TECHNICAL EXPLANATION OF DIVISION C OF H.R. 3221, THE "HOUSING ASSISTANCE TAX ACT OF 2008" AS SCHEDULED FOR CONSIDERATION BY THE HOUSE OF REPRESENTATIVES ON JULY 23, 2008

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TITLE II – REFORMS RELATED TO REAL ESTATE INVESTMENT TRUSTS ("REITS")
(secs. 3031-3071 of the bill and secs. 856 and 857 of the Code)

Present Law

In general

A real estate investment trust ("REIT") is an entity that otherwise would be taxed as a U.S. corporation but elects to be taxed under a special REIT tax regime. In order to qualify as a REIT, an entity must meet a number of requirements. At least 90 percent of REIT income (other than net capital gain) must be distributed annually;[27] the REIT must derive most of its income from passive, generally real-estate-related investments; and REIT assets must be primarily real-estate related. In addition, a REIT must have transferable interests and at least 100 shareholders, and no more than 50 percent of the REIT interests may be owned by 5 or fewer individual shareholders (as determined using specified attribution rules). Other requirements also apply.[28]

If an electing entity meets the requirements for REIT status, the portion of its income that is distributed to its shareholders each year as a dividend is deductible by the REIT (unlike the case of a regular subchapter C corporation, which cannot deduct dividends). As a result, the distributed income of the REIT is not taxed at the entity level; instead, it is taxed only at the investor level.[29]

Income tests

In general

A REIT is restricted to earning certain types of generally passive income. Among other requirements, at least 75 percent of the gross income of a REIT in each taxable year must consist of real-estate-related income. Such income includes: rents from real property; income from the sale or exchange of real property (including interests in real property) that is not stock in trade, inventory, or held by the taxpayer primarily for sale to customers in the ordinary course of its trade or business; interest on mortgages secured by real property or interests in real property; and certain income from foreclosure property (the "75-percent income test").[30] Amounts attributable

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[27] Even if a REIT meets the 90 percent income distribution requirement for REIT qualification, more stringent distribution requirements must be met in order to avoid an excise tax under section 4981.

[28] Secs. 856 and 857.

[29] A REIT that has net capital gain can either distribute that gain as a "capital gain" dividend or retain that gain without distributing it but cause the shareholders to be treated as if they had received and reinvested a capital gain dividend. In either case, the gain in effect is taxed only as net capital gain of the shareholders. Sec. 857(b)(3).

[30] Secs. 856(c)(3) and 1221(a)(1). Income from sales that are not prohibited transactions solely by virtue of section 857(b)(6) also is qualified REIT income.

to most types of services provided to tenants (other than certain "customary services"), or to more than specified amounts of personal property, are not qualifying rents.[31] In addition, rents received from any entity in which the REIT owns more than 10 percent of the vote or value also generally are not qualifying income. However, there is an exception for certain rents received from taxable REIT subsidiaries (described further below), in which a REIT may own more than 10 percent of the vote or value.

In addition, 95 percent of the gross income of a REIT for each taxable year must be from the 75-percent income sources and a second permitted category of other, generally passive investments such as dividends, capital gains, and interest income (the "95-percent income test").[32]

Income from certain hedging transactions

Except as provided by Treasury regulations, income from a hedging transaction that is clearly identified,[33] including gain from the sale or disposition of such a transaction, is not included as gross income under the 95-percent income test, to the extent the transaction hedges any indebtedness incurred or to be incurred by the REIT to acquire or carry real estate assets.[34]

Foreign currency exchange gain

A REIT must be a U.S. domestic entity, but it is permitted to hold foreign real estate or other foreign-based assets, provided the 75-percent and 95-percent income tests and the other requirements for REIT qualification are met.[35] A REIT that holds foreign real estate or other foreign-based assets may have foreign currency exchange gain under the foreign currency transaction rules of the Code (described below). Foreign currency exchange gain is not explicitly included in the statutory definitions of qualifying income for purposes of the 75-percent and 95-percent income tests, though the IRS has issued guidance that allows foreign currency gain to be treated as qualified income in certain circumstances.

The foreign currency transaction rules of sections 985 through 989 apply whenever a taxpayer engages in a business or investment activity using a currency other than the taxpayer's functional currency (a "nonfunctional currency"). Section 985 provides in general that all determinations for Federal income tax purposes are made in the taxpayer's functional currency.

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[31] Sec. 856(d). Amounts attributable to the provision of certain services by an independent contractor or by a taxable REIT subsidiary can be qualified rents. Sec. 856(d)(7).

[32] Sec. 856(c)(3).

[33] A hedging transaction for this purpose is one defined in clause (ii) or (iii) of section 1221(b)(2)(A). The identification requirement is defined in section 1221(a)(7).

[34] Sec. 856(c)(5)(G).

[35] *See* Rev. Rul. 74-191, 1974-1 C.B. 170.

A taxpayer's functional currency is the dollar except in the case of a qualified business unit ("QBU"), in which case the functional currency is "the currency of the economic environment in which a significant part of such unit's activities are conducted and which is used by such unit in keeping its books and records."[36] A QBU is any separate and clearly identified unit of a trade or business of a taxpayer if the unit maintains separate books and records.[37]

A taxpayer that engages in a business or investment activity using a currency other than the U.S. dollar may have gain or loss under section 987 or 988, depending on the nature of the activity and type of entity (if any) through which the activity is conducted.

