fee interest, or undivided leasehold interest, in real property, and that entitle the holders of the interests to the use and enjoyment of the property for a specified period of time each year. The term also includes stock held by a person as a tenant-stockholder in a cooperative housing corporation (as those terms are defined in section 216). Such term does not, however, include mineral, oil, or gas royalty interests, such as a

retained economic interest in coal or iron ore with respect to which the special provisions of section 681(c) apply.

"(f) EXCEPTION FOR HEDGING TRANSACTIONS.—

"(1) IN GENERAL.—Section 485 shall not apply to any financial instrument or other contract which is part of a hedging transaction (as defined in section 1221(c)).

"(2) SECTION 988 HEDGING TRANSACTIONS.— For exception for section 988 hedging transactions, see section 988(d)(1).".

"(g) EXCEPTION FOR CERTAIN EXCHANGEABLE INTERESTS IN A PARTNERSHIP. — Section 485 shall not apply to any partnership interest in a partnership merely because, pursuant to the terms of the partnership agreement, such partnership interest may be exchangeable, as a result of an election by someone other the owner of the partnership interest, for (i) stock of a real estate investment trust to which part II of subchapter M applies that owns a partnership interest in the partnership or (ii) an amount of cash equal to value of that stock.

"(h) EXCEPTION FOR GOVERNMENT SECURITIES.— An interest or instrument shall not be treated as described in subsection (a)(1)(C) if such interest or instrument is with respect to any security issued or guaranteed as to principal or interest by the United States, or by a person controlled or supervised by and acting as an instrumentality of the Government of the United States

pursuant to any authority granted by the Congress of the United States, or any certificate of deposit for any of the foregoing.".

(b) COORDINATION WITH RULES FOR DEALERS AND TRADERS.—

(1) DERIVATIVES NOT TREATED AS SECURITIES.—Section 475(c)(2) is amended—

(A) by adding "and" at the end of subparagraph (C),

(B) by striking subparagraphs (D) and (E) and by redesignating subparagraph (F) as subparagraph (D),

(C) by striking "subparagraph (A), (B), (C), (D), or (E)" in subparagraph (D)(i), as so redesignated, and inserting "subparagraph (A), (B), or (C)", and

(D) by amending the last sentence to read as follows: "Such term shall not include any position to which section 485(a) applies."

(2) DERIVATIVES NOT TREATED AS COMMODITIES.—Section 475(e)(2) is amended—

(A) by adding "and" at the end of subparagraph (A),

(B) by striking subparagraphs (B) and (C) and by redesignating subparagraph (D) as subparagraph (B), and

(C) by striking "subparagraph (A), (B) or (C)" in subparagraph (B)(i), as so redesignated, and inserting "subparagraph (A)".

(3) CONFORMING AMENDMENTS.—

(A) Section 475(b) is amended by striking paragraph (4).

(B) Section 475(d)(2)(B) is amended—

(i) by striking "subsection (c)(2)(F)(iii)" and inserting "subsection (c)(2)(D)(iii)", and

(ii) by striking "subsection (c)(2)(F)" and inserting "subsection (c)(2)(D)".

(C) Section 475(f)(1)(D) is amended by striking "subsections (b)(4) and (d)" and inserting "subsection (d)".

(c) COORDINATION WITH STRADDLE RULES.—

(1) IN GENERAL.—Section 1092(e) is amended to read as follows:

"(e) EXCEPTION FOR HEDGING TRANSACTIONS AND STRADDLES WITH DERIVATIVES.—This section shall not apply in the case of—

"(1) any hedging transaction (as defined in section 1221(c)), and

"(2) any straddle (as defined in section 485) which includes any derivative (as defined in section 486).".

(2) CONFORMING AMENDMENTS.—

(A) Section 263(g)(3) is amended to read as follows:

"(3) EXCEPTION FOR HEDGING TRANSACTIONS AND STRADDLES WITH DERIVATIVES.—This subsection shall not apply in the case of—

"(A) any hedging transaction (as defined in section 1221(c)), and

"(B) any straddle (as defined in section 485) which includes any derivative (as defined in section 486).".

(B) Section 1092(b) is amended—

(i) by striking paragraph (2), and

(ii) by striking all that precedes "The Secretary shall" and inserting the following:

"(b) REGULATIONS.—The Secretary shall".

