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Department of the Treasury
Washington, DC 20224

Third Party Communication: None
Date of Communication: Not Applicable

Person To Contact:

ID No.

Telephone Number:

Refer Reply To:
CC:FIP:B03
PLR-133446-15

Date:
March 3, 2016

LEGEND:

Taxpayer =

State =

Property =

Original Borrower =

Lender =

Original Borrower Principal =

Borrower =

Borrower Principal =

Servicer =

Town =

State Agency =

Engineers	=
Startup Day	=
Date 1	=
Date 2	=
Date 3	=
Date 4	=
Date 5	=
Date 6	=
Date 7	=
Date 8	=
Date 9	=
Date 10	=
Date 11	=
Date 12	=
Date 13	=
Date 14	=
Year 1	=
Year 2	=
Year 3	=
Year 4	=
<u>a</u>	=

b =
c =
d =
e =
f =

Dear :

This ruling responds to a letter dated September 30, 2015, requesting a ruling that the completion of the “Replacement Plant” as described below will not cause the Property to cease to be treated as “foreclosure property” for purposes of § 860G(a)(8) of the Internal Revenue Code.

FACTS

Taxpayer represents that it is a trust that has made an election to be treated as a real estate mortgage investment conduit (“REMIC”) under the provisions of §§ 860 et seq. of the Code. Taxpayer’s method of accounting is an accrual method. Taxpayer uses the calendar year as its taxable year.

Original Borrower executed and delivered to Lender a promissory note dated Date 1 (“Note”), which evidenced a loan (“Mortgage Loan”) made by Lender to Original Borrower. To secure the repayment of the Note, Original Borrower, among other things, executed a Mortgage, Assignment of Leases and Rents and Security Agreement also dated Date 1 (“Security Instrument”), granting a lien on the Property. Original Borrower was liable for the payment and performance of all Original Borrower’s obligations under the Note, the Security Instrument, a Loan Agreement (the “Loan Agreement”), and all other documents evidencing, securing, guaranteeing, or otherwise pertaining to the Mortgage Loan (“Mortgage Loan Documents”).

Taxpayer represents that Taxpayer holds numerous qualified mortgages and related loan documents, including the Mortgage Loan and the Mortgage Loan Documents. Taxpayer represents that all of the qualified mortgages were either (i) assigned by Original Lender to Taxpayer on Startup Day in exchange for regular or residual interests in Taxpayer, or (ii) purchased by Taxpayer within the three-month period beginning on Startup Day pursuant to a fixed-price contract in effect on Startup Day.

Taxpayer represents that as of the date the Mortgage Loan was assigned to Taxpayer, Original Borrower was current on its obligations under the terms of the Mortgage Loan. In addition, Taxpayer represents that there was no evidence suggesting that Original Borrower would not remain current on the Mortgage Loan until maturity, and no interest in Property acquired as a result of the foreclosure defined below was granted to Taxpayer at a time when Taxpayer knew or had reason to know that Original Borrower would not remain current on its obligation under the terms of the Mortgage Loan.

Pursuant to an Assumption and Release Agreement effective Date 2, by and among Original Borrower Principal, Borrower, Borrower Principal, and Taxpayer, the Taxpayer consented to the transfer of the Property to the Borrower and the assumption by the Borrower and Borrower Principal of the obligations of Original Borrower and Original Borrower Principal under the Mortgage Loan Documents.

As a result of a determination that a default on the Loan was imminent, in accordance with the Pooling and Servicing Agreement, the Loan was transferred to Servicer for special servicing on Date 3 (“Imminent Default Date”). At the time of this transfer, the operator of Property was facing significant economic pressures due to numerous tenants having filed for Chapter 11 bankruptcy protection, and the expenditures, as described below, for the necessary improvements to Property’s wastewater treatment plant that were required to maintain compliance with state and local requirements. Servicer, on behalf of Taxpayer, issued a Notice of Default, Acceleration, and Demand for Payment on Date 4.

Taxpayer acquired title to Property on Date 5, through a foreclosure proceeding in accordance with State law (“the Foreclosure”). In addition to the real property making up Property, Taxpayer acquired through the Foreclosure all ancillary personal property relating to Property. Taxpayer represents that each of these ancillary items is personal property that is related to and used in the operation of business conducted on the real property making up Property, or the use of the personal property is otherwise an ordinary and necessary corollary of the use of the real property.

