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March 12, 2014

The Honorable Mark Mazur  
Assistant Secretary (Tax Policy)  
Department of the Treasury  
1500 Pennsylvania Avenue, NW  
Washington, DC 20220

The Honorable John Koskinen  
Commissioner  
Internal Revenue Service  
1111 Constitution Avenue, NW  
Washington, DC 20224

The Honorable William J. Wilkins  
Chief Counsel  
Internal Revenue Service  
1111 Constitution Avenue, NW  
Washington, DC 20224

### Re: Report on Revenue Procedure 2011-16 (Treatment of Distressed Debt of REITs Under Section 856)

Dear Messrs. Mazur, Koskinen and Wilkins:

I am pleased to submit the enclosed New York State Bar Association Tax Section report offering commentary and recommendations on Revenue Procedure 2011-16 (the "Rev. Proc."), which addresses transactions undertaken by real estate investment trusts ("REITs") involving distressed mortgage debt.

Generally, the Rev. Proc. addresses 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 requirement that at least 75% of a REIT's gross income must be qualifying income (the "75% Income Test") or (2) deemed to have engaged in prohibited transactions. The Rev. Proc. also provides helpful guidance regarding the application to distressed mortgage debt of the requirement that at least 75% of the value of a REIT's total assets must be represented by real estate assets, cash and cash items, and government securities (the "75% Asset Test").

More specifically, the Rev. Proc. allows REITs not to re-calculate the "loan value of the real property" securing a distressed mortgage debt for purposes of the 75% Income Test (which would likely have decreased since the date on which the REIT originated or acquired the loan, jeopardizing the qualification of part of the income from the loan as qualifying REIT income) after a workout of the debt via modification that is occasioned by default or intended to substantially reduce the risk of default on the debt (the "Modification Safe Harbor"). Also, the

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Mr. Mazur  
Mr. Koskinen  
Mr. Wilkins  
March 12, 2014

Rev. Proc. implements a safe harbor under which the Internal Revenue Service (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 or (2) the “loan value of the real property” securing the mortgage, taking into account the Modification Safe Harbor (the “Asset Test Safe Harbor”).

In our report, we recommend that the Service and the Treasury Department (“Treasury”) modify the Rev. Proc. in two respects. First, we recommend eliminating certain counterintuitive results that arise under the Asset Test Safe Harbor in circumstances where the value of the loan increases after its origination or acquisition by allowing a REIT to treat a mortgage as a real estate asset based on the percentage of real property securing the mortgage determined as of the date of origination or acquisition. Second, we recommend that the principle embodied by the Rev. Proc.—namely, 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”—be extended and generalized so as to apply to workouts in which third-parties acquire distressed mortgage debt.

Finally, we recommend that the Service and Treasury consider implementing, via the promulgation of Treasury regulations, a safe harbor to simplify the determination of when (1) interest income earned with respect to a mortgage is qualifying REIT income under the 75% Income Test and (2) a mortgage is treated as a real estate asset for purposes of the 75% Asset Test. This final recommendation is not limited to the distressed debt context, but we believe it is appropriate for the Service and Treasury to consider it as a response to the administrative and practical complexities in the application of the REIT rules that are similar, if not identical, to the complexities raised by distressed debt and addressed in the Rev. Proc.

We very much appreciate your consideration of these recommendations and would be happy to discuss them with you or provide additional assistance.

Respectfully submitted,



David H. Schnabel  
Chair

Enclosure

cc: Erik H. Corwin  
Deputy Chief Counsel (Technical)  
Internal Revenue Service

Helen Hubbard  
Associate Chief Counsel (Financial Institutions & Products)  
Internal Revenue Service

David Silber  
Branch Chief (Financial Institutions & Products)  
Internal Revenue Service

Mr. Mazur  
Mr. Koskinen  
Mr. Wilkins  
March 12, 2014

Jon Silver  
Assistant to Branch Chief (Financial Institutions & Products)  
Internal Revenue Service

Lisa Zarlenga  
Tax Legislative Counsel  
Department of the Treasury

Michael Novey  
Associate Tax Legislative Counsel  
Department of the Treasury

Craig Gerson  
Attorney Advisor (Tax Legislative Counsel)  
Department of the Treasury