NATIONAL
ASSOCIATION
OF
REAL ESTATE
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REITS:
BUILDING
DIVIDENDS
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VIA ELECTRONIC SUBMISSION http://www.Regulations.gov
(CC:PA:LPD:PR (IRS REG–102656–15))

CC:PA:LPD:PR (REG–102656–15)
Courier's Desk
Internal Revenue Service
P.O. Box 7604
Ben Franklin Station
Washington, D.C. 20224

Re: Notice of Proposed Rulemaking: Notional Principal Contracts; Swaps with Nonperiodic Payments

Dear Sir or Madam:

The National Association of Real Estate Investment Trusts® (NAREIT) appreciates the opportunity to comment on, and to offer our suggestions with respect to, the Treasury Department and Internal Revenue Service's (IRS) proposed regulations (the Proposed Regulations) that amend the treatment of nonperiodic payments made or received pursuant to certain notional principal contracts (NPCs). The text of the Proposed Regulations also serves as the text of the temporary regulations (the Temporary Regulations) that were issued concurrently with the Proposed Regulations.

NAREIT® is the worldwide representative voice for 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.

The U.S. REIT industry today includes a vibrant range of companies engaged in real estate ownership or financing that support nearly all sectors of the economy. While there is great diversity within the industry, the REIT rules remain true to their original purpose: a REIT must primarily invest in and derive income from real estate; it must be widely held; and each year it must distribute all of its income to its shareholders in order to not be subject to a corporate-level tax.

A REIT may be a public company with its shares registered with the Securities and Exchange Commission (SEC), or it may be a private company. A public REIT's shares may be either listed on an established stock exchange, or its shares may be unlisted and sold directly to investors through a broker-dealer.

At the end of June 2015, 327 REITs were registered in the U.S. with the SEC, and 229 of these REITs were listed on established U.S. stock exchanges (predominantly on the NYSE). Private REITs are not registered with the SEC; nevertheless, each of them still must comply with the REIT rules, and each must file with the IRS every year.

Today's REITs generally specialize in either owning or financing real estate. "Equity REITs" primarily own, and in most cases operate, income-producing properties, including apartments, data centers, hospitals, hotels, industrial facilities, life science buildings, nursing homes, offices, shopping malls, storage centers, senior housing, student housing, telecommunications towers and timberlands. Equity REITs are estimated to currently own more than $1.3 trillion of real estate in the United States, including more than 80,000 properties in all 50 states and accounting for an estimated 15% of the total commercial real estate market.

"Mortgage REITs" primarily invest in mortgages and mortgage-backed securities, providing financing for residential and commercial properties. More than 2 million single-family homes are estimated to be currently financed by mortgages owned by mortgage REITs. Most of these mortgages would otherwise be funded on the balance sheets of commercial banks or one of the government-sponsored enterprises.

On the basis of total stock exchange-listed REIT equity market capitalization, 93% of today's stock exchange-listed REITs are equity REITs, and 7% are mortgage REITs.

EXECUTIVE SUMMARY

NAREIT appreciates the issuance of the Proposed Regulations, and urges the Treasury Department and IRS to finalize them as soon as possible, after taking into account the recommendations set forth below and as further described in this letter.

The Proposed Regulations provide that a nonperiodic payment on an NPC must be bifurcated and "treated as two separate transactions consisting of an on-market, level payment swap and one or more loans" unless it meets one of two exceptions. The second of these exceptions turns off the required bifurcation rule if certain margin or collateral requirements are met (the Margin Exception).

First, NAREIT recommends that the Proposed Regulations be modified to include a Small Amount Exception, such that the Embedded Loan Rule would not apply to NPCs that had an upfront nonperiodic payment that comprises less than 10% of the present value of the fixed payments under the contract (or 10% of the NPC's notional principal amount in the event that the NPC does not include fixed payments).

Second, NAREIT recommends that the Proposed Regulations be modified to: i) expand the type of qualifying collateral that can be posted and treated as cash (a Cash Equivalent) under the Margin Exception; ii) clarify the tax consequences when the amount of cash or Cash Equivalent on an NPC qualifying for the Margin Exception varies during the term of the NPC; and, iii) clarify the tax consequences when an NPC is overcollateralized with cash, Cash Equivalents, or other collateral.

