NATIONAL ASSOCIATION OF REAL ESTATE INVESTMENT TRUSTS®

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REITS: BUILDING DIVIDENDS AND DIVERSIFICATION®

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Dear Laurie and Viva:

The National Association of Real Estate Investment Trusts (NAREIT)[1] welcomes the opportunity to provide comments on H.R. 1, *The Tax Reform Act of 2014* (based on the discussion draft proposal, released on February 26, 2014) with respect to provisions to reform the taxation of financial products (the 2014 TRA).[2] NAREIT previously submitted comments on April 25, 2013 (the Initial Comments) regarding the initial financial products discussion draft released by former Ways and Means Committee Chair Dave Camp on January 23, 2013 (the Initial Discussion Draft). [3] A copy of the Initial Comments is attached.

Many of the concerns NAREIT expressed regarding the Initial Discussion Draft were addressed in the 2014 TRA. However, NAREIT continues to believe that aspects of the proposal to require mark-to-market accounting for derivatives and current inclusion of income on market discount bonds, if enacted, would unintentionally present problems for REITs and other investors in real estate and mortgage-related securities.

NAREIT looks forward to working with Congress on these issues.

EXECUTIVE SUMMARY

NAREIT believes that the 2014 TRA's proposal to mark-to-market "derivatives" continues to be too broad and would apply mark-to-market accounting to many common commercial transactions.[4] Accordingly, NAREIT

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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://tax.house.gov/.
[3] http://waysandmeans.house.gov/uploadedfiles/leg_text_fin.pdf and http://waysandmeans.house.gov/uploadedfiles/final_financial_products_discussion_dated_tomorrow.pdf.
[4] President Obama's fiscal year 2016 budget contains a similar proposal to mark certain derivatives to market. Depending upon the specific details of the President's proposal, NAREIT would have similar concerns with that proposal.

believes the 2014 TRA should be amended to:

1) for purposes of the exception from mark-to-market accounting for derivatives with respect to real property, clarify that the definition of "real property" is the same for both investors and dealers (*e.g.*, the definition for investors is not limited to undeveloped land);

2) expand the exception from mark-to-market accounting for derivatives with respect to hedging transactions, 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 possibly jeopardize the ability to offer 30-year, fixed rate mortgages to the public; 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; and, c) 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; and,

3) allow REITs the ability to elect not to include accrued market discount in income currently, which would eliminate the possibility that REITs could have liquidity issues (potentially resulting in the need to incur additional debt or sell assets they otherwise would hold for the long term) as a result of having to distribute or pay corporate income tax on phantom market discount income.

DISCUSSION

A. Background

1. REIT Distribution Requirement

Background on REITs and the various requirements for qualification as a REIT are described in more detail in the Initial Comments. NAREIT concerns with the 2014 TRA generally relate to the distribution requirement required for REIT qualification. [5] A REIT must distribute to its shareholders at least 90% of its REIT taxable income (excluding net capital gain) each year (the 90% Distribution Requirement).[6] Like a mutual fund (called a regulated investment company in the Internal Revenue Code of 1986, as amended (the Code))[7] 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.[8] Thus, if a REIT distributes 100% of its taxable income, it will not pay corporate income tax.

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[5] I.R.C. § 857(a)(1).
[6] *Id.*
[7] References to "section" in this letter are to sections of the Code. References to "Proposed Section" are to the Code as it would be amended by the TRA 2014.
[8] I.R.C. § 857(b)(2)(B).

A limited exception from the 90% Distribution Requirement is available for certain types of "phantom" or "noncash" income recognized by a REIT.[9] 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).[10] However, a REIT *is* required to distribute noncash income that does not exceed 5% of the REIT's taxable income (the 5% Basket). The potential sources of "excess noncash income" under section 857(e) include, *inter alia*, original issue discount (OID) and cancellation of indebtedness (COD) income.[11] A REIT is required to pay corporate income tax on any "excess noncash income" that it does not distribute to its shareholders.

