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## Legal Updates & News

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#### IRS Issues Guidance Relating to the Treatment of Foreign Currency Gains of Real Estate Investment Trusts

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The IRS recently released published guidance relating to the treatment of foreign currency gains of real estate investment trusts ('REITs') from overseas real estate operations. The guidance shows that the IRS is beginning to provide some clarity for REITs that have overseas real estate operations and operate in the global marketplace.

In Revenue Ruling 2007-33, 2007-21 I.R.B. 1281 (the "Ruling"), the IRS ruled that foreign currency gains under Section 988 of the Internal Revenue Code of 1986, as amended (the "Code") that are recognized by a REIT will constitute qualifying income for purposes of the REIT gross income tests to the extent that the underlying income so qualifies. In Notice 2007-42, 2007-21 I.R.B. 1288 (the "Notice"), the IRS provided guidance with respect to the circumstances under which foreign currency gain from a foreign branch under Section 987 is treated as qualifying income for purposes of the REIT gross income tests.

#### Background: the REIT Gross Income Tests

To qualify as a REIT for a taxable year, among other tests, at least 75% of an entity's gross income must be derived from certain real estate related items of income listed in Section 856(c)(3), such as rents from real property, interest on obligations secured by real property, gain from the sale or other disposition of real property which is not dealer property, and dividends from shares in other qualifying REITs. In addition, at least 95% of its gross income must be derived from certain passive sources listed in Section 856(c)(2), such as dividends, interest, and gains from the sale or other disposition of stock and securities that are not treated as dealer property.

If a REIT holds or acquires foreign investments, such as owning real estate in foreign jurisdictions, holding real estate leases denominated in foreign currencies or mortgages or other loans denominated in foreign currencies, such investments may generate foreign currency gains and losses under Section 987 or Section 988. Foreign currency gains are not included in any of the specified categories of income that qualify under the 95% or 75% REIT gross income tests. Prior to the issuance of the Ruling and the Notice, the IRS had not provided any specific guidance as to the proper treatment of foreign currency gains for purposes of the REIT gross income tests.

#### Revenue Ruling 2007-33: Guidance Regarding Section 988 Gains

In the Ruling, a REIT with a U.S. dollar functional currency leased real estate in exchange for rent payable in euros. In addition, the REIT acquired mortgage loans that were denominated in euros, with both principal and interest payable in euros. The REIT's activities of investing in the rent-producing real estate and in the mortgage loans were not subject to the "qualified business unit" ("QBU") foreign currency rules of Section 987. However, during its taxable year, the REIT recognized rental income on the euro-denominated leases, interest income on the euro-denominated mortgage loans, and foreign currency gain under Section 988 on payments received under the leases and the mortgage loans.

The Ruling notes that Rev. Rul. 74-191<sup>[1]</sup> held that neither Section 856 nor the regulations restrict the term “real estate assets” to those located within the United States, and accordingly, for purposes of the REIT asset tests under Section 856(c), real estate assets located outside the United States do not cause a REIT to fail the REIT assets tests merely because the assets are foreign. It follows from this holding that payments of rent on foreign real property and interest on foreign mortgage loans qualify under the 95% gross income test and the 75% gross income test to the same extent that such payments would qualify if the property were located in the United States, and that the foreign situs of a REIT’s assets does not itself prevent the income from being treated as qualifying income for purposes of the REIT gross income tests. However, Rev. Rul. 74-191 did 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 the taxpayer’s functional currency.

The Ruling further notes that although gains from foreign currency are not specifically enumerated in Section 856(c)(2) or Section 856(c)(3), neither the statute nor its legislative history describes what it means for income to be “derived from” those sources. The legislative history indicates that one of the principal purposes of the REIT gross income tests was to ensure that a large part of a REIT’s gross income would include passive income. Thus, the Ruling reasons that, because of the close nexus between Section 988 foreign currency gain on payments received by a REIT and the income from which that payment is derived, the Section 988 foreign currency gain is qualifying income for purposes of the REIT gross income tests under Section 856(c)(2) or Section 856(c)(3) to the extent that the underlying income qualifies. Accordingly, the REIT’s foreign currency gain under Section 988 on the payments received under the leases and the mortgage loan was qualifying income for purposes of the 95% and 75% REIT gross income tests.

