

REITs and Foreign Currency Gains—Rev. Rul. 2007-33

By Daniel F. Cullen

Daniel Cullen provides an overview of the REIT asset and income tests, the general rules governing Sec. 988 Transactions that may impact REITs, as well as the foreign currency gain issue specifically addressed by Rev. Rul. 2007-33.

Rev. Rul. 2007-33¹ (the “Ruling”) recently addressed the following question: If a real estate investment trust (REIT) recognizes foreign currency gain in a Code Sec. 988² transaction (a “Sec. 988 Transaction”), to what extent is that gain “qualifying income” for purposes of the REIT income tests under Code Sec. 856(c)?

Generally speaking, to qualify as a REIT, at least 95 percent of the entity’s gross income must be derived from the types of income listed in Code Sec. 856(c)(2), and at least 75 percent of its gross income must be derived from the types of income listed in Code Sec. 856(c)(3). The issue addressed in the Ruling arose in light of the fact that gains from foreign currency are not specifically enumerated in either of these Code sections.

A foreign currency gain is a gain from a Sec. 988 Transaction to the extent that the gain doesn’t exceed gain realized by reason of changes in exchange rates on or after the booking date and before the payment date.³

“Sec. 988 Transactions” are transactions where the amount the taxpayer is entitled to receive (or is required to pay) is denominated in, or determined by reference to, a nonfunctional currency (*i.e.*, a currency other than the taxpayer’s reporting currency for federal income tax determinations). Such transactions might include the acquisition of a debt instrument

(or becoming the obligor under a debt instrument) denominated in a foreign currency.⁴

This article provides an overview of the REIT asset and income tests, the general rules governing Sec. 988 Transactions that may impact REITs, as well as the foreign currency gain issue specifically addressed by the Ruling.

REIT Asset and Gross Income Requirements

Generally speaking, at the close of each quarter of the REIT’s tax year, it generally must satisfy three tests relating to the nature of its assets:

- First, at least 75 percent of the value of a REIT’s total assets (the “75-percent Qualified Assets Test”) must be represented by interests in real property, interests in mortgages on real property, shares in other REITs, cash, cash items, and government securities (as well as certain temporary investments in stock or debt instruments purchased with the proceeds of new capital raised by the REIT).
- Second, although the remaining 25 percent of a REIT’s assets generally may be invested without restriction, securities in this class generally may not exceed either (1) five percent of the value of its total assets as to any one nongovernment issuer (the “five-percent Value Test”), (2) 10 percent of the outstanding voting securities of any one issuer (the “10-percent Voting Test”), or (3) 10 percent of the value of the outstanding securities of any one issuer (the “10-percent Value Test”).

Daniel F. Cullen is a partner in the Chicago and New York offices of Bryan Cave LLP, Co-Chair of the firm’s Tax Advice and Controversy Practice, and an adjunct professor of tax law at the DePaul University College of Law.

- Third, not more than 20 percent of the total value of a REIT's assets can be represented by securities of one or more taxable REIT subsidiaries. The securities of a subsidiary (for which a taxable REIT subsidiary (TRS) election has been made) are not subject to the five-percent Value Test and the 10-percent Voting and Value Tests described above. Instead, a separate asset test applies to TRSs. The rules regarding TRSs contain provisions generally intended to insure that transactions between a REIT and its TRS occur "at arm's length" and on commercially reasonable terms.⁵

In addition to a number of other statutory requirements outside the scope of this article,⁶ a REIT must satisfy two separate percentage tests relating to the sources of its gross income for each tax year. For purposes of these tests, where a REIT invests in a partnership, it will be treated as receiving its pro rata share (based on its capital interest in the partnership) of the gross income and loss of the partnership—the gross income of the partnership will retain the same character in the REIT's hands as it has in the hands of the partnership.

