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Department of the Treasury

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Person to Contact:

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Date:

March 21, 2002

Legend

Trust B =

Type C =

Type D Investments =

E =

F =

F Program =

G =

G Loan =

Date X =

Trust B F Type D Investment =

Trust B F First Mortgage Loan =

Trust B F Additional Loan =

Year 1 =

Type H Obligation =

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Dear _____ :

This is in response to a ruling request submitted by your authorized representative dated July 31, 2001. Trust A requests rulings that:

1. The Trust B F Additional Loan, described herein, secured by partnership interests qualifies as a "real estate asset" for purposes of Section 856(c)(4)(A) of the Code.
2. The interest income earned on the Trust B F Additional Loan qualifies as "interest on obligations secured by mortgages on real property or on interests in real property" for purposes of Section 856(c)(3)(B) of the Code.

FACTS

Trust B is a real estate investment trust (a "REIT") that invests directly in Type C loans and mortgage-backed securities. A portion of the investments of Trust B consists of Type D Investments. A Type D Investment consists of (1) an E mortgage-backed security ("MBS") representing the securitized first mortgage loan on an underlying complex or a participation interest in a first mortgage loan on a complex originated under the F Program (the "Trust B First Mortgage Loan"), (2) an additional loan to the borrower (in the case of the E MBSs) or to the owner of the borrower (in the case of the F First Mortgage Loan participation interest) of the Trust B First Mortgage Loan used to provide additional funds for the financing of the complex (the "Trust B Additional Loan") and (3) a participation interest in the cash flow from and appreciation of the complex that was conveyed to Trust B through a subordinated promissory note (the "Trust B Subordinated Promissory Note") and a subordinated mortgage on the property.

G insures the Trust B First Mortgage Loan and payments of principal and interest on the E MBS are guaranteed by E. Amounts payable under the Trust B Additional Loans and the Trust B Subordinated Promissory Notes are not insured or guaranteed.

Trust B had an interest in an F Type D Investment that paid off in Date X, the Trust B F Type D Investment. The borrower under the Trust B F First Mortgage Loan was a partnership. The borrower under the Trust B F Additional Loan was the majority partner of that partnership.

In Year 1, G issued a letter to all lenders involved in mortgage loan transactions insured by G (the "G Memorandum") providing requirements regarding certain insured loans, such as the First Mortgage Loans described herein. A Type H Obligation is defined in the G Memorandum as a loan by a third-party source of loan funds (such as Trust B) of additional funds over and above the amount of the G Loan to the partner(s) or other principal(s) of the mortgagor to cover costs that are not financed with the proceeds of the G Loan. The G Memorandum states that the obligation to repay such Type H

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Obligation funds is typically secured by a pledge of the partners' (or the mortgagor's other owners') rights to cash and a pledge of the partnership interest (or other ownership interests) of one or more of the partners (or other owners) of the mortgagor. The Trust B F Additional Loan constitutes Type H Obligation under the G Memorandum.

The G Memorandum permits Type H Obligations in connection with first mortgage loans insured by G only if such obligations are secured in conformance with the specific requirements of the G Memorandum. The provisions of the G Memorandum applicable to Type H Obligations provide in part that: (1) a Type H Obligation cannot be secured by the first mortgage insured by G and (2) a Type H Obligation cannot be secured by a second mortgage, but may be collateralized by security agreements pledging the partners' partnership interests (or the other interests of the owners of the mortgagor) and/or the partners' (or other owners') right to cash and the net proceeds resulting from any payment event.

As a result of the restrictions imposed by the G Memorandum, the Trust B F Additional Loan could not be secured by a first mortgage or by a subordinated mortgage on the complex but were instead secured by a pledge of the partnership interests in the borrower under the Trust B F First Mortgage Loan. All of the proceeds of the Trust B F Additional Loan were contributed to the partnership that was the borrower under the Trust B F First Mortgage Loan or otherwise used in connection with the complex. Such amounts were required in order to close the Trust B F First Mortgage Loan and to fund certain escrow and reserve accounts.

Pursuant to the Trust B F Additional Loan Agreement and under Pledge and Security Agreements, all of the partners granted a first priority security interest in their partnership interests in the partnership and the proceeds therefrom as security for the obligations under the Trust B F Additional Loan. Under the Pledge and Security Agreement, the pledging parties agreed not to, without written consent of Trust B, cause the disposition of the assets of the borrower under the Trust B First Mortgage Loan outside of the ordinary course of business, or cause any amendment to the partnership agreement which would materially decrease the power or voting rights of general partners or cause the disposition of or the granting of a security interest in their partnership interest. In addition, under the agreements between G and the borrower under the Trust B F First Mortgage Loan, without G's approval, the partnership-borrower cannot transfer the interest of any general partner and the partnership-borrower under the Trust B First Mortgage Loan cannot convey, transfer or encumber the property that is the subject of the Trust B F First Mortgage Loan. Additionally, a refinancing of the Trust B First Mortgage Loan or the sale of the complex would result in the acceleration of the principal of and all interest due in respect of the Trust B F Additional Loan.

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Upon a default under the Trust B F Additional Loan, Trust B could have foreclosed on the partnership interest of the borrowers and other pledging parties in the partnership that is the borrower under the Trust B F First Mortgage Loan and could have disposed of and dealt with all the property of the partnership, including the complex that is the subject of the Trust B F First Mortgage Loan, to satisfy the obligations of the borrowers under the Trust B F Additional Loan. In general, in the event of a default, absent fraud, gross negligence or malfeasance with respect to the complex, Trust B's sole recourse was against the pledged partnership interests.

