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.

[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-

[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]

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[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.
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> 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.
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> 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

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[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

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[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. Application of Treas. Reg. § 1.856-5(c) to Newly Acquired Distressed Mortgage Loans

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.

> Example 4 (Distressed Commercial Mortgage Loan). 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.

75% Gross Income Test. 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).

Asset Tests. 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.

Example 5 (Distressed Residential Mortgage Loan). 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.

75% Gross Income Test. 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

[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.

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[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.

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[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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