The 75-Percent Gross Income Test

The first gross income test for a REIT is the "75-percent test"—a requirement that at least 75 percent of the REIT's gross income for a tax year must be "qualifying income." Qualifying income generally includes (1) rents from real property (except as modified below); (2) interest on obligations collateralized by mortgages on, or interests in, real property; (3) gains from the sale or other disposition of interests in real property and real estate mortgages, other than gains from property held primarily for sale to customers in the ordinary course of its trade or business ("dealer property"); (4) dividends or other distributions on shares in other REITs, as well as gain from the sale of such shares; (5) abatements and refunds of real property taxes; (6) income from the operation, and gain from the sale, of property acquired at or in lieu of a foreclosure of the mortgage collateralized by such property ("foreclosure property"); (7) commitment fees received for agreeing to make loans collateralized by mortgages on real property or to purchase or lease real property; and (8) income from temporary investments in stock or debt instruments purchased with the proceeds of new capital raised by the REIT.

Rents received from a tenant will not, however, qualify as rents from real property in satisfying the 75-percent test (or the 95-percent test described below)

if the REIT, or an owner of 10 percent or more of its equity securities, directly or constructively owns (1) in the case of any tenant that is a corporation, stock possessing 10 percent or more of the total combined voting power of all classes of stock entitled to vote, or 10 percent or more of the total value of shares of all classes of stock of such tenant; or (2) in the case of any tenant that is not a corporation, an interest of 10 percent or more in the assets or net profits of such tenant (a "related-party tenant"), unless the related-party tenant is a TRS and certain other requirements are satisfied. In addition, if rent attributable to personal property, leased in connection with a lease of real property, is greater than 15 percent of the total rent received under the lease, then the portion of rent attributable to such personal property will not qualify as rents from real property. Moreover, an amount received or accrued generally will not qualify as rents from real property (or as interest income) for purposes of the 75-percent test and 95-percent test (described below), if it is based in whole or in part on the income or profits of any person. Rent or interest will not be disqualified, however, solely by reason of being based on a fixed percentage or percentages of receipts or sales.

Finally, for rents received to qualify as rents from real property, the REIT generally must not operate or manage the property or furnish or render certain services to tenants, other than through (1) an "independent contractor" who is adequately compensated and from whom the REIT derives no revenue or (2) through a TRS. The "independent contractor" or TRS requirement, however, does not apply to the extent that the services provided by the REIT are "usually or customarily rendered" in connection with the rental of space for occupancy only, and are not otherwise considered "rendered to the occupant." For both the related-party tenant rules and determining whether an entity qualifies as an independent contractor of a REIT, certain attribution rules apply, pursuant to which ownership interests in certain entities held by one entity are deemed held by certain other related entities.

In general, if a REIT provides impermissible services to its tenants, all of the rent from that property will be disqualified from satisfying the 75-percent test and 95-percent test (described below). However, rents will not be disqualified if a REIT provides *de minimis* impermissible services. For this purpose, services provided to tenants of a property are considered *de minimis* where income derived from the services rendered equals one percent or less of all income derived from the property (as determined on a

property-by-property basis). For purposes of the one-percent threshold, the amount treated as received for any service may not be less than 150 percent of the direct cost incurred by the REIT in furnishing or rendering the service.

The 95-Percent Gross Income Test

In addition to deriving 75 percent of its gross income from the sources listed above, at least 95 percent of a REIT's gross income for a tax year must be derived from the above-described qualifying income, or from dividends, interest or gains from the sale or disposition of stock or other securities that are not dealer property. Dividends from a corporation (including a TRS but not a QRS) and interest on any obligation not collateralized by an interest in real property are included for purposes of the 95-percent test, but not (except with respect to dividends from a REIT) for purposes of the 75-percent test. For purposes of determining whether a REIT complies with the 75-percent and 95-percent tests, gross income does not include income from "prohibited transactions" (discussed below).

From time to time, a REIT may enter into hedging transactions with respect to one or more of its assets or liabilities. Its hedging activities may include entering into interest rate or other swaps, caps and floors, or options to purchase such items, and futures and forward contracts. To the extent that a transaction meets certain identification requirements and hedges any indebtedness incurred or to be incurred to acquire or carry "real estate assets," including interest rate hedges as well as other types of hedges, any income or gain from the disposition of such a hedging transaction will be disregarded in applying the 95-percent gross income test, but will continue to be taken into account as nonqualifying income for purposes of the 75-percent gross income test.

To the extent that a REIT hedges with other types of financial instruments, or in other situations, it is not entirely clear how the income from those transactions will be treated for purposes of the gross income tests. A REIT should take care to structure any hedging transactions in a manner that does not jeopardize its status as a REIT.

