NEW YORK STATE BAR ASSOCIATION SECTION

REPORT ON REVENUE PROCEDURE 2003-65

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New York State Bar Association Tax Section

Report on Revenue Procedure 2003-65[1] Mezzanine Loans Held by REITs

I. Introduction

This report comments on Revenue Procedure 2003-65 (the "Revenue Procedure") which sets forth a safe harbor under which a subordinated loan held by a REIT and which is secured solely by an interest in a disregarded entity or partnership that owns real estate will be treated as a loan secured by the real estate for purposes of the REIT rules.[2] We believe that the Revenue Procedure is helpful and consistent with the policies underlying the REIT rules. However, as discussed below, we think that the Revenue Procedure should be updated to (i) eliminate certain technical rules which REITs find very difficult, if not impossible, to comply with and which do not advance the policies underlying the REIT provisions and (ii) modify certain aspects of the Revenue Procedure that are inconsistent with the REIT rules that govern loans that are directly secured by real property.

This report is divided into four parts. Part II contains a background discussion of the REIT rules governing mortgage loans and interest payments as well as a discussion of the Revenue Procedure. Part III contains a summary of the recommendations that are set forth in this report. Part IV contains a detailed discussion of the Revenue Procedure and our suggested recommendations.

II. Background Discussion

A REIT must satisfy certain asset and income requirements in order to qualify as a REIT. One such requirement is that at least 75% of the value of a REIT's total assets must be represented by real estate assets, cash and cash items (including

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1 This report was drafted by Jeffrey D. Hochberg. Helpful comments were received from Zvi Daniel Altman, Douglas Borisky, James Brown, Robert Cassanos, Dale Collinson, Ezra Dyckman, David Miller, Michael Schler, Marc Silberberg and Larry Wolf.

2 2003-2 C.B. 336

receivables), and government securities. Interests in mortgages on real property qualify as a real estate asset to the extent of the value of the real property that (after reduction by the amount of any senior debt that is on the property) secures the mortgage.[3] A mortgage on real property will qualify as a real estate asset even if the REIT does not record the mortgage as long as the REIT holds a security interest in the real estate assets that secures the loan.[4]

In addition, at least 75% of a REIT's gross income must be derived from specified sources, including interest on obligations secured by mortgages on real property or on interests in real property.[5] If a loan is secured by both real property and other property, the interest income from the loan must be apportioned between the two types of property for purposes of the 75% test. Specifically, all of the interest income is apportioned to the real property if the "loan value" (as defined below) of the real property equals or exceeds the principal amount of the loan that is secured by the real property. If the loan value of the real property is less than the amount of the loan, the interest income apportioned to the real property is an amount equal to the product of the interest income and 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.[6]

In the case of a loan that is held by a REIT, the loan value of the real property is the fair market value of the property that secures the loan, determined as of the date on which the commitment by the REIT to originate or purchase the loan becomes binding.[7] For this purpose, the fair market value of the property must be reduced by the

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[3] IRC Section 856(c)(5)(B).

[4] GCM 39484 (underlying PLR 8611044).

[5] IRC Section 856(c)(3).

[6] Treasury Regulations Section 1.856-5(c)(1).

[7] Treasury Regulations Section 1.856-5(c)(1).

principal amount of any debt on the property that is senior to the loan that is held by the REIT.[8]

In the case of a construction loan or other loan made for purposes of improving or developing real property, the loan value of the real property is the fair market value of the real property plus the amount of the reasonably estimated costs of the improvements or developments to the real property that will secure the loan and which will be constructed from the proceeds of the loan.[9]

If a REIT is a partner in a partnership that holds a mortgage loan, the partnership is treated as an aggregate, rather than as an entity, for purposes of the REIT income and asset tests, and thus the character of the assets and income in the hands of the partnership retains the same character in the hands of the REIT partner.[10] Accordingly, the REIT is deemed to own its proportionate share of the mortgage loans that are held by the partnership and is deemed to recognize its proportionate share of the mortgage interest income that is recognized by the partnership.