When a REIT has phantom income that must be distributed to its shareholders, either because the phantom income is included in the 5% Basket or is phantom income that is not subject to the excess noncash income rules, the REIT may incur debt or sell assets it otherwise would hold long-term in order to satisfy the 90% Distribution Requirement. Similarly, a REIT with a corporate tax liability on excess noncash income may also have to incur debt or sell assets to pay the corporate income tax on the phantom income. Neither incurring debt nor selling assets that would otherwise be held long term is typically in the best economic interests of the REIT's shareholders. Incurring debt to satisfy the 90% Distribution Requirement or pay tax on excess noncash income 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.[12]

2. <u>TBA Market</u>

Approximately 90% of residential mortgage loans are currently guaranteed by the Agencies.[13] Agencies guarantee mortgage loans by guaranteeing the payment of principal and interest on,

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[9] I.R.C. § 857(a)(1)(B).
[10] I.R.C. § 857(e)(1).
[11] 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.
[12] Unlike other real estate owners that use high levels of debt, average debt levels for public equity REITs are around 40%, leading to less volatility in the real estate market and fewer bankruptcies and workouts. Additionally, academics have noted the positive impact REITs have due to the transparency of information about commercial real estate that becomes available to investors, financial institutions, regulators, and private real estate investors. *See, e.g.*, Frank Packer, Timothy Riddiough, and Jimmy Shek, *Securitization and the Supply Cycle: Evidence from the REIT Market*, 39 J. PORTFOLIO MANAGEMENT 134, 135 (2013).
[13] 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*].

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,[14] 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.[15] Only Agency-guaranteed, residential, single-class MBS 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.[16] 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.[17]

The TBA market is what connects the residential mortgage borrower to the ultimate funders of

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[14] 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.
[15] 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*].
[16] *SIFMA Testimony* at 12.
[17] *Federal Reserve Report* at 13.

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."[18] 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,[19] and only the market for trading in Treasury securities is larger than the Agency MBS market.[20] According to the Securities Industry and Financial Markets Association, the TBA market is the most liquid and most important secondary market for mortgage loans.[21] 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.[22] 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.[23] 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. <u>Proposed Sections 485 & 486: Marking-to-Market Derivatives</u>

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

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[18] *Id.* at 14.
[19] *Federal Reserve Report* at 2.
[20] *SIFMA Testimony* at 14.
[21] *Id.* at *13*.
[22] *Federal Reserve Report* at 1; *SIFMA Testimony* at 2.
[23] *Federal Reserve Report* at 1; Securities Industry and Financial Markets Association, *TBA Market Fact Sheet* at 1 (2011).

Proposed Sections 485 and 486 could impair the ability of some REITs to satisfy the 90% Distribution Requirement and could create liquidity problems for REITs.

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.[24] All items of income, loss, and deduction from any "derivative" would be treated as ordinary income.[25]

The 2014 TRA, unlike the Initial Discussion Draft, would treat mark-to-market income recognized under Proposed Section 485 as a potential source of excess noncash income.[26] Although treating mark-to-market income as "excess noncash income" is a significant improvement over the Initial Discussion Draft, 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. As noted above, a REIT is excused from distributing only the noncash income that exceeds the 5% Basket. A REIT may have difficulty distributing the mark-to-market income included in the 5% Basket. In addition, a REIT would have to pay corporate income tax on any excess noncash income that it did not distribute, and the 90% Distribution Requirement may leave a REIT with insufficient cash to pay the corporate tax on the mark-to-market income that is treated as excess noncash income. Because of the liquidity issues that Proposed Sections 485 and 486 would create for REITs and the other reasons noted below, NAREIT recommends the following improvements to Proposed Section 485 and 486.

1. <u>The Real Property Exception to the Definition of "Derivative" Should Be Clarified</u>

NAREIT believes that the current exemption in the 2014 TRA from the definition of "derivative" for real property merits clarification. The 2014 TRA did not substantively change the real property exception included in the Initial Discussion Draft. NAREIT believes that common commercial transactions entered into by investors in real estate could be subject to mark-to-market accounting, which could cause some REITs to have difficulty satisfying the 90% Distribution Requirement with respect to noncash income in the 5% Basket and would require REITs to be subject to corporate tax on any undistributed phantom income treated as excess noncash income.