If a REIT fails to satisfy one or both of the 75-percent or 95-percent tests for any tax year, it may still qualify as a REIT for such year if it is entitled to relief under certain provisions of the Internal Revenue Code. These relief provisions generally will be available if its failure to comply was due to reasonable

cause and not to willful neglect, and the REIT timely complies with requirements for reporting each item of its income to the Internal Revenue Service. It is not possible, however, to state whether in all circumstances a REIT would be entitled to the benefit of these relief provisions. Even if these relief provisions apply, the REIT still would be subject to a special tax upon the greater of either (1) the amount by which 75-percent of its gross income exceeds the amount of its income qualifying under the 75-percent test for the tax year or (2) the amount by which 95 percent of its gross income exceeds the amount of its income qualifying for the 95-percent income test for the tax year, multiplied by a fraction intended to reflect its profitability.

Code Sec. 988 Transactions in General

Subpart J of the Code was enacted by Congress as part of the 1986 Tax Act⁷ to provide a comprehensive means for dealing with transactions involving foreign currency. Under prior law, there were many issues revolving around the amount, timing, character, and source of foreign currency exchange gain or loss. Subpart J was Congress' attempt at addressing many of these issues. Generally speaking, Subpart J uses the financial accounting concept of "functional currency" as the basis for determining the amount and timing of foreign currency exchange gain or loss. Functional currency, at the most basic level, is treated like money for tax purposes – *i.e.*, a vehicle of exchange having a constant value for purposes of calculating gain or loss. Nonfunctional currency, on the other hand, is generally treated like property for federal income tax purposes—*i.e.*, often the asset exchanged having a varying value for purposes of calculating gain or loss. Thus, "exchange gains and losses" occur as the value of nonfunctional currency rises or falls in relation to the value of the functional currency. A fundamental premise under Subpart J is that the tax treatment of a foreign currency denominated transaction will turn on the determination of the taxpayer's functional currency—the key principle being that income or loss should be measured in the currency of a taxpayer's primary economic environment. For example, a U.S. REIT with the dollar as its functional currency, will normally have exchange gain or loss on outbound real estate transactions denominated in a foreign currency—*i.e.*, a currency other than the U.S. dollar.

Code Sec. 988 was included as part of Subpart J to deal with specific transactions having payments that are denominated in a nonfunctional currency (*i.e.*, Sec. 988 Transactions). Sec. 988 Transactions generally include the following:

- acquiring or becoming the obligor under a debt instrument;
- accruing any item of expense or gross income or receipt that is to be paid or received on a later date;
- entering into or acquiring any forward contract, option or similar financial instrument (*e.g.*, an *fx swap*), unless the instrument is subject to the market-to-market rules under Code Sec. 1256; and
- disposing of nonfunctional currency.

Code Sec. 988 and the regulations promulgated thereunder provide rules for determining the amount, timing, character and source of exchange gain or loss on Sec. 988 Transactions.

As stated above, Code Sec. 988, in essence, treats nonfunctional currency like property and accounts for exchange gain and loss separately from the underlying transaction at hand. As to character, exchange gain or loss on Sec. 988 Transactions is generally treated as ordinary income or loss⁸ and the source of exchange gain or loss under Code Sec. 988 is determined by the residence of the taxpayer. The Code Sec. 988 regulations contain elaborate rules regarding the realization, recognition and computation of exchange gain or loss on Sec. 988 Transactions. The regulations provide that the amount of exchange gain or loss from a Sec. 988 transaction must be separately computed for each transaction, and cannot be combined with gain or loss recognized on another transaction (even where the other transaction is related to the Sec. 988 transaction).

Exchange gain or loss arising on the sale or other disposition of nonfunctional currency generally must be recognized under the usual recognition provisions that govern the sale or disposition of property. For instance, under Code Sec. 1001 principles, an exchange of nonfunctional currency for functional currency would normally constitute a sale or other disposition (*i.e.*, a taxable event). Similarly, an exchange of nonfunctional currency for property, including different nonfunctional currency, would also be a sale or other disposition. For example, the disposition of nonfunctional currency in settlement of a Sec. 988 currency contract or similar financial instrument is considered to be a sale or disposition of such currency and, thus, is generally a taxable event—reflecting the treatment of nonfunctional currency as property for federal income tax purposes.