Prior to the issuance of the Revenue Procedure, there was some uncertainty as to whether a loan that is secured by interests in a partnership or disregarded entity that, in turn, owns real estate should be treated as a real estate asset for purposes of the REIT income and asset tests. On the one hand, the loan is not secured by the real property and therefore does not literally qualify as an obligation secured by an interest in real property, and the loan does not literally qualify as an equity interest in a partnership with real property. On the other hand, since a mortgage on real property is a real estate asset, and an equity interest in a partnership that holds only real property is also a real estate asset, as a policy matter a loan secured by an entity interest in a partnership that holds only real estate should also qualify as a real estate asset. This issue became increasingly important in light of the evolution of real estate financing

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[8] PLR 199923006.

[9] Treasury Regulations Section 1.856-5(c)(2).

[10] Treasury Regulations Section 1.856-3(g).

techniques. Traditionally, the purchase of real estate was financed with equity of the owner of the property and debt from a single lender that was directly secured by the property. If there was a subordinated loan (which is often referred to as a "mezzanine loan" because it stands between the senior debt and the equity in the capital structure), the loan would also be secured by the real property, although its lien would be subordinated to the lien held by the senior lender.

However, senior lenders began prohibiting any other liens on the property that secured their loan (even if the loan was subordinated to the senior loan). In order to accommodate this prohibition, a tiered structure of disregarded single purpose borrowers is often employed to provide structural subordination of each tier of debt to the more senior tier of debt.[11]

For example, a purchaser of real estate that wants to purchase real estate with senior and junior debt might set up a wholly owned limited liability company (the "property owning LLC") to own the real estate. The purchaser would contribute cash to the property owning LLC and the property owning LLC would borrow money from the senior lender that would be directly secured by the real estate. The purchaser would contribute its membership interests in the property owning LLC to an "upper tier LLC" that would be wholly owned by the purchaser. The upper tier LLC would borrow money from the junior lender (often referred to as the mezzanine lender) which would be secured by all of the upper tier LLCs membership interests in the property owning LLC.

If there are three tiers of loans, the purchaser would set up three LLCs with each LLC borrowing from a different lender so that the three loans could be structurally subordinated in the economically desired manner. Each of the LLCs would be disregarded as a separate entity, and thus would be treated as a branch of the purchaser, for US federal income tax purposes. Accordingly, although the more junior loans would be treated as secured by personal property (i.e., the membership interests in an LLC) for non-tax purposes, many tax advisors were of the view that such loans should

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[11] Our experience is that the use of tiered lending structures has significantly increased since the Revenue Procedure was issued in 2003.

be treated as mortgage loans for REIT purposes. This position was premised on the view that the loans should be treated as secured by the underlying real property that is held by the lower tier LLC for US federal income tax purposes, because the personal property (i.e., the membership interests in the property owning LLC) does not exist for US federal income tax purposes.

The structure described above involves a single holder of the equity of the entity that owns the real estate. This structure, however, has also been used in cases in which the real estate is held by a partnership for tax purposes. In such a case, the loan structure would be the same as described above, except that the loan would be treated as secured by the interests in the partnership that holds the real estate for tax purposes, since such interests would not be disregarded for tax purposes. As discussed above, if a REIT is a partner in a partnership that holds a mortgage loan, the partnership will be treated as an aggregate, rather than as an entity, for purposes of the REIT income and asset tests. Accordingly, many tax advisors were of the view that a loan that is secured by interests in a partnership that holds real estate should be treated as a real estate asset for REIT purposes notwithstanding that it is secured by personal property.

In 1977 the IRS issued a revenue ruling that provided support for the position that a loan that is secured by an interest in an entity should be treated as a mortgage loan for tax purposes as long the entity does not hold any assets other than real estate. More specifically, in Rev. Rul. 77-459, a REIT made a construction loan to a partnership, and the partnership assigned its interest in an Illinois land trust to the REIT as security for the loan. The partnership was the sole beneficiary of the land trust, and the land trust did not hold any assets other than real property. The beneficial interests in the trust thus had no value other than the underlying real property. The IRS ruled that the loan should be treated as a real estate asset for purposes of the REIT income and asset tests notwithstanding that the loan was secured by a personal property interest rather than a direct interest in real property.[12] In addition, the IRS issued a few private letter rulings