Upon the Foreclosure, Taxpayer represents that Property qualified as “foreclosure property” within the meaning of § 860G(a)(8) of the Code. Sixty days before the close of the initial grace period under § 856(e)(2), Taxpayer filed a request for an automatic extension of the grace period in accordance with § 856(e)(3) and § 1.856-6(g)(5) of the Income Tax Regulations (the “Regulations”) for one additional period of three years ending Date 6.

Property includes a retail shopping mall (“the Mall”) built in Year 1, consisting of inline stores, anchor stores, outparcel stores, parking areas, access roads, utility equipment and facilities, other infrastructure, as well as signs and sign structures.

Property is located in Town, which does not have a public sewer system. Accordingly it was necessary for the original developer of Property to construct on Property a wastewater treatment plant (“Existing Plant”) to serve Property. The design capacity of the Existing Plant was f gallons per day. Furthermore, it has been necessary for all subsequent owners of Property, including Taxpayer, to maintain the Existing Plant in compliance with all federal, state, and municipal environmental rules and regulations. Private wastewater treatment plants that operate in State, such as the Existing Plant, require a Groundwater Discharge Permit from State Agency. The Existing Plant treats the wastewater generated by tenants and other occupants of Property, who have no other means of disposing of their wastewater. Furthermore, two existing tenants have provisions in their respective leases, which were executed prior to the Foreclosure, that permit expansion rights that would require additional wastewater treatment capacity that the Existing Plant cannot accommodate.

The Existing Plant contains two main features: (1) the collection/treatment system and initial treatment equipment, which is located next to the Mall; and (2) the leaching areas, which are located at a distance of approximately a from the Mall on land that is also part of Property. A gravity system allows the wastewater to flow from the collection/treatment system to the leaching fields, which include sand filter beds.

In Year 2, the then-owner of Property obtained a modification of the groundwater discharge permit then in effect to increase the capacity of the Existing Plant. In Year 3, the owner of the Property at that time submitted a Groundwater Discharge Permit Renewal application to State Agency, which was not granted until Date 7 (the “Renewal Permit”). The Renewal Permit included an expiration date of Date 8, which was extended by State law to Date 9.

Following the acquisition of Property by Borrower, Engineers advised Borrower that the Existing Plant had many components that needed to be replaced or repaired to keep the Existing Plant operational and to meet the requirements of the Renewal Permit. Engineers also advised that the existing capacity would need to be increased to allow for leasing to new tenants with larger wastewater disposal needs, in particular restaurants and fast food providers.

On Date 10, Engineers submitted a letter outlining a four-year plan to either replace or repair the existing tanks at the Existing Plant as well as to increase the capacity of the sand filter beds (the “Sand Beds”) in the existing leaching areas for the Existing Plant. The letter also detailed the current condition of the Existing Plant’s equipment. All of the tanks at the Existing Plant were described as being in “poor or very poor condition,” except one tank that had been refurbished in Year 4, and was described as “average.”

On Date 11, a request for a Groundwater Discharge Permit Modification was submitted by the Borrower to State Agency, seeking to add grease/pretreatment tanks to the Existing Plant and to increase the capacity of the Existing Plant.

On Date 12, Engineers submitted a second letter which revised the schedule contained in their Date 10 letter, changing to a five-year plan to either reconstruct or repair the existing structures, replace existing structures with new structures, and/or a combination of both. After reviewing Engineer's second letter, Borrower began work on a project to improve the Existing Plant (the "Improvement Project").

Taxpayer also represents that, based on proposals submitted by the Borrower's professional advisors and not including architect's fees, administrative costs of the developer or builder, lawyers' fees, and expenses incurred in connection with obtaining zoning approval or building permits, the Improvement Project had a maximum estimated total direct cost of b. This amount represented the direct costs of the Improvement Project and includes the cost of labor and materials which were directly connected with the Improvement Project. Taxpayer represents that, not including architect's fees, administrative costs of the developer or builder, lawyers' fees, and expenses incurred in connection with obtaining zoning approval or building permits, the total direct cost of labor and materials incurred with respect to the Improvement Project as of the Imminent Default Date were not less than c. This amount consisted of the following:

(1) installation of an electrical conduit to provide a future power source as part of the renovation of the Sand Beds; (2) installation of two pretreatment/grease tanks at the Existing Wastewater Treatment Plant; and (3) demolition and removal of existing equipment and an existing structure. Taxpayer represents that the estimated total direct cost of the Improvement Project was reasonable, done in good faith, and was based on all of the data reasonably available to Taxpayer when Taxpayer undertook completion of the Improvement Project.