As with property dispositions in general, the amount of exchange gain or loss that is realized from the disposition of nonfunctional currency is the difference between the amount realized on the disposition and the adjusted basis of the currency.⁹ The amount realized is determined under Code Sec. 1001(b)—the sum of money plus the fair market value of the property received.¹⁰ Similarly, the adjusted basis of nonfunctional currency generally is determined under the standard basis provisions—Code Secs. 1011 through 1023.¹¹

As one might imagine, no exchange gain or loss is recognized with respect to transactions where the taxpayer is only converting the nonfunctional currency into different units or forms of the same nonfunctional currency. For example, traditional bank money-management activities do not trigger exchange gain or loss, including the following types of transactions:

- an exchange of units of nonfunctional currency for different units of the same nonfunctional currency;
- the deposit or withdrawal of nonfunctional currency in a demand or time deposit or similar instrument issued by a financial institution, if the instrument is denominated in such nonfunctional currency;
- the receipt of nonfunctional currency from a bank upon the maturity or termination of a certificate of deposit or similar instrument denominated in such nonfunctional currency and purchased from the issuing bank; and
- the transfer of nonfunctional currency from a demand, time deposit or similar instrument issued by a financial institution to another type of demand, time deposit or similar instrument denominated in the same nonfunctional currency and issued by a financial institution.¹²

In these cases, the taxpayer takes a carryover basis in the units of nonfunctional currency or other property received.¹³

Note that the Code Sec. 988 regulations state that, for purposes of applying Code Sec. 1031, one type of nonfunctional currency is not “property of like-kind” with respect to a different nonfunctional currency.¹⁴ Thus, an exchange of one currency for a different currency cannot qualify for nonrecognition treatment under Code Sec. 1031.

Moreover, special rules apply to property transactions—*i.e.*, transactions where nonfunctional currency is exchanged for property other than nonfunctional currency. Such property transactions are bifurcated into two separate transactions: (1) an exchange of the

units of nonfunctional currency for units of functional currency at the spot rate on the date of the exchange, and (2) the purchase or sale of the property at issue for such units of functional currency.¹⁵

Code Sec. 988 Debt Instruments

The Treasury Regulations contain a comprehensive set of rules governing Code Sec. 988 debt instruments where all payments are denominated in, or determined with reference to, a single nonfunctional currency and the instrument does not contemplate any contingent payments.¹⁶ Interest income and expense on a Code Sec. 988 debt instrument is determined as follows:

- first, the amount of interest income or expense is determined in units of the applicable nonfunctional currency;
- second, once the amount of interest has been determined for the applicable tax accrual period in units of nonfunctional currency, it must then be translated into the taxpayer's functional currency¹⁷; and
- third, once interest has been determined and translated, the taxpayer must then determine whether exchange gain or loss has separately arisen when such interest is subsequently paid.

Of course, exchange rates are likely to vary over the term of the debt, and, as a result of these rules, the amount and rate of interest as measured in functional currency also will vary from tax accrual period to period. In addition, exchange gain or loss also may arise on repayment of principal.

The appropriate spot rate used in translating interest income or expense will depend on whether the interest is accrued before it is received or paid. If the interest is not accrued prior to receipt or payment, then the interest is translated at the spot rate on the date of receipt or payment.¹⁸ If interest is accrued prior to receipt or payment, then the interest is translated at the average rate for the interest accrual period.¹⁹

The holder of a Code Sec. 988 debt instrument realizes exchange gain or loss with respect to accrued interest income on the earlier of the date the income is received, or the date the instrument is disposed of or otherwise transferred.²⁰ A disposition also includes a deemed disposition resulting from a material change in the terms of the instrument. The amount of exchange gain or loss realized is determined as follows: First, the interest income received during an accrual period (determined in units of

nonfunctional currency) is translated into functional currency using the spot rate on the date received or the date the instrument is disposed of, as applicable.²¹ Then, income previously accrued, taking into account a prior translation into functional currency, is then subtracted from this amount.²²

