NATIONAL ASSOCIATION OF
REAL ESTATE INVESTMENT TRUSTS®

May 18, 2010

Stephen R. Larson, Esq.
Office of Associate Chief Counsel (Financial Institutions & Products)
Internal Revenue Service
1111 Constitution Avenue, NW
Room 3547
Washington, DC 20224

Re: <u>Response to Published Article Regarding NAREIT's Request for Guidance</u>

Dear Mr. Larson:

On August 12, 2009, NAREIT submitted a letter (the NAREIT Letter) to then-Deputy Assistant Treasury Secretary Mundaca and Commissioner Shulman requesting guidance relating to the consequences to real estate investment trusts (REITs) of certain "distressed" debt. A recently published note by Steven Hodaszy (the Hodaszy Note) argued against the guidance requested in the NAREIT Letter (the Proposed Guidance).[1]

NAREIT believes that the Hodaszy Note includes a number of fundamental errors, both in describing existing authority and in analyzing the Proposed Guidance. Nevertheless, given the complexity of the REIT qualification issues presented, NAREIT believes that it would be helpful to offer a response as part of our continuing discussions regarding the Proposed Guidance.

DISCUSSION

I. SUMMARY OF THE PROPOSED GUIDANCE AND THE REASON NAREIT REQUESTED IT

NAREIT has requested guidance that would specifically provide that:

1. the "loan value" of the real property under Treas. Reg. Section 1.856-5(c) securing a mortgage loan held by a REIT is not re-tested upon a deemed exchange under Treas. Reg. Section 1.1001-3, so long as the "significant modification" occurs at a time when the mortgage loan is in default or default is reasonably foreseeable; and,

[1] Steven Z. Hodaszy, "Treatment of Modified or Distressed Mortgage Loans by REITs," *Tax Notes* (Mar. 29, 2010, p. 1622). For your convenience, we have attached both the NAREIT Letter and Hodaszy Note. *See* Exhibits A and B.

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2. the “amount of the loan” under Treas. Reg. Section 1.856-5(c) for a mortgage loan acquired by a REIT with market discount is the REIT’s highest adjusted tax basis during the year.

The Proposed Guidance is requested as to Treas. Reg. Section 1.856-5(c) (the Interest Apportionment Regulation) because that regulation is the only specific published guidance on the treatment for REIT qualification purposes of loans that are secured both by real property and by other property (Mixed Collateral Loans).

We note that the Interest Apportionment Regulation only applies to the treatment of interest income from Mixed Collateral Loans and does not address the asset test treatment in any way. In fact, the IRS has issued only private guidance regarding the asset test implications of Mixed Collateral Loans in a 1999 private letter ruling (PLR 199923006). In PLR 199923006, the IRS stated that “in situations where the mortgagor’s equity in the real property immediately before the mortgage is placed on the property is less than the amount of the mortgage, an allocation must be made to determine the value of the interest in the mortgage on the real property.” The IRS further stated that use of the apportionment methodology set forth in the Interest Apportionment Regulation “is a reasonable means of determining the value of an interest in a mortgage…” and that such methodology “*may* be applied…” (Emphasis added). Notably, the IRS did not take the position that the Interest Apportionment Regulation provided the only reasonable or permitted methodology to make this determination.[2]

Although NAREIT has requested direct guidance on the asset test implications of Mixed Collateral Loans, NAREIT does not believe that the asset test treatment of Mixed Collateral Loans necessarily is governed by the Interest Apportionment Regulation. Rather, we agree with the IRS’s conclusion in PLR 199923006 that a REIT’s interest in a mortgage may be determined by reference to the Interest Apportionment Regulation when that methodology would reasonably reflect the REIT’s indirect investment in real property.

NAREIT has requested the Proposed Guidance in order to clarify the treatment of distressed loans and to eliminate uncertainties that are particularly problematic for publicly traded REITs. Contrary to the Hodaszy Note’s suggestion, NAREIT does not concede in any way that there is no existing basis for Proposed Guidance. Nevertheless, the realities are that, for publicly traded REITs, uncertainties on these points are potentially paralyzing. The Hodaszy Note may not fully appreciate what is at stake for REITs when there are technical uncertainties. In the past, for example, REITs have looked to the IRS for guidance as to whether the availability of cable TV in apartment buildings and the availability of internet connectivity in downtown Washington, DC office buildings constitute impermissible services. These were instances in which REIT qualification was at stake; the economic and business environment had raised new questions; and the existing law provided a basis for analysis, but did not directly address the issues of concern. The Proposed Guidance is similar in these respects.

[2] Prior to PLR 199923006, the IRS had ruled that in the context of a Mixed Collateral Loan, an apportionment of the loan was required, but that such apportionment could be made using other, “reasonable” methods. *See* PLR 7102080330A.

Further, issuance of the Proposed Guidance is clearly an interpretive rule that is within the purview of the IRS – either through an amendment to the regulations or through other published guidance. It does not represent a policy change but merely a better measurement standard to more clearly reflect the economics of the underlying investments. Thus, there is no requirement for the Proposed Guidance to be issued through a legislative change.

The REIT rules are complicated and are prone to generate uncertainty because they provide a rather short list of what is permitted in the context of the dynamic real estate and mortgage lending industries. This means that an evolving business environment necessarily will generate the need for a "new look" at how the rules would be interpreted or applied. Absent an effective government response, the law might unnecessarily limit proper REIT investments and business decisions. This is the situation that REITs owning or buying mortgage loans find themselves in today. Any suggestion that REITs are trying to turn bad assets into good to gain an undue advantage – a sort of REIT qualification alchemy – with distressed mortgage loans is unfounded. REITs are maintaining or buying loans that are valued by reference to real estate; it is just that simple.

II. MODIFIED MORTGAGE LOANS

A. Example Illustrating the Need for the Proposed Guidance

The following example illustrates the need for the Proposed Guidance in the case of a distressed Mixed Collateral Loan held by a REIT.

- On June 15, 2005, REIT loans Borrower $100 secured by $115 of real property and $10 of personal property.
- The loan matures in 2015.
- On August 1, 2010:
    - The real property securing the loan is valued at $65 and the personal property is valued at $2.
    - Borrower is reasonably likely to be in default in the near future because of its failure to comply with liquidity and net worth covenants in the loan.
    - Borrower requests that REIT not foreclose on the collateral, but instead agree to a modification of the interest provisions of the loan in such a manner that would result in a significant modification within the meaning of Treas. Reg. Section 1.1001-3 (the Significant Modification Rules). Specifically, the modification provides for the suspension of certain financial covenants, and also the suspension of interest payments to such an extent that it constitutes a material deferral of payments under Treas. Regs. Section 1.1001-3(e)(3). The terms of the loan – including the principal amount owed – otherwise remain the same.

- Borrower and REIT both anticipate that real property values will increase above the August 1, 2010 values before the loan's scheduled maturity in 2015, even if values are not necessarily expected to return to the June 2005 levels.

If Treas. Reg. Section 1.856-5(c) is interpreted to require the re-testing of the "loan value" of the real property at the time of the modification, the loan value of the real property would be $65 and the apportionment fraction would be 65/100. All remaining interest income would be treated as being attributable to the personal property collateral. This personal property, however, has an actual value of $2 at the time of the modification and, at $10 of value on June 15, 2005, never had a value even approaching the remaining $35 of the face amount of the loan.

Therefore, without the Proposed Guidance, given the potential risk to its REIT qualification, the REIT likely will feel compelled to foreclose on the collateral – and, as a result, foreclose the possibility of recovering more of the REIT's original investment. In this example, the REIT would recognize an economic loss of $33 upon the foreclosure.

This result is counter-intuitive because the real property supporting the REIT's investment has not changed by the modification at all – no collateral has been added or removed. The entire result stems from a fluctuation in value of the collateral that has taken place after the REIT made its initial investment decision.

B. The Proposed Guidance Regarding Modified Mortgage Loans is Consistent with the Policy Underlying the Code[3] and Existing Authority

The Hodaszy Note argues that "it would be inconsistent with the fundamental requirement that REITs facilitate investment in real-estate-related assets" if a REIT could treat the modified loan in the example above as secured by real property in its entirety following the "significant modification." We believe that this analysis is incorrect.

The Interest Apportionment Regulation is intended to lock in the REIT qualification treatment of the loan at the time the REIT makes the investment (or commits to make the investment) irrespective of whether the value of the underlying collateral later fluctuates. The Interest Apportionment Regulation does not require or permit the value of the real property securing the loan – whether it increases or decreases – to be recalculated at any time. Other REIT asset tests similarly are drafted to prevent REIT qualification failures as a result of value fluctuations. For example, Section 856(c)(4) of the Code (flush language) provides that a REIT will not fail an asset test for a calendar quarter based solely on a change in the value of its investments since the previous quarter. Contrary to the Hodaszy Note's contention, this suggests that the Proposed Guidance is consistent with the Congressional intent to allow REITs to maintain their REIT qualification despite changes in the value of their investments.

[3] The Internal Revenue Code of 1986, as amended. Unless otherwise provided herein, "Section" shall refer to a section of the Code.

A closer look at the Interest Apportionment Regulation reveals that it in fact gives precedence to the timing of the REIT's *investment decision* over the time of the REITs *actual investment* through the "binding commitment" test. Notably, the requirement that collateral value be measured at the time the REIT makes a binding commitment to make or acquire a loan does not necessarily coincide with the beginning of the REIT's tax ownership or tax holding period for the loan under Section 1223 of the Code (which generally would not start until the REIT actually makes the loan). The Interest Apportionment Regulation was drafted this way to protect the REIT from a decrease in the value of the collateral between the time that the REIT makes an investment decision and the moment when tax ownership of the loan begins. It would be inconsistent to have a more adverse result when a REIT is simply engaging in loan modification activity to avoid a foreclosure on a good asset.

Without the Proposed Guidance, given the risk to its REIT qualification, a REIT is compelled to foreclose because of a technical REIT qualification uncertainty even though the fluctuations in real estate value were not at all attributable to any action by the REIT.

Our concern that re-testing upon the occurrence of a "significant modification" may be required is entirely attributable to the deemed exchange of the original loan for a "new" loan that is treated as occurring under the Significant Modification Rules. The existence of the Significant Modification Rules casts uncertainty over the interpretation of the Interest Apportionment regulation. As described above, we believe that there is substantial support in the Interest Apportionment Regulation itself for the Proposed Guidance because of the Regulation's emphasis on the REITs original investment decision. Moreover, at the time that the Interest Apportionment Regulation was finalized, the Significant Modification Rules did not exist (even in proposed form).

Given that: 1) the Significant Modification Rules make no specific reference to its interaction with the Interest Apportionment Regulation (or any other REIT qualification rules); and, 2) the Interest Apportionment Regulation has not been updated since the Significant Modification Rules were promulgated, and there has not been any explicit incorporation of the Significant Modification Rules into the Interest Apportionment Regulation. Under these circumstances, the Proposed Guidance – which is consistent with the principles underlying the existing framework and does not contradict any prior guidance, regulation, or administrative pronouncement – can hardly be said to violate any "fundamental" policy underlying the REIT provisions of the Code.

C. <u>The Proposed Guidance is Consistent with the Rules Applicable to REMICs</u>

The Hodaszy Note also argues that the analogy made in the NAREIT Letter to the rules applicable to real estate mortgage conduits (REMICs) is inappropriate. We believe that this argument reflects a misreading of the Treasury Regulations relating to significant modifications of loans held by REMICs.

As a general matter, the "new" loan held by a REMIC that is deemed to be made as a result of significant modification must constitute a "qualified replacement mortgage" under Section 860G(a)(3)(B) of the Code. Among other things, to be a qualified replacement mortgage, a loan must continue to be "principally secured by an interest in real property." The general test as to whether a loan is principally secured by an interest in real property looks to the value of the real property securing the loan.[4] The real property must generally equal at least 80% of the "adjusted issue price" of the loan.[5] Section 1.860G-2(b)(7)[6] of the Treasury Regulations provides that if a new loan is deemed under the Significant Modification Rules, the loan will continue to be treated as being principally secured by an interest in real property – and therefore continue to be eligible to be a "qualified replacement mortgage" – so long as the value of the real property securing the loan equals or exceeds the value of the real property that secured the loan immediately before the modification. In effect, this requirement focuses on whether the value of the collateral has decreased, but only if it has decreased as a result of the modification. Stated differently, the value of the collateral relative to the principal amount of the loan at the time the new loan is deemed to be made generally is irrelevant. The Proposed Guidance merely would extend this principle to modified loans held by a REIT.

The Hodaszy Note also suggests that a REIT does not face the same type of potentially "severe" consequences that might occur to a REMIC from a significant modification of a loan. To the contrary, the potential consequences to a REIT of a loan being treated in part as other than a real estate asset are quite severe. In particular, the failure of a loan to be treated as a real estate asset requires the "nonqualifying" portion of such loan to be separately analyzed as a security under the 10% value test" described in Section 856(c)(4)(B)(iii)(III) of the Code, which, subject to limited exceptions, prohibits a REIT from owning more than 10% of the value of an issuer's securities that are not treated as real estate assets. This test looks at each security separately and in relation to the outstanding securities of the issuer of the debt, and not at each asset (or all such assets) as a percentage of the REIT's total assets. If even a portion of any loan held by a REIT does not constitute a real estate asset, a REIT could fall out of compliance with Section 856(c)(4) of the Code. This could be the case even if the loan represented a relatively small portion of the REIT's total assets.

III. NEWLY ACQUIRED DISTRESSED MORTGAGE LOANS

A. Example Illustrating the Need for the Proposed Guidance

- REIT purchases a nonrecourse commercial mortgage loan secured by an office building for $60. The loan has a remaining term of 10 years.
- The face amount of the loan is $100.
- The real property collateral at the time of purchase is valued at $65 and other collateral (consisting of incidental personal property at the office building) has a value of $2.

[4] *See* Treas. Regs. Section 1.860G-2(a)(1)(i).
[5] The adjusted issue price of a loan generally equals the face amount of the loan or, where the loan is made at a discount, the amount loaned. *See generally* Treas. Regs. Section 1.1275-1.
[6] This assumes that the "original" loan (*i.e.*, the loan prior to the significant modification) was itself a qualified mortgage under Section 860G(a)(3)(A) of the Code.

- REIT recognizes $10 of interest income from the Loan in Year 1.
- If the Interest Apportionment Regulation is applied by treating the amount of the loan as $100, $6.5 of the REIT's $10 of interest income from the loan will be treated as qualifying income for purposes of the 75% REIT gross income test.
- REIT forecloses on the loan in Year 5 and takes ownership of the collateral. At foreclosure, the real property collateral has a value of $70 and the personal property has a value of $0.
- If rules similar to the Hodaszy Note's interpretation of the Interest Apportionment Regulation were used to determine the asset test characterization of the loan (and hence the character of any gain recognized with respect to the loan for purposes of the REIT 75% gross income test) by treating the amount of the loan as $100, then only $6.5 of the REIT's $10 of gain is qualifying for the 75% REIT gross income test (and $3.5 of the gain is nonqualifying). Note that this is the result even though:
    - the market value of the REIT's investment was $60 and was less than the amount of the real property collateral at the time of acquisition;
    - the REIT's original investment would have been fully collateralized by the real property at the time of that investment;
    - the amount ultimately recognized by the REIT upon foreclosure is attributable solely to real property collateral; and,
    - gross income credited to the personal property collateral in Years 1 and 5 alone was *350%* of the value of the personal property collateral at the time the loan was acquired by the REIT, while gross income attributable to the real property collateral was only equal to 20% of the value of the real property collateral at the time the loan was acquired. (Total income for these years was equal to 29% of the total value of the collateral at the time of the REIT's acquisition of the loan.)