Third, NAREIT recommends that the Proposed Regulations be modified to provide that, for purposes of the REIT gross income tests, a REIT is required to net all items from an NPC that qualifies as a hedging instrument described under section 856(c)(5)(G) (including any income or expense from a deemed loan resulting from the Embedded Loan Rule) and treat the net amount in the manner provided in section 856(c)(5)(G).

Fourth, NAREIT recommends that the Proposed Regulations be modified to provide that a *de minimis* amount, equal to 5% of the notional principal amount of the NPC, of over- or under-collateralization is ignored.

Fifth, NAREIT recommends that the effective date of the Temporary Regulations be delayed until the date that is one year after the date that final regulations are published in the Federal Register, but no earlier than January 1, 2017.

DISCUSSION

I. Background

A. REITs' Use of NPCs

The primary use of NPCs in the context of a REIT's business is for the purpose of hedging movements in interest rates. For example, a mortgage REIT may use an interest rate swap to hedge debt that it incurs to carry its real estate assets (mortgage loans and other mortgage loan-related assets).

Mortgage REITs often use rolling short-term financing that economically functions similar to variable rate debt. However, a large portion of a mortgage REIT's assets often are composed of mortgage loans or mortgage loan-related assets that bear interest at a fixed rate. The mismatch between receiving interest at fixed rate and paying it a variable rate creates interest rate exposure to the REIT. Accordingly, a mortgage REIT may use an interest rate swap to convert its variable interest rate expense to a fixed rate, which may allow the REIT to manage its interest rate exposure.

B. The Prior Regulations

Under Treasury regulations finalized in 1993 (the 1993 Regulations)[1], a swap that includes a "significant" nonperiodic payment is generally treated as two separate transactions consisting of an on-market, level payment swap and a loan (the Embedded Loan Rule).[2] Under the Embedded Loan Rule, the parties must account for the loan independently of the swap, and the time value component of the loan is recognized as interest for all purposes of the Code. Although the 1993 Regulations do not define the term "significant", they do provide two examples illustrating whether or not an upfront payment meets the significance threshold (the Significance Test). One example suggests that a payment of approximately 10% of the present value of the fixed payments under the contract (assuming the contract was on-market) is not significant, whereas the other example suggests that a payment of approximately 40% would be significant.[3]

C. The Proposed Regulations

As a result of the Dodd-Frank Act,[4] an increasing number of NPCs now require upfront payments. Thus, the determination of whether an upfront payment results in a deemed loan has become increasingly important. Because the Significance Test did not provide a specific threshold, it is difficult to apply in many situations.

Accordingly, in May, the Treasury Department and the IRS issued the Proposed Regulations. The Proposed Regulations provide that, subject to two exceptions (the Short-Term Exception[5], and the Margin Exception (described below)), an NPC with a nonperiodic payment is subject to the Embedded Loan Rule. Thus, under the Proposed Regulations, the Embedded Loan Rule may apply regardless of the size of the nonperiodic payment.

II. Recommendations

A. Adding a Small Amount Exception

According to the preamble to the Temporary Regulations, eliminating the Significance Test from the Embedded Loan Rule is warranted because that test was not acting as a rule of administrative convenience, as originally intended. NAREIT understands that, because of the test's imprecise parameters, it is unclear when the exception would apply, and also it is unclear how to apply the test when the NPC in question does not provide for any fixed payments. Further, NAREIT

[1] TD 8491. The 1993 Regulations remain in effect.
[2]Reg. § 1.446-3(g)(4). The "significance" rule of the 1993 Regulations remains in effect for NPCs entered into prior to November 4, 2015, although a taxpayer may apply the Temporary Regulations in lieu of the 1993 Regulations. The exceptions to the Embedded Loan Rule in the Temporary Regulations, however, apply to NPCs entered into on or after May 8, 2015. The Embedded Loan Rule under the Temporary and Proposed Regulations is located in paragraph (g)(4)(i).
[3] *See* examples 2 and 3 of Reg. §1.446-3(g)(6) of the 1993 Regulations. The fixed payments used in calculating the percentages were determined based on the fixed payment amount as if the swap was on-market. The discount rate used was simply the on-market swap rate provided in the example.
[4] The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (P.L. 111-203, *124 Stat. 1376*).
[5] Under the Proposed Regulations, the Short-Term Exception applies to NPCs that have a term of one year or less.