Similarly, the holder of a Code Sec. 988 debt instrument realizes exchange gain or loss on the earlier of the point when a principal payment is received or, if sooner, when the instrument is disposed of or otherwise transferred.²³ It is important to note, however, that if the holder acquired the instrument in a nonrecognition transaction, then the transferor's nonfunctional currency principal amount carries over to the new holder. Like with interest, a disposition also includes a deemed disposition resulting from a material change in the terms of the instrument. It is important to remember that, for purposes of computing exchange gain or loss on the "principal amount" of a Code Sec. 988 debt instrument, one must look to the holder's purchase price in units of nonfunctional currency.²⁴ Similar to the interest calculation, the amount of exchange gain or loss realized with respect to principal is determined in the following manner: first, one must translate the units of nonfunctional currency principal received at the spot rate in effect on the date received, or the date the debt instrument is disposed of or otherwise transferred, as applicable. Then, subtract the translated amount of nonfunctional currency principal in existence on the date the holder acquired the instrument using the spot rate in effect on the date.²⁵

In a like manner, the obligor under a Code Sec. 988 debt instrument realizes exchange gain or loss with respect to accrued interest expense on the earlier of the date when the expense is paid, or when the obligation to make payments is transferred or extinguished.²⁶ Once again, a deemed disposition constitutes a realization event as well. Here, the amount of realized exchange gain or loss is determined for each accrual period as follows: First, translate the units of nonfunctional currency interest expense accrued with respect to the amount of interest paid. Then, translate the accrued units into functional currency at the rate previously used in recording the expense for the accrual period to which the payment is allocated.²⁷ Thereafter, subtract the amount derived from translating the units paid or accrued (if calculating the amount upon termination) during the accrual period into functional currency at the spot rate on the payment date or instrument termination date, as applicable.²⁸

Similarly, exchange gain or loss is realized on the earlier of when principal payments are made or when the obligation to make payments is transferred or extinguished.²⁹ Once again, when computing exchange gain or loss, the principal amount of a debt instrument is the amount received by the obligor for the debt instrument in units of nonfunctional currency.³⁰ Here, again, it is important to note that if the obligor became the obligor in a transaction in which exchange gain or loss was realized but not recognized by the transferor, the transferor's nonfunctional currency principal amount carries over and becomes the transferee's nonfunctional currency principal amount.³¹ The amount of realized exchange gain or loss is determined as follows for each accrual period: First, translate the units of nonfunctional currency principal at the spot rate on the date the obligor became the obligor. Then, subtract the amount derived from translating such units of nonfunctional currency using the spot rate on the payment or instrument termination date, as applicable.³² Note that the amount of exchange gain or loss may be materially different depending on whether a payment is treated as a payment of principal or interest. To address this issue, one should take note of the payment ordering rules under the regulations, which are an important part of the nonfunctional currency exchange gain or loss regime.

An example (taken from Reg. §1.988-2(b)(9), Ex. 12) may prove helpful in understanding these principles—

AEB-REIT (a U.S.-REIT investing in mortgages secured by real estate, "AEB") is an accrual method, calendar-year Maryland trust with the U.S. dollar as its functional currency. On January 1, 2008, AEB lends 100 British pounds in exchange for a note under which AEB will receive two equal payments of £57.62 on December 31, 2008, and December 31, 2009. Each payment of £57.62 represents the annual payment necessary to amortize the £100 principal amount at a rate of 10 percent, compounded annually over a two-year period. The amount of principal and

interest that comprise each payment and the relevant exchange rates are as shown in chart 1.³³

Because AEB is an accrual-basis taxpayer, AEB will translate the interest and principal balance for the annual accrual period. Thus, AEB's interest income is \$13.50 (£10.00 × \$1.35) in 2008, and \$7.60 (£5.24 × \$1.45) in 2009. AEB will realize exchange gain or loss upon receipt of accrued interest computed. Thus, AEB will realize exchange gain in the amount of \$.50 [(£10.00 × \$1.40) – \$13.50] in 2008, and \$.26 [£5.24 × \$1.50) – \$7.60] in 2009.