After the Imminent Default Date, State Agency conducted an on-site inspection on Date 13 of the Existing Plant. Shortly thereafter, State Agency issued a Notice of Noncompliance with Groundwater Discharge Permit (the "Notice"). The Notice included the following findings:

- "[P]ermittee has failed to properly maintain all facilities and equipment"
- "[S]ignificant corrosion of key process tanks."
- "[P]rocess piping and valves need to be maintained."
- "[S]ignificant refurbishment or replacement may be necessary."

The Notice also included the following "Action Items Required":

- Comply with the Renewal Permit and State Agency's Groundwater Discharge Regulations.

- Within three months of the date of the Notice, Permittee (Borrower as predecessor-in-interest) is to contract with a professional engineer, licensed by State, to prepare an engineering report.
- Within nine months of date of the Notice, Permittee (Borrower as predecessor-in-interest) is to submit an engineering report, prepared by a professional engineer, licensed by State, that outlines in sufficient detail what modifications (if any) to the Existing Wastewater Treatment Plant or other changes are required to insure that the Existing Plant can remain in compliance with the Renewal Permit and other applicable requirements.
- If State Agency's approval is required for any modifications to the Existing Plant or other changes identified in such engineering report, Permittee (Borrower as predecessor-in-interest) must submit an application therefor no later than nine months from the date of the Notice.

Engineers, a firm of professional engineers that are licensed by State, then undertook a review of the findings and required actions set forth in the Notice. Engineers concluded that it would not be possible to repair or rehabilitate the collection and treatment portion of the Existing Plant at its current location.

Taxpayer and its advisors concluded that the only option available that would meet the current standards of State Agency would involve the construction of a new structure to be located at a wastewater treatment facility that would replace the Existing Plant (the "Replacement Plant"). The recommended site for the Replacement Plant is d acres of land located at a distance of approximately a from the Existing Plant, and adjacent to the existing leaching areas. The site is part of Property and is accessible to and from Mall by existing easements that benefit the owner of Property.

On Date 14, State Agency issued a Groundwater Discharge Permit (the "Replacement Discharge Permit"), which supersedes the Renewal Permit. The Replacement Discharge Permit applies only to the Replacement Wastewater Treatment Plant. The estimated cost of the Replacement Wastewater Treatment Plant is e. The construction and operation of the Replacement Wastewater Treatment Plant has also been approved by Town.

The Replacement Discharge Permit expired on Date 9. In cases where a Notice of Noncompliance has been issued, State Agency typically allows a facility to continue to operate pursuant to an expired permit, provided a new permit has been issued, construction is underway, and a completion date is known. Although State Agency issued the Replacement Discharge Permit, construction of the Replacement Wastewater Treatment Plant is not currently proceeding.

If the Existing Plant fails or if State Agency does not permit the Existing Plant to continue to operate, then the only immediate solution for Mall to stay open is to have the untreated wastewater hauled by tanker trailers on a daily basis to another wastewater

treatment plant for treatment and disposal. This arrangement, however, would be expensive and only temporary, because State Agency limits the length of time that the wastewater can be transported by trucks to an off-site location.

LAW AND ANALYSIS

The REMIC provisions were added to the Code by the Tax Reform Act of 1986. Among the conditions an entity must satisfy to be treated as a REMIC is the requirement under § 860D(a)(4) that as of the close of the third month beginning after the startup day and at all times thereafter, substantially all of the entity's assets be "qualified mortgages and permitted investments."

Section 860G(a)(5) lists "permitted investments," which include foreclosure property. Under § 860G(a)(8), foreclosure property is defined as property that is acquired in connection with the default of a qualified mortgage and that would be foreclosure property under § 856(e) if acquired by a real estate investment trust ("REIT").

Section 856(e)(1) generally defines "foreclosure property" as any real property, and any personal property incident to such real property, acquired by a REIT as a result of having bid in such property at foreclosure or having otherwise reduced such property to ownership or possession by agreement or process of law, after there was a default or default was imminent on the mortgage loan secured by the property.

Under § 856(e)(5), property is treated as foreclosure property only if a REIT makes an election to treat it as such prior to the due date for the REIT's tax return for the taxable year in which it acquires such property.

Section 856(e)(2) provides that, except as provided in § 856(e)(3), property ceases to be foreclosure property as of the close of the third taxable year following the taxable year in which the REIT acquired such property.