(C) Section 1092(c) is amended by striking paragraph (4).

(D) Section 1092 is amended by striking subsection (f).

(d) COORDINATION WITH REIT EXCESS NONCASH INCOME RULES.—

(1) IN GENERAL.—Section 857(e)(2) is amended by striking "and" from subsection (C) and replacing the "." at the end of (D) with "," and inserting the following:

"(E) the amounts includible in gross income under section 485, and

"(F) the amounts includible in gross income under section 1278.".[71]

".

(de) REPEAL OF CERTAIN OTHER SUPERCEDED RULES FOR DETERMINING CAPITAL GAINS AND LOSSES.—

[71] Note this language would apply if the Committee did not accept NAREIT's suggestion to allow REITs to retain the flexibility under current law to elect whether to include market discount into income on a current basis. NAREIT would be happy to work with Legislative Counsel to develop legislative language implementing that recommendation.

(1) IN GENERAL.—Part IV of subchapter P of chapter 1 is amended by striking sections 1234B, 1236, 1256, and (and by striking the items relating to such sections in the table of sections for such part).

(2) CONFORMING AMENDMENTS RELATED TO REPEAL OF SECTION 1236.—

(A) Section 475(d)(3)(A) is amended by striking "or section 1236(b)".

(B) Section 512(b)(5) is amended by striking "section 1236(c)" and inserting "section 1058(c)".

(C) Section 1058 is amended—

(i) by striking "(as defined in section 1236(c))" in subsection (a), and

(ii) by redesignating subsection (c) as subsection (d) and by inserting after subsection (b) the following new subsection:

"(c) SECURITIES.—For purposes of this section, the term 'security' means any share of stock in any corporation, certificate of stock or interest in any corporation, evidence of an interest in or right to subscribe to or purchase any of the foregoing.".

(3) CONFORMING AMENDMENTS RELATED TO REPEAL OF SECTION 1256.—

(A) Section 461(i)(3)(B) is amended to read as follows:

"(B) any partnership or other entity (other than a corporation which is not an S corporation) if more than 35 percent of the losses of

such entity during the taxable year are allocable to limited partners or limited entrepreneurs (within the meaning of section 464(e)(2)), and".

(B) Section 475(d)(1) is amended by striking "sections 263(g), 263A, and 1256(a)" and inserting "sections 263(g) and 263A".

(C) Section 988(c)(1) is amended by striking subparagraphs (D) and (E).

(D) Section 1092(a)(3)(C)(ii)(II) is amended by striking "section 1256(e)" and inserting "section 1221(c)".

(E) Section 1092(d) is amended by striking paragraphs (5) and (6) and by redesignating paragraphs (7) and (8) as paragraphs (5) and (6), respectively.

(F) Section 1212 is amended by striking subsection (c).

(G) Section 1223 is amended by striking paragraphs (7) and (14).

(H) Section 1258(d)(5) is amended—

(i) by striking "section 1256 contracts" in subparagraph (A)(ii) and inserting "commodity futures contracts", and

(ii) by inserting "as in effect before its repeal" after "section 1256(g)(8)" in subparagraph (B)(i).

(I) Section 1281(b)(1)(E) is amended to read as follows:

"(E) is a hedging transaction (as defined in section 1221(c)), or".

(J) Section 1402 is amended by striking subsection (i).

(K) Section 4982(e)(6)(B) is amended by striking "sections 1256 and 1296" and inserting "sections 485 and 1296".

(ef) OTHER CONFORMING AMENDMENTS.—

(1) Section 856(n)(4) is amended by inserting "or derivatives (as defined in section 486)" after "securities (as defined in section 475(c)(2))".

(2) Section 988(d)(1) is amended—

(A) by striking "or 1256" and inserting "or 485", and

(B) by striking "1092, and 1256" and inserting "485, and 1092".

(3) Section 1091(e) is amended to read as follows:

"(e) COORDINATION WITH MARK-TO-MARKET OF DERIVATIVES.—Notwithstanding any other provision of this section, a derivative (as defined in section 486) shall not be treated as a security for purposes of this section.".

(4)(A) Section 1221(a)(6) is amended to read as follows:

"(6) any derivative (as defined in section486),".

(B) Section 1221(b) is amended by striking paragraph (1).