#### **Notice 2007-42: Guidance Regarding Section 987 Gains**

In general, pursuant to regulations under Section 985, a REIT must use the U.S. dollar as its functional currency, absent a ruling to the contrary. A REIT may have a QBU (generally, any separate and clearly identified unit of a trade or business of a taxpayer, provided that separate books and records are maintained<sup>[2]</sup>) that has a functional currency other than the U.S. dollar. In such a case, the REIT may recognize foreign currency gain under Section 987 when the QBU remits property (including cash) to the REIT.<sup>[3]</sup>

Proposed regulations<sup>[4]</sup> under Section 987 were issued September 7, 2006, which generally provide that the owner of a QBU must determine the character of Section 987 gain or loss in the year of remittance using the asset method provided in Treas. Reg. § 1.861-9T(g), as modified by the proposed regulations, and cannot use the modified gross income method described in Treas. Reg. § 1.861-9T(j). If finalized as currently proposed, however, the regulations will not apply to REITs.<sup>[5]</sup> The Notice states some REITs have requested guidance concerning the status for purposes of the REIT gross income tests under Section 856(c)(2) and Section 856(c)(3) of any foreign currency gain that is recognized under Section 987 when a QBU remits property to a REIT.

The Notice provides that the Treasury Department and the IRS intend to amend proposed regulations under Section 987 to include guidance concerning the characterization for purposes of the REIT gross income tests of foreign currency gain under Section 987 recognized by a REIT on a remittance from a QBU of the REIT. The Notice further provides that until further guidance is published, if a REIT recognizes foreign currency gain under Section 987, the REIT may apply the asset method provided in Treas. Reg. § 1.861-9T(g), as modified by the proposed regulations, to determine whether foreign currency gain is derived from the sources of income that are described in Section 856(c)(2) or Section 856(c)(3). In general, the asset method allows the taxpayer to apportion Section 987 gain to the various statutory groupings (which, in the case of a REIT, would be the assets that produce the specified categories of income that qualify under the 95% or 75% REIT gross income tests) based on the average total value of assets within each such grouping for the taxable year.

#### **Impact of the Ruling and Notice**

The Ruling and the Notice provide helpful guidance with respect to foreign currency gains recognized by REITs. The guidance provides REITs with the flexibility to remain competitive in the global market place and to keep pace with changes in the U.S. economy.

Although the guidance is helpful to determine the treatment of foreign currency gains under Section 987 and Section 988, other areas of uncertainty remain that would benefit from further guidance. For example, a REIT that is a “United States shareholder” in a CFC is required to include in gross

income currently its pro rata share of certain income of the CFC (referred to as "Subpart F income"), without regard to whether the income is distributed by the CFC to its shareholders in the year the income is earned.<sup>[6]</sup> It is not clear whether a Subpart F income inclusion under Section 951(a) of a REIT that is a United States shareholder in a CFC is treated as income that qualifies under the 95% or 75% gross income tests. Another issue for REITs with extensive overseas operations is the status of foreign currency for purposes of the REIT asset tests, which generally is not treated as a "cash or cash item" for such purposes. In addition, a REIT which meets the REIT gross asset tests under Section 856(c) at the close of any quarter will not lose its status as a REIT because of a discrepancy during a subsequent quarter due solely to a change in the value of its various investments (and not due to the result of an acquisition).<sup>[7]</sup> The application of this relief provision with regard to changes in the value of a REIT's assets due solely to fluctuations in the value of foreign currencies is unclear (although legislation has been introduced in Congress that would treat foreign currency as a "cash or cash item" for purposes of the REIT asset tests and would modify the relief provision to include changes in the value of a REIT's assets due solely to fluctuations in the value of foreign currencies).<sup>[8]</sup> Accordingly, further guidance or legislative changes on these issues are needed.

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## Footnotes

<sup>[1]</sup> 1974-1 C.B. 170.

<sup>[2]</sup> See Treas. Reg. § 1.989(a)-1(b).

<sup>[3]</sup> See Section 987(3).

<sup>[4]</sup> REG-208270-86, 2006-42 I.R.B. 698.

<sup>[5]</sup> See Prop. Treas. Reg. § 1.987-1(b)(1)(iii).

<sup>[6]</sup> See Section 951(a).

<sup>[7]</sup> See Section 856(c)(4) (flush language).

<sup>[8]</sup> See REIT Investment Diversification and Empowerment Act of 2007, H.R. 1147, 110th Cong. § 102 (2007).