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[12] 1977-2 C.B. 239.

that concluded that a loan made by a REIT that was secured by interests in a partnership that held real property will be treated as a real estate asset for REIT purposes.[13]

In 2003, the IRS issued Revenue Procedure 2003-65 to address the tiered structure described above by providing for a safe harbor under which a loan from a REIT that is secured by an interest in a partnership or by the sole membership interest in a disregarded entity will be treated as a real estate asset for REIT purposes, if each of the following eight requirements are satisfied:

> (i) the borrower is either a partner in a partnership or the sole member of an eligible entity that has not elected to be treated as a corporation and is therefore disregarded as an entity separate from its owner for federal income tax purposes;
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> (ii) the loan is nonrecourse and is secured only by the partner's interest in the partnership, or the member's interest in the disregarded entity, and thus the REITs sole recourse in the event of default is against the pledged ownership interest;
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> (iii) the lender is granted a first priority security interest in the pledged ownership interest and such pledged interest cannot be further encumbered unless the additional security interest is subordinate to the lender's security interest;
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> (iv) upon default and foreclosure on the secured loan, the lender will replace the borrower as a partner or as the sole member of the disregarded entity; in the case of a

[13] See, e.g., PLR 8827062 (April 13, 1988); PLR 8708082 (November 20, 1986); PLR 8626025 (March 25, 1986).

loan secured by a partnership interest, the other partners in the partnership must have agreed that, upon default and foreclosure, they will not unreasonably oppose the admission of the lender as a partner;

(v) on the date the commitment by the lender to make the loan becomes binding, the partnership or disregarded entity holds real property; if all or part of the real property is subsequently sold or transferred, the loan will become due and payable upon such sale or transfer;

(vi) on each testing date, the value of the real property held by the partnership or disregarded entity is at least 85% of the value of all of the assets of the partnership or disregarded entity;[14]

(vii) the loan value of the real property owned by the partnership or disregarded entity equals or exceeds the amount of the loan;[15] and

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14 For this purpose a testing date means the close of the first quarter of the lender's taxable year following the date on which the commitment by the lender to make the loan becomes binding on the lender, and the close of each subsequent quarter in which the partnership or disregarded entity acquires any assets other than real estate assets, cash and cash items (including receivables), or government securities, or reasonable quantities of equipment and materials customarily used for the maintenance and repair of real property. For this purpose, asset acquisitions by a partnership or disregarded entity includes additional partnership or member contributions.

15 For this purpose, the loan value is reduced by any liens encumbering the real property, as well as by any other liabilities of the partnership or disregarded entity on the date the commitment by the lender to make the loan becomes binding on the lender. If the real property is owned by a partnership, only the proportionate share of the loan value attributable to the interest that secures the lender's loan is taken into account.

(viii) interest on the loan otherwise satisfies the REIT requirements (e.g., the interest on the loan is not contingent upon the net income of the borrower and is not classified as a fee for tax purposes).

A loan that satisfies the above requirements will be treated as a real estate asset for purposes of the REIT income and asset tests.

III. Summary of Recommendations

As discussed in more detail in the following section, we recommend that the safe harbor in the Revenue Procedure should be amended or revised in the following manner.

- The Revenue Procedure requires that the loan must be nonreourse. We recommend that the Revenue Procedure provide that a loan will not fail the nonrecourse requirement if (i) the loan becomes recourse only if the borrower or a related entity violates any of its non-financial covenants or obligations under the loan transaction documents or (ii) if the loan is subject to a pledge or guarantee that could only be called upon by the REIT lender after it has exhausted all of its remedies in respect of the collateral that secures the loan (i.e., the interests in the disregarded entity or partnership that holds the real property).
- The Revenue Procedure requires that the loan be directly secured by an interest in the property owning entity. We recommend that the Revenue Procedure provide that a loan will qualify under the safe harbor even if the borrower does not own an interest in the property owning entity and thus does not pledge an interest in such entity as long as the loan is secured by an interest in an entity that, through one or more entities that are treated as disregarded entities for tax purposes, holds an interest in a disregarded entity that owns the real estate that indirectly secures the loan. The loan should

qualify under the safe harbor, however, only if each intermediate entity directly holds no more than a de minimis amount of non-real estate assets.