The current exception for real property in Proposed Section 486(b) applies only to: 1) a "tract of real property" as defined in section 1237(c); or, 2) real property that would be property described in section 1221(a)(1) (*i.e.*, property held by a "dealer") if held directly by the taxpayer.[27] The exception for "dealer" property will not apply to REITs and other long-term investors in real

[24] Proposed Section 485(a)(1).
[25] Proposed Section 485(b)(1).
[26] TRA 2014, § 3401(f)(3).
[27] Proposed Section 486(b)(1)(A). Proposed Section 486(b)(1)(B) grants the Secretary the authority to prescribe regulations or other guidance to treat multiple tracts of real property as a single tract.

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(b)(1)(A)(i) is not entirely clear. 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.[28] 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.[29] 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.[30]

Proposed Section 486(b)(1)(A)(i) specifically references only section 1237(c) (which itself does not limit the definition of a "tract of real property" to undeveloped land). Accordingly, NAREIT assumes that the definition of "real property" for purposes of Proposed Section 486(b)(1)(A)(i) and the dealer exception in Proposed Section 486(b)(1)(A)(ii) are the same (*e.g.*, Proposed Section 486(b)(1)(A)(i) is not limited to undeveloped land and would apply to single tracts of land with improvements on them). However, given the importance of this exception, this should be further clarified.

2. The Hedging Exception to the Definition of "Derivative" Should Be Expanded to Cover Common Interest Rate Financial Hedges

NAREIT believes that the exception from mark-to-market accounting in the 2014 TRA for derivatives that are used in hedging transactions is too narrow to cover certain common commercial transactions that mitigate the risk of interest rate fluctuations. Specifically, Proposed Section 485(b) requires ordinary treatment on all items of income or loss with respect to a "derivative." Proposed Section 486(b)(2) excludes from mark-to-market accounting under Proposed Section 485 any "hedging transaction," as defined in Proposed Section 1221(b).[31] The definition of "hedging transaction" under Proposed Section 1221(b) is generally consistent with the current definition of "hedging transaction" in section 1221(b)(2), except Proposed Section

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[28] I.R.C. § 1237(a).
[29] I.R.C. § 1237(a)(2).
[30] 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).
[31] The TRA 14 also would repeal several current law Code sections that are applied to determine the character of income and losses from derivatives, on the grounds that these sections would be obsolete for derivatives that are marked to market when the gains and losses are treated as ordinary income and losses. For hedging transactions that are excluded from mark-to-market treatment, these sections remain relevant in determining the character of income and losses from these derivatives, and the Committee should consider retaining these sections for this purpose.

1221(b) includes some helpful changes to the hedge identification requirement and is expanded to include hedges of debt assets held by insurance companies. Under Proposed Section 1221(b)(2) (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(b)(2) (and section 1221(b)(2)), with the exception of debt assets held by insurance companies (under Proposed Section 1221(b)(2)). Accordingly, a hedge of a capital asset generally would be subject to mark-to-market accounting under Proposed Sections 485 and 486.

For hedges that are not treated as "hedging transactions" under Proposed Section 1221(b)(2), the 2014 TRA would require both the hedge (if it is a derivative) and the hedged asset (or other item) to be marked to market, with any built-in gain (but not loss) on the hedged asset being recognized at the time the hedge is acquired.

a. TBA Market and Interest Rate Locks

NAREIT believes that the effect of Proposed Sections 485 and 486 on the TBA market is unwarranted. The definition of "derivatives" would include TBAs, as that phrase includes a "forward contract."[32] As discussed above, the TBA market is vital to the 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.

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 2014 TRA, the same REIT would have ordinary income if the

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[32] Proposed Section 486(a).

