

Internal Revenue Service

Department of the Treasury
Washington, DC 20224

Number: **202424011**
Release Date: 6/14/2024

Third Party Communication: None
Date of Communication: Not Applicable

Index Number: 856.00-00, 856.01-00,
856.02-00

Person To Contact:
, ID No.

Telephone Number:

Refer Reply To:
CC:FIP:B02
PLR-118239-23

Date:
March 15, 2024

Legend:

Taxpayer =

Subsidiary =

State =

County =

Date 1 =

Date 2 =

a =

b =

c =

d =

Dear _____ :

This ruling responds to a letter dated September 6, 2023, and subsequent correspondence, requesting the following rulings with respect to the Hypothecation Loan described below:

- (1.) The Hypothecation Loan is secured by mortgages on real property within the meaning of section 856(c) of the Internal Revenue Code (the "Code"); and
- (2.) The Hypothecation Loan is an interest in mortgages on real property within the meaning of section 856(c).

FACTS:

Taxpayer is a State limited liability company which elected to be treated as a real estate investment trust (a "REIT") by filing Form 1120-REIT, *U.S. Income Tax Return for Real Estate Investment Trusts*, for its initial tax year beginning Date 1 and ended Date 2. Subsidiary is a State limited liability company disregarded as separate from Taxpayer for federal income tax purposes.

A third-party lender ("Borrower") originated and made the initial advance on a loan (the "Construction Loan") to another party ("Construction Borrower") secured by mortgages on certain real property within the meaning of section 1.856-10 of the Income Tax Regulations (the "Development Property"). The Construction Loan is evidenced by a separate promissory notes (the "Underlying Notes") and secured by a separate mortgages (the "Underlying Mortgages") on the Development Property.

Concurrently, and in order to finance Borrower's making of the Construction Loan, Subsidiary originated and made the initial advance on a loan to Borrower (the "Hypothecation Loan"). The Hypothecation Loan is a "loan-on-loan" financing, in which the Hypothecation Loan is secured by all of Borrower's rights under the Construction Loan. This is accomplished through the collateral assignment of all of the documents evidencing and securing the Construction Loan, including, without limitation, the Underlying Notes and the Underlying Mortgages (the "Construction Loan Documents"). A Uniform Commercial Code ("UCC") financing statement with respect to the collateral assignment of the Construction Loan Documents has been filed in State, where Borrower is organized. The collateral assignments of the Underlying Mortgages were recorded in the real estate records of County, where the Development Property is located.

The initial stated maturity date of the Hypothecation Loan is the same as the stated maturity date of the Construction Loan, although the maturity date of the Hypothecation Loan may be accelerated upon an event of default (described in further

detail below).¹ The Hypothecation Loan and the Construction Loan were originated on the same date (the "Origination Date").

Taxpayer represents that on the Origination Date, the amount of the Construction Loan exceeded the amount of the Hypothecation Loan, and the value of the Development Property securing the Construction Loan was greater than the amount of the Hypothecation Loan.

A file containing the Construction Loan Documents, the collateral assignments of the Construction Loan Documents, as well as other documents securing the Hypothecation Loan (the "Collateral File") was delivered to an institutional custodian ("Custodian") to hold on behalf of Subsidiary. Taxpayer represents that the possession of the Collateral File by Custodian (as Subsidiary's agent) perfects Subsidiary's security interest for purposes of Article 9 of the UCC.

The Collateral File also contains a set of documents in blank for the possible absolute assignment of the Construction Loan Documents to Subsidiary under the circumstances described below (the "Absolute Assignment Documents"). In connection with delivery of the Absolute Assignment Documents, Borrower granted to Subsidiary a power of attorney to unilaterally complete, execute and record the Absolute Assignment Documents assigning to itself the Construction Loan Documents in the event that Borrower defaults on the Hypothecation Loan.

Upon the occurrence of an event of default under the aforementioned agreement between Subsidiary and Borrower (a "Hypothecation Loan EOD"), Subsidiary is permitted to instruct Construction Borrower to pay all amounts due under the Construction Loan directly to Subsidiary. Borrower has the initial right to foreclose in the event of a default by Construction Borrower under the Construction Loan Documents (a "Construction Loan EOD"). However, in the event that Borrower forecloses on or otherwise takes title to the Development Property, Borrower is required to grant Subsidiary a new mortgage on the Development Property (a "Replacement Mortgage") to secure the Hypothecation Loan. Taxpayer represents that once the collateral assignments of the Underlying Mortgages are recorded, Borrower may not foreclose on the Underlying Mortgages without granting a Replacement Mortgage to Subsidiary. Similarly, because the collateral assignments of the Underlying Mortgages are recorded, Borrower may not impermissibly release the Underlying Mortgages on its own accord.

¹ Borrower has an option to extend the maturity date of the Hypothecation Loan by b months, but only if the maturity date of the Construction Loan has also been extended to at least the same date. Borrower has two further successive options to extend the maturity date of the Hypothecation Loan by c months. To exercise any c-month successive option, Borrower must commit in writing to diligently pursue a foreclosure action against the Development Property and must actually commence and diligently pursue such foreclosure action within d days after the maturity date as extended by the first c-month option.