B. <u>The Proposed Guidance Regarding Purchases of Loans at a Discount is Consistent with the Policy Underlying the Code and Existing Authority</u>

The premise of the Hodaszy Note is that the Proposed Guidance is "inconsistent with the fundamental requirement that REITs facilitate investment in real-estate-related assets." The Hodaszy Note claims that the Interest Apportionment Regulation is not intended to "measure the REIT's investment in a particular asset" and that "the degree to which a loan represents an interest in real estate…can be accurately measured *only* by comparing the value of the real estate securing the loan with the outstanding principal amount that the borrower owes on the loan." (Emphasis added). Simply stated, this is incorrect. The Interest Apportionment Regulation is obviously intended to determine the portion of the lender's *investment* that should be treated as being attributable to real estate.

The REIT's income and asset tests are tied to the REIT's gross income and the value of the REIT's assets in the REIT's hands. These tests measure (and are intended to measure) the nature of the REIT's assets and underlying source of the value of those assets. This is undeniable. Facts unique to parties with which the REIT has contracts are not relevant in determining how the asset is treated for purposes of the REIT asset tests.

In the case of a market discount loan, this point is clear. The maximum economic value of a nonrecourse loan with a face amount of $100, secured by collateral with a value of $65 is, of course, $65. In this example, its market value is $60, which is what the REIT pays for the loan. Section 1.856-2(d)(3) of the Treasury Regulations directs the REIT to determine its total assets by reference to generally accepted accounting principles or "GAAP."[7] For GAAP, this Mixed Collateral Loan would be booked with a value of $60 – the REIT's purchase price. Treating a significant portion of the $60 asset as nonqualifying for either the REIT asset tests or the REIT gross income tests because there exists a portion of the asset – an unsecured contract right to an additional $35 – that has no market value distorts the characterization of what the REIT owns.[8]

The existing regulations would treat a loan with a face amount of $100, purchased for $60 and secured *only* by $65 of real property collateral as generating only real estate interest because the Interest Apportionment Regulation is inapplicable if there is only real property collateral. Just as in our example above, the contract right to potentially receive $35 that is unsecured, has no market value and would not be treated as an asset for REIT asset test purposes. The fact that there is just $2 of incidental "other property" securing the loan should not lead to a dramatically different result. It does not seem that any policy would underlie such a result; it would be an anomaly produced by an overly restrictive interpretation of a regulation drafted without any intention of addressing a situation involving a *de minimus* amount of personal property.

Continuing the example above, assume that the REIT later sells the loan for $80, recognizing $20 of accrued market discount, which is treated as interest income for tax purposes. The REIT has an economic return on its investment and gross income for tax purposes of $20. If the REIT could have foreclosed on real property with a value equal to its investment at the time of acquisition, the appropriate result would seem to be to characterize the interest income recognized as qualifying for the 75% gross income test. This is supported by the existing rules applicable to plain-vanilla mortgage loans sold at a premium and to "shared appreciation mortgages."[9]

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[7] *See also* Treas. Reg. Section 1.856-3(a), which provides that a REIT's gross assets are determined in accordance with GAAP and the value (where the security is not traded) is determined in good faith by the trustees.

[8] We note that in the case of a nonrecourse Mixed Collateral Loan, the borrower's maximum economic liability is $65 when the REIT acquires the loan. The borrower only stands to lose its assets that serve as collateral for the loan. Accordingly, a rational economic analysis would indicate that the lender will only receive principal payments on the loan in excess of $65 if the collateral increases in value.

[9] Section 856(j) of the Code (dealing with "shared appreciation mortgages") specifically addresses a REIT's return based on future appreciation in the real estate asset securing the loan. There is no requirement that the real estate value of the collateral at the time that a REIT makes a shared appreciation mortgage loan be greater than the maximum return to the REIT under the shared appreciation provision.

> *Example 1*: If a $100 mortgage loan secured by $100 of real property and $10 of personal property is sold at a premium of $5, the gain generated will be treated as real estate income even if the real estate value is still $100 at the time the loan is sold. The source of the premium and the reason that the buyer paid a premium are irrelevant in determining whether any gain recognized in connection with the sale constitutes qualifying income for purposes of the 75% REIT gross income test.
>
> *Example 2*: REIT makes a loan for $80 secured by $80 of non-income producing real property (*e.g.*, undeveloped land) and $40 of personal property. In addition to a fixed annual interest rate, the loan bears additional interest equal to 25% of the appreciation in the land at a fixed date in the future. As of that future date, the appreciation is $20 attributable to unexpected new zoning rules that allows the land to be developed for retail use. The REIT is paid $5 of additional interest. All of that interest is treated as income qualifying for purposes of the 75% REIT gross income test even though the real estate value at the time the REIT acquired the loan did not equal $85.

These examples – both of which reflect widely accepted and easily analyzed transactions – underscore that *the amount of the REIT's investment at the time that the investment is made* is the most important factor in determining whether a loan or the income from that loan will be treated as being attributable to real estate. Clearly, the amount that the REIT may ultimately be paid with respect to the loan is not taken into account for these purposes.

The source of the payments made to the REIT under a Mixed Collateral Loan is also irrelevant for purposes of the 75% REIT gross income test. Neither the Code nor the Interest Apportionment Regulation requires that interest paid on a mortgage loan be traceable to any specific source of real property-related revenue. This is most obvious in the context of a residential mortgage loan, where the property itself is not expected to generate revenue with which the borrower will service the loan. Similarly, when a REIT makes a Mixed Collateral Loan to a business and that loan provides for interest based on the gross revenues of the business, the fact that the interest payments on the loan are directly sourced to general business revenue does not prevent the interest from being treated as qualifying income.

The Proposed Guidance is consistent with the Interest Apportionment Regulation and the IRS' analysis in PLR 199923006 because it seeks to reasonably determine whether the value of the real property securing the loan is at least equal to the REIT's investment and it is firmly grounded in the existing federal income tax law. Applying the Interest Apportionment Regulation without regard to the REIT's actual investment is unreasonable because it creates rather egregious results that reflect neither the REIT's economic investment in the loan nor the federal income tax treatment of the loan in the REIT's hands. Determining REIT qualification of a loan by reference to a feature of that loan – *i.e.*, the face amount of the loan in excess of the REIT's purchase price – that has been attributed no market value by the parties is distortive.

Respectfully, the approach advocated in the Hodaszy Note makes little economic sense. Specifically, it is difficult to see how the Note's suggested interpretation of the Interest

Apportionment Regulation could be considered to "more closely reflect" the extent to which the loan "represents an interest in real estate."

C. The Proposed Guidance Appropriately Considers the Market Discount Rules

The Hodaszy Note states that NAREIT's reference to the market discount rules is inappropriate. In fact, it would be inappropriate to ignore the market discount rules that clearly address the treatment of market discount in the hands of a taxpayer.

In the case of the purchase of a loan at a discount, the market discount rules treat the excess of the face amount of the loan over the purchase price of the loan as interest for federal income tax purposes. By implication, the purchase price is treated as principal. By enacting the market discount rules, Congress decided that market discount should be treated as interest or gain to the holder for purposes of the Code.[10] If recognized market discount is interest income or gain to the holder, it cannot also be principal (*i.e.*, a return of the lender's capital at risk or investment). This is true even though the borrower has a legal obligation to pay the face amount of the loan or face foreclosure.

The REIT as the purchaser of a market discount loan is not entitled to treat any recognized market discount as a tax-free return of principal for its own income tax purposes – including for purposes of determining the amount of its annual distribution requirement under Section 857 of the Code. As described above, the Interest Apportionment Regulation clearly requires that the value of the real estate collateral be equal to or greater than the value of the REIT's investment in the loan, but these rules do not require that the value of the real estate collateral also cover all payments due to the REIT under the loan that are considered interest or gain for federal income tax purposes. Reliance on the market discount rules for purposes of this analysis is not misplaced, as the Hodaszy Note argues; it is compelling and appropriate guidance for how a REIT's market discount should be taken into account for purposes of the REIT qualification tests.

IV. APPROPRIATENESS OF TREASURY OR IRS ACTION

The Hodaszy Note argues that, with respect to mortgage loans that undergo significant modifications, "NAREIT's proposed rule does not have any basis in the statutory language…" Similarly, the Note argues that, with respect to purchases of loans at discount, adoption of the Proposed Guidance would "effectively be constructing an entirely new rule out of whole cloth." In either instance, the Note suggests that Section 7805 of the Code would limit the ability of Treasury or the IRS to implement the Proposed Guidance, and that only Congress can address the problems raised in the NAREIT Letter. These arguments are not grounded in the actual language of the Code. Moreover, these arguments ignore the fact that relevant non-statutory authority already exists.

[10] Section 1276(a)(4) of the Code provides certain exceptions related to withholding, reporting requirements and state and local bonds.

The Code neither specifies nor directs the Treasury to clarify to what extent a mortgage loan constitutes a real estate asset, or to what extent income from a loan constitutes qualifying interest for purposes of the 75% REIT gross income test. Section 856(c)(3)(B) of the Code merely states that "interest on obligations secured by mortgages on real property or interests in real property" is qualifying income, and Section 856(c)(5)(B) of the Code provides that real estate assets include "interests in mortgages on real property." In fact, under the plain language of the Code, any mortgage loan that is secured by any amount of real property, regardless of whether it is fully secured by real property or woefully undersecured, could be treated as a 100% real estate asset producing 100% qualifying income since it is a "mortgage on real property." The Interest Apportionment Regulation was Treasury's interpretation of the applicability of that statutory language and NAREIT seeks the Proposed Guidance only to clarify this interpretation in the context of a distressed mortgage loan, a situation in which the Interest Apportionment Regulation could create an unintended and unreasonable result.

Similarly, by issuing PLR 199923006, the IRS in effect both acknowledged that the provisions of the Code did not address to what extent a Mixed Collateral Loan constitutes a real estate asset, and that the IRS could (and should) provide guidance to taxpayers regarding the application of the Code to a particular loan. These existing authorities were created by Treasury and the IRS, and the responsibility for interpreting those authorities lies with Treasury and the IRS, not Congress. If, as Hodaszy Note suggests, NAREIT's proposal is not supported by the Code, neither are the Interest Apportionment Regulation and PLR 199923006.

Moreover, Treasury already has authority under Section 856(c)(5)(J) of the Code to determine categories of income which are qualifying income, or are disregarded, for purposes of the REIT gross income tests. Under this authority, Congress has clearly delegated to the IRS the authority to decide whether income from a worked-out loan or a newly purchased loan qualifies under the REIT income tests and how to measure such amount.

V. TEMPORARY AS OPPOSED TO PERMANENT GUIDANCE

The Hodaszy Note argues that the economic crisis of recent years might justify Treasury or the IRS temporarily adopting some portion of the Proposed Guidance. In our view, this argument is unpersuasive. Economic conditions have almost certainly led to a greater number of loans falling into default, and more and greater discounts on purchases of loans. This unfortunate fact should not, however, influence the legal analysis under the provisions of the Code applicable to REITs. Loans can and will become "distressed" in even the most favorable economic conditions. Whether more or less loans fall into this category at a given time should not have any effect on REITs' certainty as to the consequences of their investment in these loans. Therefore, adoption of the Proposed Guidance on a permanent basis would be appropriate.

We believe that the Interest Apportionment Regulation, though appropriate and fair in a large number of fact patterns, has unintended and unduly harsh consequences in the identified fact patterns. Thus, it is in the interest of sound tax administration for these issues to be addressed as a general matter and not just as a temporary fix.

In any event, NAREIT believes that any guidance – including temporary guidance – consistent with the Proposed Guidance would be beneficial. However, for the reasons described above and in the NAREIT Letter, the Proposed Guidance is sound regardless of economic conditions and, accordingly, should be issued on a permanent basis.

Unless the Proposed Guidance is issued, REITs will continue to foreclose on distressed mortgage loans in situations in which other lenders would not. Furthermore, REITs will be hampered in their efforts to inject liquidity into the market for distressed mortgage loans by the uncertain interpretation of the Interest Apportionment Regulation. Accordingly, it is important that the Proposed Guidance be issued at the earliest possible time.

Thank you for your consideration of this letter and the policy initiative described in NAREIT's August 12, 2009 letter. Please contact me at (202) 739-9408 or Dara Bernstein, NAREIT's Senior Tax Counsel, at (202) 739-9446, if we can provide with you any additional information regarding the Proposed Guidance.

Respectfully submitted,

Tony M. Edwards
Executive Vice President & General Counsel

Cc: Alice Bennett, Esq.
David B. Silber, Esq.
Jonathan D. Silver, Esq.

Exhibit A:
NAREIT Letter of August 12, 2009

NATIONAL ASSOCIATION OF
REAL ESTATE INVESTMENT TRUSTS®

August 12, 2009

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

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

Re: Guidance Request With Respect to Treas. Reg. § 1.856-5(c)

Dear Messrs. Mundaca and Shulman:

The National Association of Real Estate Investment Trusts (NAREIT)[1] encourages the Internal Revenue Service (the Service) to issue guidance under Treas. Reg. § 1.856-5(c) regarding the treatment of modified mortgage loans and newly acquired distressed mortgage loans for purposes of the gross income and asset tests applicable to REITs. Guidance in this area would help ensure that REITs can work out existing mortgage loans and participate in the market for distressed mortgage loans without jeopardizing their qualification as REITs for federal income tax purposes.

EXECUTIVE SUMMARY

Treas. Reg. § 1.856-5(c) generally addresses whether interest income on a mortgage loan is treated as qualifying income for purposes of the 75% gross income test applicable to REITs when the loan is secured by both real property and other property. To the extent that the "loan value of the real property" securing the loan exceeds the "amount of the loan," all of the interest income on the loan is treated as qualifying income. To the extent the "amount of the loan"

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

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exceeds the “loan value of the real property,” a portion of the interest income is treated as nonqualifying. The “loan value of the real property” is generally the value of the real property securing the loan on the date the REIT committed to originate or acquire the mortgage loan. The “amount of the loan” is generally the highest principal amount of the loan during the applicable year.

When a REIT works out a mortgage loan in default or when default is reasonably foreseeable, the modification is likely be treated as a “significant modification” under Treas. Reg. § 1.1001-3. A “significant modification” triggers a deemed exchange of the old loan for the modified loan. In a workout scenario, the “loan value of the real property” on the modified mortgage loan may be less than its stated principal amount. To the extent that the Service treats a deemed exchange under Treas. Reg. § 1.1001-3 as a new “commitment” to acquire the modified mortgage loan under Treas. Reg. § 1.856-5(c), working out a mortgage loan with the borrower may cause a significant portion of the post-modification interest on the mortgage loan to be treated as nonqualifying income for the 75% gross income test and a corresponding portion of the loan to constitute a nonqualifying asset for the 75% asset test. This result would discourage REITs from working out mortgage loans.

When a REIT acquires a mortgage loan in a distressed condition, the value of the real property securing the loan likely has decreased, but the stated principal amount of the loan likely has not. A restrictive reading of the definition of “amount of the loan” under Treas. Reg. § 1.856-5(c) in the context of a distressed mortgage loan could result in a REIT recognizing a significant amount of nonqualifying income and holding a nonqualifying asset—even though the price paid by the REIT for the distressed mortgage loan is less than the fair market value of the real property securing the loan on the acquisition date.

The government’s response to the credit crisis has 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. Uncertainty regarding the application of Treas. Reg. § 1.856-5(c) to mortgage loans that are modified in connection with a default and to newly acquired distressed mortgage loans impedes the ability of REITs to advance those goals.

Accordingly, NAREIT encourages the Service to issue guidance under Treas. Reg. § 1.856-5(c) applicable to the 75% gross income test and the asset tests that addresses both modified mortgage loans and newly acquired distressed mortgage loans. For modified mortgage loans, the Service should issue guidance that the “loan value of the real property” does not change following a deemed exchange under Treas. Reg. § 1.1001-3 when the loan was in default or default was reasonably foreseeable. For newly acquired distressed mortgage loans, the Service should issue guidance that the “amount of the loan” under Treas. Reg. § 1.856-5(c) is the REIT’s highest adjusted tax basis in the mortgage loan during the taxable year. NAREIT believes the requested guidance could be issued in the form of an interpretation of Treas. Reg. § 1.856-5(c).