understands that there may be some concern that taxpayers may exploit the test's ambiguity and thus avoid applying the Embedded Loan Rule to NPCs with large nonperiodic payments.[6]

Although NAREIT appreciates the shortcomings of the Significance Test under the 1993 Regulations, we believe that the original purpose of the test (*i.e.*, carving out from the Embedded Loan Rule, for administrative convenience, NPCs with small aggregate nonperiodic payments) remains valid. Consequently, NAREIT recommends that the Proposed Regulations be modified to include a "small amount exception" (Small Amount Exception), which, as described below, would be both administratively easy to apply and consistent with the underlying rationale of the Proposed Regulations.

NAREIT recommends that the Small Amount Exception to the Embedded Loan Rule should apply when an NPC's aggregate nonperiodic payments comprise 10% or less of the present value of the aggregate fixed payments under the contract, assuming for measurement purposes that the contract is on-market (or 10% of the NPC's notional principal amount in the event that the NPC does not include a true fixed payment leg).[7] Thus, the Embedded Loan Rule would not apply to NPCs that meet the Small Amount Exception.

Because the 1993 Regulations currently include an example concluding that an upfront payment that is approximately 10% or less of the present value of the fixed payments on the swaps should not give rise to a deemed loan, we believe that this 10% threshold can be incorporated easily into the Proposed Regulations. However, because swaps may not have a fixed payment leg, a different threshold for the Small Amount Exception would be necessary for those contracts. Accordingly, we recommend using a threshold of 10% of the notional principal amount of such contracts. This threshold is simple to apply and we believe consistent with the overall policy behind the Embedded Loan Rule.[8]

B. Clarification of the Embedded Loan Rule with respect to the Margin Exception

Under the Proposed Regulations, the Embedded Loan Rule will not apply to NPCs that satisfy the Margin Exception. The Margin Exception applies to NPCs with nonperiodic payments that are subject to prescribed margin or collateral requirements. To qualify for the Margin Exception, the NPC must either:

(1) Be cleared by a derivatives clearing organization or clearing agency that requires the parties to post and collect margin or collateral to fully collateralize the mark-to-market exposure on the contract on a daily basis for the entire term of the contract; or,

[6] *See* also the ISDA Letter dated June 18, 2015, reprinted at 2015 TNT 126-19 (the ISDA Letter), which expresses similar concerns.
[7] For example, a basis swap where the parties to the swap agree to swap amounts determined under two variable interest rates would use 10% of the notional principal amount as the threshold.
[8] We would also be supportive of applying the 10% of notional principal amount rule across all swaps, including swaps with fixed payment legs, which was recommended in the ISDA Letter.

(2) Require the parties to the contract, either pursuant to the terms of the contract or the requirements of a federal regulator, to post and collect margin or collateral to fully collateralize the mark-to-market exposure on the contract on a daily basis for the entire term of the contract.

In general, the mark-to-market exposure on a contract will be fully collateralized only if the contract is subject to both initial variation margin/collateral in an amount approximately equal to the nonperiodic payment and daily variation margin/collateral in an amount equal to the daily change in the fair market value of the contract.[9] In addition, the Margin Exception applies only to the extent that cash collateral is posted and collected (the Cash Collateral Requirement). Accordingly, if collateral other than cash is posted but the contract still otherwise meets the Margin Exception, the Margin Exception does not apply to the extent that the nonperiodic payment exceeds the cash collateral, and the excess is subject to the Embedded Loan Rule.

In addition, if the amount of cash collateral is in excess of the amount required to fully collateralize the NPC's mark-to-market exposure, that excess is also subject to the Embedded Loan Rule.

In NAREIT's view, the Cash Collateral Requirement is too restrictive. We see very little reason to limit to cash the acceptable collateral that may be used without triggering an embedded loan. In our view, the type of collateral that is permitted should be extended, at a minimum, to U.S. Government securities including U.S. Treasuries and Agency mortgage-backed securities (the Permitted Non-Cash Collateral).[10] Although we understand that when analyzing the nature of the nonperiodic payment the use of Permitted Non-Cash Collateral may resemble mere security for the embedded loan, this view ignores the fact that such non-cash collateral is readily used as a cash equivalent across financial transactions.