- The Revenue Procedure requires that the loan will become due and payable if all or part of the underlying real property is sold or transferred. We recommend that the Revenue Procedure provide that a loan will not fail to qualify under the safe harbor even if the loan fails to accelerate when a portion of the underlying real property is sold as long as the loan value of the real property that is owned by the property owning entity after the sale equals or exceeds the principal amount of the loan.
- The Revenue Procedure requires that the lender hold a first priority interest in the pledged interest. We recommend that the Revenue Procedure provide that the safe harbor will apply even if the lender does not hold a first priority interest in the pledged interest as long as the value of the underlying real estate satisfies the safe harbor after reduction in value for any debt that is senior to the loan that is held by the REIT.
- The Revenue Procedure requires that in the case of a loan secured by a partnership interest, the other partners in the partnership must have agreed that, upon default and foreclosure, they will not unreasonably oppose the admission of the lender as a partner. We recommend that the Revenue Procedure provide that this requirement will be treated as satisfied even if there is no such affirmative agreement in the partnership agreement as long as the partnership agreement or any other applicable law does not require the consent of the other partners to admit the REIT lender as a partner in the partnership.

- The Revenue Procedure provides that the loan value of the real property owned by the partnership or disregarded entity must equal or exceed the amount of the loan. We recommend that the Revenue Procedure provide that the safe harbor will apply even if the loan value of the real property owned by the partnership or disregarded entity is less than the amount of the loan, provided that (as is the case with respect to a loan that is directly secured by real property) the portion of the loan that is treated as a real estate asset is equal to the product of the principal amount of the loan and 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 Revenue Procedure requires that on each testing date, the value of the real property held by the partnership or disregarded entity is at least 85% of the value of all of the assets of the partnership or disregarded entity. We recommend that the Revenue Procedure provide that the safe harbor will apply even if the value of the real property held by the partnership or disregarded entity does not satisfy the 85% requirement, provided that the loan should only be treated as a real estate asset to the extent of the value of the underlying real property that is held by the partnership or disregarded entity (after reduction for any debt that is senior to the debt that is held by the REIT).

IV. Discussion of Recommendations

A safe harbor that is issued by the IRS is generally not intended, and is generally not perceived by taxpayers, as setting forth an exclusive list of requirements that must be satisfied in order to comply with the tax law that is the subject matter of the safe harbor. We believe, however, that in light of the potentially catastrophic consequences to a REIT that fails to satisfy the asset and income tests (i.e., a corporate level tax) many taxpayers and their advisors effectively view the safe harbor as providing

for an exclusive set of requirements that must be satisfied in order to conclude that mezzanine loans qualify as real estate assets for tax purposes.

More specifically, many REITs will not own an asset such as a mezzanine loan unless there is certainty that their ownership of the asset and the associated income from the asset will not jeopardize its REIT status. Furthermore, a REIT generally needs an opinion from outside counsel that it "will" qualify as a REIT in order to issue securities in public capital markets, and outside counsel will often be unable to issue such an opinion if the mezzanine loans do not satisfy the safe harbor. Thus, while it might be appropriate in certain contexts for the IRS to issue safe harbors that are quite narrow, we do not think that that would be appropriate in the case of the safe harbor in the Revenue Procedure because of the specific REIT related issues described above and the fact that there is little other authority that addresses when a loan that is secured solely by an interest in a disregarded entity or partnership that owns real estate will be treated as a qualifying real estate asset for REIT purposes.

We also note that the current state of uncertainty in the market regarding the REIT status of loans that do not satisfy the safe harbor has created artificial constraints in respect of the real estate mezzanine loan market because many mortgage REITs are unwilling to acquire a loan that does not satisfy all of the requirements of the safe harbor. We believe that this market constraint has increased significantly in recent years as it has been our collective experience that very few of the mezzanine loans in the market comply with all of the requirements in the safe harbor.

The discussion below addresses in greater detail the seven recommendations set forth above that we believe should be made to update the safe harbor in the Revenue Procedure. The first four of the recommendations suggest that the Revenue Procedure should eliminate certain technical rules which REITs find very difficult, if not impossible, to comply with and which do not advance the policies underlying the REIT provisions. The last three of the recommendations address certain aspects of the Revenue Procedure that are inconsistent with the REIT rules that govern loans that are directly secured by real property. The policy position that underlies all of

the recommendations, and that seemingly (though more cautiously) underlies the safe harbor in the Revenue Procedure, is that a subordinated loan that effectuates the subordination via structural subordination should not be treated differently for REIT purposes than a loan that effectuates the subordination via direct economic subordination.

1. Nonrecourse Requirement

As discussed above, the safe harbor requires that the loan be nonrecourse and secured only by the partner's interest in the partnership or the member's interest in the disregarded entity. The REIT's sole recourse in the event of default will thus be against the pledged ownership interest. This requirement was presumably intended to ensure that, in the event of a default, the REIT would proceed against the real estate by acquiring the equity interest in the property owning entity rather than proceeding against the borrower.

The safe harbor does not include any definition of the term nonrecourse. This has created some uncertainty in the following cases. First, many loans that are otherwise nonrecourse include a so-called "bad boy" provision under which the loan becomes recourse only if the borrower or a related entity violates any of its non-financial covenants or obligations under the loan transaction documents. Second, many loans that are nonrecourse include a guarantee or pledge that can only be realized upon after the borrower has exhausted all of its remedies against the assets that directly secure the loan. In each of these cases there is no evident policy reason why a loan that is otherwise nonrecourse should fail to be treated as a real estate asset for purposes of the REIT rules as neither provision reduces the likelihood that the lender will proceed against the property as long as the borrower does not violate its obligations under the loan agreement.

We therefore recommend that the Revenue Procedure provide that a loan will not fail the nonrecourse requirement if (i) the loan becomes recourse only if the borrower or a related entity violates any of its non-financial covenants or obligations under the loan transaction documents or (ii) if the loan is subject to a pledge or guarantee that could only be called upon by the REIT lender after it has exhausted all of its

remedies in respect of the collateral that secures the loan (i.e., the interests in the disregarded entity or partnership that holds the real property).

2. Tiered Borrowers

As discussed above, the Revenue Procedure requires that the loan that is held by the REIT be directly secured by an interest in the property owning entity. However, as discussed above, if there are more than two tiers of lenders, structural subordination could often only be achieved by setting up at least two tiers of LLCs above the property owning entity. For example, if there are three tiers of lenders and the REIT holds the most subordinated loan, the borrower might hold equity in the top tier LLC that is the borrower from the REIT. The top tier LLC would then own an intermediate level LLC that would borrow from the second tier lender. The intermediate tier LLC would own all of the equity in the property owning equity that would be the borrower from the senior lender. The intermediate LLC and the property owning LLC would be treated as disregarded entities for tax purposes and the upper tier LLC that borrows from the REIT would be a partnership if there is more than one equity holder and would be a disregarded entity if there is a single equity holder.

The transaction described above would violate the safe harbor even though (i) in the event of a default under the loan the REIT would own the equity of the intermediate LLC and it would thefore effectively control the real estate that is owned by the property owning entity subject to the claims of the senior lenders to the lower tier entities and (ii) the intermediate tier LLC and the property owning LLC are disregarded entities so that the loan is effectively secured by the underlying real estate for US federal income tax purposes. There is no evident policy reason why the loan described above would fail to qualify for the safe harbor while a loan to the intermediate LLC would qualify for the safe harbor. We therefore recommend that a loan should qualify under the safe harbor even if the borrower does not own an interest in the property owning entity and thus does not pledge an interest in such entity as long as the loan is secured by an interest in an entity that, through one or more entities that are treated as disregarded entities for tax purposes, holds an interest in a disregarded entity that owns one or more

real estate properties that indirectly secures the loan.[16] The loan should qualify under the safe harbor, however, only if each intermediate entity directly holds no more than a de minimis amount of non-real estate assets.