DISCUSSION

I. TREATMENT OF MORTGAGE LOANS UNDER THE REIT GROSS INCOME AND ASSET TESTS

A. REIT Gross Income and Asset Tests

Qualification as a REIT requires satisfaction of annual gross income tests and quarterly asset tests. A REIT must derive at least 75% of its gross income each year from certain real estate related sources (the 75% Gross Income Test). Among the sources of qualifying income for the 75% Gross Income Test are: 1) "interest on obligations secured by mortgages on real property or on interests in real property;" and, 2) "gain from the sale or other disposition of real property (including…interests in mortgages on real property)…."[2]

At the close of each calendar quarter, at least 75% of the value of the REIT's total assets must consist of "real estate assets," cash and cash items (including receivables), and Government securities (the 75% Asset Test).[3] Section 856(c)(5)(B)[4] defines "real estate assets" to include "interests in mortgages on real property."[5] Other asset tests include a requirement that a REIT not hold "securities" possessing more than 10% of the total value of the outstanding securities of any one issuer (the 10% Value Test).[6] Any security that qualifies as a "real estate asset" for purposes of the 75% Asset Test is not tested under the 10% Value Test.[7] In addition, section 856(m) exempts certain debt securities, such as "straight debt" (the straight debt exception), a loan to an individual, and any debt of a partnership that derives 75% of its gross income from sources that are qualifying income under the 75% Gross Income Test (the real estate partnership exception), from the definition of "securities" for purposes of the 10% Value Test.[8]

The Code does not define the phrases "interest on obligations secured by mortgages on real property or on interests in real property" for purposes of the 75% Gross Income Test or "interests in mortgages on real property" for purposes of the 75% Asset Test.

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[2] I.R.C. § 856(c)(3)(B), (C). A REIT must also derive 95% of its gross income each year from real estate income plus passive sources (the 95% Gross Income Test). I.R.C. § 856(c)(2). Interest income and gain from the sale of debt securities are treated as qualifying income for the 95% Gross Income Test, regardless of whether attributable to an obligation secured by a mortgage on real property or an interest in real property. I.R.C. § 856(c)(2)(B), (D).
[3] I.R.C.§ 856(c)(4)(A).
[4] For purposes of this submission, "section" refers to the Internal Revenue Code of 1986, as amended (Code), unless otherwise indicated.
[5] Section 856(c)(5)(B).
[6] Section 856(c)(4)(B)(iii)(III).
[7] Section 856(c)(4)(B)(iii).
[8] Section 856(m)(1)(A), (1)(B), (4)(B).

B. Treas. Reg. § 1.856-5(c)

1. *75% Gross Income Test*

In 1981, the Department of the Treasury (Treasury) promulgated Treas. Reg. § 1.856-5, which addresses the treatment of "interest" under the 75% Gross Income Test and the 95% Gross Income Test.[9] Treas. Reg. § 1.856-5(c) addresses the treatment of interest under the 75% Gross Income Test when "a mortgage covers both real property and other property."[10] In that circumstance, Treas. Reg. § 1.856-5(c) requires an apportionment of the interest income for the 75% Gross Income Test based on the "loan value of the real property" and the "amount of the loan."

"Loan value of the real property" is defined as "the fair market value of the [real] property, determined as of the date on which the commitment by the trust to make the loan becomes binding on the trust."[11] In the case of a loan purchased by a REIT, the "loan value of the real property" is the real property's fair market value "determined as of the date on which the commitment by the trust to purchase the loan becomes binding on the trust."[12] Treas. Reg. § 1.856-5(c) defines the "amount of the loan" as the "highest principal amount of the loan outstanding during the taxable year."[13]

The apportionment methodology under Treas. Reg. § 1.856-5(c) compares the "loan value of the real property" to the "amount of the loan." If the "loan value of the real property" is equal to or exceeds the "amount of the loan," then 100% of the interest income is attributed to the real property, even though a significant portion of the security for the loan may be "other property."[14] Conversely, if the "amount of the loan" exceeds the "loan value of the real property," then the interest income is apportioned.[15] The interest income apportioned to the real property is the amount equal to the interest income multiplied by a fraction, the numerator of which is the "loan value of the real property" and the denominator of which is the "amount of the loan." The interest income apportioned to the "other property" securing the loan is the amount equal to the excess of the total interest income over the interest income apportioned to the real property.

[9] T.D. 7767 (Feb. 3, 1981).
[10] Treas. Reg. § 1.856-5(c)(1).
[11] Treas. Reg. § 1.856-5(c)(2).
[12] Treas. Reg. § 1.856-5(c)(2). In the case of a construction loan or a loan to improve or develop real property, the "loan value" includes the fair market value of the land plus the reasonably estimated cost of the improvements or developments (other than personal property) which will secure the loan and which are to be constructed from the proceeds of the loan. Treas. Reg. § 1.856-5(c)(2). If a mortgage on the real property is given as additional security (or as a substitute for other security) for the loan after the REIT's commitment to originate or acquire the loan is binding, the real property loan value is its fair market value when it becomes security for the loan (or, if earlier, when the borrower makes a binding commitment to add or substitute the property as security). Treas. Reg. § 1.856-5(c)(2).
[13] Treas. Reg. § 1.856-5(c)(3).
[14] Treas. Reg. § 1.856-5(c)(1)(i). So long as the interest income is not based on the income or profits of any person, 100% of the interest income will be qualifying income for the 75% Gross Income Test.
[15] Treas. Reg. § 1.856-5(c)(1)(ii).

The following examples show the application of the apportionment methodology under Treas. Reg. § 1.856-5(c).

> Example 1 (Fully Secured Mortgage Loan).[16] A REIT originates a nonrecourse commercial mortgage loan secured by an interest in a hotel with a principal amount of $100 and interest rate of 10% per annum. On the date the REIT's commitment to originate the loan became binding, the loan was secured by real property with a fair market value of $100 and personal property with a fair market value of $20. Under Treas. Reg. § 1.856-5(c), the "loan value of the real property" is $100 and the "amount of the loan" is $100. Consequently, 100% of the interest income on the loan is attributable to real property.

> Example 2 (Undersecured Mortgage Loan). A REIT originates a nonrecourse commercial mortgage loan secured by an interest in a hotel with a principal amount of $100 and interest rate of 10% per annum. On the date the REIT's commitment to originate the loan became binding, the loan was secured by real property with a fair market value of $90 and personal property with a fair market value of $20. Under Treas. Reg. § 1.856-5(c), the "loan value of the real property" is $90 and the "amount of the loan" is $100. Consequently, 90% of the interest income on the loan is attributable to real property and 10% of the interest income on the loan is attributable to "other property" securing the loan.

In Treas. Reg. § 1.856-5(c), Treasury adopted an apportionment methodology that was easy to administer and generally favorable to REITs. The "loan value of the real property" under Treas. Reg. § 1.856-5(c) is fixed as of the date the commitment to originate or acquire the loan became binding. As a result, a REIT does not need to retest in the future the value of the real property that initially secured the loan.[17] Any decline in the value of the real property following origination or acquisition does not cause a decrease in the amount of interest income that would be treated as qualifying income under the 75% Gross Income Test. In addition, the apportionment methodology in Treas. Reg. § 1.856-5(c) treats a loan as producing nonqualifying income only if the "amount of the loan" exceeds the "loan value of the real property," and then interest income is treated as attributable first to real property to the extent of the value of the real property.

Treasury could have adopted a strict proportionality rule under which interest income was apportioned to the value of the real property based on the relative values of the real property and other property securing the loan. Under such a rule, 83.3% of the interest income in Example 1 and 81.8% of the interest income in Example 2 would be attributable to the real property ($100/$120 and $90/$110, respectively), rather than 100% and 90% under Treas. Reg. § 1.856-

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[16] Each of Examples 1 through 5 herein assume that each of the loans discussed constitutes debt for federal income tax purposes both before and after any loan modifications in the examples.

[17] Only when new property is added as security is there a new valuation, and then the valuation is made only with respect to the new property added as security, not any property that was already security for the loan. Treas. Reg. § 1.856-5(c)(2).

5(c). Instead, Treas. Reg. § 1.856-5(c) reflects Treasury's policy to encourage REITs to invest in mortgage loans, which it did by applying an apportionment methodology that was easy to administer, protected REITs from fluctuations in the value of the underlying real property, and resulted in a priority allocation of interest income to real property as opposed to the other property securing the loan. As is demonstrated in the examples discussed below, however, application of the apportionment methodology in Treas. Reg. § 1.856-5(c) in the distressed mortgage loan context can cause more negative gross income and asset test consequences for a REIT than if a strict proportionality rule applied.

2. *Asset Tests*

Neither the Code nor the Treasury regulations address a specific methodology for determining what portion of a mortgage will be treated as a qualifying asset for the 75% Asset Test. In PLR 199923006, the Service ruled that an apportionment was required when the value of the real property was less than the loan amount, and that the methodology set forth in Treas. Reg. § 1.856-5(c) was a "reasonable" means of apportioning the value as between a qualifying real estate asset and a nonqualifying asset.[18] However, that ruling apparently involved newly originated loans, rather than distressed mortgage loans acquired at a discount, and thus the extent to which the ruling provides guidance in the distressed mortgage loan context is unclear. Nonetheless, because the Service has not indicated what other methodologies would also be "reasonable," REITs often apply the methodology from Treas. Reg. § 1.856-5(c) to distressed mortgage loans for purposes of the asset tests.

3. *Mezzanine Loans*

The "loan value of the real property" is also important for the treatment of a mezzanine loan under the gross income and asset tests. A mezzanine loan is a loan that is secured by the borrower's equity interest in a special purpose vehicle that owns real property. In Revenue Procedure 2003-65, the Service announced that it will treat mezzanine loans that satisfy certain requirements as real estate assets for the 75% Asset Test and as producing qualifying income for the 75% Gross Income Test.[19] One of those requirements is that the "loan value of the real property" owned by the special purpose entity is equal to or exceeds the "amount of the loan" as determined under Treas. Reg. § 1.865-5(c)(2).[20]

[18] PLR 199923006 (Feb. 19, 1999).
[19] Rev. Proc. 2003-65, 2003-2 C.B. 36.
[20] Rev. Proc. 2003-65, § 3.07.

II. CONSEQUENCES OF A "SIGNIFICANT MODIFICATION" UNDER TREAS. REG. § 1.1001-3

A. Generally

In 1996, Treasury promulgated Treas. Reg. § 1.1001-3 addressing when a modification of a debt instrument would be treated as an exchange for tax purposes.[21] This regulation was issued in response to the U.S. Supreme Court's decision in *Cottage Savings Ass'n v. Commissioner*,[22] which created uncertainty regarding the threshold for when a modification of a debt instrument would be treated as an exchange for tax purposes.

Under Treas. Reg. § 1.1001-3, a "significant modification" of a debt instrument results in an exchange of the original debt instrument for a modified instrument.[23] The regulation prescribes a general rule for what types of modifications constitute "significant modifications" and a set of standards for testing different types of modifications. Under the general standard, a modification of a debt instrument is a "significant modification" if, based on all the facts and circumstances, the legal rights or obligations that are altered and the degree to which they are altered are "economically significant."[24] The separate tests address modifications that: 1) change the yield to maturity of a debt instrument; 2) change the time of payment; 3) change the obligor or the security for the obligation; 4) change the nature of the debt instrument (*e.g.*, recourse versus nonrecourse); and, 5) add, delete, or alter customary accounting of financial covenants.[25]

B. The Interaction between Treas. Reg. § 1.1001-3 and Treas. Reg. § 1.856-5(c)

When promulgating Treas. Reg. § 1.1001-3, Treasury did not indicate the effect, if any, that a deemed exchange as a result of a "significant modification" should have on the treatment of the modified mortgage loan for purposes of the 75% Gross Income Test and the asset tests. Furthermore, the Service has not subsequently addressed the issue in its public or private rulings. Absent guidance on this issue, REITs have been concerned that a "significant modification" requires that the "loan value of the real property" be retested for purposes of applying Treas. Reg. § 1.856-5(c). This issue has come to the fore as the credit crisis has caused more REITs to confront the REIT qualification consequences of working out a loan with a borrower. If a "significant modification" requires retesting under Treas. Reg. § 1.856-5(c), then REITs face potentially dire REIT qualification issues.

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[21] T.D. 8675 (June 26, 1996).
[22] 499 U.S. 544 (1991).
[23] Treas. Reg. § 1.1001-3(b).
[24] Treas. Reg. § 1.1001-3(e)(1).
[25] Treas. Reg. § 1.1001-3(e)(2)–(6). Depending on whether the old or modified debt instrument is publicly traded and the holder's basis in the old debt instrument, a "significant modification" under Treas. Reg. § 1.1001-3 could cause the holder of the debt to recognize a gain or loss for tax purposes and may cause the issuer to recognize cancellation of indebtedness income. For a discussion of the general federal income tax consequences of a "significant modification," *see* David C. Garlock et al., *Federal Income Taxation of Debt Instruments* ¶ 1303 (5th ed. 2006).

The following example demonstrates the issues under the 75% Gross Income Test and potentially under the asset tests caused by modifying a mortgage loan.

> Example 3 (Modified Hotel Mortgage Loan). In 2006, a REIT acquires a nonrecourse mortgage loan bearing a 10% interest rate and secured by an interest in a hotel that is operated by the borrower. The REIT acquired the mortgage loan at its par amount, $100. At the time the commitment to acquire the loan became binding on the REIT, the value of the real property securing the mortgage loan was $100 and the personal property securing the loan was $20. Under Treas. Reg. § 1.856-5(c), 100% of the interest on the mortgage loan was qualifying income under the 75% Gross Income Test and, based on PLR 19923006, 100% of the value of the mortgage loan was a qualifying asset for purposes of the 75% Asset Test. In 2009, the borrower is in default and the value of the real property securing the loan has decreased significantly to $50 and the value of the personal property has decreased to $5. The REIT works out the mortgage loan in a manner that constitutes a "significant modification," but the stated principal amount of the loan is not reduced. Under the modified mortgage loan, the "loan value of the real property" is now $50. The "amount of the loan" remains at $100. Because the mortgage loan would be undersecured, an apportionment under Treas. Reg. § 1.856-5(c) could be required for both gross income and asset test purposes.
>
> 75% Gross Income Test. Based on a "loan value of the real property" of $50 and an "amount of the loan" of $100, 50% of the interest on the loan would be allocated to the real property, and 50% of the interest would be allocated to the other property securing the loan.
>
> Asset Tests. Based on PLR 199923006, a similar allocation would be required for purposes of the asset tests. Under the most conservative interpretation of Treas. Reg. § 1.856-5(c), 50% of the value of the modified loan would be treated as a qualifying asset for purposes of the 75% Asset Test and 50% of the value would be treated as a nonqualifying asset. Thus, although the mortgage loan has a value of $55, $5 of which is attributed to personal property, the nonqualifying portion of the loan would have a value of $27.50.[26] The modification would create a significant nonqualifying asset for purposes of the 75% Asset Test, which would need to be tested for compliance with the 10% Value Test. Unless the modified mortgage loan qualifies for the straight debt exception, it may cause the REIT to violate the 10% Value Test.

As shown by Example 3, requiring retesting of the "loan value of the real property" upon a "significant modification" could cause a significant portion of the post-modification interest

[26] A more reasonable methodology would be to determine the allocation to the "other property" based on the value of the real property compared to all property securing the loan (*i.e.*, $50/$55) and would treat the loan as a $50 qualifying asset and a $5 nonqualifying asset. Although that methodology reaches a more reasonable result than the one discussed above, the Service has not approved that alternative methodology.

income not to qualify under the 75% Gross Income Test. A REIT with a large portfolio of mortgage loans may find it difficult to continue to satisfy the 75% Gross Income Test if it works out a significant number of its loans. Although the application of Treas. Reg. § 1.856-5(c) under the asset tests is less clear, a "significant modification" of numerous loans could cause a REIT to fail the 75% Asset Test, and the modification of even one mortgage loan could cause a violation of the 10% Value Test.