In addition to allowing Permitted Non-Cash Collateral to be used without triggering an embedded loan, NAREIT recommends that the final regulations provide the exact manner in which the Embedded Loan Rule operates where the Margin Exception applies but either the Cash Collateral Requirement[11] is not met or there is excess collateral. As written, the Proposed Regulations merely state that the Embedded Loan Rule found in paragraph (g)(4)(i) applies. The examples below illustrate some of the questions that may arise without additional explanation.

[9] We note that because the preamble to the Temporary Regulations noted that payments across swaps were often netted, we believe that the netting of payments does not make swaps ineligible for the Margin Exception. However, we recommend that the final regulations explicitly so state.

[10] *See, e.g.,* section 856(c)(4)(A), which requires that, at least 75% of the value of the REIT's total assets at the end of each calendar quarter "is represented by real estate assets, cash and cash items (including receivables), and Government securities"; Rev. Rul. 64-85, 1964-1 C.B. 230 (securities of the 1) Federal Housing Administration, 2) Federal National Mortgage Association, 3) Federal Home Loan Bank, 4) Federal Land Bank, 5) Federal Intermediate Credit Banks, 6) Banks for Cooperatives, and, 7) Public Housing Administration are "Government securities" within the meaning of section 856); *cf.* Rev. Proc. 2004-28, 2004-1 C.B. 984 (certain repurchase agreements are "government securities" under same definition for regulated investment companies); Rev. Rul. 92-89, 1992-2 C.B. 154 (similar list of government securities for RICs).

[11] Under our prior recommendation, the Cash Collateral Requirement would allow the use of Permitted Non-Cash Collateral.

For purposes of each example, assume the terms of the interest rate swap meet the Margin Exception[12] but the terms allow for collateral that would not meet the Cash Collateral Requirement (such collateral referred to in the example as Unpermitted Collateral).

Example 1: Taxpayer and Counterparty enter into a 5-year on-market interest rate swap. Accordingly, no upfront payment is made. However, shortly thereafter interest rates change and taxpayer is required to post collateral on the swap. Taxpayer posts Unpermitted Collateral on the swap. NAREIT requests confirmation that the posting of Unpermitted Collateral does not result in a deemed loan because the posting of collateral is not a nonperiodic payment on the swap.

Example 2: Taxpayer and Counterparty enter into a 5-year off-market interest rate swap. Counterparty is required to make an upfront payment on the swap of $100. As required under the terms of the swap, Taxpayer immediately posts $100 of collateral consisting of $80 of cash and $20 of Unpermitted Collateral. NAREIT requests confirmation that under the Embedded Loan Rule, the interest rate swap is bifurcated into a $20 deemed loan and an off-market swap that would require an $80 upfront payment.

Example 3: Same facts as Example 2 except that Taxpayer immediately posts $100 of collateral consisting entirely of cash. However, shortly thereafter interest rates change, and Taxpayer is required to post additional collateral worth $20 on the swap, which Taxpayer posts using Unpermitted Collateral. NAREIT requests confirmation that the posting of Unpermitted Collateral does not result in a deemed loan because the posting of collateral is not a nonperiodic payment on the swap. Alternatively, NAREIT requests an explanation of the how the Embedded Loan Rule would apply in this case.

Example 4: Same facts as Example 2 except that Taxpayer immediately posts $100 of collateral consisting entirely of cash. However, shortly thereafter interest rates change, and the Counterparty is required to post collateral worth $20, which the Counterparty posts with Unpermitted Collateral. NAREIT requests confirmation that the posting of Unpermitted Collateral does not result in a deemed loan because the posting of collateral is not a nonperiodic payment on the swap. Alternatively, NAREIT requests an explanation of the how the Embedded Loan Rule would apply in this case.

Example 5: Same facts as Example 4 except that instead of posting Unpermitted Collateral after interest rates change, Counterparty posts cash collateral. NAREIT requests confirmation that the posting of cash collateral does not result in a deemed loan because the posting of collateral is not a nonperiodic payment on the swap. Alternatively, NAREIT requests an explanation of the how the Embedded Loan Rule would apply in this case.