In addition, AEB will realize exchange gain or loss upon the receipt of principal each year. Thus, AEB will realize exchange gain in the amount of \$4.76 [(£47.62 × \$1.40) – (£47.62 × \$1.30)] in 2008, and \$10.48 [(£52.38 × \$1.50) – (£52.38 × \$1.30)] in 2009.³⁴

Rev. Rul. 2007-33: Foreign Currency Gain— Qualifying REIT Income

As noted above, the Ruling addressed the following question: if a REIT recognizes foreign currency gain in a Sec. 988 Transaction, to what extent is that gain "qualifying income" for purposes of the REIT income tests under Code Sec. 856(c)?

The facts of the Ruling are as follows (with slight editorial changes): AEB, a Maryland trust with the U.S. dollar as its functional currency, has elected, and qualifies, to be treated as a REIT under the Code. AEB invests both in real property from which AEB derives rental income and in debt instruments that are partially or fully secured by mortgages on real property. Some of the leases of the real estate that AEB owns provide for rents to be paid in Euros. For some of the leases, AEB recognizes rental income for federal income tax purposes before receiving the corresponding rent payments. AEB's rental income from these Euro-denominated leases is described in Code Sec. 856(c)(2)(C) and in Code Sec. 856(c)(3)(A)—*i.e.*, rents from real property. Some of the mortgage loans that AEB acquires are denominated in Euros as well, and both principal and interest under these loans are payable in Euros. AEB's income from these Euro-denominated loans is described in Code Sec. 856(c)(2)(B) and in Code Sec. 856(c)(3)(B)—*i.e.*, interest income.

AEB's activities of investing in rent-producing real estate and in mortgage loans are not subject to Code Sec. 987 (which requires, in general, that any taxpayer

Chart 1

Date	Principal	Interest
12/31/08	£47.62	£10.00
12/31/09	£52.38	£ 5.24
Date	Spot Rate	Average Rate
1/01/08	\$1.30	\$1.35
12/31/08	\$1.40	\$1.35
12/30/09	\$1.50	\$1.45

having one or more qualified business units (QBUs) with a functional currency other than the dollar must compute separately the taxable income or loss for each QBU in its functional currency). Accordingly, if the Euro changes in value against the dollar, payments of rent under the leases of the real estate and periodic payments made under the mortgage loans may generate a Sec. 988 Transaction.³⁵

During its tax year, AEB recognized rental income on the Euro-denominated leases, interest income on the Euro-denominated mortgage loans, and Code Sec. 988 gain on payments received under the leases and the mortgage loans.

Analysis under Rev. Rul. 2007-33

As discussed above, to qualify as a REIT for a tax year, at least 95 percent of an entity's gross income must be "derived from" the types of income listed in Code Sec. 856(c)(2), and at least 75 percent of its gross income must be "derived from" the types of income listed in Code Sec. 856(c)(3). Unfortunately, gains from foreign currency are not specifically enumerated in Code Secs. 856(c)(2) or (c)(3).

Code Sec. 988(c)(1) defines a Sec. 988 Transaction as any transaction if the amount which the taxpayer is entitled to receive (or is required to pay) by reason of such transaction is denominated in terms of a nonfunctional currency or is determined by reference to the value of one or more nonfunctional currencies. As discussed above, under Code Sec. 988(c)(1)(B)(i), a Sec. 988 Transaction includes the acquisition of a debt instrument or becoming the obligor under a debt instrument. Under Code Sec. 988(c)(1)(B)(ii), a Sec. 988 Transaction also includes accruing (or otherwise taking into account) any item of gross income or receipts which is received after the date on which so accrued or taken into account. Further, Code Sec. 988(b)(1) provides that the term "foreign currency gain" means any gain from a Sec. 988 transaction to the extent that such gain does not exceed gain realized by reason of changes in exchange rates on or after the booking date³⁶ and before the payment date.³⁷

The Ruling relied, in part, on the holding of Rev. Rul. 74-191,³⁸ which provides that otherwise-qualifying assets do not fail to satisfy Code Sec. 856(c)(4) (*i.e.*, the 75-percent Qualified Assets Test) merely because the assets are foreign:

Neither section 856 of the Code nor the regulations thereunder restrict the term "real estate assets" to those located within the United States.