C. Treatment of a "Significant Modification" under the Rules for REMICs

Unlike Treas. Reg. § 1.856-5(c), Treas. Reg. § 1.860G-2 specifically addresses the consequences of a "significant modification" of a mortgage loan for real estate mortgage investment conduits (REMICs) and reflects the government's policy that a REMIC should not jeopardize its tax classification if it modifies a mortgage loan to avoid foreclosure.

Substantially all of the assets of a REMIC must consist of "qualified mortgages" and other permitted investments.[27] Treas. Reg. § 1.860G-2(b) generally provides that a "significant modification" of a mortgage within the meaning of Treas. Reg. § 1.1001-3 results in the creation of a modified obligation that is treated as newly issued in exchange for the unmodified obligation it replaced.[28] Unless the modified obligation qualifies as a "qualified replacement mortgage,"[29] then the modified obligation will not be a "qualified mortgage" and the deemed disposition will be subject to the prohibited transaction tax applicable to REMICs under section 860F(a)(2).[30]

Treas. Reg. § 1.860G-2(b)(3), however, provides that certain changes will not be treated as causing a "significant modification" for REMIC purposes even though they may cause a "significant modification" under Treas. Reg. § 1.1001-3. In particular, changes to the terms of the obligation "occasioned by default or a reasonably foreseeable default" are not treated as "significant modifications" for REMIC qualification and prohibited transaction purposes.[31] In response to the credit crisis, the Service has issued several Revenue Procedures allowing REMICs to modify distressed mortgage loans pursuant to private sector and government modification programs without having the modifications treated as "significant modifications" for REMIC purposes.[32]

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[27] Section 860D(a)(4). This requirement applies beginning three months after the startup date of the REMIC.
[28] Treas. Reg. § 1.860G-2(b).
[29] Section 860G(a)(4) (defining "qualified replacement mortgage").
[30] Treas. Reg. § 1.860G-2(b)(1)(i).
[31] Treas. Reg. § 1.860G-2(b)(3)(i).
[32] Rev. Proc. 2009-23, 2009-17 I.R.B. 884; Rev. Proc. 2008-47, 2008-31 I.R.B. 272, *amplifying and superseding* Rev. Proc. 2007-72, 2007-52 I.R.B. 1. Revenue Procedure 2008-47 provides that the Service will not challenge the REMIC qualification of a securitization vehicle on the grounds that a modification to a subprime mortgage loan made pursuant to a program of the American Securitization Forum is not among the exceptions listed in Treas. Reg. § 1.860G-2(b)(3). Similarly, in Revenue Procedure 2009-23, the Service announced that it would not challenge the REMIC qualification of a securitization vehicle on the grounds that a modification to a residential mortgage loan under the Treasury's "Home Affordability Modification Program" is not among the exceptions listed in Treas. Reg. § 1.860G-2(b)(3).[32]

D. Treatment of Loan Modifications under the Foreclosure Property Rules

A REIT generally may make a foreclosure property election with respect to property acquired as a result of having bid in the property at foreclosure or having otherwise reduced the property to ownership or possession by agreement or process of law after there was a default (or default was imminent) on a lease of the property (when the REIT is the lessor) or on indebtedness owed to the REIT which the property secured.[33] A property is not eligible for a foreclosure property election if the loan, with respect to which the default occurred was made, entered into or acquired by the REIT with an intent to foreclose or when the REIT knew or had reason to know that default would occur.[34] Treas. Reg. § 1.856-6(b)(3) provides that if a REIT, in an attempt to avoid default or foreclosure, advances additional amounts to the borrower in excess of amounts contemplated in the original loan commitment or modifies the loan, such advance or modification will be considered not to have been made with an intent to evict or foreclose, or with improper knowledge, unless the original loan was entered into with that intent or knowledge.

Thus, the foreclosure property rules do not "retest" a modified loan to see whether all or a portion of the loan should be treated as having been entered into with an intent to evict or foreclose, or with improper knowledge. Rather, Treas. Reg. § 1.856-6(b)(3) encourages a REIT to modify loans to avoid default or foreclosure by specifically providing that a modification does not change the character of the loan for foreclosure property purposes. Treas. Reg. § 1.856-6(b)(3) further advances the policy goal of encouraging REITs to avoid foreclosing on mortgage loans.

This policy objective (providing incentives for REITs not to foreclose) would be undercut if Treas. Reg. § 1.856-5(c) were interpreted in a manner that causes the REIT to suffer negative income and asset test consequences from a loan modification. Such an interpretation would only encourage a REIT to foreclose on a distressed mortgage loan rather than agree to a significant modification.

E. REIT Tax Consequences of Foreclosing on a Mortgage Loan

In contrast to the income and asset test consequences of modifying a mortgage loan, the consequences for a REIT foreclosing on a mortgage loan are more settled and benign. In the case of a mortgage loan secured by property that produces qualifying "rents from real property," such as an office building or multi-family apartment building, a REIT can acquire the property through foreclosure without negatively affecting its REIT qualification. All of the "rents from real property" will be treated as qualifying income for both the 75% Gross Income Test and the 95% Gross Income Test,[35] and the property acquired by the REIT upon foreclosure will be a qualifying asset to the extent of the value of the real property and will be a nonqualifying asset to the extent of the value of any other property acquired.

[33] Treas. Reg. § 1.856-6(b)(1). The consequences of a foreclosure property election are discussed in Part II.E below.
[34] Treas. Reg. § 1.856-6(b)(3).
[35] Section 856(c)(2)(c).

Thus, in a foreclosure context, a REIT does not face the risk that its income from the property will be treated as partially nonqualifying for purposes of the 75% Gross Income Test, nor does it face the risk that a disproportionate amount of the value of the foreclosed asset will be treated as nonqualifying for the 75% Asset Test. In addition, if the loan is extinguished as part of the foreclosure, the REIT will no longer own a "security" following foreclosure and, thus, foreclosing on the loan could not cause the REIT to violate the 10% Value Test.

If the secured property does not produce qualifying income, such as a hotel operated by the borrower, or if the REIT intends to dispose of the foreclosed property in a manner that could be treated as a "prohibited transaction,"[36] the REIT may make a foreclosure property election.[37] A REIT's net income from foreclosure property is subject to corporate income tax,[38] but any income from foreclosure property is treated as qualifying income for purposes of both the 75% Gross Income Test and the 95% Gross Income Test.[39] As described in the preceding paragraph, the REIT would have a qualifying asset to the extent of the value of the real property acquired on foreclosure and a nonqualifying asset to the extent of the value of any other acquired property.

Thus, a REIT deciding whether to modify a mortgage loan faces significant uncertainty regarding the income and asset test consequences. On the other hand, the REIT faces much more certain REIT income and asset test consequences if it forecloses, which could drive it to foreclose in situations where modification otherwise is the more attractive option.[40] NAREIT believes that the Service should issue guidance that would lessen the incentives for REITs to foreclose on mortgage loans in default or when default is reasonably foreseeable.

III. CONSEQUENCES OF A REIT ACQUIRING DISTRESSED MORTGAGE LOANS

A. General Federal Income Tax Consequences

When a REIT or any other taxpayer acquires a distressed mortgage loan, the mortgage loan will generally be treated as having "market discount" for federal income tax purposes. Market discount generally arises when the stated redemption price of a bond[41] at maturity exceeds the basis immediately after acquisition (generally the purchase price).[42] That excess is treated as "market discount." If a bond has more than a *de minimis* amount of market discount, the taxpayer generally includes the accrued market discount in income as ordinary income upon a disposition

[36] Section 857(b)(6). A REIT is subject to a 100% tax on the net income derived from the sale of property described in section 1221(a)(1) (*i.e.*, "dealer property").
[37] Section 856(e).
[38] Section 857(b)(4).
[39] Section 856(c)(2)(F), (3)(F).
[40] From a business perspective, a REIT may nevertheless want to avoid foreclosure either because it does not want to own the property securing the loan or it wants to avoid the tax on the net income from the foreclosure property.
[41] A "bond" for purposes of the market discount rules includes any bond, debenture, note, certificate, or other evidence of indebtedness. Section 1278(a)(3).
[42] Section 1278(a)(2). In the case of a bond issued with original issue discount, the stated redemption price of the bond at maturity is treated as being equal to the "revised issue price." I.R.C. § 1278(a)(2)(B), (4).

or retirement of the bond and upon a receipt of a partial principal payment.[43] Any amount treated as ordinary income under the market discount rules is generally treated as interest for federal income tax purposes.[44]

The treatment of market discount for federal income tax purposes is significantly different than the treatment generally afforded to a payment of principal. A principal payment on a bond is generally treated as a tax-free return of loan proceeds. However, if a REIT acquires a distressed mortgage loan at a discount and the loan pays off in accordance with its terms, the entire difference between the purchase price and the stated redemption price at maturity is treated as interest income. If the REIT disposes of the distressed mortgage loan prior to maturity for an amount in excess of its basis, the amount received in excess of the REIT's basis for the loan is treated as interest to the extent of accrued market discount and the amount in excess of the accrued market discount is treated as gain from sale. Thus, for general federal income tax purposes, any "principal" on a distressed mortgage loan that exceeds the purchase price of the loan is not treated upon repayment as a tax-free return of "principal."

The provisions of the Code addressing market discount were added in 1984,[45] three years after the promulgation of Treas. Reg. § 1.856-5(c). Treasury has not amended Treas. Reg. § 1.856-5(c) since the adoption of the market discount rules.

B. <u>Application of Treas. Reg. § 1.856-5(c) to Newly Acquired Distressed Mortgage Loans</u>

The application of Treas. Reg. § 1.856-5(c) in the context of a distressed mortgage loan is not clear. The "amount of the loan" in Treas. Reg. § 1.856-5(c)(3) is defined to mean the "highest principal amount of the loan outstanding during the taxable year." The Service has not indicated whether "principal amount" in the context of a market discount bond means the highest stated principal amount on the bond or, following the treatment of market discount for federal income tax purposes generally, the purchase price for the bond. Using the stated principal amount of a market discount bond as the "principal amount" of the bond for purposes of Treas. Reg. § 1.856-5(c)(3) would cause nonsensical results, as the examples below illustrate.

> <u>Example 4 (Distressed Commercial Mortgage Loan)</u>. A nonrecourse commercial mortgage loan was originally issued with a principal amount of $100 and an interest rate of 10%. The borrower is a partnership for federal income tax purposes. When issued, the loan was secured by real property with a value of $120 and personal property of $5. A REIT acquires the distressed commercial loan for $50, at which time no principal payments have been made on the loan, the fair market value of the real property is worth $60, and the personal property

[43] Section 1276(a)(1), (3). A taxpayer may elect to include market discount in income as it accrues. Section 1278(b).
[44] Section 1276(a)(4). Ordinary income attributable to accrued market discount generally is treated as interest except for certain withholding and reporting purposes. Section 1276(a)(4).
[45] P.L. 98-369, 98 Stat. 494 (1984). Prior to 1984, market discount was generally treated as gain for federal income tax purposes. *Smith v. Comm'r*, 48 T.C. 872, 878-79 (1967).

and other property securing loan (such as tenant loans for overdue rent) have a fair market value of $5.

<u>75% Gross Income Test</u>. If the "principal amount" for purposes of Treas. Reg. § 1.856-5(c)(3) is based on the stated principal amount, the interest income on the loan would be apportioned as follows. The "loan value of the real property" would be $60, and the "amount of the loan" would be $100. Sixty percent of the interest on the loan would be treated as qualifying income for purposes of the 75% Gross Income Test ($60/$100).

<u>Asset Tests</u>. Based on PLR 199923006, a similar allocation would be required for purposes of the asset tests. Applying the most conservative interpretation of Treas. Reg. § 1.856-5(c), 60% of the value of the modified loan would be treated as a qualifying asset and 40% of the value would be treated as a nonqualifying asset ($60 "loan value of the real property"/$100 "amount of the loan"). Thus, although the mortgage loan would have a value of $50, is secured by real property with a fair market value in excess of $50, and is only secured by $5 of personal property, the REIT could be treated as having a qualifying real estate asset of only $30 and a nonqualifying asset of $20.[46] Because the underlying property is an office building, the mortgage loan would likely qualify for the real estate partnership exception to the 10% Value Test even if it does not qualify for the "straight debt" safe harbor.

<u>Example 5 (Distressed Residential Mortgage Loan)</u>. A recourse residential mortgage loan was originally issued with a principal amount of $100 and an interest rate of 6%. When issued, the loan was secured by a fee interest in a single-family home with a fair market value of $105. The REIT acquires the distressed residential mortgage loan for $50, at which time the principal balance is $90 and the fair market value of the real property is $60. The commercial value of items of used personal property, if any, located on the property is zero, as is the value of the recourse against the borrower,[47]and so there is in effect no other property securing the loan.

<u>75% Gross Income Test</u>. Because the residential mortgage is secured by real property and no "other property" secures the loan, no allocation would be required under Treas. Reg. § 1.856-5(c)(3). Thus, 100% of the interest income would be qualifying income for the 75% Gross Income Test.

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[46] As discussed in footnote 26, a more reasonable methodology would be to determine the allocation to the "other property" based on the value of the real property compared to all property securing the loan (*i.e.*, $60/$65) and would treat the loan as a $46.2 qualifying asset and a $3.8 nonqualifying asset. However, this alternative would merely reduce the size of the nonqualifying asset, rather than eliminate it, despite the fact that the value of the loan is fully secured by real estate.

[47] The costs of suing a defaulting borrower and the unlikelihood of collecting a recovery mean that a commercial lender attaches no value to the recourse feature of a residential mortgage loan.

> Asset Tests. Based on PLR 199923006, an allocation would be required because the residential mortgage loan is only partially secured by real property. Applying the most conservative interpretation of Treas. Reg. § 1.856-5(c), 67% of the value of the modified loan would be treated as a qualifying asset and 33% of the value would be treated as a nonqualifying asset ($60 "loan value of the real property"/$90 "amount of the loan"). Thus, although the mortgage loan would have a value of $50, is secured by real property with a fair market value of $60, and is not secured by any other property, the REIT could be treated as having a nonqualifying asset with a $16.5 value.

As Example 4 illustrates, in the context of a distressed commercial mortgage loan, interpreting the "amount of the loan" in Treas. Reg. § 1.856-5(c)(3) to mean initial stated principal amount would cause a significant portion of the post-modification interest income to be nonqualifying income for the 75% Gross Income Test and cause the REIT to be treated as holding a significant nonqualifying asset for the 75% Asset Test—even though the value of the real property securing the distressed mortgage loan exceeds the REIT's economic investment in the loan. Similarly, in the context of a distressed residential mortgage loan, Example 5 illustrates that a REIT may have a significant nonqualifying asset for the 75% Asset Test even though the value of the real property securing the distressed residential mortgage loan exceeds the REIT's economic investment in the loan.

Using the stated principal amount of a distressed mortgage loan as the "amount of the loan" under Treas. Reg. § 1.856-5(c)(3) could make it difficult for a REIT to make a significant investment in distressed mortgage loans and continue to satisfy the requirements necessary for REIT qualification. NAREIT believes this result is not in accord with the policy behind Treas. Reg. § 1.856-5(c), the economic realities of the investment made by the REIT, and the treatment of market discount generally for federal income tax purposes.