Example 6: Same facts as Example 2 except that Taxpayer immediately posts $110 of collateral consisting entirely of cash. Accordingly, Taxpayer has posted $10 of excess collateral. NAREIT requests confirmation that the posting of excess collateral is not treated as a nonperiodic

[12] That is, the contract requires the parties to post and collect margin or collateral to fully collateralize the mark-to-market exposure on the contract on a daily basis for the entire term of the contract

payment. Alternatively, NAREIT requests an explanation of the how the Embedded Loan Rule would apply in this case.

Example 7: Same facts as Example 2 except that Taxpayer immediately posts $110 of collateral consisting of $80 of cash and $30 of Unpermitted Collateral. NAREIT requests confirmation that under the Embedded Loan Rule, the interest rate swap is bifurcated into a $20 deemed loan and an off-market swap that would require an $80 upfront payment. NAREIT also requests confirmation that the $10 of excess collateral is not treated as a nonperiodic payment. Alternatively, NAREIT requests an explanation of the how the Embedded Loan Rule would apply in this case.

Example 8: Taxpayer has entered into 3 interest rate swaps. On 2 swaps Taxpayer receives upfront payments of $100 each. On the third swap, Taxpayer must make a $120 upfront payment. As a result of netting, Taxpayer is required to post $80 of collateral, which it posts using $60 of cash and $20 of Unpermitted Collateral. Assuming netting does not disqualify a contract from meeting the Margin Exception, NAREIT requests confirmation that, for purposes of the Embedded Loan Rule, Taxpayer is treated as having posted $75 of cash and $25[13] of Unpermitted Collateral on each of the 2 swaps for which Taxpayer received an upfront payment and Counterparty is treated as posting $90 of cash and $30[14] of Unpermitted Collateral on the third swap. Alternatively, NAREIT requests an explanation of the how the Embedded Loan Rule would apply in this case.

Example 8 in particular highlights the difficulty of differentiating between cash and other types of collateral. If, for example, the Taxpayer in Example 8 did not have to post collateral because it was net positive on all its contracts, for purposes of the Embedded Loan Rule, it may be deemed to have posted collateral on the individual swaps contracts that required collateral (absent netting) in the same ratio of cash/non-cash as its counterparty posted to it. Alternatively, there may be other ways in which to determine the level of cash versus non-cash collateral where netting is used, but no method appears to be intuitive. Accordingly, this illustrates an additional reason why the types of collateral that should be permitted without triggering a deemed loan should be broadened.

NAREIT recommends, therefore, that the final regulations: i) broaden the type of collateral that is permitted without triggering a deemed loan; and, ii) clarify the mechanics of the Margin Exception.

C. Treatment of Deemed Loans from Swaps Used as Hedging Transactions for Purposes of the REIT Income Tests

Section 856(c) requires a REIT to derive at least: i) 95% of its gross income from sources listed in section 856(c)(2), which includes dividends, interest, rents from real property and certain other

[13] $60 of cash collateral represents 75% of the $80 collateral Taxpayer posted. Accordingly we would expect that when applied to each swap on which Taxpayer is required to post $100 of collateral, 75% or $75 would be treated as being posted in cash and the remaining 25% or $25 in Unpermitted Collateral.
[14] In this example the ratio applicable to Taxpayer carries over to the Counterparty.

items; and, ii) 75% of its gross income from sources listed in section 856(c)(3), which include rents from real property, interest from mortgage obligations, gains on the sale of real estate assets and certain other real estate-related sources of income. Section 856(c)(5)(G)(i) generally provides that income from a hedging transaction, as defined in section 1221(b)(2)(A)(ii) or (iii), including income from the sale or disposition of the transaction, will not constitute gross income for purposes of the 95% or 75% income tests to the extent that the transaction hedges any indebtedness incurred or to be incurred by the REIT to acquire or carry real estate assets, provided the hedging transaction is properly identified. In general, Section 856(c)(5)(J) authorizes the IRS to determine, to the extent necessary to carry out the purposes of the REIT provisions, whether any item of income or gain that does not otherwise qualify under the 95% or 75% income tests may nevertheless be: i) excluded from the income tests, or, ii) treated as qualifying income for purposes of the income tests.