Upon the occurrence of a Construction Loan EOD, Borrower is required to ensure protection of the collateral by either (i) curing the Construction Loan EOD or (ii) paying down a portion of the Hypothecation Loan and enforcing the Construction Loan. Borrower's failure to take such required actions upon a Construction Loan EOD constitutes a Hypothecation Loan EOD, and Subsidiary would thereafter be permitted to enforce the Construction Loan directly.²

Upon a Hypothecation Loan EOD, Subsidiary may either (i) complete the Absolute Assignment Documents and take full ownership of the collaterally assigned Construction Loan Documents, or (ii) resort to the remedies provided in Part 5 of Article 9 of the UCC, which, in essence, lead to either a sale of the collateral (i.e., the Construction Loan Documents) or the retention of the collateral by Subsidiary in satisfaction of the debt.

Taxpayer represents that due to Subsidiary's perfected security interest with respect to the Construction Loan through Custodian's possession of the Collateral File, Subsidiary has priority with respect to any future purchaser or assignee of the Construction Loan Documents. Therefore, if Borrower were to impermissibly sell the Construction Loan Documents to another purchaser or pledge the Construction Loan Documents as collateral to another Lender, such sale or assignment would not be effective with respect to Subsidiary.

LAW & ANALYSIS:

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

Section 856(c)(5)(B) defines the term "real estate assets", in part, to mean real property (including interests in real property and interests in mortgages on real property or on interests in real property). Section 1.856-3(b)(1) provides that the term "real estate assets" means real property, interests in mortgages on real property (including interests in mortgages on leaseholds of land or other improvements thereon) and shares in other qualified REITs. Section 1.856-10(b) provides that local law definitions are not controlling for purposes of determining the meaning of the term "real property" for these purposes.

² Construction Borrower may obtain a future mezzanine financing that is secured by a pledge of Construction Borrower's direct or indirect interests in its subsidiary that holds title to the Development Property (a "Mezzanine Loan"). Any Mezzanine Loan would be subordinate to the Construction Loan. To date, Construction Borrower has not obtained a Mezzanine Loan.

A holder of a Mezzanine Loan, instead of Borrower, may provide additional funds to Construction Borrower (in the form of additional debt financing, which would be subordinate to the Construction Loan) to cure a Construction Loan EOD. In such instance the Construction Loan EOD would not cause the Hypothecation Loan to become immediately due and payable.

Rev. Rul. 80-280, 1980-2 C.B. 207, concerned a REIT that made loans to commercial real estate developers (the “developer loans”). The developer loans were nonrecourse except for the security of commercial mortgage notes held by the developers that were assigned and delivered to the REIT by the developers as collateral (the “assigned mortgages”). The balances of the developer loans would never exceed 80 percent of the unpaid balance of the assigned mortgages. As holder of the assigned mortgages, the REIT was able to enforce payment in its own name if an original mortgagor defaulted. The REIT collected all amounts due from the original mortgagors. From these amounts, the REIT retained the interest due on the developer loans and remitted the balance to the developers. Rev. Rul. 80-280 held that the developer loans (commonly referred to as hypothecation loans) qualified as real estate assets under section 856, and the interest on the developer loans qualified as “interest on obligations secured by mortgages on real property.”

The Hypothecation Loan is analogous to the developer loans made by the REIT in Rev. Rul. 80-280. Through the collateral assignment of the Construction Loan Documents, the Hypothecation Loan is secured by the Construction Loan which is in turn secured by the Underlying Notes and Underlying Mortgages (i.e., the mortgages on the Development Property). Moreover, the value of the Development Property securing the Construction Loan (and the amount of the Construction Loan) was greater than the amount of the Hypothecation Loan on the Origination Date. In addition, Taxpayer represents that the security interest in the Underlying Mortgages has been perfected through delivery of the Collateral File to Custodian. The requirement that Borrower grant a Replacement Mortgage ensures that the Hypothecation Loan is always secured by the Development Property, and the Absolute Assignment Documents ensure that Subsidiary is able to take possession of the Development Property if Borrower defaults on the Hypothecation Loan. Therefore, Subsidiary has an equivalent ability to protect its interests as in the case of Rev. Rul. 80-280.

CONCLUSION

Accordingly, based on the information submitted and representations made, we conclude that:

- (1.) The Hypothecation Loan is secured by mortgages on real property within the meaning of section 856(c); and
- (2.) The Hypothecation Loan is an interest in mortgages on real property within the meaning of section 856(c).

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. Specifically, no opinion is expressed or implied whether Taxpayer otherwise qualifies as a REIT.

This ruling is directed only to the taxpayer 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 representatives.

Sincerely,

Bernard J. Audet, Jr
Chief, Branch 2
Office of Associate Chief Counsel
(Financial Institutions & Products)

cc: