

**Report No. 1300**

**NEW YORK STATE BAR ASSOCIATION TAX SECTION**

**REPORT ON REVENUE PROCEDURE 2011-16**

**(TREATMENT OF DISTRESSED DEBT OF REITS UNDER SECTION 856)**

March 12, 2014

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**New York State Bar Association Tax Section**  
**Report on Revenue Procedure 2011-16**

**I. INTRODUCTION AND BACKGROUND**

This report<sup>1</sup> comments on Revenue Procedure 2011-16 (the “**Rev. Proc.**”), which provides guidance on transactions undertaken by real estate investment trusts (“**REITs**”) involving distressed mortgage debt, *i.e.*, debt secured by real estate, the fair market value of which has declined. The Rev. Proc. addresses the application of the rules requiring (1) at least 75% of a REIT’s gross income each year to be derived from certain types of qualifying income (the “**75% Income Test**”)<sup>2</sup> and (2) at least 75% of the value of a REIT’s total assets at the end of each quarter of each year to be represented by real estate assets, cash and cash items, and government securities (the “**75% Asset Test**”),<sup>3</sup> in each case, when a REIT holds distressed mortgage debt that has been modified. The Department of the Treasury’s (“**Treasury**”) 2012-2013 Priority Guidance Plan includes a project to release a “Revenue Procedure that will modify Revenue Procedure 2011-16 relating to the treatment of distressed debt under [Section] 856.”<sup>4</sup> This report recommends and discusses provisions that could be included in that Revenue Procedure and suggests a provision that we would recommend be implemented through Treasury regulations.

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<sup>1</sup> The principal author of this report was Joshua Holmes; the invaluable assistance of Rachel Reisberg is gratefully acknowledged. Helpful comments were provided by Peter Connors, Edward Gonzalez, Elizabeth Kessenides, Stephen Land, Andrew Needham, Erika Nijenhuis, Elliot Pisem, Michael Schler, David Schnabel, Peter Schuur, David Sicular, Willard Taylor, and Diana Wollman. This report reflects solely the views of the Tax Section and not those of the NYSBA Executive Committee or the House of Delegates.

<sup>2</sup> Section 856(c)(3).

<sup>3</sup> Section 856(c)(4)(A).

<sup>4</sup> DEP’T OF THE TREAS., 2012-2013 PRIORITY GUIDANCE PLAN 13 (May 2, 2013), *available at* [http://www.irs.gov/pub/irs-utl/2012-2013\\_pgp\\_3rd\\_quarter\\_update.pdf](http://www.irs.gov/pub/irs-utl/2012-2013_pgp_3rd_quarter_update.pdf).

The approach in the Rev. Proc. adheres to the intent of the REIT regime to “encourage the investment in rental real estate and real estate mortgages,”<sup>5</sup> allowing, for purposes of both the 75% Income Test and the 75% Asset Test, distressed mortgage debt held by REITs to continue to qualify as a real estate asset, and interest income earned by REITs with respect to such mortgages to continue to be treated as qualifying REIT income, if certain criteria are satisfied. The Rev. Proc. seems to reflect the belief that workouts of distressed mortgage debt generally should not result in the character of the modified mortgages changing from “real estate” to “non-real estate.” We agree with this principle and believe that it should be extended and generalized, so as to apply not only to workouts effected directly via *modifications* of distressed mortgage debt, but also to workouts in which a third party *acquires* the distressed mortgage debt. In both cases, the modified or acquired mortgages should not become something other than “real estate” assets simply by virtue of the relevant workout. Thus, as described below, the applicable rules should, as the REIT regime generally does, encourage continued investment by REITs in these assets by preserving the treatment of such modified and acquired mortgages as “real estate assets” (and by preserving the treatment of interest income earned with respect to such modified and acquired mortgages as qualifying REIT income). We also believe that these rules could better perform their function if mortgages that are principally secured by real property are treated in full as real property under the 75% Asset Test, and as generating solely qualifying income under the 75% Income Test.

**A. The 75% Income Test**

Under Section 856(c)(3) of the Internal Revenue Code of 1986, as amended (the “Code”), to qualify as a REIT, a corporation must satisfy the 75% Income Test, which requires that at least 75% of the REIT’s gross income for the taxable year, other than income from

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<sup>5</sup> H.R. Rep. No. 86-2020, at 317 (1960).

prohibited transactions (within the meaning of Section 857(b)(6)), be derived from certain qualifying sources, including “interest on obligations secured by mortgages on real property or on interests in real property.”<sup>6</sup> The statute does not define when an obligation is “secured by mortgages on real property or on interests in real property.”

Treasury Regulations provide that if a mortgage is secured solely by real property or interests in real property, all of the interest from the mortgage is qualifying income for purposes of the 75% Income Test. The Treasury Regulations also provide that, when a mortgage is secured by both real property and other property, the interest income earned on such obligation must be apportioned between qualifying and non-qualifying REIT income for purposes of the 75% Income Test.<sup>7</sup> Treasury Regulations Section 1.856-5(c) (the “**Interest Apportionment Regulations**”) requires a comparison of (1) the “**loan value of the real property,**” a fixed amount equal to the fair market value of the real property securing the mortgage determined as of the date on which the REIT’s commitment to originate or acquire the loan became binding,<sup>8</sup> and (2) the “**amount of the loan,**” a variable amount equal to the highest principal amount of the loan outstanding during the relevant taxable year.<sup>9</sup> If the “loan value of the real property” securing the mortgage is greater than or equal to the “amount of the loan,” then all interest income earned on the obligation is qualifying REIT income for purposes of the 75% Income Test.<sup>10</sup> If the “loan value of the real property” securing the mortgage is less than the “amount of the loan,” then a rule of proportionality applies—the amount of qualifying REIT income for purposes of the 75% Income Test is determined by multiplying the entire amount of the interest

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<sup>6</sup> Section 856(c)(3)(B).

<sup>7</sup> Treasury Regulations Section 1.856-5(c).

<sup>8</sup> Treasury Regulations Section 1.856-5(c)(2).

<sup>9</sup> Treasury Regulations Section 1.856-5(c)(3).

<sup>10</sup> Treasury Regulations Section 1.856-5(c)(1)(i).

income earned with respect to the obligation by the following fraction (and the remainder is non-qualifying REIT income for purposes of the 75% Income Test):

$$\frac{\text{Loan value of the real property}}{\text{Amount of the loan}}$$

The practical consequences of these rules are that if the fair market value of the real property is greater than or equal to the principal amount of the loan when the loan is first issued, then all interest income is qualifying REIT income throughout the life of the loan. The “loan value of the real property” is fixed at the time the loan is made.

#### **B. The 75% Asset Test**

Under Section 856(c)(4)(A) of the Code, to qualify as a REIT, a corporation must (among other things) satisfy the 75% Asset Test, which requires that at the close of each quarter of the taxable year at least 75% of the value of the REIT’s assets be represented by “real estate assets, cash and cash items, and Government securities.” The statute provides that the term “real estate assets” includes “interests in mortgages on real property.”<sup>11</sup> There is no corollary to the rule provided in the Interest Apportionment Regulations in the context of the 75% Asset Test; the Treasury Regulations merely repeat the statutory definition and do not address the extent to which mortgages are treated as good real estate assets.<sup>12</sup> Where the value of real property securing a newly originated mortgage is less than the amount of the loan, the Internal Revenue Service (the “**Service**”) has privately ruled that principles similar to those embodied by the Interest Apportionment Regulations apply to apportion the mortgage between a good real estate asset and a non-qualifying asset for purposes of the 75% Asset Test.<sup>13</sup> Accordingly, prior to the issuance of the Rev. Proc., there was uncertainty in this area, especially in the context of

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<sup>11</sup> Section 856(c)(5)(B).

<sup>12</sup> See Treasury Regulations Section 1.856-3(b)(1).

<sup>13</sup> See Priv. Ltr. Rul. 199923006 (Feb. 19, 1999).

modifications and acquisitions of distressed mortgage debt (*i.e.*, debt where the total due exceeds the fair market value of the real property securing the debt).

**C. Guidance Provided in the Rev. Proc.**

The Rev. Proc. (1) addresses two concerns that arise as a result of the interaction of the rules governing REIT qualification and those governing significant modifications of debt and (2) provides welcome guidance concerning the application of the 75% Asset Test to distressed mortgage debt. However, the Rev. Proc. does not modify the application of the Interest Apportionment Regulations in situations in which REITs participate in workouts of distressed mortgage debt via acquisitions of distressed mortgage loans.

**1. *REIT Qualification Concerns Raised by Modifications of Distressed Mortgage Debt***

The Rev. Proc. addresses the interplay between the rules regarding significant modifications of debt and those governing REIT qualification, eliminating the concern that REITs engaging in workouts of distressed mortgage debt via modifications of such mortgages could be (1) required to treat a significant amount of interest income earned thereafter with respect to the modified mortgages as non-qualifying REIT income for purposes of the 75% Income Test or (2) deemed to have engaged in prohibited transactions.

**a. *Section 4.01(1) of the Rev. Proc.***

Prior to the issuance of the Rev. Proc., taxpayers were concerned that a modification of distressed mortgage debt constituting a “significant modification” of such debt for purposes of Treasury Regulations Section 1.1001-3 would require the “loan value of the real property” securing the mortgage to be recalculated, providing a significant disincentive to REITs to work out nonperforming loans. Under Treasury Regulations Section 1.1001-3, if debt undergoes a “significant modification,” there is a deemed exchange of the original debt instrument for a new

debt instrument.<sup>14</sup> In the context of a modification of distressed mortgage debt, if the modification constitutes a significant modification, the resulting deemed exchange could be treated as a new commitment by the REIT to originate the modified mortgage loan for purposes of the Interest Apportionment Regulations. In this case, the “loan value of the real property” securing the mortgage would be recalculated as of the date on which the new commitment became binding. In a distressed situation, the new “loan value of the real property” as of the date of the modification would be less than the “loan value of the real property” as of the date of the original loan and would potentially be significantly lower than the “amount of the loan” (*i.e.*, the stated principal amount). Thus, following a modification giving rise to a deemed exchange, because of this revaluation, a significant amount of the interest income earned with respect to the modified mortgage would be treated as non-qualifying REIT income for purposes of the 75% Income Test (pursuant to the Interest Apportionment Regulations). The concern is demonstrated by the following example:

***Example 1A. Pre-Rev. Proc. modification concern.*** In year 1, Lender REIT made a \$100 mortgage loan to Borrower secured by both real and other property. The “loan value of the real property” securing the mortgage (measured as of the time Lender REIT became committed to originate the mortgage loan) was \$115. Through the end of year 3, the “amount of the loan” was \$100. By the end of year 3, the fair market value of the real property securing the mortgage was only \$55 and the fair market value of the other property securing the mortgage was \$5. Lender REIT and Borrower agreed to work out the distressed mortgage debt via

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<sup>14</sup> Treasury Regulations Section 1.1001-3(b).



a modification (effective on the last day of year 3); the modification qualified as a significant modification of the mortgage within the meaning of Treasury Regulations Section 1.1001-3.

From the origination date through the modification date, under the Interest Apportionment Regulations, all interest income Lender REIT earned with respect to the mortgage was qualifying REIT income for purposes of the 75% Income Test, because the “loan value of the real property” securing the mortgage (\$115) exceeded the “amount of the loan” (\$100). Upon modification, prior to the issuance of the Rev. Proc. and under the Interest Apportionment Regulations, only 55% of the interest income Lender REIT earned with respect to the mortgage would have been qualifying REIT income for purposes of the 75% Income Test—the fraction represented by dividing the “loan value of the real property” securing the modified mortgage as of the date on which Lender REIT became committed to originate the modified mortgage loan (\$55), by the “amount of the loan” (\$100). The remaining 45% of the interest income Lender REIT earned with respect to the mortgage would have been non-qualifying REIT income for purposes of the 75% Income Test.

Section 4.01(1) of the Rev. Proc. (the “**Modification Safe Harbor**”) addresses this concern by providing that, for purposes of determining the “loan value of the real property” securing a mortgage under the Interest Apportionment Regulations, a REIT may treat a “Covered Modification” as *not* being a new commitment to originate or acquire the mortgage loan.

Section 3.01 defines “Covered Modification” as any modification of a mortgage held by a REIT that meets one of two standards: (1) the modification was occasioned by default, or (2) based on all the facts and circumstances, the REIT or servicer of the pre-modified mortgage reasonably

believes that (a) there is a significant risk of default of the pre-modified mortgage at or before maturity and (b) the modified mortgage presents a substantially reduced risk of default, as compared with the pre-modified mortgage.<sup>15</sup> The following example illustrates the operation of the Modification Safe Harbor:

***Example 1B. Modification Safe Harbor.***<sup>16</sup> Same facts as Example 1A except that the Rev. Proc. was issued in year 2, and the year 3 modification qualified as a “Covered Modification.”

In Example 1A, prior to the issuance of the Rev. Proc., only 55% of the interest income Lender REIT earned with respect to the modified mortgage would have been qualifying REIT income for purposes of the 75% Income Test. But in Example 1B, under the Rev. Proc.’s Modification Safe Harbor, all post-modification interest income is qualifying REIT income because the “loan value of the real property” securing the mortgage continues to be determined as of the date Lender REIT committed to originate the mortgage loan.

*b. Section 4.01(2) of the Rev. Proc.*

As described in Part I.C.1.a above, prior to the issuance of the Rev. Proc., REITs were similarly concerned that a modification of distressed mortgage debt resulting in a significant modification of such mortgage for purposes of Treasury Regulations Section 1.1001-3 would constitute a “prohibited transaction” for purposes of Section 857(b)(6) of the Code, further discouraging REITs from working out nonperforming loans. Under Section 857(b)(6), a REIT must pay a tax equal to 100% of the net income derived from “prohibited transactions,” which include sales or other dispositions of property described in Section 1221(a)(1) of the Code that is

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<sup>15</sup> As discussed further in Part III.A below, Section 4.01(1) of the Rev. Proc. reflects a similar approach to that of the Treasury Regulations governing real estate mortgage investment conduits (“**REMICs**”), which do not treat debt held by a REMIC as having undergone a significant modification for purposes of the REMIC rules where the modification is occasioned by a default that is reasonably foreseeable.

<sup>16</sup> See Example 1 of the Rev. Proc.

not foreclosure property.<sup>17</sup> If the deemed exchange resulting from a modification of distressed mortgage debt were treated as a disposition by the REIT of the pre-modified mortgage, the deemed disposition could qualify as a “prohibited transaction,” giving rise to a significant tax burden. Section 4.01(2) of the Rev. Proc. eliminates this concern by providing that a “Covered Modification” (as described above) will not be treated as a “prohibited transaction” under Section 857(b)(6).

## 2. *Application of the 75% Asset Test to Distressed Mortgage Debt*

As noted above, for purposes of the 75% Asset Test (which must be met at the end of each calendar quarter), the Code and the Treasury Regulations provide only that “interests in mortgages on real property” are real estate assets. Before the Rev. Proc. was issued, there was uncertainty and concern as to how a mortgage should be treated if the real estate securing the mortgage had declined in value below the principal amount of the loan. Section 4.02 of the Rev. Proc. (the “**Asset Test Safe Harbor**”) provides helpful guidance regarding the application of the 75% Asset Test to distressed mortgage debt, reducing taxpayer uncertainty in this area.