(5) Section 4975(f)(11)(D) is amended by striking clauses (i) and (ii) and inserting the following:

"(i) SECURITY.—The term 'security' means any security described in section 475(c)(2) (without regard to subparagraph (D)(iii) thereof) and any derivative with respect to such a security (within the meaning of section 486).

"(ii) COMMODITY.—The term 'commodity' means any commodity described in section 475(e)(2) (without regard to subparagraph (B)(iii) thereof) and any derivative with respect to such a commodity (within the meaning of section 486).".

(6) The table of parts for subchapter E of chapter 1 is amended by adding at the end the following new item:

PART IV. DERIVATIVES.

(~~f~~g) EFFECTIVE DATE.—The amendments made by this section shall apply to property acquired and positions established after December 31, 2013.

Sec. 402. TREATMENT OF HEDGES IDENTIFIED FOR FINANCIAL ACCOUNTING PURPOSES

(a) IN GENERAL.—Section 1221 is amended by adding at the end the following new subsection:

"(c) HEDGING TRANSACTION.—For purposes of this section—

"(1) IN GENERAL.—The term 'hedging transaction' means any transaction described in paragraph (2) and identified under paragraph (3).

"(2) TRANSACTION DESCRIBED.—A transaction is described in this paragraph if such transaction is entered into by the taxpayer in the normal course of the taxpayer's trade or business primarily—

"(A) to manage risk of price changes or currency fluctuations with respect to ordinary property which is held or to be held by the taxpayer,

"(B) to manage risk of interest rate or price changes or currency fluctuations with respect to borrowings made or to be made, or ordinary obligations incurred or to be incurred, by the taxpayer, or

"(C) to manage such other risks as the Secretary may prescribe in regulations.

"(3) IDENTIFICATION.—A transaction is identified under this paragraph if—

"(A) such transaction is clearly identified as a hedging transaction for purposes of this paragraph before the close of the day on which it was acquired, originated, or entered into (or such other time as the Secretary may by regulations prescribe), or

"(B) such transaction is treated as a hedging transaction (within the meaning of generally accepted accounting principles) for purposes of an audited financial statement of the taxpayer which—

"(i) is certified as being prepared in accordance with generally accepted accounting principles, and

"(ii) is used for the purposes of a statement or report—

"(I) to shareholders, partners, or other proprietors, or to beneficiaries, or

"(II) for credit purposes.

"(4) TREATMENT OF NONIDENTIFICATION OR IMPROPER IDENTIFICATION OF HEDGING TRANSACTIONS.—The Secretary shall prescribe regulations to properly characterize any income, gain, expense, or loss arising from a transaction—

"(A) which would be a hedging transaction if identified under paragraph (3), or

"(B) which is identified under paragraph (3) but is not a transaction described in paragraph (2).

In the case of a transaction identified under paragraph (3) solely by reason of paragraph (3)(B), subparagraph (B) of this paragraph shall not apply with respect to such transaction unless the taxpayer treats such transaction as a hedging transaction for purposes of any provision of this title.".

(b) CONFORMING AMENDMENTS.—

(1) Section 856(c)(5)(G)(i) is amended by striking "(as defined in clause (ii) or (iii) of section 1221(b)(2)(A)) which is clearly identified pursuant to section 1221(a)(7)" and inserting "(as defined in section 1221(c) (determined without regard to paragraph (2)(A) thereof)".

(2) Section 954(c)(5)(A) is amended by striking "if such transaction—" and all that follows and inserting the following: "if such transaction is a hedging transaction (as defined in section 1221(c)), determined—

"(i) without regard to paragraph (1)(B) thereof,

"(ii) by applying paragraph (1)(A) thereof by substituting 'ordinary property or property described in section 1231(b)' for 'ordinary property', and

"(iii) by substituting 'controlled foreign corporation' for 'taxpayer' each place it appears.".

(3) Section 1221(a)(7) is amended by striking "which is clearly" and all that follows through "regulations prescribe)".

(4)(A) Section 1221(b), as amended by this Act, is amended by striking paragraph (2) and by redesignating paragraphs (3) and (4) as paragraphs (1) and (2), respectively.

(B) Section 170(e)(1)(A) is amended by striking "section 1221(b)(3)" and inserting "section 1221(b)(1)".