IV. SECURITIZED MORTGAGES

The issues discussed above also affect the treatment of mortgage-backed securities held by REITs. When a REIT holds mortgage-backed securities treated as equity interests in a grantor trust for federal income tax purposes, the REIT generally is treated as owning its undivided portion of the assets of the grantor trust.[48] Although the mortgage loans held by the grantor trust may have been fully secured by real property at the time of the formation of the grantor trust, those mortgage loans may not be fully secured when the REIT acquires its interest in the grantor trust. To the extent that a mortgage loan held by a grantor trust is not treated in full as a real estate asset, a concomitant portion of the REIT's interest in the grantor trust is not treated as a real estate asset.[49] Similarly, the REIT's portion of the interest from such a mortgage loan is

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[48] Rev. Rul. 77-349, 1977-2 C.B. 20.
[49] To the extent the interest in the grantor trust is guaranteed as to principal and interest by a government agency, the interest should fall within the category of "Government securities" for purposes of the 75% Asset Test. *See* G.C.M. 39626 (Apr. 30, 1987) (holding that pass-through mortgage-backed certificates guaranteed as to principal and

treated as producing nonqualifying income for purposes of the 75% Gross Income Test. A REIT's compliance with the gross income and asset tests could be jeopardized if it holds an interest in a grantor trust the underlying mortgage loans of which are, as a result of Treas. Reg. § 1.856-5(c), treated as producing some nonqualifying income for the 75% Gross Income Test or as partially nonqualifying assets for purposes of the 75% Asset Test. In addition, if one of the grantor trust's mortgage loans experiences a significant modification after the REIT acquires an interest in the grantor trust, the REIT would encounter the same issues under Treas. Reg. § 1.856-5(c) discussed in Part III.B above as it would if it held the mortgage loan directly.

In the case of mortgage-backed securities issued by entities treated as REMICs for federal income tax purposes, the regular or residual interests in the REMIC are treated as producing qualifying income for purposes of the 75% Gross Income Test and as qualifying assets for purposes of the 75% Asset Test for any calendar quarter, provided that 95% or more of the value of the REMIC's assets for the calendar quarter consist of "real estate assets."[50] If less than 95% of the REMIC's assets for the calendar quarter are real estate assets, then the REIT is treated as holding directly its proportionate share of the assets of the REMIC, and as receiving directly its proportionate share of the income, of the REMIC.[51]

Treas. Reg. § 1.856-3(b)(2) indicates that the definition of "real estate assets" for this purpose is based on the general definition of "real estate assets" for purposes of the 75% Asset Test, which presumably includes the apportionment methodology of Treas. Reg. § 1.856-5(c).[52] There is no guidance addressing how a mortgage loan held by a REMIC that has experienced a "significant modification" under Treas. Reg. § 1.1001-3, but which is not treated as a "significant modification" under the REMIC rules, is treated for purposes of the REIT gross income and asset tests.

Because the determination of whether a mortgage loan for the 95% REMIC threshold is based on the general REIT definition of "real estate asset" (presumably including Treas. Reg. § 1.856-5(c)) and the determination of whether a REMIC satisfies the 95% threshold appears to be made as of each calendar quarter, it appears that a REMIC that initially satisfied the 95% threshold could, as a result of working out a significant number portion of its mortgage loans, subsequently fail the 95% threshold. As a result, any REIT holding an interest in such a REMIC could be treated as holding a partially nonqualifying asset for the 75% Asset Test that produces some nonqualifying income for the 75% Gross Income Test.[53]

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interest by government agencies are treated as "Government securities" for purposes of the asset tests applicable to regulated investment companies).

[50] Treas. Reg. § 1.856-3(b)(2).

[51] Treas. Reg. § 1.856-3(b)(2).

[52] Treas. Reg. § 1.856-3(b)(2).

[53] REMICs have thus far not been used as vehicles for distressed debt investing. Accordingly, the application of Treas. Reg. § 1.856-5(c) to distressed mortgage loans is currently not a significant issue in the REMIC context.

V. UNCERTAINTY REGARDING THE APPLICATION OF TREAS. REG. § 1.856-5(c) IMPAIRS THE ABILITY OF REITS TO FURTHER THE GOVERNMENT'S RESPONSE TO THE CREDIT CRISIS

In its response to the credit crisis, the government has promoted policies that: 1) encourage lenders to work out loans rather than foreclose; and, 2) seek to inject liquidity into the market for distressed mortgage loans and mortgage-backed securities. Programs such as Treasury's "Home Affordable Modification Program" help at-risk homeowners modify their mortgages to avoid foreclosure by providing incentives to lenders/investors, loan servicers, and borrowers.[54] The government is also attempting to draw new private capital to the markets for distressed mortgage loans and mortgage-backed securities through programs such as the Public-Private Investment Program (PPIP).[55]

The uncertainty regarding the application of Treas. Reg. § 1.856-5(c) in the context of modified mortgage loans and newly acquired distressed mortgage loans impedes the government's response to the credit crisis. As discussed above in Part II.B, a "significant modification" of a mortgage loan may cause a REIT difficulty in maintaining its REIT qualification, whereas the REIT can avoid those problems by foreclosing on the loan. NAREIT believes that this preferential treatment of foreclosure over workouts is inconsistent with the government's response to the credit crisis.

Similarly, the uncertainty regarding the application of Treas. Reg. § 1.856-5(c) impedes the ability of REITs to acquire distressed mortgage loans. Because there is uncertainty as to whether a distressed mortgage loan may produce significant nonqualifying income for the 75% Gross Income Test and could be treated in part as a nonqualifying asset for the 75% Asset Test, REITs are limited in their ability to acquire distressed mortgage loans. Again, NAREIT believes this result is inconsistent with the government's response to the credit crisis and does not further any purpose of the REIT rules.

[54] *See* U.S. Dep't of the Treasury, Making Home Affordable Summary of Guidelines (Mar. 4, 2009), *available at* http://www.treas.gov/press/releases/reports/guidelines_summary.pdf. The Service has advanced the goals of the "Home Affordable Modification Program" by issuing guidance providing that the Service will not challenge a securitization vehicle's qualification as a REMIC on the grounds that a modification is not among the exempted types of "significant modifications" under the REMIC rules. *See* Rev. Proc. 2009-23.

[55] The Legacy Loans Program under PPIP is creating public-private investment funds to acquire troubled loans from insured depository institutions, and the Legacy Securities Program under PPIP is designed to draw private capital into the market for legacy mortgage-backed securities through public-private investment funds and an expansion of debt financing available under the Term Asset-Backed Securities Loan Facility. *See* U.S. Dep't of the Treasury, Public-Private Investment Program, *available at* http://www.treas.gov/press/releases/reports/ppip_whitepaper_032309.pdf.

VI. REQUESTED GUIDANCE

NAREIT requests that the Service issue public guidance addressing the treatment of both modified mortgage loans and newly acquired distressed mortgage loans under Treas. Reg. § 1.856-5(c) for purposes of the 75% Gross Income Test and the asset tests.

A. Modified Mortgage Loans

NAREIT requests guidance that the "loan value of the real property" under Treas. Reg. § 1.856-5(c) of a mortgage loan does not change upon a deemed exchange under Treas. Reg. § 1.1001-3 so long as the "significant modification" occurs at a time when the mortgage loan is in default or default is reasonably foreseeable, consistent with the treatment of significant modifications under REMIC rules.[56] Treas. Reg. § 1.856-5(c) requires a determination of the "loan value of the real property" only when the "commitment" by the REIT to originate or acquire the loan becomes binding. The modification of a loan that is in default or when default is reasonably foreseeable should not be treated as a new "commitment" by the REIT to acquire a mortgage loan under Treas. Reg. § 1.865-5(c). Rather, the REIT is merely continuing its original lending commitment instead of foreclosing. Indeed, when a loan is in default or default is reasonably foreseeable, a REIT is being involuntarily forced to decide between modifying the loan and foreclosing. That decision is not akin to the voluntary "commitment" to originate or acquire a loan that was contemplated by Treas. Reg. § 1.856-5(c).

NAREIT believes that it is appropriate to allow a REIT to benefit from this guidance only when the mortgage loan is in default or when default is reasonably foreseeable, the same standard used for REMICs under Treas. Reg. § 1.860G-2(b)(3). This will ensure that the requested protection from fluctuations in market value is provided only when the modification is prompted by events outside of the REIT's control (*i.e.*, the borrower's default or reasonably foreseeable default on the loan).

We note that the requested guidance is consistent with the treatment of "significant modifications" for REMICs under Treas. Reg. § 1.860G-2(b)(3) when the terms of a mortgage loan are changed as a result of a "default or a reasonably foreseeable default." Indeed, NAREIT proposes using the same "reasonably foreseeable default" standard in the requested guidance for REITs.[57] The Service has issued guidance in the REMIC context further liberalizing that standard for loans modified as a part of private and government modification programs, which guidance further assures REMICs that modifying distressed loans will not jeopardize their tax

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[56] Treas. Reg. § 1.860G-2(b)(3)(i).

[57] Because the proposed standard is the same as the one used in Treas. Reg. § 1.860G-2(b)(3), NAREIT requests that any guidance interpreting or changing the "reasonably foreseeable default" standard in Treas. Reg. § 1.860G-2(b)(3)(i) also apply in the REIT context, such as that suggested in a July 24, 2009, letter to the Treasury signed by a number of national real estate organizations, including NAREIT, available at http://www.rer.org/atf/cf/{42ee8980-837f-4af0-a738-d43f0925666b}/2009_07_24_REMIC_TREASURY LETTERV2.PDF.

classification.[58] NAREIT believes that it is similarly appropriate to allow REITs to modify loans that are in a distressed condition without jeopardizing their tax classification.[59]

Moreover, the requested guidance is also consistent with the treatment of modified loans under the foreclosure property rules. Under Treas. Reg. § 1.856-6(b)(3), a modification of a loan is not treated has having been made with an intent to evict or foreclose, or with improper knowledge, unless the original loan was entered into with that intent or knowledge. Much like a modification of a loan does not affect its treatment for purposes of the foreclosure property rules, a modification should not affect the treatment of the loan and its interest income for purposes of the gross income and asset tests.

B. Newly Acquired Distressed Mortgage Loans

NAREIT requests guidance clarifying that the "amount of the loan" under Treas. Reg. § 1.856-5(c) for a mortgage loan acquired by a REIT with market discount is the REIT's highest adjusted tax basis during the year.[60] NAREIT believes it is appropriate and consistent with the treatment of market discount generally to limit the "principal amount" for purposes of Treas. Reg. § 1.856-5(c) to the amount that a REIT may receive tax-free upon repayment of the mortgage loan. To the extent a REIT receives a payment attributable to the stated principal amount in excess of its adjusted tax basis, that payment will be treated as interest income or gain for federal income tax purposes. Accordingly, using adjusted tax basis as the "amount of the loan" under Treas. Reg. § 1.856-5(c) would conform the interpretation of that regulation, which was promulgated in 1981, with the provisions of the Code addressing market discount, which were added in 1984.

C. Form of Guidance

The requested guidance would be limited to an interpretation of an existing Treasury regulation and does not implicate the interpretation of any statutory language in the Code. Accordingly, NAREIT believes that the Service could issue the requested guidance in the form of an interpretation of Treas. Reg. § 1.856-5(c), such as a Revenue Procedure or Revenue Ruling. If it is believed that Treas. Reg. § 1.856-5(c) should be revised, the guidance could be a Notice indicating that the regulation will be revised and establishing rules REITs could rely upon pending issuance of the revised regulation. If it would expedite the process, NAREIT could furnish a draft of the requested guidance.

[58] Rev. Proc. 2009-23; Rev. Proc. 2008-47.
[59] NAREIT does not seek guidance that would limit the federal income tax consequences of a "significant modification" under Treas. Reg. § 1.1003-1 beyond the consequences under Treas. Reg. § 1.856-5(c). Thus, a REIT may still recognize gain or loss upon a "significant modification." *See* footnote 25.
[60] As Treas. Reg. § 1.856-5(c)(3) sets the "amount of the loan" based on the highest principal amount during the year, NAREIT believes it is appropriate in the distressed mortgage loan context to base the "amount of the loan" on the highest adjusted tax basis.

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

Respectfully submitted,

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of less than 10 percent, without paying any U.S. tax.[3] It is time for Congress to do something to level the playing field for small domestic businesses that are subject to the full 35 percent tax on their profits and that are our principal job creators.

[3]*See* Avi-Yonah, Clausing, and Durst, "Allocating Business Profits for Tax Purposes: A Proposal to Adopt a Formulary Profit Split," 9 *Florida Tax Review* 497 (2009).

Treatment of Modified or Distressed Mortgage Loans by REITs

By Steven Z. Hodaszy

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The primary trade organization for the real estate investment trust industry has made a request to Treasury and the IRS for administrative guidance concerning the regulations for testing modified mortgage loans held by REITs and distressed mortgage loans purchased by REITs. In this article, Hodaszy argues that the trade group's request is really a proposal to relax the income and asset test requirements for REITs that hold those loans (which could properly be done only by Congress), and he concludes that, although a temporary change to the rules for testing modified loans may be appropriate in light of the credit crisis, the proposed changes to the rules for testing distressed loans purchased by REITs should be rejected altogether.

A. Introduction

The credit crisis has presented real estate investment trusts (REITs) with extraordinary challenges and opportunities. The challenges, of course, stem from the sharp declines in value of residential and commercial real estate during the last two years and from the simultaneous increases in delinquencies and defaults on residential and commercial real estate loans. Faced with a confluence of rising loan nonperformance and falling collateral values, many mortgage REITs (and other mortgagees) have increasingly had to make a difficult choice. When a mortgage loan becomes in danger of defaulting, the lender must decide whether to allow the loan to default and foreclose on the related mortgaged property (in which case the lender will typically recover only a fraction of the outstanding loan amount) or to modify the loan (often by extending terms to maturity, decreasing interest rates, or writing down principal amounts) to try to maximize the portion of the original loan that is ultimately repaid.

However, these same economic conditions create the potential for significant profits to mortgage REITs that purchase distressed mortgage loans, often for prices representing small fractions of the outstanding loan amounts. A REIT (or any other mortgage investor) that purchases a nonperforming loan at a deep discount to its outstanding principal amount can realize a substantial return by restructuring the loan and then receiving the cash flow generated once the borrower resumes making payments.[1] To take advantage of these opportunities, a number of mortgage REITs have made significant investments in distressed mortgage loans since the onset of the credit crisis. Some of those REITs were established exclusively or primarily for that purpose.[2]

As many mortgage REITs have confronted the need to modify ever-expanding numbers of underperforming loans, and as many others have become enticed by potentially lucrative investment in distressed mortgage debt, the National Association of Real Estate Investment Trusts (NAREIT) has become increasingly anxious that these activities threaten a REIT's qualification as a REIT under the code. As the primary trade association for the REIT industry, NAREIT is concerned that the IRS may have grounds to argue that some modified mortgage loans and distressed mortgage loans held by mortgage REITs do not constitute real estate assets for purposes of the 75 percent quarterly asset test under section 856(c)(4) (the 75 percent asset test) and that at least a portion of the interest received on those loans does not constitute interest on obligations secured by mortgages on real property for purposes of the 75 percent gross income test under section 856(c)(3) (the 75 percent income test). Section 856(c) provides that a corporation, trust, or association will not be considered a REIT for any tax year unless it satisfies both the 75 percent income test and the 75 percent asset test during that tax year (subject only to some limited exceptions in section 856(c)(6) and (7)). Thus, for REITs that hold substantial portfolios of modified or distressed loans, any determination that those assets or the income derived from them fall outside the requirements of those tests could threaten the entity's status as a REIT for federal income tax purposes.

To foreclose the possibility of such an unhappy result, NAREIT wrote a letter to the Treasury Department and the IRS, dated August 12, 2009 (the NAREIT letter),[3] urging the IRS to issue guidance under reg. section 1.856-5(c) "regarding the treatment of modified mortgage loans and newly acquired distressed mortgage loans for purposes of the gross income and asset tests applicable to REITs."[4] As discussed below, the guidance encouraged by NAREIT would ensure that modified or distressed mortgage loans would be good assets for purposes of the 75 percent asset test and that all interest received on those loans would count under the 75 percent income test.