Under the Asset Test Safe Harbor, the Service will not challenge the treatment of a mortgage as a real estate asset for purposes of the 75% Asset Test in an amount equal to the lesser of

(1) the value of the loan as determined under Treasury Regulations Section 1.856-3(a) (which is essentially the current fair market value of the loan),<sup>18</sup> or

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<sup>17</sup> Section 1221(a)(1) includes “dealer property” (*i.e.*, real property, interests in real property, and interests in mortgages on real property held by a REIT primarily for sale to customers in the ordinary course of its business).

<sup>18</sup> Under Treasury Regulations Section 1.856-3(a), “value” means “with respect to securities for which market quotations are readily available, the market value of such securities; and with respect to other securities and assets, fair value as determined in good faith by the trustees of the [REIT].”

(2) the “loan value of the real property” securing the mortgage (as determined under the Interest Apportionment Regulations, taking into account the Rev. Proc.’s Modification Safe Harbor).

Thus, a mortgage secured by distressed real estate would be considered a real estate asset in an amount equal to *the lesser of* (i) the current fair market value of the loan and (ii) the value of the real property when the loan was first issued.

The following example illustrates the operation of the Asset Test Safe Harbor:

***Example 1C. Asset Test Safe Harbor.***<sup>19</sup> In year 1, Lender REIT made a \$100 mortgage loan to Borrower, secured by both real and other property. The “loan value of the real property” securing the mortgage (measured as of the time Lender REIT became committed to originate the mortgage loan) was \$115 and, as of the end of the quarter in which Lender REIT originated the mortgage loan, the value of the loan as determined under Treasury Regulations Section 1.856-3(a) was \$100. As of the end of year 3, the fair market value of the real property securing the mortgage was only \$55, the fair market value of the other property securing the mortgage was \$5, and the value of the loan under Treasury Regulations Section 1.856-3(a) was \$60; the “amount of the loan” was still \$100.<sup>20</sup> As of the last day of year 3, Lender REIT and Borrower worked out the distressed mortgage debt via a modification, which qualified as a “Covered Modification.”

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<sup>19</sup> See Example 1 of the Rev. Proc.

<sup>20</sup> For purposes of this report, we assume that a REIT makes at least one acquisition of property during each quarter requiring it to revalue its assets for purposes of the 75% Asset Test at the end of each quarter.

At the end of the quarter in which Lender REIT originated the mortgage loan, under the Asset Test Safe Harbor, the mortgage qualified as a real estate asset in the amount of \$100, determined as the lesser of (1) the value of the loan (\$100) and (2) the “loan value of the real property” securing the mortgage (\$115). At the end of the quarter in which Lender REIT and Borrower modified the mortgage, under the Asset Test Safe Harbor and applying the Modification Safe Harbor, the mortgage qualified as a real estate asset in the amount of \$60, the lesser of (1) the value of the loan (\$60) and (2) the “loan value of the real property” securing the mortgage (\$115). Note that without the application of the Modification Safe Harbor to Example 1C, at the end of the quarter in which Lender REIT and Borrower modified the mortgage, the mortgage would only have qualified as a real estate asset in the amount of \$55, because the “loan value of the real property” securing the mortgage would have been re-determined as of the date on which Lender REIT became committed to originate the modified mortgage loan. The combined effect of the Rev. Proc.’s Modification Safe Harbor and Asset Test Safe Harbor are that the non-real estate assets securing the loan and contributing to its “value” are taken into account in determining the extent to which the modified mortgage represents a real property asset.

**3. *REIT Qualification Concerns Raised by Workouts Undertaken Via Acquisitions of Distressed Mortgage Debt***

While the Modification Safe Harbor and the Asset Test Safe Harbor mitigate certain concerns regarding the ability of REITs to work out distressed mortgage debt via modifications, the Rev. Proc. does not provide similar relief to REITs *acquiring* distressed mortgage debt from another lender (which is another method of working out nonperforming or otherwise distressed mortgages). In the context of an acquisition of distressed mortgage debt, the “loan value of the real property” securing the mortgage (determined as of the date on which the REIT became

committed to acquire the distressed mortgage loan) would have likely declined since the origination date of the loan, and would potentially be significantly lower than the “amount of the loan” (*i.e.*, the stated principal amount). Thus, under the Interest Apportionment Regulations, a significant amount of the interest income earned with respect to the acquired mortgage would be treated as non-qualifying REIT income for purposes of the 75% Income Test. By jeopardizing the acquiror REIT’s ability to maintain its status as a REIT, the Interest Apportionment Regulations may undermine incentives for REITs to engage in workouts via investments in distressed mortgage debt. The concern, which is similar to the concern highlighted by Example 1A above and described in the accompanying text, is demonstrated by the following example:

***Example 2A. Acquisition concern.***<sup>21</sup> In year 1, Lender REIT made a \$100 mortgage loan to Borrower, secured by both real and other property. The “loan value of the real property” securing the mortgage (measured as of the time Lender REIT became committed to originate the mortgage loan) was \$115. During the first quarter of year 4, when the fair market value of the real property securing the mortgage was only \$55, and the fair market value of the other property securing the mortgage was \$5, as part of a debt workout, Acquiror REIT committed to acquire and acquired the mortgage loan from Lender REIT for \$60. The principal amount of then loan remained \$100.

Upon acquisition, under the Interest Apportionment Regulations, only 55% of the interest income Acquiror REIT earns with respect to the mortgage is qualifying REIT income for purposes of the 75% Income Test, the fraction represented by dividing the “loan value of the real

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<sup>21</sup> See Example 2 in the Rev. Proc.

property” securing the mortgage as of the date on which Acquiror REIT became committed to acquire the mortgage loan (\$55), by the “amount of the loan” (\$100). The remaining 45% of the interest income Acquiror REIT earns with respect to the mortgage is non-qualifying REIT income for purposes of the 75% Income Test. Acquiror REIT is not afforded the protections of the Modification Safe Harbor that would have applied to Lender REIT had Lender REIT worked out the distressed mortgage debt via a modification rather than a sale (in which case, as shown in Example 1B, all interest income Lender REIT earned with respect to the mortgage would have been treated as qualifying REIT income for purposes of the 75% Income Test).

Example 2A thus demonstrates that the Rev. Proc. both encourages REITs to engage in workouts of distressed mortgage debt via modifications and discourages REITs to instead participate in workouts of distressed mortgage debt by playing the role of third-party acquiror. Further, the applicable rules place acquirors of distressed mortgage debt in a worse position than new lenders with respect to the same real property, as demonstrated by the following example:

***Example 2B. New lender advantage.*** Same facts as Example 2A, however, during the first quarter of year 4, Refinance REIT made a \$60 mortgage loan to Borrower, secured by the same real and other property. The interest rate on this debt was calibrated to equal the yield on a debt instrument issued with \$40 of original issue discount. Borrower used the proceeds of the new mortgage loan to fully discharge its mortgage obligation to Lender REIT.

This example shows that a workout effected through a sale to a third party is economically equivalent to a “longhand” transaction in which the purchaser of the debt lent the distressed borrower an amount equal to the amount that the purchaser would have otherwise paid

for the loan, which amount was then used to repay the original lender (at the same discount the lender would have accepted in the case of a sale). Upon origination, under the Interest Apportionment Regulations, 91.67% of the interest income Refinance REIT earns with respect to the mortgage is qualifying REIT income for purposes of the 75% Income Test, the fraction represented by dividing the “loan value of the real property” securing the mortgage as of the date on which Refinance REIT became committed to originate the mortgage loan (\$55), by the “amount of the loan” (\$60). The remaining 8.33% of the interest income Refinance REIT earns with respect to the mortgage is non-qualifying REIT income for purposes of the 75% Income Test. Compared to a REIT that uses the same funds (\$60) to acquire distressed mortgage debt secured by the same real and other property (*i.e.*, Acquiror REIT in Example 2A), Refinance REIT is afforded the benefit of a lower “amount of the loan” (even though both loans are purchased/issued for \$60), and thus is entitled to treat a substantially greater amount of the interest income earned with respect to the mortgage as qualifying REIT income for purposes of the 75% Income Test.