(c) EFFECTIVE DATE.—The amendments made by this section shall apply to transactions entered into after December 31, 2013.

PART 2—TREATMENT OF DISCOUNT AND PREMIUM

SEC. 411. DETERMINATION OF ISSUE PRICE IN THE CASE OF SPECIFIED DEBT MODIFICATIONS.

(a) IN GENERAL.—Subpart A of part V of subchapter P is amended by inserting after section 1274A the following new section:

"SEC. 1274B. DETERMINATION OF ISSUE PRICE IN THE CASE OF SPECIFIED DEBT MODIFICATIONS.

"(a) IN GENERAL.—In the case of any specified debt modification, for purposes of this subpart, the issue price of the modified debt instrument (whether by exchange or significant modification) shall be the lesser of—

"(1) the adjusted issue price of the existing

"(2) the issue price of such modified debt instrument which would be determined under section 1274 if such modified debt instrument were a debt instrument to which such section applied.

"(b) ADJUSTED ISSUE PRICE.—

"(1) IN GENERAL.—For purposes of subsection (a)(1), the adjusted issue price of the existing debt instrument is its issue price, increased by the portion of any original issue discount previously includible in the gross income of any holder (without regard to subsection (a)(7) or (b)(4) of section 1272 (or the corresponding provisions of prior law)).

"(2) SPECIAL RULE FOR APPLYING SECTION 163(e).—For purposes of section 163(e), the adjusted issue price of the existing debt instrument is its issue price, increased by any original issue discount previously allowed as a deduction.

"(c) SPECIFIED DEBT MODIFICATION.—For purposes of this section, the term 'specified debt modification'

means—

"(1) the exchange by an issuer of a new debt instrument for an existing debt instrument issued by such issuer, and

"(2) the significant modification of an existing of an existing debt instrument which is accomplished by the issuer and holder indirectly through one or more transactions with unrelated parties.".

(b) CONFORMING AMENDMENTS.—

(1) Section 108(e)(10)(B) is amended by striking "and 1274" and inserting ", 1274, and 1274B".

(2) Section 1274(c)(3) is amended by adding at the end the following new subparagraph:

"(G) CERTAIN MODIFIED DEBT.—Any debt instrument the issue price of which is determined under section 1274B.".

(3) The table of sections for subpart A of part V of subchapter P is amended by inserting after the item relating to section 1274A the following new item:

"Sec. 1274B. Determination of issue price in the case of specified debt modifications.".

(c) EFFECTIVE DATE.—The amendments made by this section shall apply to transactions after December 31, 2013.

SEC. 412. DEDUCTION FOR AMORTIZABLE BOND PREMIUM ALLOWED IN DETERMINING ADJUSTED GROSS INCOME.

(a) IN GENERAL.—Subsection (a) of section 62 is amended by inserting after paragraph (7) the following new paragraph:

"(8) AMORTIZABLE BOND PREMIUM.—The deduction allowed under section 171(a)(1).".

(b) EFFECTIVE DATE.—The amendments made by this section shall apply to taxable years beginning after December 31, 2013.

SEC. 413. CURRENT INCLUSION IN INCOME OF MARKET DISCOUNT.

(a) IN GENERAL.—Subpart B of part V of sub-chapter P of chapter 1 is amended by redesignating section 1278 as section 1279 and by inserting after section 1277 the following new section:

"SEC. 1278. CURRENT INCLUSION IN INCOME OF MARKET DISCOUNT ON BONDS ACQUIRED AFTER 2013.

"(a) IN GENERAL.—There shall be included in the gross income of the holder of any market discount bond acquired after December 31, 2013, an amount equal to the sum of the daily portions of the market discount for each day during the taxable year on which such holder held such bond.

"(b) DETERMINATION OF DAILY PORTIONS.—

"(1) IN GENERAL.—For purposes of subsection (a), the daily portion of the market discount on any market discount bond shall be the daily portion which would be determined under section 1272(a)(3)

"(A) originally issued on the date on which such bond was acquired by the taxpayer,

"(B) for an issue price equal to the basis of such bond immediately after such acquisition.