REITs are sometimes described as, or analogized to, "mutual fund[s] for real estate."[5] The purpose of the original REIT legislation in 1960 was "to provide a tax-favored vehicle through which the average person could invest in a professionally managed portfolio of real property."[6] The benefits of investing in such a portfolio would be significantly reduced if the real estate funds were fully subject to corporate-level federal income tax. The added tax expenses would be borne by the funds' shareholders and would substantially reduce the return on the shareholders' investment. In that case, investing in a real estate mutual fund would not be a feasible alternative to investing directly in individual real estate assets. The REIT rules[7] remove this impediment by essentially according conduit treatment to a REIT to the extent that it distributes its taxable income and net capital gains to its shareholders each year, thereby enabling a REIT to avoid all federal income taxes at the entity level.[8] To ensure that the substantial tax benefits conferred by REIT status are enjoyed only by entities that further the legislative purpose of facilitating diversified real estate investment, the REIT rules impose the aforementioned income and asset tests that must be satisfied to maintain qualification as a REIT.[9] These tests are intended to ensure that substantially all of a REIT's assets consist of

[1]There is also money to be made by purchasing undervalued distressed loans at deep discounts and then reselling them in the secondary market at slightly smaller discounts. This cannot be done directly by REITs, however, because the net income from those sales would be subject to a 100 percent prohibited transactions tax under section 857(b)(6). In contrast, a taxable REIT subsidiary meeting the requirements of section 856(l) could engage in this activity.

[2]*See, e.g.*, Hortense Leon, "Slow Thaw for CMBS," *Mortgage Banking*, Nov. 1, 2009, at 46, 2009 WLNR 24019436 ("Fourteen mortgage REITs filed initial public offerings . . . last spring and summer . . . in an effort to buy up distressed commercial real estate debt"); "Property Financing Trends," *Real Estate Executive Report*, Nov. 25, 2009, at 11, 2009 WLNR 23774792 ("In the U.S., REITs are raising money to buy distressed property loans"); "Colony, Apollo Price REIT Offerings," *Daily Deal*, Sept. 24, 2009, 2009 WLNR 19213977 ("The two REITs hope to capitalize on forecasts that banks will unload commercial and residential real estate loans at distressed prices").

[3]A copy of the NAREIT letter is available at *Doc 2010- 5350* or *2010 TNT 50-14*.

[4]*Id.* at 1.

[5]Michael Carnevale et al., *Real Estate Investment Trusts* (BNA Portfolio 742), at Section I.

[6]*Id.*

[7]For provisions related to the qualification and federal income taxation of REITs, see generally sections 856 through 860 and the Treasury regulations thereunder.

[8]Carnevale et al., *supra* note 5, at Section I. A "REIT is not a pass-through entity like a partnership or S corporation, but rather avoids taxation at the entity level only by distributing its income as dividends." *Id.* at Section IV.B.1. Under section 857(b)(2)(B), a REIT is entitled to receive a dividends paid deduction for all dividends that it pays to shareholders during a given tax year. Under section 857(b)(3)(A)(ii), a REIT is entitled to receive a dividends paid deduction for all capital gains dividends that it pays to shareholders in a tax year. Section 857(a)(1)(A) provides that, to receive tax treatment as a REIT for a tax year, the REIT must distribute to its shareholders at least 90 percent of its real estate investment trust taxable income (as defined under section 857(b)(2)) for the tax year and at least 90 percent of its after-tax net income on foreclosure property for the tax year. A REIT has the option to retain the remaining 10 percent of its annual ordinary income and to retain all or part of its annual net capital gains; however, if it does so, the REIT "will be subject to a corporate tax on such income." *Id.* Thus, to completely avoid corporate-level tax, a REIT must distribute 100 percent of its ordinary income and net capital gains to its shareholders each year.

[9]*See* section 856(c)(2) through (4). In addition to the 75 percent income test and the 75 percent asset test, section 856(c)(2) imposes a separate test on 95 percent of a REIT's annual gross income.

interests in real property and that substantially all of its income derives from interests in real property.

The basic question raised by NAREIT's proposal is how best to evaluate modified mortgage loans held by REITs and distressed mortgage loans purchased by REITs, for purposes of the income and asset tests. On one hand, a REIT's qualification should not be jeopardized by a rule that does not sufficiently treat real-estate-related assets as real estate. On the other hand, a rule that mischaracterizes non-real-estate assets as real property could permit an entity to receive the tax benefits of REIT status when that status is unwarranted. Viewed in this light, does the apportionment test imposed by reg. section 1.856-5(c) accurately measure the extent to which modified or distressed mortgage loans comprise interests in real property and the extent to which the cash flow received on those loans consists of income derived from interests in real property? Do today's economic conditions present public policy grounds for relaxing the test? And if there is a reason to modify the test, how should that change be effected?

This article examines the regulatory guidance that NAREIT suggests and compares NAREIT's proposal with reg. section 1.856-5(c) as currently interpreted and applied, as well as with the relevant sections of the code itself. In the case of NAREIT's proposal for the treatment of modified loans, the article also considers Treasury's recent regulations concerning loan modifications in the analogous sphere of the real estate mortgage investment conduit (REMIC) rules. The article determines that, although the public policy arguments NAREIT invokes in support of its proposal for modified loans are not without force, the proposal constitutes a significant change from (rather than a mere interpretation of) the current provisions of reg. section 1.856-5(c) as applied to modified loans, and it lacks any support in the statutory language of the code. Moreover, the article notes that the proposal is at odds with Treasury's position on loan modifications in the REMIC area. To balance the competing interests of ensuring that REITs are invested primarily in real estate assets and encouraging mortgage loan modifications during the credit crisis, the article proposes an expressly temporary suspension in the application of reg. section 1.856-5(c) to mortgage loans that are modified because of an actual or reasonably foreseeable default. (This contrasts with NAREIT's proposal, which in effect would permanently cease the regulation's application to those loans.) However, this article concludes that, if the public policy arguments NAREIT advances are sufficient to justify relaxing the general requirements of the 75 percent income test and the 75 percent asset test for those loans (even for a limited time), the appropriate way to effect that change is through congressional, rather than administrative, action.

Regarding NAREIT's proposal for the treatment of distressed loans, the article first notes that the proposal is directly contrary to the clear and unambiguous language of reg. section 1.856-5(c)(1)(iii) and thus cannot be considered to be an "interpretation" of that regulation, as NAREIT contends. The article determines that the proposal would thus constitute an entirely new regulation, which would lack any support in the statutory language of the code and would therefore fall outside the broad scope of the rulemaking authority of the Treasury secretary and the IRS. Because the purported policy justifications NAREIT raises in support of its distressed loan proposal are ultimately unconvincing, the article concludes that the proposal should be rejected.

B. Significantly Modified Mortgage Loans

The potential adverse consequences of mortgage loan modifications under the 75 percent income test and the 75 percent asset test arise from (1) the treatment of some "significant" loan modifications as exchanges of one debt instrument for another under reg. section 1.1001-3, and (2) the rules under reg. section 1.856-5(c) for apportionment of interest received on mortgage loans (and, by extension of the application of that regulation, apportionment of the value of the loan itself) for some loans secured by both real property and other property.

Reg. section 1.1001-3 provides rules for determining whether a modification of a debt instrument constitutes an exchange of property that results in the realization of gain or loss for purposes of reg. section 1.1001-1(a).[10] If there is a significant modification of the terms of a debt instrument, as determined under reg. section 1.1001-3(e), that modification will be deemed to result in a section 1001 taxable exchange of the original debt instrument for a new debt instrument.[11]

Under the general rule of reg. section 1.1001-3(e), a modification is significant "if, based on all facts and circumstances, the legal rights or obligations that are altered and the degree to which they are altered are economically significant."[12] That general rule is supplemented by a list of categories of modifications in reg. section 1.1001-3(e)(2) through (6) that are deemed always to be significant. Among them are changes in the yield of a debt instrument by more than the greater of one-quarter of 1 percent or 5 percent of the annual yield of the unmodified instrument; modifications that result in a material deferral of scheduled payments under the debt instrument; and releases, substitutions, or other alterations of collateral for the debt that result "in a change in payment expectations."[13] Of course, these categories comprise the most common term changes mortgagees (including REITs) use to try to work out delinquent and defaulted loans.

1. Retesting of significantly modified mortgage loans under the apportionment test of reg. section 1.856-5(c).

"Because a significant modification of a debt instrument results in the deemed issuance of a new debt instrument,"[14] REITs have puzzled over whether those modifications can affect their compliance with the 75 percent

[10] *See* reg. section 1.1001-3(a)(1).

[11] Richard M. Lipton, "Debt Workout Issues for REITs Are Complicated, Whether They Are Debtors or Creditors," 111 *J. Tax'n* 158, 160 (describing reg. section 1.1001-3).

[12] Reg. section 1.1001-3(e)(1) (cited in Lipton, *supra* note 11, at 160).

[13] Lipton, *supra* note 11, at 160 (summarizing reg. section 1.1001-3(e)(2), (3), and (4)).

[14] *Id.* at 167.

income test and the 75 percent asset test.[15] When a REIT significantly modifies a mortgage loan that it holds, do the regulations treat the modified loan as a newly acquired loan that must be retested under reg. section 1.856-5(c) to determine whether the REIT continues to satisfy the income and asset tests? To date, the IRS has not issued any guidance on this question.[16] In the absence of such guidance, NAREIT has expressed concern, and a past chair of the American Bar Association Section of Taxation has concluded that retesting may in fact be required.[17]

The retesting of significantly modified loans for purposes of the 75 percent income test and the 75 percent asset test may be particularly problematic for REITs in the case of loans secured by both real property and other property.[18] This is a significant issue for any REIT that holds commercial mortgage loans, because those loans are frequently collateralized by both real property and personalty.[19]

Section 856(c)(3)(B) specifies that, for purposes of the 75 percent income test, interest income "includes only mortgage interest income on loans secured by real property or interests in real property."[20] Accordingly, reg. section 1.856-5(c)(1) provides that for a mortgage collateralized by both real and personal property, an apportionment must be made to determine the amount of mortgage interest that qualifies under the 75 percent income test.[21] Under that regulation, if the "loan value" of the real property equals or exceeds the amount of the loan, all interest income is apportioned to the real property.[22] In contrast, "if the amount of the loan exceeds the loan value of the real property, the interest income apportioned to the real property is an amount equal to the interest income multiplied by the ratio of the loan value of the real property to the amount of the loan. . . . The balance of the interest income is apportioned to the 'other property.'"[23] The portion of the interest income apportioned to the other property does not qualify as good income under the 75 percent income test.[24]

For a loan purchased by a REIT, the loan value of the real property is the property's fair market value, determined as of the date on which the REIT's commitment to purchase the loan becomes binding on the REIT.[25] The "amount of the loan," in turn, means the highest principal amount of the loan outstanding during the REIT's tax year.[26] Therefore, when retesting a significantly modified mortgage loan under reg. section 1.856-5(c), the loan value of the real property would be the fair market value (FMV) of that property immediately after the modification occurs, and the amount of the loan would be the highest principal amount of the loan during the tax year in which the modification occurs.

A significant modification often occurs after the FMV of the real property collateral has declined substantially, and that lower postmodification value will constitute the loan value of the real property under reg. section 1.856-5(c)(2) for purposes of a retest of the modified loan. At the same time, under reg. section 1.856- 5(c)(3), the amount of the modified loan for purposes of a retest will continue to be the highest outstanding principal balance of the loan during the tax year in which the modification occurs. For those reasons, in the case of a significantly modified loan secured by both real property and other property, the percentage of the interest income received on the loan that is apportioned to the other property — and that is thus not taken into account as good income under the 75 percent income test — is likely to be considerably greater than the percentage of interest income that was so apportioned (and excluded) when the REIT originally acquired the loan. For a mortgage REIT that significantly modifies a lot of mixed-collateral loans in its portfolio, the retesting could cumulatively cause enough interest income to be reclassified as non-mortgage-related that the REIT would fail the 75 percent income test.[27]

Retesting significantly modified mixed-collateral mortgage loans under reg. section 1.856-5(c) can cause similar outcomes under the 75 percent asset test. Under section 856(c)(4)(A) and (c)(5)(B), interests in mortgages on real property constitute good assets for purposes of the 75 percent asset test. However, if a mortgage loan held by a REIT is collateralized by both real property and other property, "an apportionment is necessary because only the value of the real property or the portion of a mortgage secured by real property is included for purposes of the" 75 percent asset test.[28] There are no regulations under section 856(c)(4) that specify how to calculate such an apportionment under the 75 percent asset test. However, in LTR 199923006 (Feb. 19, 1999), *Doc 1999-20496, 1999 TNT 113-43*, the IRS concluded that "the apportionment methodology specified in section 1.856-5(c)(1) may be applied to make this determination."[29] Thus, for a mixed-collateral loan in which the amount of the loan exceeds the loan value of the real property securing the loan, the portion of the loan that qualifies as

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[15] NAREIT letter, *supra* note 3, at 7.

[16] *Id.*; Lipton, *supra* note 11, at 167.

[17] NAREIT letter, *supra* note 3, at 7; Lipton, *supra* note 11, at 167.

[18] NAREIT letter, *supra* note 3, at 7-9.

[19] *Id.* at 8 (citing an example of a commercial real estate loan secured by real property and personal property); *see also* Letter From the American Securitization Forum (ASF) to Treasury, Oct. 13, 2009, at 2. ("Commercial real property loans existing in the securitization world are generally secured by . . . real property and the personal property or reserves utilized in connection therewith.") A copy of the letter is on the ASF's Web site, *available at* http://www.americansecuritization.com.

[20] Carnevale et al., *supra* note 5, at Section III.C.6.b.(4).

[21] *Id.* (summarizing reg. section 1.856-5(c)(1)).

[22] Robert J. Haft and Peter M. Fass, *Tax Advantaged Securities*, at para. 25:113 (paraphrasing reg. section 1.856-5(c)(1)(i)).

[23] *Id.*

[24] *Id.*; reg. section 1.856-5(c)(1)(ii).

[25] Reg. section 1.856-5(c)(2).

[26] Reg. section 1.856-5(c)(3).

[27] *See generally* NAREIT letter, *supra* note 3, at 3-11; Lipton, *supra* note 11, at 167.

[28] Carnevale et al., *supra* note 5, at Section III.B.2.d.

[29] LTR 199923006 at 4 (cited in Carnevale et al., *supra* note 5, at Section III.B.2.d, and NAREIT letter, *supra* note 3, at 6).

a real estate asset under section 856(c)(4)(A) is determined by analogy to the rules for apportioning interest income. By operation of those rules, the qualifying portion of the loan is limited to the "amount of the loan" (as determined under reg. section 1.856-5(c)(3)) multiplied by a fraction, the numerator of which is the "loan value of the real property" (as determined under reg. section 1.856-5(c)(2)) and the denominator of which is the amount of the loan.[30]

Because the same method used to retest the qualifying income of a mixed-collateral loan following a significant modification is also to be used to retest the qualifying asset value of that loan, the same result may be expected. As a result of a probable decline in the FMV of the real property collateral since the acquisition of the loan (and because of the rule for defining the amount of the loan as the highest outstanding principal amount during the tax year of the modification), the percentage of the loan that qualifies under the 75 percent asset test after the modification is likely to be considerably smaller than the percentage of the loan that originally qualified. Thus, similar to the issue raised under the 75 percent income test, a mortgage REIT that significantly modifies a lot of mixed-collateral loans in its portfolio runs the risk that retesting those loans under reg. section 1.856-5(c) could result in the reclassification of enough of its assets as non-real-estate-related to cause the REIT to fail the 75 percent asset test.[31]

2. NAREIT's proposed change to reg. section 1.856-5(c). To avoid these consequences under the 75 percent income test and the 75 percent asset test, NAREIT has asked the IRS to issue guidance under reg. section 1.856-5(c) that would preclude any retesting of a significantly modified loan for purposes of either test if the modification occurred when the loan was in default or in danger of default.[32] Specifically, "NAREIT requests guidance that the 'loan value of the real property' under reg. section 1.856-5(c) of a mortgage loan does not change upon a deemed exchange under reg. section 1.1001-3 so long as the 'significant modification' occurs at a time when the mortgage loan is in default or default is reasonably foreseeable."[33]

That guidance, if granted, would effectively eliminate any requirement to retest the loan under reg. section 1.856-5(c), because the loan value of the real property securing the loan, for purposes of the retest, would continue to be the same as it was when the REIT originated or acquired the loan. Thus, the ratio of the amount of the modified loan to the value of the real property collateral would never be greater than the loan-to-value ratio of the "old" loan at the time of origination or acquisition, even if the property's FMV declined substantially or if the lien on some or all of the real property originally securing the loan had been released. Indeed, the loan-to-value ratio might even decrease, depending on the extent to which the loan amount was or was not reduced since origination or acquisition. In other words, the extent to which the modified loan was secured by real property would be deemed to be greater (and often perhaps far greater) than the actual amount of that security. In that case, a correspondingly greater percentage of the postmodification interest received on the loan would be deemed to qualify under the 75 percent income test than would qualify if the loan were retested after the modification using the actual loan value of the real property securing the loan at that time. Similarly, a correspondingly greater percentage of the modified loan itself would be deemed to qualify under the 75 percent asset test. In essence, this would allow a REIT to treat property that the REIT rules would not otherwise consider to be real-estate-related as good income and good assets.