## **II. SUMMARY OF RECOMMENDATIONS**

In this report, we recommend that the Service make the following two primary changes to the Rev. Proc.:

- The Service should eliminate the counterintuitive results that arise under the Asset Test Safe Harbor in circumstances where the value of the loan increases after origination or acquisition of the mortgage loan due to appreciation in the value of the real property securing the mortgage. Such illogical results arise because the Rev. Proc. applies a “lesser of” rule where the value of the loan fluctuates, but the “loan value of the real property” securing the mortgage is fixed upon the REIT’s



commitment to originate or acquire the mortgage loan. A potential solution would be to allow a REIT to treat a mortgage as a real estate asset based on the percentage of the loan value represented by the real property securing the mortgage, determined as of the date the REIT committed to originate or acquire the mortgage loan (the “**Proposed Fixed Percentage Rule**”). An alternative approach would be to use the percentage of the loan value represented by the real property securing the mortgage, calculated at the end of each calendar quarter for which the REIT would otherwise be required to revalue its assets under the 75% Asset Test using then-current fair market values.

- The Service should promulgate additional guidance applying principles similar to those embodied in the Modification Safe Harbor to workouts effected via acquisitions of distressed mortgage debt to reduce the differences between modifications and acquisitions undertaken to workout distressed debt. A potential solution would be to allow a REIT that acquires a distressed mortgage loan at a discount (and such acquisition is occasioned by default or is intended to facilitate a further workout of the loan to substantially reduce the risk of default) to use its highest adjusted tax basis in the mortgage loan as the “amount of the loan” for purposes of the Interest Apportionment Regulations (the “**Proposed Basis Rule**”).<sup>22</sup>

Moreover, to simplify the rules regarding the origination, modification, and acquisition of mortgage debt by REITs, we recommend that the Service consider implementing, via the

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<sup>22</sup> We note that the National Association of Real Estate Investment Trusts has also submitted comments letters describing these issues and proposing similar solutions. *See, e.g., NAREIT Recommends Topics for IRS’s Priority Guidance List*, 2012 TNT 95-23 (May 1, 2012); *REIT Group Requests Clarification of Guidance on Distressed Mortgage Debt*, 2011 TNT 212-21 (Oct. 25, 2011); *NAREIT Recommends Topics for IRS’s Priority Guidance List*, 2011 TNT 109-25 (May 26, 2011); *REIT Group Seeks Changes to Guidance Affecting REITs That Hold Distressed Mortgage Debt*, 2011 TNT 38-21 (Feb. 3, 2011); *REIT Group Seeks Guidance on Tax Treatment of Some Mortgage Loans*, 2010 TNT 50-14 (Aug. 12, 2009).

promulgation of Treasury regulations, a rule that would treat (1) all interest income earned with respect to a mortgage as qualifying REIT income under the 75% Income Test and (2) the entire mortgage as a real estate asset for purposes of the 75% Asset Test if, in each case, the mortgage is “principally secured by” real property, determined as of the date the REIT commits to originate or acquire the mortgage loan (the “**Proposed Principally Secured By Safe Harbor**”).

### **III. DISCUSSION OF RECOMMENDATIONS**

#### **A. Eliminating Counterintuitive Results Under the Asset Test Safe Harbor When Loan Values Increase After a Third-Party Acquisition of a Mortgage Loan**

We recommend that the Service modify the application of the Asset Test Safe Harbor in the context of acquisitions of distressed mortgage loans that, following the date of acquisition, increase in value, to avoid illogical results under the current approach. As described above, the Asset Test Safe Harbor applies a “lesser of” rule where one variable, the value of the loan as determined under Treasury Regulations Section 1.856-3(a), fluctuates over time (because, at any time, it is the then-fair market value of the loan), while the other variable, the “loan value of the real property” securing the mortgage, remains fixed (because it is set at the fair market value of the property at the time the REIT commits to originate or acquire the mortgage loan). Because of the differing nature of the variables and the inapplicability of the Modification Safe Harbor to acquisitions, counterintuitive results arise when the value of the loan increases after an acquisition of a mortgage loan (for example, due to appreciation in the value of the real property securing the mortgage), but the “loan value of the real property” securing the mortgage is not subject to change because there has been no new origination or acquisition. Consider the following example:

**Example 2C. Increasing loan value.** During year 4, Acquiror REIT commits to acquire and acquires a distressed mortgage loan from the original lender for \$60. The face amount of the loan is \$100, and at the time Acquiror REIT commits to acquire the loan, such loan is secured by real property with a value of \$55 and other property with a value of \$5. During the first quarter of year 4, the fair market value of the real property securing the mortgage appreciates to \$65, the fair market value of the other property securing the mortgage remains \$5 (because of these changes, the value of the loan appreciates to \$70).

The loan value of the real property for Acquiror REIT, throughout its ownership of the mortgage loan, will be \$55. At the end of the quarter in which Acquiror REIT acquired the loan, under the Asset Test Safe Harbor, the mortgage qualifies as a real estate asset for purposes of the 75% Asset Test in the amount of \$55, the lesser of the value of the loan (\$60) and the “loan value of the real property” securing the mortgage (\$55). The remaining \$5 of the value of the loan is treated as a non-qualifying REIT asset for purposes of the 75% Asset Test.

At the end of the first quarter of year 4, under the Asset Test Safe Harbor, despite the appreciation in the fair market value of the real property securing the mortgage, the mortgage continues to qualify as a real estate asset for purposes of the 75% Asset Test in the amount of \$55, the lesser of the value of the loan (\$70) and the “loan value of the real property” securing the mortgage (\$55). On the other hand, the amount of the mortgage treated as a non-qualifying REIT asset for purposes of the 75% Asset Test increases to \$15.

As Example 2C shows, under the Asset Test Safe Harbor, the effect of an increase in the value of the loan is an increase in the amount of the mortgage treated as a non-qualifying REIT asset for purposes of the 75% Asset Test, regardless of whether the increase in the value of the loan is attributable to appreciation in the value of the real property securing the mortgage, appreciation in the value of the other property securing the mortgage, or otherwise. This result is distortive and could provide an incentive for REITs to engage in dispositions and acquisitions of mortgage loans with other REITs in order to cause a recalculation of the “loan value of the real property” securing the mortgage.<sup>23</sup>

We recommend that the Service modify the Asset Test Safe Harbor to eliminate the inappropriate results that arise in circumstances where the value of a distressed mortgage loan increases after the distressed mortgage loan has been acquired by a REIT. Specifically, we suggest that the Service allow a REIT to treat a fixed percentage of the value of a mortgage as a real estate asset, calculated based on the percentage of real property securing the mortgage determined as of the date the REIT commits to originate or acquire the mortgage loan (the “**Proposed Fixed Percentage Rule**”).<sup>24</sup> Under this rule, the relevant percentage would remain fixed throughout the duration of a REIT’s ownership of the mortgage loan, unless there were a change in the makeup of the collateral securing the mortgage, in which case the percentage would be recalculated. The following example demonstrates the operation of our Proposed Fixed Percentage Rule:

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<sup>23</sup> In other words, the illogical result highlighted by Example 2C could provide an incentive for REITs to undertake related-party acquisitions of distressed mortgage debt to reap the benefits of a recalculated “loan value of the real property” securing the mortgage and to avoid the result of Example 2C. *See, e.g.,* Cottage Sav. Ass’n v. Comm’r, 111 S. Ct. 1503 (1991).

<sup>24</sup> An alternative rule, which would take into account fluctuating market values but would require frequent testing (the “**Variable Percentage Rule**”), would allow a REIT to treat a variable percentage of the value of a mortgage as a real estate asset, calculated based on the percentage of real property securing the mortgage determined as of the end of each calendar quarter for which the REIT would otherwise be required to revalue its assets under the 75% Asset Test.