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 having to distribute any mark-to-market income that is included in the 5% Basket. In addition, the REIT could have a significant corporate tax liability on any mark-to-market income treated as excess noncash income. REITs would either have to reduce their participation in the TBA market, which could contribute to difficulties in arranging for home financings, or potentially face difficult issues satisfying the 90% Distribution Requirement and paying the corporate income tax on any excess noncash income.

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 2014 TRA contemplates in its current form.

NAREIT believes the 2014 TRA should include an expanded exception for hedging transactions that would address the issues discussed above with TBAs and interest rate locks, which are standard commercial real estate transactions and not speculative in nature. Specifically, to ensure that TBAs are not subject to mark-to-market accounting, NAREIT suggests treating Government securities as ordinary property solely for the purpose of determining whether the exception for hedging transactions applies to a derivative that hedges these securities.[33] By treating Government securities as ordinary property, TBAs would satisfy the definition of a "hedging transaction" under Proposed Section 1221(b) for this purpose, and they would not be subject to mark-to-market accounting. A "Government security" would be 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 the same definition of "Government securities" that is used for purposes of the Investment Company Act of 1940, [34] and that is incorporated into the rules for REITs and regulated investment companies.[35] NAREIT believes

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[33] Alternatively, the Committee should consider addressing this specific issue through a broader reform to the current law section 1221(b)(2) definition of a hedging transaction that generally would permit hedges of capital assets to be treated as hedging transactions for tax purposes. Gains and losses from hedges of capital assets already typically result in capital gains and losses, and concerns regarding the "harvesting" of tax losses presumably would be addressed by the application of regulation section 1.446-4.
[34] Investment Company Act of 1940, 15 U.S.C. § 80a-2(a)(16) (2012).
[35] 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

treating Government securities as ordinary property for this purpose would ensure that the TBA market is not disrupted by strategies to avoid mark-to-market accounting. In addition, mortgage REITs would be able to use derivatives on Government securities as asset hedging transactions without i) endangering their ability to satisfy the 90% Distribution Requirement (as a result of having to distribute any mark-to-market income that is included in the 5% Basket), and, ii) causing liquidity issues as a result of having a significant corporate tax liability on any mark-to-market income treated as excess noncash income.

With regard to interest rate locks, these transactions already satisfy the "hedging transaction" definition and, therefore, are eligible for the exception for hedging transactions in the 2014 TRA. However, individual borrowers are likely unaware of the identification requirement for securing hedging transaction treatment of their residential mortgage loan interest rate locks. The consequences under current law of failing to satisfy the identification requirement are unlikely to be significant for these borrowers, but could be significant if their interest rate locks were marked to market under the 2014 TRA. Therefore, NAREIT recommends that the identification requirement not apply solely for the purpose of determining whether an interest rate lock on a residential mortgage loan satisfies the definition of a "hedging transaction" under Proposed Section 1221(b) and, in turn, the exception from mark-to-market accounting for hedging transactions.

b. Hedges of Outstanding MBS and Mortgage Loans

NAREIT notes that the 2014 TRA 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 2014 TRA, both the derivative and the hedged MBS or mortgage loan would be marked to market, and any built-in gain (but not loss) on the hedged MBS or mortgage loan would be recognized upon acquisition of the derivative because the MBS or mortgage loan in the hands of the mortgage REIT is a capital asset and, therefore, does not satisfy the definition of a "hedging transaction" under Proposed Section 1221(b).

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

securities" from the Investment Company Act of 1940 for purposes of the rules for regulated investment companies).

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.[36]

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 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.[37] However, asset hedging transactions may produce qualifying income for the 95% gross income test applicable to REITs when they give rise to gain from the sale of "securities."[38]

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

Under Proposed Section 485, however, both the asset hedging transaction and the hedged MBS or mortgage loan would be marked to market (with gains and losses be treated as ordinary), and any built-in gain on the MBS or mortgage loan would be recognized upon acquisition of the asset hedging transaction. While the gains and losses on the asset hedging transaction and the hedged MBS or mortgage loan would be expected to largely offset each other, they will not entirely offset each other in all cases. Any residual gains, as well as the recognition of any built-in gains on the hedged MBS or mortgage loan, may increase a mortgage REIT's distribution requirement, impair its ability to satisfy the 90% Distribution Requirement, and require the REIT to pay the corporate income tax liability on excess noncash income.