Suppose, for example, that a mortgage REIT originated a loan for the purchase of an office building and that the loan was secured by the building and the underlying land and was also secured by some related personal property. Assume that the initial principal amount of the loan was $60 million and, at the time of origination, the FMV of the real property was $60 million and the FMV of the personal property was $15 million. Under reg. section 1.856-5(c)(2), the loan value of the real property would have then been $60 million and, under reg. section 1.856-5(c)(3), the amount of the loan also would have been $60 million. Because the loan value of the real property was equal to the amount of the loan at origination, the entire amount of the interest income on the loan would be apportioned to the real property under reg. section 1.856-5(c)(1)(i) and thus would be qualifying income under the 75 percent income test. By further application of that regulation using the method set forth in LTR 199923006, the entire outstanding principal amount of the loan would be apportioned to the real property and would constitute a qualifying asset for purposes of the 75 percent asset test.

Next, suppose that, after having made scheduled payments on the loan, which reduced the principal amount by $10 million, the borrower becomes more than 60 days delinquent on the loan and default is thus reasonably foreseeable. To try to work out the loan, the REIT agrees to decrease the interest rate on the loan by 2 percent. This change constitutes a significant modification of the loan under reg. section 1.1001-3(e)(2). Assume that the FMV of the building and underlying land immediately after the modification had declined to $40 million, and the FMV of the personal property securing the loan was then $10 million. During the tax year of the REIT in which the modification occurred, the highest outstanding principal amount of the loan was $50 million. Under the most likely interpretation of the current regulations, the loan would be retested after the modification. Under reg. section 1.856-5(c)(2), the loan value of the real property would then be $40 million and, under reg. section 1.856-5(c)(3), the amount of the loan would then be $50 million. Because the amount of the loan would then exceed the loan value of the real property, under reg. section 1.856-5(c)(1)(ii), 80 percent of the interest income on the modified loan would be apportioned to the real property and the remaining 20 percent would be apportioned to the other property under reg.

[30]*See* reg. section 1.856-5(c)(1)(ii).
[31]*See* NAREIT letter, *supra* note 3, at 6, 8.
[32]*Id.* at 2.
[33]*Id.* at 17.

section 1.856-5(c)(1)(ii). As a result, 80 percent of that income would qualify under the 75 percent asset test and the other 20 percent would not. Similarly, $32 million of the $40 million outstanding amount of the modified loan would be treated as a qualifying asset under the 75 percent asset test, and the remaining $8 million of the modified loan would be a nonqualifying asset. Thus, the modified loan would constitute good property under the income and asset tests only to the extent that it was actually secured by real property.

In contrast, under NAREIT's proposal, the loan value of the real property securing the modified loan would be deemed to be $60 million (the original amount) for purposes of reg. section 1.856-5(c)(2), even though the FMV of that property immediately after the modification was only $40 million. Therefore, in any retest of the modified loan, the loan value of the property would be deemed to exceed the amount of the loan (even though it would actually be up to 20 percent less). Accordingly, by operation of reg. section 1.856-5(c)(1)(i) and the other provisions discussed in the prior example, the results of the retest would be the same as the results of the test of the "old" loan at origination: All of the income would qualify under the 75 percent income test, and the entire loan would qualify under the 75 percent asset test. Thus, for a significantly modified mixed-collateral loan, NAREIT's proposal would allow a REIT to treat the portion of the loan not secured by real property as a qualifying asset under the 75 percent asset test and to treat the interest on that portion of the loan as qualifying income under the 75 percent income test. For REITs that have a substantial number of those loans in their portfolio, this could enable them to continue to enjoy the tax benefits of REIT status while holding considerably greater percentages of non-real-estate-related property than would otherwise be permitted.

Given that the fundamental intent of the original REIT legislation was to provide a tax-favored vehicle through which to invest in real property,[34] what could justify revising the REIT regulations to relax the limits on non-real-estate-related assets and income in these circumstances? NAREIT argues primarily that its proposal would further the government's policy goal, in response to the credit crisis, of "encouraging lenders to modify mortgage loans to avoid foreclosure."[35] According to the trade group, that policy objective "would be undercut if reg. section 1.856-5(c)(2) were interpreted in a manner that causes [a] REIT to suffer negative income and asset test consequences from a loan modification. . . . Such an interpretation would only encourage a REIT to foreclose on a distressed mortgage loan rather than agree to a significant modification."[36] To buttress its position, NAREIT further argues that "the requested guidance is consistent with the treatment of 'significant modifications' for REMICs under reg. section 1.860G-2(b)(3) when the terms of a mortgage loan are changed as a result of a 'default or a reasonably foreseeable default.'"[37]

3. NAREIT's inapposite analogy to the REMIC rules. As an initial matter, NAREIT misses the mark when it argues that its proposed guidance under reg. section 1.856-5(c) would be consistent with the treatment of significant modifications under the rules for REMICs. It is true, as NAREIT points out, that changes in the terms of a mortgage loan held by a REMIC, which otherwise would be significant modifications of the loan under reg. section 1.1001-3(e), will not be classified as significant if those changes are "occasioned by default or a reasonably foreseeable default" on the loan.[38] By analogizing that rule to its proposal for REITs, NAREIT seems to suggest that significantly modified loans in REMICs do not have to be retested to determine whether they continue to be sufficiently secured by real property after the modification.[39] In reality, however, newly enacted REMIC regulations expressly impose such a requirement, as discussed below. NAREIT's analogy is therefore inapposite.

Under section 860D(a), for an entity to be qualified as a REMIC, substantially all of its assets must consist of qualified mortgages and permitted investments.[40] This assets test "applies continuously over the entire life of a REMIC except during an initial period and final period."[41] For a mortgage loan to be a qualified mortgage, it must be an obligation that is "principally secured by an interest in real property."[42] Reg. section 1.860G-2(a)(1) sets forth precise tests for determining whether a loan is principally secured by an interest in real property for purposes of section 860G(a)(3)(A). Generally, that regulation requires either that the FMV of the real estate collateral equal at least 80 percent of the adjusted issue price of the loan at the time of the loan's origination or at the time of the REMIC's acquisition of the loan,[43] or that substantially all of the loan proceeds were used to acquire, improve, or protect an interest in real property that was the only security for the loan at the time of origination.[44]

Also, to be a qualified mortgage, the loan must be (1) transferred to the REMIC on the startup day in exchange for REMIC regular interests; (2) purchased by the REMIC within three months after the startup day under a fixed price contract in effect on the startup day; or (3) a

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[34] *See* Carnevale et al., *supra* note 5, at Section I.

[35] NAREIT letter at 2.

[36] *Id.* at 10.

[37] *Id.* at 17.

[38] Reg. section 1.860G-2(b)(3); *see also* NAREIT letter, *supra* note 3, at 9 (discussing same).

[39] *See, e.g.*, NAREIT letter, *supra* note 3, at 17 (arguing that precluding retesting of the loan value of real property securing a defaulted loan in a REIT, following a significant modification of the loan, would produce the same result for REITs that reg. section 1.860G-2(b)(3) produces for REMICs).

[40] *See* section 860D(a)(4).

[41] James M. Peaslee and David Z. Nirenberg, *The Federal Income Taxation of Mortgage-Backed Securities*, at 109 (rev'd ed. 1994).

[42] Section 860G(a)(3)(A).

[43] *See* reg. section 1.860G-2(a)(1)(i).

[44] *See* reg. section 1.860G-2(a)(1)(ii); *see also* Peaslee and Nirenberg, *supra* note 41, at 114-115 (summarizing reg. section 1.860G-2(a)(1)).

qualified replacement mortgage.[45] If the loan is a qualified replacement mortgage (as defined under section 860G(a)(4)), it must be transferred to the REMIC within two years after the startup day.[46]

Given that substantially all of the mortgages held by a REMIC must be qualified mortgages, deeming a significant modification of a mortgage loan in a REMIC as an exchange for a new loan could have "severe" consequences.[47] Further, because of the timing restrictions on when a REMIC can acquire a qualified mortgage, those severe consequences could occur even if the significantly modified loan continues to be principally secured by real estate after the modification. Assuming that the modification occurs more than three months after the startup date, "the 'new' mortgage would not be a qualified mortgage unless it is a qualified replacement mortgage, which would be impossible if the date of the exchange is more than two years after the startup day."[48] If the new mortgage were not a qualified mortgage, all income from the new mortgage would be subject to a 100 percent prohibited transactions tax under section 860F(a)(1), "and the REMIC election would terminate unless the new mortgage, together with other nonpermitted assets, is considered de minimis in amount."[49] To prevent that result in the context of workouts of defaulted loans (or loans that are in danger of default), reg. section 1.860G-2(b)(3)(i) provides that changes in the terms of a loan that are occasioned by default or a reasonably foreseeable default will not result in deemed exchanges, even if the changes would otherwise constitute a significant modification under reg. section 1.1001-3(e).[50]

Nevertheless, Treasury recently made clear that, if those changes to the loan terms could affect the value of the real property collateralizing the loan, the modified loan will be retested to ensure that it continues to be principally secured by an interest in real property.[51] Treasury recently issued new REMIC regulations to expand the list of loan modifications that will not be treated as an exchange of obligations, even though the modifications would otherwise constitute significant modifications under reg. section 1.1001-3(e).[52] Although they apply to all mortgages, the new regulations expand the list of permitted loan modifications to include "certain modifications that are often made to commercial mortgages."[53] Importantly, however, because some of these newly permitted modifications are changes that "could affect the value of the collateral securing the mortgage loan,"[54] those changes are allowed only "so long as the obligation continues to be principally secured by an interest in real property."[55]

The new regulations now permit a modification "that releases, substitutes, adds, or otherwise alters a substantial amount of the collateral for, a guarantee on, or other form of credit enhancement for, a recourse or nonrecourse obligation, *so long as the obligation continues to be principally secured by an interest in real property following the release, substitution, addition or other alteration.*"[56] They also permit a "change in the nature of the obligation from recourse . . . to nonrecourse" or vice versa *"so long as the obligation continues to be principally secured by an interest in real property following such a change.*"[57]

Under reg. section 1.860G-2(b)(7), a modified obligation will continue to be principally secured by an interest in real property for purposes of reg. section 1.860G-2(b)(3)(v) and (vi) if (1) the FMV of the interest in real property securing the obligation determined as of the modification date is at least 80 percent of the adjusted issue price of the modified obligation determined as of the modification date, or (2) the FMV of the interest in real property that secures the obligation immediately after the modification equals or exceeds the FMV of the interest in real property that secured the obligation immediately before the modification.[58] An example illustrating how these rules work is set forth in reg. section 1.860G-2(b)(7). In that example, it is reasonably foreseeable that the borrower might default on the loan and, to reduce the risk of default, the REMIC servicer agrees to release the lien on the real property originally securing the loan and to substitute new real property as collateral. This example thus makes clear that the retesting rules under reg. section 1.860G-2(b)(7) apply even when the modification is made because the loan is in default or in danger of default.

Predictably, before final enactment of the regulations, several commentators argued against retesting under reg. section 1.860G-2(b)(7).[59] Even after the regulations became final, the American Securitization Forum (ASF), a large trade group for the securitization industry, has continued to press such arguments. In particular, the ASF has vigorously objected to applying reg. section 1.860G-2(b)(7) to the release of a lien on real property securing a loan, because commercial mortgage documents often require those releases in specific circumstances and "when real property is released, the fair market value of the real property collateral cannot help but decline by the market value of the real property released."[60] None of

[45] *See* section 860G(a)(3)(A).

[46] *See* section 860G(a)(4)(B)(ii).

[47] Peaslee and Nirenberg, *supra* note 41, at 147.

[48] *Id.*

[49] *Id.*

[50] *Id.* at 148-150 (discussing reg. section 1.860G-2(b) and policies related thereto).

[51] *See* 74 *Fed. Reg.* 47,437 (describing requirement for retesting of mortgage loans following newly permitted modifications under REMIC regulations).

[52] *See* T.D. 9463, 74 *Fed. Reg.* 47,436-47,439 (Sept. 16, 2009) (Modifications of Commercial Mortgage Loans Held by a Real Estate Mortgage Investment Conduit (REMIC)), *Doc 2009-20504, 2009 TNT 177-11.*

[53] *Id.* at 47,436.

[54] *Id.* at 47,437.

[55] *Id.* at 47,436.

[56] Reg. section 1.860G-2(b)(3)(v) (emphasis supplied).

[57] Reg. section 1.860G-2(b)(3)(vi) (emphasis supplied).

[58] Reg. section 1.860G-2(b)(7)(ii) and (iii).

[59] *See* 74 *Fed. Reg.* at 47,437 (paraphrasing those arguments).

[60] Letter from the ASF to the IRS and Treasury, dated Sept. 30, 2009, at 2 (a copy of which is *available at* http://www.americansecuritization.com); *see also* the October ASF letter, *supra* note 19, at 1-3 (arguing against retesting under the "principally secured" standard after a lien release).

those arguments has prevailed thus far. "To ensure that a modified mortgage loan continues to be principally secured by an interest in real property, the IRS and the Treasury Department continue to believe that it is appropriate to retest at the time of the modification."[61]

Therefore, even if there might be a legitimate public policy argument to support NAREIT's proposed guidance under reg. section 1.856-5(c), the proposal contradicts the position recently taken by Treasury and the IRS in the analogous sphere of the REMIC regulations.

4. Responses to NAREIT's proposal regarding the treatment of modified mortgage loans. NAREIT contends that its requested guidance "would be limited to an interpretation of an existing Treasury regulation," reg. section 1.856-5(c), and that the guidance would not "implicate the interpretation of any statutory language in the Code."[62] Yet NAREIT's proposed rule appears far more akin to an entirely new regulation than to the interpretation of an existing one. Simply put, nothing in the current apportionment rules under reg. section 1.856-5(c) distinguishes in any way between the treatment of defaulted loans (or loans for which default is reasonably foreseeable) and the treatment of other loans. Because nothing in the regulation speaks to the issue, there is by definition no language within the regulation susceptible of the "interpretation" NAREIT presses. Indeed, as previously noted, at least one prominent commentator has concluded that reg. section 1.856-5(c) can be reasonably interpreted to require the retesting of *any* significantly modified mortgage loan held by a REIT for purposes of both the 75 percent income test and the 75 percent asset test.[63] NAREIT itself has effectively acknowledged this point by expressing its concern about the effects of such an interpretation.[64] Thus, rather than a mere elaboration of reg. section 1.856-5(c), NAREIT's proposal may instead contradict the current regulation.