**Example 2D. Proposed Fixed Percentage Rule.** Same facts as Example 2C, however, during the first quarter of year 4, the fair market value of the real property securing the mortgage appreciated to \$65, the fair market value of the other property securing the mortgage remained \$5, and the value of the loan appreciated to \$70.

At the end of the quarter in which Acquiror REIT acquired the loan, under the Proposed Fixed Percentage Rule, 91.67% of the value of the loan (*i.e.*, \$55) qualifies as a real estate asset for purposes of the 75% Asset Test, the portion of the value of the loan (\$60) that is represented by the fair market value of the real property securing the mortgage (\$55), measured on the date Acquiror REIT committed to acquire the mortgage loan. The remaining 8.33% of the value of the loan (*i.e.*, \$5) is treated as a non-qualifying REIT asset for purposes of the 75% Asset Test. The fixed percentage, 91.67%, would continue to apply to determine the portion of the value of the loan treated as a real estate asset throughout Acquiror REIT's ownership of the mortgage loan. Thus, under the Proposed Fixed Percentage Rule, at the end of the first quarter of year 4, 91.67% of the value of the loan (*i.e.*, \$64.17) continues to qualify as a real estate asset,<sup>25</sup> and 8.33% of the value of the loan (*i.e.*, \$5.83) continues to be treated as a non-qualifying asset for purposes of the 75% Asset Test.<sup>26</sup> Although the Proposed Fixed Percentage Rule does not afford Acquiror REIT the entire benefit of the appreciated real property values in a situation where the increase in the value of the loan is solely attributable to an increase in the fair market value of the real property securing the mortgage (as Acquiror REIT is required to increase the amount of the

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<sup>25</sup>  $\$70 \text{ (value of the loan)} \times 91.67\% = \$64.17$ .

<sup>26</sup> We note that, had Acquiror REIT not otherwise been required to revalue its assets for purposes of the 75% Asset Test due to its unrelated acquisition of property, the Fixed Percentage Rule would not itself require a revaluation, and the loan would have continued to qualify as a real estate asset in the amount of \$55, with the remaining \$5 of value being treated as a non-qualifying REIT asset.

mortgage treated as a non-qualifying REIT asset by \$0.83), we believe this approach more appropriately reflects appreciated real property values by attributing a proportional percentage, based on fair market values on the date of origination or acquisition, to the real property securing the mortgage debt while maintaining a simple and administrable rule.<sup>27</sup>

We suggest that, in its evaluation of the Proposed Fixed Percentage Rule, the Service consider the application of the rule to a situation where decreases in market interest rates result in the value of the loan increasing in excess of the “loan value of the real property” securing the mortgage. Consider the following example:

***Example 2E. Decrease in market interest rates.*** In year 1, Lender REIT made a \$100 mortgage loan to Borrower, secured by both real and other property. The “loan value of the real property” securing the mortgage (measured as of the time Lender REIT became committed to originate the mortgage loan) was \$125 and, as of the end of the quarter in which Lender REIT originated the mortgage loan, the value of the loan as determined under Treasury Regulations Section 1.856-3(a) was \$100. Through the end of year

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<sup>27</sup> The Variable Percentage Rule would afford Acquiror REIT the full benefit of the appreciated real property values. We note that the Proposed Fixed Percentage Rule effectively applies a presumption that the increase in the value of the loan is proportionately attributable to appreciation in the values of the real property and other property securing the mortgage, based on the proportionate values of the real property and other property securing the mortgage as of the date the REIT committed to acquire the mortgage loan. It is possible that this may either (1) unfairly penalize REITs where a greater portion of the increase in loan value is attributable to appreciated real property values, or (2) unduly benefit REITs where a lesser portion of the increase in loan value is attributable to appreciated real property values. However, we believe the Proposed Fixed Percentage Rule represents a fair and administrable approach without requiring the complexity and difficulties that would be associated with an approach that attempted to isolate factors giving rise to fluctuations in loan values.

We also note that, similar to the concern raised in footnote 23, the Proposed Fixed Percentage Rule could provide an incentive for REITs to engage in modifications of mortgage debt in periods of increasing real property values to reap the benefits of a recalculated (higher) percentage and a disincentive for REITs to engage in modifications of mortgage debt in periods of decreasing real property values to retain the benefit of an inflated percentage.

4, the “amount of the loan” was \$100. In the first quarter of year 3 and through the end of the last quarter of year 4, market interest rates decreased, the fair market value of the real property securing the mortgage remained \$125, the fair market value of the other property securing the mortgage was \$25, and the value of the loan increased, due to the decrease in interest rates, to \$175.

At the end of the quarter in which Lender REIT originated the mortgage loan, under the Asset Test Safe Harbor, the mortgage qualified as a real estate asset in the amount of \$100, the lesser of (1) the value of the loan (\$100) and (2) the “loan value of the real property” securing the mortgage (\$125). At the end of the first quarter of year 3 and through the last quarter of year 4, under the Asset Test Safe Harbor as set forth in the Rev. Proc., the mortgage would qualify as a real estate asset in the amount of \$125, the lesser of (1) the value of the loan (\$175) and (2) the “loan value of the real property” securing the mortgage (\$125). Under the Proposed Fixed Percentage Rule, however, at the end of the quarter in which Lender REIT originated the mortgage loan and until there is a new commitment to acquire the mortgage loan or until there is a change in the makeup of the collateral securing the mortgage, 100% of the value of the loan would be treated as a real estate asset. Thus, at the end of the first quarter of year 3 and through the last quarter of year 4, the mortgage would qualify as a real estate asset in the amount of \$175, despite the fact that only 71.43% of the value of the loan (\$175) was represented by the “loan value of the real property” securing the mortgage (\$125) in each such quarter. The Service should consider whether the Proposed Fixed Percentage Rule should require that the relevant percentage be re-determined upon the decrease of market interests rates to an extent that results in the value of the loan exceeding the “loan value of the real property” securing the mortgage.

Such a re-determination would require the development of a standard for determining and isolating the cause of an increase in loan value, which could prove to be an administratively challenging task. Alternatively, the value of the mortgage that would be treated as a real estate asset could simply be capped at the value of the underlying real property. In any case, we do feel it is important that any such standard should operate in a way that a REIT would not be harmed or otherwise penalized by extrinsic factors or events beyond its control.

**B. Application of Principles Similar to the Modification Safe Harbor to Third-Party Acquisitions of Distressed Mortgage Debt**

We recommend that the Service promulgate guidance allowing REITs acquiring distressed mortgage debt from other lenders in order to effect a workout of such debt (*i.e.*, REITs such as Acquiror REIT in Example 2A above) to benefit from the presumptions underlying the Modification Safe Harbor—*i.e.*, the presumption that a workout of distressed mortgage debt should not alter the nature of the mortgage as a real estate asset or the nature of the interest income earned with respect to the mortgage as qualifying REIT income. Both modifications and acquisitions of mortgages could be viewed, under the REIT 75% Income Test, as a new commitment to originate or acquire a mortgage loan, thus resulting in a re-determined “loan value of the real property” securing the mortgage, which would, in turn, affect the application of the Interest Apportionment Regulations. Modifications and acquisitions of distressed mortgage debt are similar in many respects. Under the REIT 75% Income Test, both result in a redetermination of the “loan value of the real property” securing the mortgage and this, in turn, affects the application of the Interest Apportionment Regulations. The Rev. Proc. solves this problem in the context of “Covered Modifications,” *i.e.*, those modifications occasioned by a default or anticipated default of the relevant mortgage. The Modification Safe Harbor allows a REIT to work out distressed mortgage debt with the borrower via a modification without



requiring a recalculation of the “loan value of the real property” securing the mortgage at a decreased valuation, which would potentially jeopardize the REIT’s qualification under the 75% Income Test. In implementing the Modification Safe Harbor, the Service seems to be recognizing that, despite the distressed nature of the mortgage, the REIT’s ownership of the mortgage loan comports with the general purpose of the REIT regime and, thus, modification of such mortgage should not alter the nature of the mortgage as a real estate asset or the nature of the interest income earned with respect to the mortgage as qualifying REIT income.