NAREIT believes the 2014 TRA should include an additional expansion to the exception for hedging transactions that would address the issues discussed above with hedges of outstanding MBS and mortgage loans which—like TBAs and interest rate locks—are standard commercial real estate transactions and not speculative in nature. Specifically, to ensure that these asset hedging transactions s are not subject to mark-to-market accounting, NAREIT suggests treating MBS and mortgage loans as ordinary property solely for the purpose of determining

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[36] I.R.C. § 856(c)(5)(G).
[37] I.R.C. § 856(c)(5)(G).
[38] I.R.C. § 856(c)(2)(D) (treating gain from the sale of "securities" as qualifying income for the 95% gross income test applicable to REITs).

whether the exception for hedging transactions applies to a derivative that hedges these assets.[39] By treating MBS and mortgage loans as ordinary property, the asset hedging transactions would satisfy the definition of a "hedging transaction" under Proposed Section 1221(b) for this purpose, and they would not be subject to mark-to-market accounting.

C. <u>Proposed Section 1278: Current Inclusion of Deemed Interest Component of Market Discount – NAREIT Recommends That Flexibility under Current Law Regarding Recognition of Market Discount Be Retained for REITs</u>

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 (as a result of having to distribute any market discount income that is included in the 5% Basket) and could cause some REITs to have liquidity issues as a result of the corporate tax liability on any market discount treated as excess noncash income.

Under the 2014 TRA, REITs would be required to include a portion of the accrued market discount in income even if no cash payment was received in respect of the debt instrument.[40] The 2014 TRA, unlike the Initial Discussion Draft, would treat market discount income as a potential source excess noncash income.[41] Although treating market discount income as excess noncash income is a significant improvement over the Initial Discussion Draft, there may be situations in which a REIT would have to recognize significant market discount income and would not have cash from the transaction to satisfy the 90% Distribution Requirement. As noted above, a REIT is excused from distributing noncash income only to the extent it exceeds the 5% Basket. A REIT may have difficulty distributing the market discount income included in that 5% Basket. Moreover, a REIT may not have sufficient liquidity to pay the corporate income tax on any market discount income treated as excess noncash income.

The proposed treatment of market discount 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 2014 TRA to include in income market discount, even though they would not receive any cash that could be used to i) satisfy the distribution requirement with respect to the market discount income included in the 5% Basket, or, ii) pay corporate tax on the noncash income that exceeds the 5% Basket.

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[39] As noted above with regard to TBAs and interest rate locks, the Committee alternatively should consider addressing this specific issue through a broader reform to the current law section 1221(b)(2) definition of a hedging transaction that generally would permit hedges of capital assets to be treated as hedging transactions for tax purposes. Gains and losses from hedges of capital assets already typically result in capital gains and losses, and concerns regarding the "harvesting" of tax losses presumably would be addressed by the application of regulation section 1.446-4.

[40] Proposed Section 1278(a).

[41] 2014 Discussion Draft, § 3401(f)(3).

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 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.[42] 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 and pay corporate tax on any market discount income treated as excess noncash income.[43]

If you would like to discuss these issues in greater detail, feel free to 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.

Respectfully submitted,

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Attachment

[42] I.R.C. § 1276(a).
[43] The government's response to the 2007-2009 credit crisis evidenced the policy goals of: 1) encouraging lenders to modify mortgage loans to avoid foreclosure; and, 2) injecting liquidity into the market for distressed debt, mortgage loans, and mortgage-backed securities. Failure to retain for the flexibility under current law regarding recognition of market discount for REITs would impede the ability of REITs to advance those goals in the event of a similar future crisis.