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REIT Update

The Internal Revenue Service (the "IRS") has published guidance that will allow real estate investment trusts ("REITs") to treat certain foreign currency gains that arise from transactions under Section 988 of the Internal Revenue Code of 1986, as amended (the "Code") and certain gains that arise under Code Section 987 when a REIT receives income from qualified business units ("QBUs") as qualifying income. This guidance has potential implications for any REITs that invest in real property or other assets that produce income denominated in a currency other than United States currency (the functional currency of a REIT) or REITs that invest in such assets through a QBU with a functional currency other than United States currency.

To qualify as a REIT for a taxable year the REIT must derive at least 95% of its gross income from the types of income specifically enumerated in Code Section 856(c)(2), with at least 75% of its gross income derived from the income specifically enumerated in Code Section 856(c)(3) (the "REIT Income Tests"). Neither of these subsections nor any other authority restricts a REIT from investing in assets located only in the United States.

Revenue Ruling 2007-33

Under Revenue Ruling 2007-33 foreign currency gains in a Code Section 988 transaction will count as qualifying income to the extent that the underlying income is qualifying income under the REIT Income Tests.

Gains from rents from real property, the sale or other disposition of real property and foreclosure property are examples of some items specifically enumerated as qualifying income for purposes of meeting the REIT Income Tests.

Generally a Code Section 988 transaction in the case of REITs is the acquisition of a debt instrument or becoming an obligor under a debt instrument, accruing any item of expense or gross income or receipts which is to be paid or received after the date on which the amount is accrued, entering into or acquiring any forward or futures contract, option, warrant or similar financial instrument in each case, if the amount the REIT is entitled to receive or is required to pay is denominated in terms other than United States currency or is determined by reference to the value of one or more currencies other than United States currency, or the disposition of any non-United States currency.

Foreign currency gain is any gain from a Code Section 988 transaction to the extent that such gain does not exceed gain realized by reason of changes in exchange rates on or after the date on which the taxpayer becomes and obligor, the date of acquisition, or the date such item is accrued and before the payment date.

Until this ruling, if a REIT had income from rent from real property, for example, and such income was received in Euros, rather than U.S. Dollars, then the REIT could have gain from a Code Section 988 transaction on the date that such income is accrued and that income may not have been qualifying income even though the rent received would be qualifying income. Now, pursuant to this ruling, if a REIT recognizes such gain, then both the rent and the amount of any Code Section 988 gain derived from the receipt of such rent will be qualifying income.

In sum, because there is a close nexus between the Code Section 988 foreign currency gain on payments received by a REIT and the income from which the payment is derived, under this ruling any gain from a Code Section 988 transaction will be qualifying income under the REIT Income Tests to the extent the underlying income qualifies under such subsections.

Notice 2007-42

Under Notice 2007-42 if a REIT recognizes Code Section 987 gain it may apply the principals of the proposed regulations issued on September 7, 2006 under that section to determine whether such gain is derived from qualifying income under the REIT Income Tests.

Code Section 987 generally provides that if a taxpayer has a QBU with a currency different from the taxpayer's currency (U.S. Dollar for REITs) then the taxable income of the taxpayer with respect to the QBU is determined by computing the taxable income (or loss) of the QBU separately and then translating such income (or loss) into United States currency under the applicable exchange rate.

A QBU means any separate and clearly identified unit of a trade or business of a taxpayer which maintains separate books and records. A REIT may have a QBU if, for example, it invests in a foreign country through a disregarded entity or through a qualified REIT subsidiary. A qualified REIT subsidiary is any corporation if 100% of the stock of such corporation is owned by a REIT.

If a REIT has a QBU that has a functional currency other than United States currency then the calculation of such QBU's income may be subject to Code Section 987. Under such circumstances, a REIT may recognize currency gain under Code Section 987 when the QBU remits cash or property to the REIT. This notice provides that the REIT may rely on the principals of the proposed regulations under Code Section 987 to determine if any such gain will be considered qualifying income.

Proposed Treasury Regulations Section 1.987-6(b) provides that the owner of a QBU must determine the character of Code Section 987 gain or loss in the year of remittance using the asset method provided in Treasury Regulations Section 1.861-9T(g) and may not use the gross income method described in Treasury Regulations Section 1.861-9T(i).

As a general matter under the asset method described in Treasury Regulations Section 1.861-9T(g), as modified by Treasury Regulations Section 1.987-6(b), a taxpayer apportions its Code Section 987 gain to various statutory groupings based on the average total value of such assets within each grouping for the taxable year. The characterization of the taxpayer's Code Section 987 gain is then determined by such apportionment. Treasury Regulations Section 1.861-9T(g) provides alternatives for determining the value of such assets.

For example, if a REIT has a QBU that has a functional currency other than United States currency and the QBU holds real estate assets then income produced from such assets will be qualifying income under the REIT Income Tests. If Section 987 gain results from the QBU's translation of income to United States currency and remittance of such income to the REIT then, to the extent the proceeds giving rise to such gain are apportioned to real estate assets that portion of the Section 987 gain will also be qualifying income.

Before the publication of this notice the regulations under Code Section 987 specifically excluded REITs. This notice announces the IRS's intent to amend these regulations to provide guidance regarding the characterization for purposes of the REIT Income Tests of Code Section 987 gain. Until such guidance is issued, pursuant to this notice, REITs may apply the principals of the proposed regulations, as described above, to determine whether any of its Code Section 987 gain will be qualifying income.

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