We believe that the same principle should apply where a distressed mortgage loan does not continue to be held by the same lender, but instead is taken over by another lender that is willing to step into the same position the prior lender would have been in had the prior lender agreed to a modification. To date, the Service has not provided similar treatment for acquisitions of distressed mortgage loans, even where such acquisitions occur in situations similar to “Covered Modifications.” As Example 2 of the Rev. Proc. and Example 2A above demonstrate, the Interest Apportionment Regulations continue to apply to newly acquired distressed mortgage debt. Thus, whereas in Example 1 of the Rev. Proc. and Examples 1B and 1C above, upon modification, all of the interest income earned with respect to the modified mortgage is treated as qualifying REIT income for purposes of the 75% Income Test, in Example 2 of the Rev. Proc. and Example 2A above, upon acquisition of the same mortgage loan, only 55% of the interest income earned with respect to the acquired mortgage is treated as qualifying REIT income for purposes of the 75% Income Test.

We believe that, just as the modification of distressed mortgage debt should not alter the nature of the debt as a real estate asset or the nature of the interest income earned with respect to the debt as qualifying REIT income, a REIT that is willing to take up distressed mortgage debt

from another lender in order to work out the debt should be afforded similar treatment. We believe the rules should ensure parity between the treatment of a REIT that agrees to acquire distressed mortgage debt to facilitate a workout and the treatment of a REIT, such as Refinance REIT in Example 2B above, that lends an amount of cash equal to the purchase price of the distressed mortgage debt to the debtor, who then uses the proceeds of the borrowing to pay off the original distressed mortgage debt.

In order not to penalize a REIT that acquires distressed mortgage debt relative to a REIT that originates a new mortgage loan with respect to the same property, and in furtherance of the principles motivating the Service’s promulgation of the Modification Safe Harbor, we recommend that the Service allow a REIT that acquires a mortgage loan at a discount, when the REIT’s acquisition of the loan is occasioned by its default or anticipated default (*i.e.*, under the same conditions that trigger that Modification Safe Harbor) to use its highest adjusted tax basis as the “amount of the loan” for purposes of the Interest Apportionment Regulations (we refer to this as the “Proposed Basis Rule”).<sup>28</sup>

The following example demonstrates the application of the Proposed Basis Rule:

***Example 2F. Proposed Basis Rule.*** Lender REIT made a \$100 mortgage loan to Borrower in year 1, secured by both real and other property. The “loan value of the real property” securing the mortgage (measured as of the time Lender REIT became committed to originate the mortgage loan) is \$115. Through the end of year 4, the “amount of the loan” was \$100, but the fair market value of the real property and other property securing the

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<sup>28</sup> While the Modification Safe Harbor modifies how the loan value of the real property is computed, our Proposed Basis Rule operates by modifying how the amount of the loan is computed. As noted in the text, the Proposed Basis Rule is expected to put Acquiror REIT in the same position as Refinance REIT.

mortgage had decreased to \$55 and \$5, respectively. In anticipation of default, during the first quarter of year 5, another Acquiror REIT committed to acquire and acquired the mortgage loan from Lender REIT for \$60.

Upon acquisition, under the Proposed Basis Rule, 91.67% of the interest income Acquiror REIT earns with respect to the mortgage is treated as qualifying REIT income for purposes of the 75% Income Test, the fraction represented by dividing the “loan value of the real property” securing the mortgage as of the date on which Acquiror REIT became committed to acquire the mortgage loan (\$55) by the “amount of the loan” (*i.e.*, Acquiror REIT’s adjusted tax basis in the acquired mortgage loan, \$60). The remaining 8.33% of the interest income Acquiror REIT earns with respect to the mortgage is non-qualifying REIT income for purposes of the 75% Income Test. Without the Proposed Basis Rule, under the approach of the Rev. Proc., which would apply the Interest Apportionment Regulations without modification,<sup>29</sup> only 55% of the interest income Acquiror REIT earned with respect to the mortgage would be qualifying income, and the remaining 45% of the interest income Acquiror REIT earned with respect to the mortgage would be non-qualifying REIT income. The result under the Proposed Basis Rule, however, maintains parity with Example 2C, *i.e.*, the treatment of a new REIT lender that, instead of acquiring the distressed mortgage debt, originates a new mortgage loan, allowing the debtor to settle its original mortgage obligation.

We recognize that a REIT that agrees to a modification of debt it already owns may present a more sympathetic case for providing an exception to the normal rules for calculating how much of the debt is a “real estate asset” than a REIT that acquires an existing loan from a third party. We believe, however, that, in the absence of a compelling reason to treat

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<sup>29</sup> See Example 2A, above.

modifications and acquisitions differently, REITs should not be discouraged from working out distressed mortgage debt via acquisitions (or incentivized to require that the transaction take the form of a refinancing instead). If the acquisition is expected to avoid a foreclosure (*i.e.*, the same conditions that trigger the Modification Safe Harbor are present), we think the treatment under the REIT qualification rules should be similar.

For this reason, we propose that the Proposed Basis Rule only apply to acquiror REITs that undertake acquisitions of distressed mortgage debt for the purpose of working out the debt in circumstances similar to “Covered Modifications” giving rise to the application of the Modification Safe Harbor. We do not believe that acquiror REITs undertaking acquisitions of mortgage debt for purely speculative or opportunistic reasons, or REITs acquiring non-distressed mortgage debt, ought to be covered by the Proposed Basis Rule, much in the same way REITs undertaking modifications that are not reasonably anticipated to reduce the risk of default of the relevant loan are not entitled to protection under the Modification Safe Harbor.

### **C. The Proposed Principally Secured By Real Property Safe Harbor**

#### ***1. Discussion of Recommendation***

Our final recommendation is not limited to the distressed debt context, but rather would apply to all REITs and to assets that have no distressed component. We are, however, making this suggestion at this time because it responds to an administrative and practical complexity in the application of the REIT rules that is similar, if not identical, to the complexities raised by distressed debt.

The 75% Income Test and the 75% Asset Test are set out in Section 856. For purposes of both tests, the statute uses the term “mortgages on real property or on interests in real property” to define qualifying assets. Under the income test, interest from such mortgages is good income, and, under the asset test, such mortgages are good assets.

The Treasury Regulations' Interest Apportionment Regulations and the Rev. Proc.'s Asset Test Safe Harbor are complex computational approaches that separate a single mortgage into two parts: one part that is a qualifying "real estate" asset, and another part that is not a "real estate" asset. This separation will occur, for purposes of the 75% Income Test, whenever (i) the original amount of the loan exceeds, by any amount, the fair market value of the real property security on the day the loan was committed to or acquired, and (ii) the security for the loan includes some non-real property. This separation will occur, for purposes of the 75% Asset Test, whenever the (i) value of the loan has declined below the initial value of the loan or (ii) the loan value of the real property securing the loan is less than the value of the loan (*e.g.*, at origination because the real property's value is less than the principal of the loan or subsequently because the value of the loan increases) and the REIT must revalue its assets for purposes of the 75% Asset Test.

We believe that the statute does not mandate this type of bifurcation and that it would be preferable to treat any mortgage that is secured by a sufficient amount of real property as a qualifying real estate asset in its entirety for purposes of the 75% Income Test and the 75% Asset Test. Not only would such a rule be simple and easily administrable, but it would also accord with the general intent of the REIT regime to provide tax favored treatment to entities that invest primarily in real estate assets, without requiring that each and every investment be a real estate asset or that the real estate assets be entirely composed of or secured by real estate and no other property.

There are a variety of potential standards that could be used to determine whether the amount of real property securing a mortgage is sufficient to warrant treatment of such mortgage and its interest income as a real estate asset and qualifying REIT income in their entirety.