"(2) LIMITATION ON DAILY PORTION.—The daily portion determined under paragraph (1) shall not exceed the amount that would be so determined if the amount under subparagraph (B) thereof was the imputed principal amount determined under section 1274(b) by using a discount rate equal to the greater of—

"(A) such bonds's yield to maturity (determined as of the date of the issuance of such bond) plus 5 percentage points, or

"(B) the applicable Federal rate for such bond (determined under section 1274(d) as of the date of the acquisition of such bond) plus 10 percentage points.

"(3) REDUCTION FOR ORIGINAL ISSUE DISCOUNT.—Each daily portion determined under paragraph (1) (after the application of paragraph (2)) shall be reduced by the daily portion of the original issue discount determined

under section 1272(a) with respect to such bond for the day involved (or, in the case of any bond to which section 1272(a) does not apply, the daily portion of the original issue discount which would be so determined if section 1272(a) applied to such bond).

"(c) SPECIAL RULES.—

"(1) ACCRUALS TREATED AS INTEREST.—Except for purposes of sections 103, 871(a), 881, 1441, 1442, and 6049 (and such other provisions as may be specified in regulations), any amount included in gross income under this section shall be treated as interest for purposes of this title.

"(2) BASIS ADJUSTMENT.—The basis of any market discount bond in the hands of the taxpayer shall be increased by the amount included in gross income pursuant to this section.

"(d) EXCEPTION FOR CERTAIN DEBT INSTRUMENTS SUBJECT TO RATABLE INCLUSION.—This section shall not apply to any debt instrument to which section 1272(b) applies.".

(b) CURRENT INCLUSION OF MARKET DISCOUNT ON SHORT-TERM NONGOVERNMENTAL BONDS.—Section 1283 is amended by striking subsection (c).

(c) COORDINATION WITH RULES RELATED TO TREATING MARKET DISCOUNT AS ORDINARY INCOME UPON DISPOSITION.—

(1) IN GENERAL.—Section 1276 is amended by adding at the end the following new subsection:

"(e) COORDINATION WITH RULES FOR CURRENT INCLUSION OF MARKET DISCOUNT.—This section shall not apply to any market discount bond to which section 1278 applies.".

(2) DEFERRAL OF INTEREST DEDUCTION.— Section 1277 is amended by adding at the end the following new subsection:

"(d) COORDINATION WITH RULES FOR CURRENT INCLUSION OF MARKET DISCOUNT.—This section shall not apply to any market discount bond to which section 1278 applies.".

(3) ELECTION TO INCLUDE MARKET DISCOUNT CURRENTLY.—Section 1279(b), as redesignated by subsection (a), is amended by adding at the end the following new paragraph:

"(5) COORDINATION WITH RULES FOR CURRENT INCLUSION OF MARKET DISCOUNT.—This subsection shall not apply to any market discount bond to which section 1278 applies.".

(d) TREATMENT OF CERTAIN BONDS HELD BY PARTNERSHIPS.—Section 1279(a), as redesignated by subsection (a), is amended by adding at the end the following new paragraph:

"(6) TRANSFERS OF PARTNERSHIP INTERESTS.—In the case of a transfer described in section 743 of an interest in a partnership holding a bond, the partnership shall be treated as acquiring the transferee partner's proportionate share of such bond at the time of such transfer.".

e) BROKER REPORTING OF INCLUDIBLE DISCOUNT ON BONDS.—

(1) IN GENERAL.—Section 6045 is amended by adding at the end the following new subsection:

"(i) DISCOUNT ON BONDS.—

"(1) IN GENERAL.—If any customer of a broker holds a covered bond in an account with such broker at any time during a calendar year—

"(A) such broker shall file a return under subsection (a) for such calendar year, and

"(B) such return shall include with respect to each such covered bond—

"(i) the amount (if any) includible in the gross income of such customer as original issue discount with respect to such bond under section 1272 for periods during such calendar year, and.

"(ii) the amount (if any) includible in the gross income of such customer as market discount with respect to such bond under section 1278(a) for periods during such calendar year.

"(2) COVERED BOND.—For purposes of this subsection, the term 'covered bond' means any obligation to which section 1272 or 1278(a) applies if such obligation—

"(A) was acquired after December 31, 2013, through a transaction in the account in which such obligation is held, or

"(B) was transferred to such account from an account in which such obligation was a covered bond, but only if the broker received a statement under section 6045A with respect to the transfer.

"(3) STATEMENTS TO CUSTOMERS.—The requirements of subsections (b) shall apply with respect to any return filed under subsection (a) by reason of this subsection.".

(2) Information Required In Connection With Transfers Of Covered Bonds To Brokers.—Subsection (a) of section 6045A is amended—

(A) by inserting "or a covered bond (as defined in section 6045(i)(2))" after "covered security (as defined in section 6045(g)(3))", and

(B) by striking "section 6045(g)" and inserting "subsections (g) and (i) of section 6045".

(3) COORDINATION WITH REPORTING BY ISSUER OF ORIGINAL ISSUE DISCOUNT.—Paragraph (6) of section 6049(d) is amended by adding at the end the following new subparagraph:

"(C) PREVENTION OF DOUBLE REPORTING.—Except as otherwise provided by the Secretary, original issue discount with respect to any obligation shall not be required to be reported under this section if such

original issue discount is required to be reported with respect to such obligation under section 6045(i).".

(f) CONFORMING AMENDMENTS.—

(1) Section 751(c)(2) is amended by striking "section 1278" in the matter following paragraph (2) and inserting "section 1279".

(2) Section 1042(d) is amended by striking "section 1278(a)(2)(A)(ii)" in the matter following paragraph (2) and inserting "section 1279(a)(2)(A)(ii)".

(3) Section 1276 is amended by inserting "ON BONDS NOT SUBJECT TO CURRENT INCLUSION" after "ACCRUED MARKET DISCOUNT" in the heading thereof.

(4) Section 1277 is amended by inserting "ON BONDS NOT SUBJECT TO CURRENT INCLUSION" after "ACCRUED MARKET DISCOUNT" in the heading thereof.

(5) Section 1281 is amended by striking subsection (c).

(6) The table of sections for subpart B of part V of subchapter P of chapter 1 is amended to read as follows:

"Sec. 1276. Disposition gain representing accrued market discount on bonds not subject to current inclusion treated as ordinary income.
"Sec. 1277. Deferral of interest deduction allocable to accrued market discount on bonds not subject to current inclusion.
"Sec. 1278. Current inclusion in income of market discount on bonds acquired after 2013.
"Sec. 1279. Definitions and special rules.".

(g) EFFECTIVE DATE.—The amendments made by this section shall apply to obligations acquired after December 31, 2013.

SEC. 414. RULES REGARDING CERTAIN GOVERNMENT DEBT.

(a) REPEAL OF CERTAIN SUPERCEDED RULES.—

(1) IN GENERAL.—Subpart B of part II of subchapter E of chapter 1 is amended by striking section 454 (and by striking the item relating to such section in the table of sections for such subpart).

(2) PRESERVATION OF RULES RELATED TO UNITED STATES SAVINGS BONDS.—

(A) IN GENERAL.—Subpart A of part V of subchapter P of chapter 1 is amended by inserting after section 1272 the following new section:

"SEC. 1272A. UNITED STATES SAVINGS BONDS.

"(a) ELECTION TO INCLUDE INCREASE IN REDEMPTION PRICE IN INCOME.—A taxpayer holding a United States savings bond may elect to treat any increase in the redemption price as income received in the taxable year. If any such election is made with respect to any such obligation, it shall apply also to all such obligations owned by the taxpayer at the beginning of the first taxable year to which it applies and to all such obligations thereafter acquired by the taxpayer and shall be binding for all subsequent taxable years, unless on application by the taxpayer the Secretary permits the taxpayer, subject to such conditions as the Secretary deems necessary, to change to a different method. In the case of any such obligations owned by the taxpayer at the beginning of the first taxable year to which his election applies, the increase in the redemption price of such obligations occurring between the date of

acquisition and the first day of such taxable year shall also be treated as income received in such taxable year.

"(b) TREATMENT UPON REDEMPTION OR FINAL MATURITY.—The increase in redemption value of a United States savings bond (to the extent not previously included in gross income) in excess of the adjusted basis of such bond shall be included in gross income in the earlier of the taxable year in which the bond is redeemed or in the taxable year of final maturity.

"(c) CROSS REFERENCES.—

"(1) For treatment of United States savings bonds redeemed to pay qualified higher education expenses, see section 135.

"(2) For exception from current inclusion of original issue discount, see section 1272(a)(2)(B).