Section 856(e)(3) provides that, if the REIT establishes to the satisfaction of the Secretary that an extension of the grace period is necessary for the orderly liquidation of the trust's interests in such property, the Secretary may grant one extension of the grace period for such property.

Under § 856(e)(4) property will cease to qualify as foreclosure property on the first day (occurring on or after the day on which the REIT acquired the property) on which any construction takes place on such property (other than completion of a building, or completion of any other improvement, where more than 10 percent of the construction of such building or other improvement was completed before default became imminent), among other activities.

Section 1.856-6(e)(1) of the Regulations provides, in part, that under § 856(e)(4)(B), all real property (and any incidental personal property) for which a particular election has been made ceases to be foreclosure property on the first day (occurring on or after the day on which the REIT acquired the property) on which any construction takes place on the property, other than completion of a building (or completion of any other improvement) where more than 10 percent of the construction of the building (or other improvement) was completed before default became imminent.

Under § 1.856-6(e)(2), the determination of whether the construction of a building or other improvement was more than 10 percent complete when default became imminent is made by comparing the total direct costs of construction incurred with respect to the building or other improvement as of the date default became imminent with the estimated total direct costs of construction as of such date. If the building or other improvement qualifies as more than 10 percent complete under this method, the building or other improvement shall be considered to be more than 10 percent complete. For these purposes, direct costs of construction include the cost of labor and materials which are directly connected with the construction of the building or improvement. However, architect's fees, administrative costs of the developer or builder, lawyers' fees, and expenses incurred in connection with obtaining zoning approval or building permits are not considered to be direct costs of construction. In addition, generally, the REIT's estimate of the total direct costs of completing construction as of the date the default became imminent will be accepted, provided that the estimate is reasonable, done in good faith, and is based on all of the data reasonably available to the REIT when the REIT undertakes completion of construction of the building or other improvement.

Section 1.856-6(e)(3) provides that generally, the terms "building" and "improvement" in section 856(e)(4)(B) mean the building or improvement (including any integral part thereof) as planned by the mortgagor or lessee (or other person in possession of the property, if appropriate) as of the date default became imminent. In addition, § 1.856-6(e)(3) permits a REIT to make subsequent modifications which increase the direct cost of construction of the building or improvement if such modifications (i) are required by a Federal, State, or local agency, or (ii) are alterations that are either required by a prospective lessee or purchaser as a condition of leasing or buying the property or are necessary for the property to be used for the purpose planned at the time default became imminent.

Taxpayer represents that the Property was acquired by Taxpayer in connection with the default of a qualified mortgage held by Taxpayer and thus qualifies as "foreclosure property" within the meaning of §§ 860G(a) and 856(e)(1).

Taxpayer represents that as of the date default became imminent, the total estimated allowable direct costs of the Improvement Project was b; and that the total amount spent on the allowable direct costs of the Improvement Project was c. Thus,

based on a comparison between the estimated allowable direct costs and the amount spent on allowable direct costs, more than 10 percent of the Improvement Project was completed before the Imminent Default Date.

Taxpayer represents that any additional direct costs incurred by Taxpayer, as well as the need to locate the Mall's Wastewater Treatment Plant at the site of the Replacement Plant, are modifications to the Improvement Project taken in response to the Notice, which was issued by a State government agency. Subsequent modifications that increase the "direct cost of construction of the building or improvement" are permitted under § 1.856-6(e)(3) because State Agency is a state government agency.

Accordingly, the Improvement Project as described is an improvement to the Property that was more than 10 percent complete before the Imminent Default Date. Thus, completion of the "Replacement Plant" will not cause the Property to cease to be treated as "foreclosure property" for purposes of § 860G(a)(8).

CONCLUSION

Based on the facts submitted and representations made by Taxpayer, we rule that the transactions described above will not cause the Property to cease to be treated as "foreclosure property" for purposes of § 860G(a)(8).

This ruling's application is limited to the facts, representations, Code sections, and Regulations cited herein. 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. In particular, no opinion is expressed concerning whether Taxpayer otherwise qualifies as a REMIC under subchapter M of the Code or whether the Property otherwise qualifies as foreclosure property for purposes of §§ 860G(a)(8) or 856(e) (without regard to paragraph (5) thereof).

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 representative.

Sincerely,

Julanne Allen
Assistant to the Branch Chief, Branch 3
Office of Associate Chief Counsel
(Financial Institutions & Products)