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Revenue Ruling 2008-31: IRS Rules That A Swap Interest in A Broad-Based U.S. Real Estate Index Is Not a U.S. Real Property Interest Under FIRPTA

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On June 12, 2008, the Internal Revenue Service (“IRS”) published Revenue Ruling 2008-31, I.R.B. 2008-26 (the “Ruling”), holding that an interest in a notional principal contract that references data from an index derived from a geographically and numerically broad range of U.S. real estate values does not constitute a United States real property interest (“USRPI”) for purposes of the Foreign Investment in Real Property Tax Act of 1980 (“FIRPTA”). As described below, the effect of the Ruling is to exempt income derived by foreign persons in respect of notional principal contracts on broad-based U.S. real property indices from U.S. federal income tax. The guidance has already been hailed by some as a measure beneficial to foreign investors who wish to gain exposure to the U.S. real property market.

In general, U.S. source income of a foreign investor is taxed under one of two regimes under the Internal Revenue Code (the “Code”): either (i) the income (including income derived from the disposition of a USRPI) is subject to tax at full graduated rates (in the manner in which a U.S. person generally is taxed) as net income “effectively connected” with the conduct of a U.S. trade or business, or (ii) if U.S. source and not effectively connected, the income is (absent an exemption under the Code or a treaty) subject to a flat 30% tax as “fixed or determinable annual or periodical” (“FDAP”) income. Income derived in respect of a swap is generally sourced to the residence of the payee. Under these rules, a foreign investor’s income from a notional principal contract that is not a USRPI is generally treated as foreign source income not subject to United States federal income tax.

Under Code Section 897 (added by FIRPTA), a foreign person’s gain or loss from the disposition of a USRPI is treated as effectively connected with a U.S. trade or business. Additionally, under Code Section 1445, a buyer of a USRPI from a foreign seller is required to withhold 10% of the amount realized on the disposition from the proceeds, which is applied towards the seller’s tax liability. Therefore, under the U.S. federal tax system a foreign investor is subject to full graduated rates on income from the disposition of a USRPI. Under applicable Treasury regulations, a USRPI includes “. . . any direct or indirect right to share in the appreciation in the value, or in the gross or net proceeds or profits generated by, the real property.” Under this definition, an interest in a financial instrument (such as a notional principal contract) that is linked to the appreciation of U.S. real property may be viewed as an interest in a USRPI.

In the Ruling, the IRS holds that an interest in a swap contract whose return is calculated by reference to a broad-based U.S. real estate index does not constitute a USRPI. The Ruling involves a foreign corporation that enters into a swap with a U.S. counterparty based on a widely published index calculated by reference to sales prices, appraisals, reported income, or other objective financial information gathered from a given U.S. geographical area.^[1] The index measures real estate values in geographic areas with populations exceeding one million people that contain a broad range of real property holdings of unrelated owners during a relevant testing period. Pursuant to the terms of the swap, the foreign corporation receives the value of the index appreciation and suffers a loss on any index depreciation. The IRS ruled that the broad-based nature of the index does not represent a “direct or indirect right to share in the appreciation in the value . . . [of] the real property” for purposes of FIRPTA. As a consequence, income derived under such notional principal

contracts is not subject to the regime that taxes “effectively connected” income. Additionally, as stated above, a foreign investor’s income from such non-USRPI swaps is foreign source income not subject to the alternative 30% tax regime.

Importantly, the facts of the Ruling indicate that the foreign corporation and the U.S. counterparty are not related and do not otherwise have an interest in the underlying real property. Moreover, neither the foreign corporation nor the U.S. swap provider is related to the entity that maintains the index, and the index is based upon a broad range of unrelated real-estate owners over a large geographic area. It is unclear whether and to what extent the IRS would be willing to diverge from the facts of the Ruling and still hold that income derived from a similar swap would not constitute a USRPI.

Footnotes

[1] An example of such an index is the National Counsel of Real Estate Investment Fiduciaries (“NCREIF”), an organization that publishes the NCREIF Property Index (“NPI”). The NPI is a quarterly composite total rate of return measure of investment performance of a very large pool of individual commercial real estate properties acquired in the private market for investment purposes only. See, www.ncreif.com.