As described above, the primary use of NPCs in the context of a REIT's business is for the purpose of hedging movements in interest rates. Generally, when REITs make investments or otherwise enter into financial transactions, they must consider the potential impact of the transactions on the REIT income tests. However, section 856(c)(5)(G)(i) allows a REIT to ignore the consequences of a valid hedging transaction on the REIT income tests. This provision permits a REIT to focus on reducing risk without the need to consider the potential effect of the income from the hedging transaction on the REIT income tests. Unfortunately, without further clarification, the Embedded Loan Rule arguably could subject income from hedging transactions to the REIT income test because any deemed loan from such transaction may give rise to interest income. In NAREIT's view, this result is unnecessary and contrary to the purpose behind section 856(c)(5)(G)(i).

Accordingly, NAREIT recommends that the final regulations clarify that, for purposes of the REIT income tests, a REIT will net all items (including any income or expense from a deemed loan resulting from the Embedded Loan Rule) from an NPC that qualifies as a hedging instrument described under section 856(c)(5)(G) or a counterhedge[15] (pursuant to the Commissioner's authority under section 856(c)(5)(J)[16]), and treat the net amount in the manner provided in section 856(c)(5)(G). NAREIT believes that this clarification is in line with the policy rationale behind section 856(c)(5)(G)(i). Moreover, treating the interest income from the deemed loan as excluded from the REIT income tests is consistent with the authority granted the IRS by section 856(c)(5)(J).

D. De Minimis Margin Exception

As described earlier, NAREIT believes that the final regulations should clarify the mechanics of the Margin Exception. As part of this clarification, NAREIT also recommends that the final regulations provide that a *de minimis* amount of over- or under- collateralization is ignored. For

[15] For an example of a counterhedge (also referred to as a counteracting hedge) see PLR 201527012.

[16] *See* also Private Letter Rulings 201527012 (July 2, 2015) and 201527013 (July 2, 2015) where the IRS ruled that i) income received by a REIT from original hedges are excluded from the 95% and 75% income tests under the hedging rule of section 856(c)(5)(G), and, ii) income received by the REIT from counteracting hedges are excluded from the 95% and 75% income tests under the IRS's section 856(c)(5)(J)(i) authority.

these purposes, NAREIT recommends that the *de minimis* amount equal 5% of the notional principal amount.

E. Delay of the Effective Date of the Temporary Regulations

Because market participants will need to commit a significant amount of resources and time to modify existing, and to create new withholding and information reporting systems to be able to implement the Temporary Regulations, NAREIT recommends that the effective date of the Temporary Regulations be delayed until the date that is one year after the date that final regulations are published in the Federal Register, but no earlier than January 1, 2017.[17]

F. Miscellaneous Recommendations

As described earlier, NAREIT recommends that the final regulations explicitly provide that the netting of amounts required to be posted as margin or collateral does not prevent an NPC from qualifying for the Margin Exception.

Finally, NAREIT notes that, in its current form, Reg. § 1.446-3(g)(4) applies only to swaps; however, the Proposed Regulations broaden the rule to all NPCs without explanation of how certain types of NPCs that are not swaps can be bifurcated into an on-market level payment swap and a loan. NAREIT recommends that the final regulations clarify the manner in which the Embedded Loan Rule applies for NPCs that are not swaps. NAREIT suggests that the final regulations exempt upfront payments on caps and floors from the Embedded Loan Rule. If there is a concern with respect to caps and floors, NAREIT recommends that the final regulations provide a separate rule in Reg. § 1.446-3(g)(5).[18]

III. Conclusion

We would be pleased to discuss these comments if you believe it would be helpful. Please feel free to please contact me at (202) 739-9408 or tedwards@nareit.com, or Dara Bernstein, NAREIT's Vice President & Senior Tax Counsel, at (202) 739-9446 or dbernstein@nareit.com, to schedule a meeting.

Respectfully submitted,

Tony M. Edwards

Tony M. Edwards
Executive Vice President and General Counsel

[17] This recommendation is identical to a recommendation made in the ISDA Letter.
[18] There currently are rules in proposed form (Proposed Reg. § 1.446-3(e)(4)(iv)) that provide specific rules for caps and floors that are "significantly-in-the-money."