3. Sale of a Portion of Underlying Real Estate

As discussed above, the Revenue Procedure requires that the loan will become due and payable if all or part of the underlying real property is sold or transferred. This rule was presumably intended to ensure that the loan will continue to be secured by real property during the term of the loan. However, this rule makes it practically impossible for a REIT to comply with the safe harbor when it makes a loan that is secured by multiple assets. A purchaser of multiple properties would typically refuse to enter into a loan that is secured by multiple properties if the loan will be accelerated if it only sells one of the properties. Rather, a loan agreement that is secured by multiple properties will typically provide either that the borrower is required to use all of the sales proceeds from a sale of a portion of the properties to reduce the principal amount of the loan and/or that the borrower must pay down a portion of the loan upon such a sale based on the portion of the loan that was allocated to the sold property in the loan agreement.[17]

There is no evident policy reason why the loan that is addressed by the Revenue Procedure must accelerate upon a sale of a portion of the properties that secure the loan, particularly if the property that indirectly secures the loan after the sale has a

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16 We recommend that this rule should also clarify that a loan to the top tier LLC should not be treated as recourse simply because one or more of the lower tier LLCs guarantees the loan (subject to the seniority of the claims of the senior lenders to the lower tier LLCs). This structure is often employed in order to ensure that other creditors of the lower tier LLCs do not have a claim that is senior to that of the lender to the top tier LLC.

17 The percentage of the allocated loan amount that is required to be repaid upon a sale of a particular property usually exceeds 100%. This mitigates the risk to the lender if the borrower sells the properties that have declined in value over the term of the loan while retaining the properties that have increased in value over the term of the loan.

value that would have been sufficient to enable the loan to qualify under the safe harbor if it was originated immediately after the sale of the property.[18] We therefore recommend that a loan should not fail to qualify under the safe harbor even if the loan does not accelerate if any of the underlying real property is sold as long as the loan value of the real property that is owned by the property owning entity immediately after the sale equals or exceeds the principal amount of the loan.[19] A similar recommendation with respect to REMICS was also proposed in a recent NYSBA tax section report on the proposed regulations regarding the modification of mortgage loans held by REMICs.[20]

4. Admission of REIT as Partner

As discussed above, the Revenue Procedure requires that the lender will replace the borrower as a partner or as the sole member of the disregarded entity upon default and foreclosure on the secured loan. The safe harbor further provides that in the case of a loan secured by a partnership interest, the other partners in the partnership must

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18 One could also reasonably take the view that the loan should qualify as a real estate asset even after the sale of all of the underlying real property as that would be consistent with the rules governing mortgage loans that are directly secured by real estate under which a loan may still qualify as a good real estate asset for REIT purposes even after the sale of the underlying real estate.

19 As discussed below, we would also recommend that a portion of the loan qualify as a real estate asset even if the loan value of the real property that is owned by the property owning entity immediately after the sale is less than the principal amount of the loan. The portion of the loan that would qualify as a real estate asset would be based on the ratio of the value of the remaining real property to the principal amount of the loan.

20 Recommendation 6 of the Tax Section Report on Modifications to Commercial Mortgage Loans Held by a Real Estate Mortgage Investment Conduit (REMIC), dated March 6, 2008, suggests that a release of a lien on a portion of real property collateral pursuant to the terms of a mortgage loan that is not a significant modification of the mortgage loan under Section 1001 should not be treated a release that disqualifies the mortgage loan from being a qualified REMIC asset so long as the value of the remaining real property collateral is sufficient to permit the mortgage to remain a qualified mortgage, based on the value of the real property collateral as of any of (i) the origination of the mortgage loan, (ii) the contribution of the mortgage loan to the REMIC, or (iii) the release of real property collateral.

have agreed that, upon default and foreclosure, they will not unreasonably oppose the admission of the lender as a partner. This rule was presumably included in the safe harbor in order to ensure that the REIT will in fact be able to obtain an equity interest in the underlying real estate in the event of a default under the loan.