Accordingly, it is held that, for purposes of section 856(c), the term "real property" includes land or improvements thereon located outside the United States and the term "mortgages on real property" includes a security interest which, under the laws of the jurisdiction in which the property is located, is the legal equivalent of a mortgage or deed of trust in the United States.³⁹

Based upon the underlying premise of Rev. Rul. 74-191, the Ruling concludes that rents on foreign real property qualify under Code Secs. 856(c)(2)-(3) to the same extent that they would qualify if the property were located in the United States and that interest on foreign mortgage loans qualifies under Code Sec. 856(c)(2)-(3) to the same extent that it would qualify if the loans were governed by United States law and the property were located in the United States. Accordingly, the foreign *situs* of AEB's assets does not necessarily prevent AEB from satisfying the income and asset tests of Code Sec. 856(c), which must be met in order to qualify as a REIT. The Ruling further noted, however, that Rev. Rul. 74-191, does not address the treatment of foreign currency gain that may result from investing in real property or other assets that produce income denominated in a currency other than AEB's functional currency. With this in mind, the Ruling notes that the legislative history describing the tax treatment of REITs indicates that "*the central concern behind the gross income restrictions in Sec. 856(c) is that a REIT's gross income should largely be composed of passive income.*"⁴⁰

The Ruling goes on to provide that, "[a]lthough Sec. 856(c) describes the sources of REIT qualifying income, neither the statute nor its legislative history describes what it means for income to be 'derived from' those sources. *Because of the close nexus, however, between section 988 gain on payments received by a REIT and the income from which that payment is derived, the section 988 gain qualifies under Sec. 856(c)(2) or (3) to the extent that the underlying income does.*" (Emphasis added.) In essence, the Ruling provides that one must look at the transaction underlying the Code Sec. 988 gain to determine if it will be qualifying income for REIT purposes. Specifically, the Ruling provided that if interest income recognized by AEB qualifies under Code Secs. 856(c)(2) or (3) (*i.e.*, the 95-percent and 75-percent Gross Income Tests), then so will the Code Sec. 988 gain from that interest income. Similarly, if an item of income qualifies as rents from real property for purposes of Code Sec. 856(c)(3)(C), then, for

purposes of Code Sec. 856(c)(3), Code Sec. 988 gain with respect to that income is derived from a type of income permissible by a REIT (*i.e.*, an item of income listed in Code Secs. 856(c)(3)(A)-(H)).⁴¹

Conclusion

The Ruling provides a much needed REIT-friendly confirmation of what many tax advisors felt was the appropriate result—*i.e.*, Code Sec. 988 gain should

be qualifying REIT income to the extent that the income from the underlying Sec. 988 Transaction also so qualifies. From a policy perspective, the Ruling is right-on-the-mark based on the close nexus between the Code Sec. 988 gain on payments received by a REIT and the income from which the underlying payment is derived. Any other conclusion would have produced unnecessary complexities and, most likely, inappropriately created a bias against foreign investments by REITs.

ENDNOTES

¹ Rev. Rul. 2007-33, IRB 2007-21, 1281.

² All Code Sec. references are to the Internal Revenue Code of 1986, as amended, and the Regulations promulgated thereunder.

³ Code Sec. 988(b)(1).

⁴ Code Sec. 988(c)(1).

⁵ The REIT and a corporate subsidiary in which it owns stock may make a joint election to treat the subsidiary as a TRS. A TRS also includes any corporation other than a REIT, if a TRS owns more than 35 percent of the total voting power or value of the outstanding securities of such corporation. Other than some activities relating to lodging and health care facilities, a TRS generally may engage in any business, including the provision of customary or noncustomary services to tenants of its parent REIT.

⁶ In addition to the gross income tests, a REIT must also satisfy various shareholder requirements, asset-type tests and distribution requirements. A discussion of these additional REIT qualifications is beyond the scope of this article.

⁷ Tax Reform Act of 1986 (P.L. 99-514). The following discussion is derived from, and additional information may be found at, KEYES: FEDERAL TAXATION OF FINANCIAL INSTRUMENTS & TRANSACTIONS; PART III, *Derivatives and Other Financial Instruments*, Ch. 15: *Foreign Currency Denominated Instruments*, WG&L.