The REMIC regime, which, for purposes of determining qualification as a REMIC, contains a test parallel to the 75% Asset Test,<sup>30</sup> utilizes a “principally secured by” standard to determine if mortgages are treated as qualifying REMIC assets.<sup>31</sup> This standard is instructive in the current context as well, and we believe it should inform the development of an appropriate standard for determining whether a mortgage and its interest income should qualify under the REIT rules. The REIT and REMIC regimes have much in common: (i) both are modified pass-through regimes; (ii) both provide favorable tax treatment to investors in order to encourage certain types of investments;<sup>32</sup> (iii) both are intended to encourage investments in real property assets; and (iv) both even use the exact same definition of “real property.” The Treasury Regulations governing REMICs define “real property” by cross-reference to the REIT Treasury Regulations’ definition of “real property”.<sup>33</sup>

Moreover, the Rev. Proc. turns to the REMIC regime for a model on which to base the definition of “Covered Modification,” indicating the Service’s recent recognition of the parallel nature of the two regimes. Indeed, the Rev. Proc. refers to Treasury Regulations Section 1.860G-2(b)(3)(i), a safe harbor in the REMIC rules providing that certain loan modifications are not significant for purposes of those rules when they are “occasioned by default or a reasonably foreseeable default.”<sup>34</sup>

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<sup>30</sup> Under Section 860D(a)(4) of the Code, to qualify as a REMIC, substantially all of an entity’s assets must consist of “qualified mortgages” and permitted investments.

<sup>31</sup> Section 860G(a)(3)(A) and Treasury Regulations Section 1.860G-2(a) (same as the statutory text).

<sup>32</sup> The REMIC regime applies to entities holding “qualified mortgages and permitted investments” (as defined in Section 860G(a)(3) of the Code), and a “qualified mortgage” is one that is “principally secured by an interest in real property,” as such term is defined in Treasury Regulations Section 1.856-3(d).

<sup>33</sup> See Treasury Regulations Section 1.860G-2(a)(4) (referencing Treasury Regulations Section 1.856-3(d)).

<sup>34</sup> See Section 2.08 of the Rev. Proc. (citing Treasury Regulations Section 1.860G-2).

The “principally secured by an interest in real property” standard found in the REMIC regime<sup>35</sup> works as follows: an obligation is “principally secured by an interest in real property” if either

(1) the fair market value of the interest in real property securing the obligation equaled or exceeded 80% of the adjusted issue price of the obligation at origination or at contribution of the obligation by the sponsor to the REMIC, or

(2) substantially all of the proceeds of the obligation were used to acquire or to improve or protect an interest in real property that, at origination, was the only security for the obligation.<sup>36</sup>

Treasury Regulations Section 1.860G-2(a)(3) provides a safe harbor for a sponsor that “reasonable believes” that the obligation is “principally secured by an interest in real property” under one of these two tests.

With that as a guidepost, a similar, simpler rule in the REIT context (*i.e.*, what we are calling the Proposed Principally Secured By Safe Harbor) might provide that a mortgage is a real estate asset for purposes of the 75% Asset Test, and the interest income earned with respect to a mortgage is qualifying REIT income for purposes of the 75% Income Test, if the mortgage is “principally secured by an interest in real property,” which would be the case if on the date the REIT committed to originate or acquire the mortgage loan, the “loan value of the real property” securing the mortgage equaled or exceeded a specified percentage of the value of the loan as determined under Treasury Regulations Section 1.856-3(a). This rule would be similar to prong

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<sup>35</sup> We note that the differences between the REMIC regime and the REIT regime could also justify distinct tests for determining qualification under either regime. A discussion of the wisdom of adopting a unified set of rules for REITs and REMICs generally is beyond the scope of this report. However, we believe that given the similarities between the intent of the two regimes and the references to the REMIC regime in the Rev. Proc., the standard for determining when a mortgage is a qualifying mortgage for purposes of the REMIC rules is a helpful guidepost for developing a standard to determine when a mortgage is a real estate asset and its interest income is qualifying REIT income for purposes of the REIT rules.

<sup>36</sup> Treasury Regulations Section 1.860G-2(a)(1).

(1) of the REMIC rule and would incorporate concepts that are already used in the REIT regime. Thus, if the fair market value of the real property were a specified minimum percentage of the amount of the loan at the time the loan was extended (or the loan was acquired), then the loan would be 100% real property throughout the period that the lender held the loan.

In determining what the specified minimum percentage under the Proposed Principally Secured By Safe Harbor should be, we think consideration should be given to how that percentage will interact with the 75% Asset Test and the 75% Income Test. Under the REMIC rules, the statute requires that “substantially all” of the entity’s assets be “qualified mortgages and permitted investments,” and the Treasury Regulations interpret that to mean that the entity’s non-qualifying assets must be “no more than a de minimis amount” of the entity’s assets.<sup>37</sup> Thus, there is very little room for non-qualifying assets. By contrast, under the REIT regime, the 75% Asset Test provides REITs with a 25% “cushion” for the ownership of non-real estate assets, and the 75% Income Test provides REITs with a similar 25% “cushion” for the receipt and accrual of non-qualifying income. The specified minimum percentage of the Proposed Principally Secured By Safe Harbor would provide a second layer of “cushion” with respect to each test, such that, the amount of real property required to be owned by and the amount of qualifying income required to be received or accrued by a REIT would be reduced below 75%. For example, if the Proposed Principally Secured By Safe Harbor were to specify a minimum percentage of 80% (which is the minimum percentage specified in the REMIC regime), an entity could qualify as a REIT (that is, satisfy the 75% Asset Test, at least) if 75% of its assets consisted of mortgages secured 80% by real property—meaning that its real estate asset security

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<sup>37</sup> Treasury Regulations Section 1.860D-1(b)(3). A safe harbor provides that the amount of “other” assets is considered “de minimis if the aggregate of the adjusted bases of those assets is less than one percent of the aggregate of the adjusted bases of all of the REMIC’s assets.” Treasury Regulations Section 1.860D-1(b)(3)(ii).



constituted only 60% of the value of the security for its loan.<sup>38</sup> The REIT rules already permit a 25% non-real estate component; the issue to consider is whether and by how much Treasury and the IRS are willing to increase this percentage in order to accomplish simplification.<sup>39</sup>

We believe the adoption of the Proposed Principally Secured By Safe Harbor with an appropriate minimum percentage would achieve the goals of simplifying the operation and administration of the REIT qualification rules without compromising their integrity and the intent that those qualification rules limit the application of the favorable REIT regime to entities that primarily hold passive real estate investment.<sup>40</sup>

With respect to distressed mortgages that satisfy the Proposed Principally Secured By Safe Harbor, this approach would also eliminate certain issues, as discussed above in Parts III.A and III.B, that arise with respect to the apportionment of interest income and the bifurcation of assets under the Interest Apportionment Regulations and the Rev. Proc. These complications

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<sup>38</sup> If the entity owned the minimum amount of real estate assets required by the 75% Asset Test (in other words, if exactly 75% of its assets were real estate assets) entirely in the form of mortgages that qualified, to the minimum extent, as “real estate assets” under the Proposed Principally Secured By Safe Harbor (in other words, if all of the entity’s mortgages were secured 80% by real property), the entity would qualify as a REIT, but its assets would be secured only 60% (75% x 80%) by real property, and 40% by non-real estate assets.

<sup>39</sup> We note that a similar dilutive effect results from the application of certain existing REIT safe harbors, such as the 85% safe harbor for loans secured by interests in partnerships or disregarded entities in Revenue Procedure 2003-65, 2003-2 C.B. 336, (which safe harbor is compounded with the 75% Asset Test and 75% Income Test) and the 85% safe harbor for mixed collateral leases in Section 856(d)(1)(C) (which safe harbor is compounded with the test requiring 95% of a REIT’s gross income to be derived from certain types of qualifying income). See the discussion of these safe harbors below.