"(3) For exception from market discount rules, see section 1279(a)(1)(B)(iii).".

(B) CLERICAL AMENDMENT.—The table of sections for subpart A of part V of subchapter P of chapter 1 is amended by inserting after the item relating to section 1272 the following new item:

"Sec. 1272A. United States savings bonds.".

(3) CONFORMING AMENDMENTS.—

(A) Section 852(b)(2) is amended by striking subparagraph (F) and redesignating subparagraph (G) as subparagraph (F).

(B) Section 1283(d)(3) is amended by striking "Section 454(b) and paragraphs" and inserting "Paragraphs".

(C) Section 7871(a)(6) is amended by adding "and" at the end of subparagraph (A) and by striking subparagraph (C).

(4) EFFECTIVE DATE.—The amendments made by this subsection shall take effect on the date of the enactment of this Act.

(b) REPEAL OF SPECIAL RULE FOR EXCHANGES OF UNITED STATES OBLIGATIONS.—

(1) IN GENERAL.—Part III of subchapter O of chapter 1 is amended by striking section 1037 (and by striking the item relating to such section in the table of sections for such part).

(2) CONFORMING AMENDMENTS.—

(A) Subsections (b) and (c) of section 1031 are each amended by striking "of section 1036(a), or of section 1037(a)" and inserting "or of section 1036(a)".

(B) Section 1031(d) is amended by striking "section 1036(a), or section 1037(a)" both places it appears and inserting "or section" 1036(a)".

(3) EFFECTIVE DATE.—The amendments made by this subsection shall apply to exchanges after December 31, 2013.

SEC. 415. SPECIFIED DEBT MODIFICATIONS.

(a) IN GENERAL. —Part III of subchapter O is amended by inserting after section 1045 the following new section:

"SEC. 1046. SPECIFIED DEBT MODIFICATIONS.

"(a) The holder of a debt instrument shall not recognize gain or loss as a result of a specified debt modification (as defined in section 1278B).".

(b) EFFECTIVE DATE.—The amendment made by this subsection shall apply any specified debt modification occurring after the date of the enactment of this Act.

SEC. 416. REIT ASSET AND INCOME TEST CLARIFICATION REGARDING ANCILLARY PERSONAL PROPERTY.

(a) IN GENERAL.—Subsection (c) of section 856 is amended by adding at the end the following new paragraph:

"(9) SPECIAL RULES FOR CERTAIN PERSONAL PROPERTY WHICH IS ANCILLARY TO REAL PROPERTY.—

"(A) CERTAIN PERSONAL PROPERTY LEASED IN CONNECTION WITH REAL PROPERTY.—Personal property shall be treated as a real estate asset for purposes of paragraph (4)(A) to the extent that rents attributable to such personal property are treated as rents from real property under subsection (d)(1)(C).

"(B) CERTAIN PERSONAL PROPERTY MORTGAGED IN CONNECTION WITH REAL PROPERTY.—In the case of an obligation

secured by a mortgage on both real property and personal property, if the fair market value of such personal property does not exceed 15 percent of the total fair market value of all such property, such personal property shall be treated as real property for purposes of applying paragraphs (3)(B) and (4)(A). For purposes of the preceding sentence, the fair market value of all such property shall be determined in the same manner as the fair market value of real property is determined for purposes of apportioning interest income between real property and personal property under paragraph (3)(B).".

(b) EFFECTIVE DATE.—The amendments made by this section shall apply to taxable years beginning after the date of the enactment of this Act.

PART 3—CERTAIN RULES FOR DETERMINING GAIN AND LOSS

SEC. 421. COST BASIS OF SPECIFIED SECURITIES DETERMINED IN ACCORDANCE WITH AVERAGE BASIS METHOD.

(a) IN GENERAL.—Subsection (d) of section 1012 is amended to read as follows:

"(d) COST BASIS OF SPECIFIED SECURITIES DETERMINED IN ACCORDANCE WITH AVERAGE BASIS METHOD.—

"(1) IN GENERAL.—In the case of the sale, exchange, or other disposition of a specified security on or after January 1, 2014, the cost of such security

shall be determined under this section in accordance with the average basis method.

"(2) TRANSITIONAL RULE FOR DETERMINING AVERAGE BASIS.—Any specified security which is acquired before January 1, 2014, shall be treated as a separate account from any such security which is acquired on or after such date.