⁸ Code Sec. 988(a)(1). Ordinary income treatment follows the premise that exchange gains and losses are a function of interest rates and therefore should be accorded ordinary treatment. Note, however, except in limited cases, exchange gain or loss is not actually characterized as interest for federal income tax purposes. In certain Sec. 988 Transactions, an election can be made to treat exchange gain or loss as being capital gain or loss rather than ordinary gain or loss.

In addition, an election can be made to apply Code Sec. 988, rather than Code Sec. 1256, to regulated futures contracts and nonequity options. These elections can be useful in reducing character mismatches between gain or loss on the Sec. 988 Transaction and gain or loss on the related transaction.

⁹ Reg. §1.988-2(a)(2)(i).

¹⁰ Reg. §1.988-2(a)(2)(ii)(A).

¹¹ Reg. §1.988-2(a)(2)(iii)(A).

¹² Reg. §1.988-2(a)(1)(iii).

¹³ *Id.*

¹⁴ Reg. §1.988-2(a)(1)(ii).

¹⁵ Reg. §1.988-2(a)(2)(ii)(B).

¹⁶ Reg. §1.988-2(b)(2)(i)(A). Note that a debt instrument does not constitute a contingent debt instrument merely because payments are denominated in, or determined with reference to, a single nonfunctional currency.

¹⁷ The regulations provide that interest includes OID, as adjusted for acquisition premium under Code Sec. 1272 and acquisition discount under Code Secs. 1281 through 1283.

¹⁸ Reg. §1.988-2(b)(2)(ii)(B).

¹⁹ Reg. §1.988-2(b)(2)(ii)(C). A taxpayer may elect to translate interest at the spot rate on the last day of the interest accrual period. Under this election, if interest is received or paid within five business days of the last day of the interest accrual period, a translation at the spot rate in effect on the receipt or payment date may be made. Once made, this election must be applied consistently to all debt instruments from year to year and cannot be changed without consent from the IRS. Reg. §1.988-2(b)(2)(iii)(B).

²⁰ Reg. §1.988-2(b)(3).

²¹ *Id.*

²² *Id.*

²³ Reg. §1.988-2(b)(5).

²⁴ *Id.*

²⁵ *Id.*

²⁶ Reg. §1.988-2(b)(4).

²⁷ *Id.*

²⁸ *Id.*

²⁹ Reg. §1.988-2(b)(6).

³⁰ *Id.*

³¹ *Id.*

³² *Id.*

³³ As provided in Reg. §1.988-2(b)(9), Ex. 12, because each interest payment is equal to the product of the outstanding principal balance of the obligation and a single fixed rate of interest, each stated interest payment constitutes periodic interest under the principles of Code Sec. 1273, and, therefore, there is no original issue discount (“OID”) in connection with the debt instrument.

³⁴ Note that when the IRS prepared this example the value of the U.S. dollar was a bit better than it is today.

³⁵ See Reg. §1.988-2(b).

³⁶ As defined in Code Sec. 988(c)(2).

³⁷ As defined in Code Sec. 988(c)(3).

³⁸ Rev. Rul. 74-191, 1974-1 CB 170.

³⁹ *Id.*

⁴⁰ The Ruling notes, as an example, H.R. Rep. No. 2020, 86th Cong., 2d Sess. 4 (1960) at 6, 1960-2 CB 819, 822-23 which states that, “One of the principal purposes of your committee in imposing restrictions on types of income of a qualifying real estate investment trust is to be sure the bulk of its income is from passive income sources and not from the active conduct of a trade or business.”

⁴¹ The Ruling also notes Rev. Rul. 92-56, 1992-2 CB 153 (concluding that a regulated investment company’s (RIC’s) receipt of a reimbursement of an investment advisory fee was “derived from” the RIC’s business of investing in stock, securities or foreign currencies and was therefore qualifying income under the “other income” provision of Code Sec. 851(b)(2)).

This article is reprinted with the publisher’s permission from the JOURNAL OF PASSTHROUGH ENTITIES, a bi-monthly journal published by CCH, a Wolters Kluwer business. Copying or distribution without the publisher’s permission is prohibited. To subscribe to the JOURNAL OF PASSTHROUGH ENTITIES or other CCH Journals please call 800-449-8114 or visit www.CCHGroup.com.

All views expressed in the articles and columns are those of the author and not necessarily those of CCH or any other person. All Rights Reserved.