When viewed in this light, it is important to note that NAREIT's proposed rule does not have any basis in the statutory language of section 856(c) itself. Neither section 856(c)(3) nor any other code provision contemplates any special considerations for defaulted loans in determining whether interest income therefrom qualifies under the 75 percent income test, and neither section 856(c)(4) nor any other code provision contemplates any special consideration for defaulted loans in determining whether the loan itself qualifies under the 75 percent asset test. Accordingly, there can be no argument that NAREIT's proposed rule constitutes the mere interpretation or application of existing statutory language. For this reason, the promulgation of that rule — whether in a revenue ruling or in a Treasury regulation, as NAREIT alternatively suggests — arguably exceeds the broad scope of the authority of the Treasury secretary (and, by extension, the IRS[65]) under section 7805(a) to "prescribe all needful rules and regulations" for enforcement of the code.[66]

None of this is to deny that the substance of NAREIT's argument has some force. Requiring the retesting of significantly modified mortgage loans under the apportionment rules of reg. section 1.856-5(c) provides a tax incentive for a REIT to foreclose on defaulted mixed-collateral loans rather than modify them whenever modification might jeopardize its REIT qualification. This incentive is indeed at odds with the often-stated policy goal of discouraging foreclosures and encouraging mortgage loan modifications during the credit crisis.

Still, NAREIT's requested limitation of reg. section 1.856-5(c) would constitute a significant exception to the fundamental principle that REITs are accorded their substantial tax benefits specifically to facilitate investment in real-estate-related assets.[67] The obvious corollary to that precept, reflected in the 75 percent income test and the 75 percent asset test, is that entities enjoying tax treatment as REITs should not derive material income from, or be materially invested in, non-real-estate assets. Any change to the REIT rules that would vary from that foundational principle — for example, an exception permitting REITs to satisfy the income and asset tests by holding loans that are not sufficiently secured by real estate — should not be made lightly.

There is one approach that might strike an appropriate balance between requiring mortgage REITs to hold loans secured by real estate assets, on one hand, and furthering the goal of promoting mortgage modifications in the current economic environment, on the other: Congress could enact amendments to the 75 percent income test and the 75 percent asset test that would suspend the requirement to retest significantly modified loans under reg. section 1.856-5(c) for modifications made during a limited period (say, between now and January 1, 2012) if the modifications occur because the loans are in default or are about to go into default. This exception to the general rule would be only temporary, and it would be enacted expressly as a response to the credit crisis and economic conditions. The exception would sunset after a point at which the economy and the credit markets are anticipated (or at least hoped) to have improved sufficiently, and there would then be a reversion to the regular apportionment test for measuring whether significantly modified mixed-collateral loans meet the 75 percent

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[61] 74 *Fed. Reg.* at 47,437.

[62] *Id.* at 18.

[63] *See* Lipton, *supra* note 11, at 167.

[64] *See* NAREIT letter, *supra* note 3, at 7.

[65] "The Secretary of the Treasury has delegated the authority to issue regulations to the Commissioner of Internal Revenue, subject to the approval of the Assistant Secretary of the Treasury for Tax Policy," Michael J. Graetz and Deborah H. Schenk, *Federal Income Taxation Principles and Policies*, at 72 (6th ed. 2009).

[66] *See generally* Leandra Lederman and Stephen W. Mazza, *Tax Controversies: Practice and Procedure*, at 5-6 (3d ed. 2009) (discussing the authority of Treasury and the IRS "to promulgate various types of rules and pronouncements to assist taxpayers in *interpreting* and *applying* the Code") (emphasis supplied).

[67] *See generally* Carnevale et al., *supra* note 5, at Section I (discussing policy considerations underlying REIT rules).

income test and the 75 percent asset test.[68] Such an action would be consistent in spirit and approach with other recent temporary measures that Congress has enacted into the code in response to the economic downturn.[69]

However, the decision whether to adopt either that temporary measure or the permanent rule change NAREIT advocates should lie with Congress, not Treasury or the IRS. If a temporary measure is to be enacted or if any version of NAREIT's proposal for a permanent revocation of the retesting requirement is to be effected, it should be done directly through congressional action rather than through a new Treasury regulation or through the IRS's issuance of a revenue procedure or revenue ruling, as NAREIT suggests.[70] Any rule that would relax a REIT's restrictions on holding or deriving income from non-real-estate-related assets (even for a limited period) would be too significant a change to the REIT regime — and too far removed from any current statutory provision — to be done merely through administrative action under the Treasury secretary's or the IRS's general authority to interpret and apply the code. If Congress concludes that a significantly modified mixed-collateral loan held by a REIT should not be retested for apportionment under reg. section 1.856-5(c) if the modification occurred because the loan was in default or was about to go into default, it should either enact appropriate substantive amendments to the 75 percent income test and the 75 percent asset test or, at the very least, add language to section 856(c)(3) and (4) to provide the secretary with specific authority to promulgate regulations on the issue.

C. Purchases of Distressed Mortgage Loans

The apportionment rules under reg. section 1.856-5(c) can also create adverse consequences under the 75 percent income test and the 75 percent asset test for REITs that invest in distressed mortgage loans. Typically, the FMV of the real property securing a distressed mortgage loan will be lower (often substantially lower) than the outstanding principal amount of the loan. To reflect the corresponding risk of limited recovery on such a loan, the purchase price of the loan in the secondary market will generally be only a small fraction of the outstanding loan amount. An investor who purchases a distressed mortgage loan at such a fire sale price can make a significant profit — despite the limited value of the collateral — by modifying the loan to an extent that enables and incentivizes the borrower to resume payment. If the loan is valued accurately at purchase and then restructured properly, the cash flow on the modified loan could substantially exceed the discounted price at which the distressed loan was bought.

The potential pitfall for REITs that invest in distressed mortgage loans arises under reg. section 1.856-5(c)(3). As noted above, that provision defines the amount of the loan, for purposes of the apportionment retest, as the highest principal amount of the loan outstanding during the tax year. In the case of a mixed-collateral distressed loan secured by both real property and personalty, the amount of the loan under reg. section 1.856-5(c)(3) will likely be considerably higher than the loan value (the FMV) of the real property securing the loan under reg. section 1.856-5(c)(2) at the time of the REIT's acquisition of the loan. Under reg. section 1.856-5(c)(1)(ii), a substantial portion of the interest on the loan — and, by extension, a substantial portion of the outstanding loan amount itself — will thus be apportioned to the other property. The interest apportioned to the other property will not be qualifying income under the 75 percent income test, and the portion of the loan apportioned to the other property will not be a qualifying asset under the 75 percent asset test.

For example, consider a loan for the purchase of a hotel. Assume that, at the time of origination, the outstanding principal amount of the loan was $30 million, the FMV of the hotel building and underlying land securing the loan was also $30 million, and the FMV of related personal property also securing the loan was $5 million. Suppose that, by nine months after origination, the borrower has failed to make any payment on the loan (and the outstanding amount thus remains $30 million), the FMV of the real property collateral has declined to $15 million, and the value of the other property has remained $5 million. Suppose further that a REIT then purchases the loan in the secondary market for $10 million. At the time of acquisition, the loan would be tested for apportionment under reg. section 1.856-5(c)(1)(ii). Because the loan value of the real property under reg. section 1.856-5(c)(2) would be $15 million and the amount of the loan under reg. section 1.856-5(c)(3) would be $30 million, only half of the interest (and, by extension, half of the loan itself) would be apportioned to the real property, and the remaining half would be apportioned to the other property. Thus, half the interest on the loan would be nonqualifying income under the 75 percent income test and half of the loan would be treated as a nonqualifying asset under the 75 percent asset test.

Because of the outcome of the apportionment test under reg. section 1.856-5(c) in the case of a newly acquired mixed-collateral distressed mortgage loan, a REIT that invests substantially in those loans runs the risk of failing the 75 percent income test and the 75 percent asset test. Thus, as NAREIT states, "Using the stated principal amount of a distressed mortgage loan as the 'amount of the loan' under reg. section 1.856-5(c)(3) could make it difficult for a REIT to make a significant

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[68]Of course, if such a temporary measure were passed for REITs, sound public policy and considerations of internal consistency within the code might suggest considering a similar temporary measure for REMICs.

[69]For examples of code sections providing tax benefits during a limited period in response to the economic downturn, see, e.g., section 168(k) (providing for accelerated depreciation deductions for depreciable business property placed in service between Dec. 31, 2007, and Jan. 1, 2010); section 108(a)(1)(E) (excluding cancellation of indebtedness (COD) income when indebtedness on principal residences is discharged before Jan. 1, 2010); and section 108(i) (permitting deferral of recognition of COD income from reacquisition of some business indebtedness between Dec. 31, 2008, and Jan. 1, 2011).

[70]*See* NAREIT letter, *supra* note 3, at 18.

investment in distressed mortgage loans and continue to satisfy the requirements necessary for REIT qualification."[71]

NAREIT argues that such an outcome is inconsistent with the government's public policy objective, in response to the credit crisis, of "injecting liquidity into the market for distressed debt."[72] To remedy that perceived problem, NAREIT proposes simply that "for newly acquired distressed mortgage loans, the [IRS] should issue guidance that the 'amount of the loan' under reg. section 1.856-5(c) is the REIT's highest adjusted tax basis in the mortgage loan during the taxable year."[73] NAREIT contends that this approach would better reflect "the economic realities of the investment made by the REIT."[74]

Perhaps that is true, but the amount of the REIT's economic investment is not what the apportionment test under reg. section 1.856-5(c) is intended to measure. Rather, the purpose of that test is to calculate the ratio of the value of the real property securing the loan to the amount of the loan to determine the portion of the loan that is a qualifying asset and the portion of the interest thereon that is qualifying income. In short, NAREIT fails to offer any convincing explanation for how the purchase price of a distressed loan is a more accurate measure of the outstanding amount of the loan than the outstanding principal amount of the loan itself.

In proffering an explanation, NAREIT relies in large part on a misplaced appeal to the market discount rules.[75] It points out that under those rules, "if a REIT acquires a distressed mortgage loan at a discount and the loan pays off in accordance with its terms, the entire difference between the purchase price and the stated redemption price at maturity is treated as interest income."[76] Thus, for purposes of determining the portion of the cash flow generated by the loan that is includable in the REIT's gross income for federal income tax purposes, "any 'principal' on a distressed mortgage loan that exceeds the purchase price of the loan is not treated upon repayment as a tax-free return of principal."[77] NAREIT argues that treating the REIT's purchase price as the amount of the distressed loan under reg. section 1.856-5(c) would be consistent with the REIT's income tax treatment under the market discount rules.[78] Again, however, NAREIT confuses rules intended to measure the REIT's economic investment in an asset (to determine the taxable portion of the REIT's return on that investment) with a rule intended to ascertain the extent to which the asset itself is a real-estate-related asset for purposes of applying the 75 percent income test and the 75 percent asset test. How much a REIT pays for an asset is distinct from whether the asset constitutes an interest in real property. How much return a REIT receives on its investment is similarly distinct from whether that income derives from an interest in real property. Simply put, the degree to which a loan represents an interest in real estate (and the degree to which income from the loan thus arises from real estate) can be accurately measured only by comparing the value of the real estate securing the loan with the outstanding principal amount that the borrower owes on the loan. The amount the REIT paid to acquire the obligation sheds no light on the question.

As with its proposal for modified loans, NAREIT suggests that its requested guidance "could be issued in the form of an interpretation of reg. section 1.856-5(c)."[79] However, NAREIT's proposed interpretation lacks any support in the language of the regulation. Indeed, such an interpretation would be contrary to the plain meaning of the regulatory language. On its face, the definition of the phrase "amount of the loan" in reg. section 1.856-5(c)(3) clearly and unambiguously refers to the principal amount of the loan. There is no reasonable way to construe that language instead as a reference to the REIT's basis in the loan. Thus, whatever else NAREIT's proposal may be, it cannot be credibly described as an interpretation of the current regulation. Rather, it is a request for a substantial change to that regulation as it applies to distressed loans.

Moreover, and most importantly, there is nothing in section 856(c) or any other section of the code that lends any statutory support to such a change in the regulations. Nowhere in the income tests, the asset test, or any other qualification provision of the REIT rules is there a distinction between the treatment of distressed debt and the treatment of any other income or asset of a REIT. More particularly, there is nothing in the code to provide, for purposes of the income tests or the asset test, that one should determine the amount of a mortgage loan by reference to the amount that the REIT paid for it rather than by reference to the loan's principal balance. Thus, if the IRS were to issue the guidance NAREIT requests, it would effectively be constructing an entirely new rule out of whole cloth. If section 7805 imposes any limits on the authority of the Treasury secretary or the IRS to interpret and apply the language of the code, NAREIT's proposal must surely be an

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[71] *Id.* at 14.
[72] *Id.* at 2.
[73] *Id.*
[74] *Id.* at 14.
[75] "Any discount at which an obligation is purchased below its principal amount (if the obligation has no [original issue discount]), or below its adjusted issue price (if the instrument does have [OID]), is considered to be market discount" within the meaning of section 1278(a)(2). Peaslee and Nirenberg, *supra* note 41, at 252, 253 n.90. Under section 1276(a), gain on the disposition of a bond having market discount is generally "treated as ordinary income to the extent it does not exceed the accrued market discount on such bond." Section 1276(a)(1). (Limited exceptions to, or modifications of, this general rule exist for obligations that are excluded under section 1278(a)(1)(B) from the definition of "market discount bond" and for taxpayers who elect under section 1278(b) to include market discount in gross income as it accrues, rather than on disposition of the bond. There is also a de minimis exception under section 1278(a)(2)(C).)
[76] NAREIT letter, *supra* note 3, at 12.
[77] *Id.*
[78] *Id.* at 14.
[79] *Id.* at 18.

example of an administrative pronouncement that would fall outside those limits. Therefore, just as with its proposal for modified loans, if NAREIT's requested change in the apportionment rules for distressed loans is to be adopted, the most preferable way to effect the change would be through congressional, rather than administrative, action.

However, the policy arguments for adopting NAREIT's distressed loan proposal are decidedly less compelling than the arguments supporting its proposal for modified loans. While it may be desirable to inject liquidity into the market for distressed debt, it does not follow that an entity that invests in distressed mortgage loans should enjoy the tax benefits of REIT status when an insufficient portion of its assets are qualifying assets or an insufficient portion of its income is qualifying income, as determined under the rules applicable to all other REITs. Simply put, a REIT that invests substantially in distressed debt is likely to amass a portfolio comprised in large part of obligations that are not secured by interests in real property (at least as determined under the apportionment rules as generally applied). To that extent, acquisitions of distressed debt seem to be well outside the scope of the real estate investments contemplated by Congress under the original REIT rules. Permitting REITs to acquire loans after they have become distressed thus seems to be a further departure from the spirit of those rules than does permitting REITs to work out mortgage loans that were good when acquired but have since gone bad.

This view of the spirit of the REIT rules is reflected in the provisions governing the treatment of foreclosure property. Recognizing that REITs may have to foreclose on some loans in their portfolios, section 857(b)(6)(B)(iii) provides that sales of foreclosure property, as defined under section 856(e)(i), will not subject REITs to the 100 percent prohibited transactions tax otherwise imposed under section 857(b)(6)(A) on specified dispositions of real property. "The foreclosure property rules do not apply, however, if a loan is acquired with the intent to foreclose."[80] Thus, a REIT is protected when it is required to foreclose on a good loan gone bad, but it faces significant adverse tax consequences when it attempts to profit by investing in a distressed loan with the specific intent to liquidate it and profit on the sale of the underlying property. Drawing this line allows REITs to engage in a necessary aspect of investing in mortgage loans, while at the same time respecting the "original legislative policy behind the REIT income tests . . . to ensure that a REIT's gross income consists mainly of passive income and not income from the active conduct of a trade or business."[81]

By parity of reasoning, even if there are legitimate policy reasons to consider relaxing the rules for retesting and apportioning modified loans in the case of modifications occasioned by a default or reasonably foreseeable default on the loan, those policy arguments do not support permitting a REIT to invest in newly acquired distressed loans if doing so would cause the REIT to fail the 75 percent income test or the 75 percent asset test under the general rules for apportionment under reg. section 1.856-5(c). NAREIT's proposal for purchases of distressed mortgage loans should therefore be rejected.

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[80]Lipton, *supra* note 11, at 166.

[81]Carnevale et al., *supra* note 5, at Section III.C.1 (internal citations omitted).