<sup>40</sup> While our proposal is principally animated by the administrative goal of simplifying an often complicated regime, the adoption of the Proposed Principally Secured By Safe Harbor could indeed solve some substantive issues arising under the current rules. For example, consider a distressed mortgage loan that represents the only security of the debtor, is secured by both real property and other property, and does not satisfy the safe harbor of Section 856(m) (which treats certain securities as not being held by a REIT for purposes of applying Section 856(c)(4)(B)(iii)(III), the rule prohibiting REITs from owning securities representing more than 10% of the total value of the outstanding securities of any one issuer). Such a mortgage loan would not qualify in full as a “real estate asset” under the Rev. Proc., and the portion that does not qualify could cause the REIT to violate the rule prohibiting it from owning securities representing more than 10% of the total value of the outstanding securities of any one issuer. Such a loan, however, could potentially qualify under the Proposed Principally Secured By Safe Harbor. In that case, the Proposed Principally Secured By Safe Harbor would allow a REIT to own the distressed mortgage debt without jeopardizing its status under this 10% limitation, which it would otherwise be precluded from owning. Because we believe that the Proposed Principally Secured By Safe Harbor identifies assets that are appropriately considered “real estate assets” for purposes of the REIT qualification rules, we think satisfying the 10% limitation by application of this safe harbor is equally appropriate.

will only remain relevant with respect to distressed mortgages that fail to satisfy the Proposed Principally Secured By Safe Harbor. Further, the Proposed Principally Secured By Safe Harbor would adhere to the intent of the REIT regime, *i.e.*, providing tax benefits only to entities investing primarily in real property. A mortgage does not begin to resemble something other than an interest in real property until a substantial amount of such mortgage is secured by property other than real estate, in which case the mortgage would fail to satisfy the Proposed Principally Secured By Safe Harbor and, if distressed, would be subject to the more nuanced rules of the Interest Apportionment Regulations and the Rev. Proc.

Further, we believe both the REIT regime and the Service's interpretation and application of that regime historically support the Proposed Principally Secured By Safe Harbor. For example, Revenue Procedure 2003-65 established a safe harbor under which, generally, a REIT may treat (1) loans secured by interests in partnerships or the sole membership interest in a disregarded entity as real estate assets for purposes of the 75% Asset Test and (2) interest income earned with respect to such loans as qualifying REIT income for purposes of the 75% Income Test if, in each case, 85% of the value of the assets of the relevant partnership or disregarded entity consists of real property.<sup>41</sup> Essentially, the safe harbor of Revenue Procedure 2003-65 is meant to apply to loans that are, indirectly through partnerships or disregarded entities, principally secured by interests in real property. Similarly, for purposes of the 75% Income Test and the test in Section 856(c)(2) of the Code requiring at least 95% of a REIT's gross income to be derived from certain types of qualifying income, including "rents from real property," Section 856(d)(1)(C) provides a safe harbor allowing rent from mixed collateral leases to qualify as "rents from real property" as long as not more than 15% of the total rent is attributable to personal property. The Service has adopted similar safe harbors in various other non-REIT areas

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<sup>41</sup> Rev. Proc. 2003-65, 2003-2 C.B. 336.

of the tax law, for example, the safe harbor set forth in Revenue Procedure 77-37<sup>42</sup> providing that the “substantially all” requirement of certain provisions of the Code relevant in the context of corporate reorganizations is satisfied if at least 90% of the fair market value of the target’s net assets and 70% of the fair market value of the target’s gross assets are transferred in the transaction.

If our Proposed Principally Secured By Safe Harbor or a similar approach were adopted, we would recommend that a rule similar to the Modification Safe Harbor should also apply, such that, upon a “Covered Modification” of a mortgage, a REIT would not be required to recalculate whether such mortgage continued to satisfy the Proposed Principally Secured By Safe Harbor. We believe that the same principles motivating the Service’s adoption of the Modification Safe Harbor in the context of the Interest Apportionment Regulations and the Asset Test Safe Harbor justify its application in the context of the Proposed Principally Secured By Safe Harbor—neither distressed mortgage debt nor the interest income earned with respect to it should lose its character as a real estate asset or qualifying REIT income, respectively, merely because the debtor and the REIT are able to agree to a workout.<sup>43</sup>

We acknowledge that this recommendation goes beyond the context of distressed debt. Nonetheless, we think this would be a valuable refinement of the REIT rules and that now is an appropriate time to consider such a change; the issues identified and addressed in the Rev. Proc. are specific examples (arising in the context of distressed debt) of more general problems that our Proposed Principally Secured By Safe Harbor is intended to address. We do believe,

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<sup>42</sup> 1977-2 C.B. 568.

<sup>43</sup> However, we do believe it would be appropriate for the Service to provide an exception to the Proposed Principally Secured By Safe Harbor requiring redetermination of whether a mortgage continues to satisfy the safe harbor if (and as of the date when) there is a change in the collateral (either the real property, other property, or both) securing the mortgage.

however, that a rule like this should be promulgated through the notice and rulemaking process of a Treasury regulation, because such a process would add to the weight of its authority.

## 2. *Authority*

We believe that Treasury and the Service have authority to issue regulations reflecting the Proposed Principally Secured By Safe Harbor, as recommended in Part III.C.1. The determination of whether Treasury and the Service have this regulatory authority is governed by *Mayo Foundation for Medical Education & Research, Et. Al. v. United States*,<sup>44</sup> which applied the two-part inquiry of *Chevron U.S.A. Inc. v. Natural Resources Defense Council, Inc.*<sup>45</sup> The first part of the inquiry asks whether Congress has “directly addressed the precise question at issue.”<sup>46</sup> If the answer is “yes,” then the regulations must follow “the unambiguously expressed intent of Congress.”<sup>47</sup> If the answer is “no,” then the analysis proceeds to the second part of the inquiry, which asks whether the administrative interpretation at issue is a “permissible construction of the statute.”<sup>48</sup>

As noted above, for purposes of both the 75% Income Test and 75% Asset Test, the Code refers to “mortgages on real property or on interests in real property” as qualifying assets. Although the Interest Apportionment Regulations make clear that where a mortgage is secured by both real and other property, the propriety of treating such mortgage as a qualifying asset will depend on certain facts relating to the underlying properties, Congress has not defined when a mortgage is secured by real property or interests in real property for purposes of either test. Thus, Congress has not directly addressed the question at issue.

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<sup>44</sup> 131 S.Ct. 704 (2011).

<sup>45</sup> 467 U.S. 837 (1984).

<sup>46</sup> *Id.* at 842–3.

<sup>47</sup> *Id.*

<sup>48</sup> *Id.* at 843.

We believe that the Proposed Principally Secured By Safe Harbor is a reasonable and permissible interpretation of Section 856(c)(3) and (4)(A) of the Code. As described above, the safe harbor would provide an administrable method of determining when a mortgage is treated as secured by real property or interests in real property for purposes of both the 75% Income Test and the 75% Asset Test. It would operate by reference to the “loan value of the real property” securing the mortgage and the value of the loan, concepts that Treasury and the Service considered determinative in formulating both the Interest Apportionment Regulations and the Rev. Proc. The Proposed Principally Secured By Safe Harbor adheres to the intent of the REIT regime, which, as discussed above, has historically supported similar safe harbors intended to define when obligations are qualifying assets for purposes of the REIT qualification rules.<sup>49</sup> Moreover, by promulgating regulations reflecting the Proposed Principally Secured By Safe Harbor, Treasury would be interpreting Section 856(c)(3) and (4)(A) of the Code in a manner consistent with its interpretation of substantively similar concepts in the context of the REMIC regime.<sup>50</sup>

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<sup>49</sup> See note 41 and accompanying text.

<sup>50</sup> See notes 30–35 and accompanying text.