The partnership requirement has created some uncertainty because most partnership agreements do not specifically provide that the partners agree that a lender can be admitted as a partner if there is a foreclosure in respect of a partner's interest in the partnership. Notwithstanding the lack of an explicit provision that so provides, the partnership agreement will often effectively provide that the lender will be admitted to the partnership if the partnership does not prohibit the partners from pledging or otherwise transferring their interests in the partnership. We therefore recommend that the safe harbor should apply even if the partnership agreement does not specifically provide that the partners in the partnership will not unreasonably oppose the admission of the lender as a partner as long as the partnership agreement or any applicable law does not require the consent of the other partners to admit the REIT lender as a partner in the partnership.[21]

5. Subordinated Mezzanine Loans

As discussed above, the Revenue Procedure requires that the lender hold a first priority interest in the pledged interest. This rule is presumably intended to ensure that the loan is secured by a sufficient amount of real property after taking into account any senior loan that is also secured by the pledged interest.

There is no evident policy reason why this issue should not be addressed in the same manner as a subordinated loan that is directly secured by real property. More specifically, as discussed above, if a REIT holds a subordinated loan that is secured by real property, the fair market value of the property must be reduced by the principal

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21 This should not place any additional burden on the IRS because, as under general tax principles, the taxpayer would have the burden of demonstrating that the partnership agreement and any applicable law does not require the consent of the other partners to admit the REIT lender as a partner in the partnership.

amount of any debt on the property that is senior to the loan that is held by the REIT. We recommend that a similar rule apply in the case of a loan that is subject to the Revenue Procedure. We therefore recommend that a loan may qualify under the safe harbor even if the lender does not hold a first priority interest in the pledged interest as long as the value of the underlying real estate satisfies the safe harbor after reduction in value for any debt that is senior to the loan that is held by the REIT.

6. <u>Value of Real Estate that is Held by the Property Owning Entity</u>

As discussed above, the Revenue Procedure provides that the loan value of the real property owned by the partnership or disregarded entity must equal or exceed the amount of the loan. This rule is presumably intended to ensure that there is a sufficient amount of real property that is available to secure the loan. However, there is no evident policy reason as to why a portion of the loan should not qualify as a real estate asset for REIT purposes even if the loan value of the underlying property is less than the amount of the loan, particularly in light of the fact that there is no such equivalent rule in the case of a loan that is directly secured by real property.

As discussed above, if a REIT holds a loan that is directly secured by both real property and other property, the interest income from the loan must be apportioned between the two types of property for purposes of the 75% test. Specifically, all of the interest income is apportioned to the real property if the "loan value" of the real property equals or exceeds the principal amount of the loan that is secured by the real property. If the loan value of the real property is less than the amount of the loan, the interest income apportioned to the real property is an amount equal to the product of the interest income and 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.

We recommend that a similar rule also apply in the case of a loan that is subject to the safe harbor set forth in the Revenue Procedure. We therefore recommend that the safe harbor should apply even if the loan value of the real property owned by the partnership or disregarded entity is less than the amount of the loan, provided that (as is the case with respect to a loan that is directly secured by real property) the portion of the

loan that is treated as a real estate asset should be equal to the product of the principal amount of the loan and 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.

7. Percentage of Underlying Assets that Consists of Real Estate

As discussed above, the Revenue Procedure provides that the value of the real property held by the partnership or disregarded entity on each testing date must be at least equal to 85% of the value of all of the assets of the partnership or disregarded entity. The rule may also be intended to ensure that there is a sufficient amount of real property that is available to secure the loan, or may be intended to prohibit the loan from being indirectly secured by a significant amount of non-real estate assets. However, there is no such equivalent rule in the case of a loan that is directly secured by real property. Moreover, as a policy matter, we believe that a loan should qualify as a real estate asset for REIT purposes, even if it does not satisfy the 85% test, as long as the value of the real estate that is held by the property owning entity is at least equal to the principal amount of the loan. Therefore, we recommend that the safe harbor apply even if the value of the real property held by the partnership or disregarded entity on a testing date is less than 85% of the value of all of the assets of the partnership or disregarded entity, provided that the loan should be treated as a real estate asset only to the extent of the value of the underlying real property that is held by the partnership or disregarded entity (after reduction for any debt that is senior to the debt that is held by the REIT).