

Internal Revenue Service

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Legend:

Company =

State =

This is in reply to a letter dated August 21, 1998, and subsequent correspondence submitted by your representative requesting rulings on behalf of Company. You have requested a ruling that the same methodology provided by § 1.856-5(c) of the Income Tax Regulations for apportioning interest income may be applied under the 75 percent asset test of § 856(c)(4) of the Internal Revenue Code in circumstances involving first and second mortgages. This letter also acknowledges your withdrawal of two of the requested rulings.

FACTS

Company was organized and formed on Date, under the laws of State. Company represents that it is qualified and intends to continue to qualify as a real estate investment trust ("REIT"), as defined in § 856(a). Company invests primarily in non-conforming residential mortgage loans and securities backed by such loans.

Company intends to purchase for long-term investment certain residential mortgage loans, pass-through securities backed by such loans, certain franchise loans and interests in partnerships holding such franchise loans. The terms of the mortgages and franchise loans do not require the holder to pursue any personal property that secures the loan prior to proceeding against any real property that also secures the

loan.

First and Second Residential Mortgage Loans

The residential mortgage loans will be secured solely by first or second mortgages on fee simple interests in one-to-four-family residential properties. The mortgage loans have a fixed interest rate and the loan proceeds are generally used by the borrowers for debt consolidation. The loan-to-value ratios on the first mortgage loans may exceed 100 percent. Company will also acquire pass-through securities with comparable underlying mortgage loans whose loan-to-value ratios may exceed 100 percent.

Some of the second mortgage loans will be secured by real property in which the mortgagor has no equity (*i.e.*, the principal amount of the existing first mortgage loan will equal or exceed the fair market value of the real property securing the mortgage loan at the time the second mortgage loan is made). Other second mortgage loans will be secured by real property in which the mortgagor has some equity (*i.e.*, the fair market value of the real property will exceed the principal amount of the existing first mortgage loan but will be less than the sum of the principal amounts of the existing first mortgage loan and the new second mortgage loan at the time the second mortgage loan is made). Generally, with respect to any second mortgage loan to be acquired, the sum of the principal amounts of the second mortgage loan and the first mortgage loan will not exceed 125-percent of the loan value of the real estate securing the loans. Company also intends to purchase pass-through securities that represent individual ownership interests in such second residential mortgage loans.

Franchise Loans

The franchise loans will be made to franchisees generally in the fast-food and restaurant industries. Each loan will be made with full recourse to the borrower. In connection with each loan, the borrower will execute a promissory note and the lender will be granted a security interest in its equipment and other restaurant-related personal property pursuant to a pledge and security agreement. Generally, the loans will also be secured by mortgages on either a fee interest or leasehold interest in real property upon which the franchisee's business is operated. Company also intends to purchase interests in partnerships that hold such franchise loans.

LAW

Section 856(c) provides that a trust shall not be considered a REIT for any taxable year unless certain gross income and asset tests are satisfied. Section 856(c)(3) provides that a trust must derive at least 75 percent of its gross income from, among other things, interest on obligations secured by mortgages on real property or on interests in real property. Section 856(c)(4) provides that a trust must have at least 75 percent of the value of its total assets represented by real estate assets, cash and cash items (including receivables) and Government securities at the close of each quarter of

the taxable year.

Section 1.856-5(c) provides rules for apportioning interest income for purposes of the 75 percent income requirement where a mortgage covers both real and other property. Section 1.856-5(c)(1)(i) provides that 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. Section 1.856-5(c)(1)(ii) provides that if the amount of the loan exceeds the loan value of the real property, 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. For purposes of these rules, § 1.856-5(c)(2) defines loan value of the real property as 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. Section 1.856-5(c) does not address the effect of first mortgages when apportioning interest income to interests in second mortgages.

Section 856(c)(5)(B) 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 REITs which meet the requirements of §§ 856 through 859. The Code and Regulations do not provide a specific methodology for determining the value of an interest in a mortgage on real property for purposes of the 75 percent asset test of § 856(c)(4) when a loan is secured by real and personal property or is only partially secured by real property.

ANALYSIS

An interest in a mortgage on real property is qualifying property under the 75 percent income test of § 856(c)(3) and the 75 percent asset test of § 856(c)(4). Section 856 does not prescribe a methodology or rules for apportioning the income from or the value of an interest in a mortgage on real property where the loan is collateralized by both real and personal property.

The regulations under § 856 do provide a method for apportioning interest income, but the method is not based on the relative value of real property collateral to the total of all sources of collateral. Rather, under the apportionment methodology specified for income under § 1.856-5(c), interest income on a mortgage loan is treated as first being derived from real estate to the full extent of the value of the underlying real property collateral. Thus, interest on a loan is treated as entirely from an obligation secured by real property (even where personal property also secures the loan) if the fair market value of the real property securing the loan equals or exceeds the loan amount. By focusing on the ratio of the value of the real property (loan value) to the loan amount, the apportionment methodology specified in § 1.856-5(c)(1)(ii) takes the underlying real property collateral into account without regard to any personal property that also secures the loan.

Section 856(c)(5)(B) provides that an interest in a mortgage is a real estate

asset. Interests in loans that are unsecured or secured only by personal property are not real estate assets. Therefore, in situations where the mortgagor's equity in the real property immediately before the mortgage is placed on the property is less than the amount of the mortgage, an allocation must be made to determine the value of the interest in the mortgage on the real property. The methodology set forth in § 1.856-5(c) is a reasonable means of determining the value of an interest in a mortgage for purposes of the asset test of § 856(c)(4).

Section 1.856-5(c) does not address the effect of a first mortgage when apportioning interest to a loan secured by a second mortgage on real property. Because the loan value of the real property that secures the first mortgage is not economically available to secure the second mortgage, the loan value must be reduced by any senior mortgages that reduce the loan value of the real property that economically secures the second mortgage. If the loan value were not reduced by the value of the property encumbered by senior mortgages, interest on loans secured by second mortgages in which the borrower has no equity to secure the second mortgage would be treated as qualifying interest income. Such a result is inconsistent with the intent of § 856(c)(3) and § 1.856-5(c).

CONCLUSION

An interest in a mortgage on real property is a real estate asset within the meaning of § 856(c)(5)(B) to the extent of the value of the real property that is economically available to secure the mortgage. Thus, where the value of the real property is less than the loan amount, an allocation must be made to determine the value of the interest in the mortgage. The apportionment methodology specified in § 1.856-5(c)(1) may be applied to make this determination. When applying the methodology to second mortgages, the loan value of the real property must be reduced by the amount of all senior encumbrances on the real property.

Except as specifically ruled above, no opinion is expressed concerning the federal income tax consequences of the facts herein. No opinion is expressed as to whether Company qualifies as a REIT. Further, no opinion is expressed regarding whether assets presently owned or subsequently acquired qualify as interests in mortgages or interests in real property under § 856. In particular, we do not rule that securities, pass-through securities, franchise loans or interests in partnerships holding such franchise loans constitute qualifying interests in mortgages or interests in real property under § 856. No opinion is expressed regarding the circumstances under which a lessee's leasehold interest in real property has value as collateral for a loan.

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

Sincerely,

Assistant Chief Counsel
(Financial Institutions & Products)

By Richard C. Hoge
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Assistant to the Chief,
Branch 1

Enclosures:
Copy of this letter
Section 6110 copy