"(3) SPECIAL RULE FOR CERTAIN SECURITIES.—In the case of any specified security with respect to which the applicable date is after January 1, 2014, this subsection shall be applied by substituting 'the applicable date' for 'January 1, 2014' each place it appears.".

(b) CONFORMING AMENDMENTS.—

(1) Section 1012(c)(1) is amended by striking "the conventions prescribed by regulations under this section" and inserting "the method applicable for determining the cost of such security".

(2) Section 1012(c)(2)(A) is amended by striking "section 1012" and inserting "this section (as in effect prior to the enactment of the Tax Reform Act of 2013)".

(3) Section 6045(g)(2)(B)(i) is amended by striking "shall be determined—" and all that follows and inserting "shall be determined in accordance with the average basis method.".

(c) EFFECTIVE DATE.—The amendments made by this section shall apply to sales, exchanges, and other dispositions after December 31, 2013.

SEC. 422. WASH SALES BY RELATED PARTIES.

(a) APPLICATION OF WASH SALE RULES TO RELATED PARTIES.— Subsection (a) of section 1091 is amended by striking "the taxpayer has acquired" and inserting "the taxpayer (or a related party) has acquired".

(b) DISALLOWANCE OF LOSS FROM WASH SALES INVOLVING RELATED PARTIES.— Subsection (d) of section 1091 is amended by adding at the end the following: "The preceding sentence shall not apply with respect to any acquisition by a related party (other than the taxpayer's spouse)."

(c) RELATED PARTY.—Section 1091 is amended by adding at the end the following new subsection:

"(g) RELATED PARTY.—For purposes of this section—

"(1) IN GENERAL.—The term 'related party'

means—

"(A) the taxpayer's spouse,

"(B) any dependent of the taxpayer and any other taxpayer with respect to whom the taxpayer is a dependent,

"(C) any individual, corporation, partnership, trust, or estate which controls, or is controlled by, (within the meaning of section

954(d)(3)) the taxpayer or any individual described in subparagraph (A) or (B) with respect to the taxpayer (or any combination thereof),

"(D) any individual retirement plan, Archer MSA (as defined in section 220(d)), or health savings account (as defined in section 223(d)), of the taxpayer or of any individual described in subparagraph (A) or (B) with respect to the taxpayer,

"(E) any account under a qualified tuition program described in section 529 or a Coverdell education savings account (as defined in section 530(b)) if the taxpayer, or any individual described in subparagraph (A) or (B) with respect to the taxpayer, is the designated beneficiary of such account or has the right to make any decision with respect to the investment of any amount in such account, and

"(F) any account under—

"(i) a plan described in section 401(a),

"(ii) an annuity plan described in section 403(a),

"(iii) an annuity contract described in section 403(b), or

"(iv) an eligible deferred compensation plan described in section 457(b) and maintained by an employer described in section 457(e)(1)(A),

if the taxpayer or any individual described in subparagraph (A) or (B) with respect to the taxpayer has the right to make any decision with respect to the investment of any amount in such account .

"(2) RULES FOR DETERMINING STATUS.—

"(A) RELATIONSHIPS DETERMINED AT TIME OF ACQUISITION.—Determinations under paragraph (1) shall be made as of the time of the purchase or exchange referred to in subsection (a) except that determinations under subparagraphs (A) and (B) of paragraph (1) shall be made for the taxable year which includes such purchase or exchange.

"(B) DETERMINATION OF MARITAL STATUS.—

"(i) IN GENERAL.—Except as provided in clause (ii), marital status shall be determined under section 7703.

"(ii) SPECIAL RULE FOR MARRIED INDIVIDUALS FILING SEPARATELY AND LIVING APART.—A husband and wife who—

"(I) file separate returns for any taxable year, and

"(II) live apart at all times during such taxable year,

shall not be treated as married individuals.

"(3) REGULATIONS.—The Secretary shall issue such regulations or other guidance as may be necessary to prevent the avoidance of the purposes of this subsection, including regulations which treat persons as related parties if

such persons are formed or availed of to avoid the purposes of this subsection.”.

(d) EFFECTIVE DATE.—The amendments made by this section shall apply to sales and other dispositions after December 31, 2013.

Subtitle B—[Additional Reforms to Be Provided]