During the term of the Trust B F Additional Loan, at least 75 percent of the assets of the borrower under the Trust B F First Mortgage Loan consisted of real property. The provisions of an agreement entered into by the Trust B First Mortgage Loan borrower did not allow the borrower to engage in any other business, including the operation of any other similar project, without G's consent for so long as G's insurance remains in effect. Further, under the G Memorandum, no additional mortgages could have been placed on the complex and pursuant to the subordinated mortgage on the complex, no inferior liens could have been placed on the complex without the prior consent of Trust B. Additionally, the agreements with respect to the Trust B F First Mortgage Loan contained restrictions with respect to the incurrence of liabilities and generally only permit funds to be paid out from cash.

LAW AND ANALYSIS

Section 856(a) of the Code provides that a trust shall not be considered a real estate investment trust for any taxable year unless certain requirements are satisfied.

Section 856(c)(4)(A) of the Code provides that at the close of each quarter of the taxable year at least 75 percent of the value of the trust's total assets must be represented by real estate assets, cash and cash items (including receivables), and government securities.

Section 856(c)(5)(B) of the Code provides that the term "real estate assets" means real property (including interests in real property and interests in mortgages on real property) and shares (or transferable certificates of beneficial interest) in other real estate investment trusts which meet the requirements of section 856 through 859.

Under section 1.856-3(a) of the Income Tax Regulations, the term "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 trustee of the real estate investment trust.

Section 1.856-3(g) of the regulations provides that in the case of a real estate investment trust which is a partner in a partnership, the trust will be deemed to own its proportionate share of each of the assets of the partnership and will be deemed to be

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entitled to the income of the partnership attributable to such share. For purposes of section 856, the interest of a partner in the partnership's assets will be determined in accordance with his capital interest in the partnership. The character of such assets in the hands of the partner will be the same as the character of the assets to the partnership.

In Revenue Ruling 77-459, 1977-2 C.B. 239, a real estate investment trust made a construction loan to a partnership and as security for the loan, the partnership assigned its interest in an Illinois land trust to the real estate investment trust. The partnership was the sole beneficiary of the land trust and the sole asset of the land trust was real property. In that instance, the Service concluded that the loan constituted a "real estate asset" under section 856(c)(5)(A) of the Code.

Section 856(c)(3) of the Code provides that a trust must derive at least 75 percent of its gross income from certain categories of income, one of which is interest on obligations secured by mortgages on real property or on interests in real property.

Section 856(f) of the Code provides, in part, that the term "interest" excludes any amount received or accrued, directly or indirectly, if the determination of such amount depends in whole or in part, on the income or profits of any person except that any amount so received or accrued will not be excluded from the term "interest" solely by reason of being based on a fixed percentage or percentage of receipts or sales. Section 856(f) also provides a special rule with regard to qualified rents.

Section 1.856-5(c)(1) of the regulations provides that where a mortgage covers both real and other property an apportionment of the interest income must be made for purposes of the 75-percent requirement. This provision would be applicable in the event that the underlying assets of a partnership is made up of real estate assets as well as other assets. The regulations provide that for purposes of the 75-percent requirement if the Loan value of the real property is equal to or exceeds the amount of the loan, then the entire interest income shall be apportioned to the real property. If the amount of the loan exceeds the loan value of the real property, then the interest income apportioned to the real property is an amount equal to the interest income multiplied by a fraction, the numerator of which is the loan value of the real property, and the denominator of which is the amount of the loan. The interest income apportioned to the other property is an amount equal to the excess of the total interest income over the interest income apportioned to the real property.

Section 1.856-5(c)(2) of the regulations provides, in part, that the loan value of the real property is the fair market value of the property, determined as of the date on which the commitment by the trust to make the loan becomes binding on the trust. However, 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 land plus the reasonably estimated cost of the improvements or developments

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(other than personal property) which will secure the loan and which are to be constructed from the loan proceeds of the loan. The fair market value of the land and the reasonably estimated cost of improvements or developments shall be determined as of the date on which a commitment to make the loan becomes binding on the trust.

Section 1.856-3(g) of the regulations recognizes that if a real estate investment trust is a partner in a partnership, the real estate investment trust will be considered to own the partnership's real estate assets in the same proportion as its capital interest in the partnership. Based on the facts presented, the principles of section 1.856-3(g) of the regulations provide a sufficient nexus between the Trust B F Additional Loan and the complex underlying the partnership interests used as security for the Trust B F Additional Loan to qualify the Trust B F Additional Loans as "real estate assets" under section 856(c)(5)(B) of the Code.

CONCLUSIONS

Based on the facts and representations submitted, we conclude as follows:

1. To the extent that the fair value of the pledged partnership interests' share of the real property included in the complex as of the date on which Trust B entered into the Trust B F Additional Loan with respect to such property, and on the date of any additional borrowings, was at least equal to the total aggregate amount of any and all loans secured by the real property as well as the amount of the Trust B F Additional Loan, the Trust B F Additional Loan described herein qualifies as a "real estate asset" for purposes of section 856(c)(4)(A) of the Code.
2. The interest income earned on the Trust B F Additional Loan qualifies as "interest on obligations secured by mortgages on real property or on interests in real property" for purposes of Section 856(c)(3)(B) of the Code to the extent that the pledged partnership interests' share of the loan value of the real property was at least equal to the total aggregate amount of any and all loans secured by the real property as well as the amount of the Trust B F Additional Loan, provided that the amount of such income does not depend in whole or in part on the income or profits of any person, except as provided in section 856(f).

Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter.

This ruling is directed only to the taxpayer(s) requesting it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to your authorized representative.

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A copy of this letter must be attached to any income tax return to which it is relevant.

Sincerely,
William E. Coppersmith
Chief, Branch 2
Office of Office of Associate Chief Counsel
(Financial Institutions and Products)