A U.S. taxpayer becomes subject to section 988 when it enters into a "section 988 transaction." Among other things, a "section 988 transaction" includes the acquisition of a debt instrument, becoming an obligor under a debt instrument, the accrual of items of expense or gross income, or the disposition of any nonfunctional currency.[38]

When a REIT holds a mortgage (or other instrument or arrangement described in section 988)[39] denominated in a nonfunctional currency or determined by reference to the value of a nonfunctional currency and the applicable foreign currency exchange rate changes between the time interest on an obligation to (or an obligation of) the REIT accrues and the time it is paid, the REIT may have foreign currency gain or loss under the rules of section 988. Foreign currency exchange gain under section 988 also can result when a REIT receives payment of principal on a debt instrument denominated in a nonfunctional currency or sells such a debt instrument, or when a REIT incurs a debt obligation denominated in a nonfunctional currency and pays interest or principal in that currency.

In May 2007, the IRS ruled in Rev. Rul. 2007-33 that if section 988 currency gain is recognized by a REIT with respect to an item of income, the section 988 gain will be qualifying income for purposes of the 95-percent and 75-percent income tests of section 856(c)(2) and (3),

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[36] Sec. 985(b)(1).

[37] Sec. 989(a).

[38] Sec. 988(c)(1)(B) and (C).

[39] Section 988 applies to (i) the acquisition of a debt instrument or becoming the obligor under a debt instrument; (ii) accruing (or otherwise taking into account) any item of expense or gross income or receipts which is to be paid after the date on which so accrued or taken into account, and (iii) entering into or acquiring any forward contract, futures contract, option, or similar financial instrument (except for any regulated futures contract or nonequity option which would be marked to market under section 1256 if held on the last day of the taxable year). Section 988 also applies to the disposition of any nonfunctional currency. Nonfunctional currency includes "coin or currency, and nonfunctional currency denominated demand or time deposits or similar instruments issued by a bank or other financial institution." Sec. 988(c)(1).

respectively, to the extent the underlying income so qualifies. Analogous relief was not provided for section 988 gain with respect to any items other than income items.[40]

Section 987 applies when there is a remittance from a foreign business or investment activity conducted through a QBU that is a branch that keeps its books and records in a functional currency other than the dollar. If a REIT has a QBU that keeps its books and records in a foreign currency, the REIT could have foreign currency exchange gain or loss under section 987 with respect to remittances.[41]

The IRS has ruled in several private rulings that a REIT may establish a REIT subsidiary that itself qualifies as a separate REIT (and thus would not be treated as a branch) to conduct qualified REIT activity with respect to foreign investments in a particular foreign currency, and that subsidiary can itself be treated as a QBU whose functional currency is that particular foreign currency, if that subsidiary keeps its books and records in that particular foreign currency.[42] This structure provides a method for a REIT to conduct activities abroad and minimize any concerns regarding the treatment of foreign currency gain for purposes of the 75-percent and 95-percent income tests. However, this structure effectively requires a separate REIT subsidiary that itself qualifies as a REIT, for each different currency in which the REIT may conduct activities.[43]

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[40] Rev. Rul. 2007-33, 2007-1 C.B. 1281. This ruling does not address the treatment of currency gain that might arise with respect to the payment of principal on an obligation that would produce qualified income. The ruling also does not address the treatment of foreign currency gain that might arise in connection with indebtedness denominated in a foreign currency that is incurred to acquire assets that produce qualifying income. A private letter ruling concluded that section 988 currency gain attributable to fluctuation in the exchange rates of currency used to make payments on non-dollar debt obligations incurred to acquire investments that produced qualifying non-dollar income would be treated as qualifying income, where the borrowings were to be used to finance the acquisition of the investments on a cost-effective basis, and not to speculate in foreign currency. PLR 200808024. A private letter ruling may be relied upon only by the taxpayer to which the ruling is issued.

[41] Recent proposed regulations under section 987 would replace previously proposed rules in an attempt to limit the ability of taxpayers to recognize non-economic foreign currency losses that could reduce otherwise taxable income, as well as to prevent non-economic currency gains that could arise. The 2006 proposed regulations would provide certain tracing-type rules. See REG-208270-86 (Sept. 7, 2006). See also, Notice 2000-20 (March 22, 2000), discussing concerns regarding earlier proposed regulations issued in 1991. The 2006 proposed regulations when originally issued did not by their terms apply to REITs, RICs, or certain other types of entities. Prop. Reg. Sec. 1.987-1(b)(iii). But see Notice 2007-42, 2007-1 C.B. 1288, *infra*.

[42] *See, e.g.,* PLR 200625019 and PLR 200550025. A private letter ruling may be relied upon only by the taxpayer to which the ruling was issued.

[43] In this structure, the parent REIT treats the dividends paid by the subsidiary REIT as a qualified REIT dividend, minimizing any currency gains by exchanging the foreign currency into dollars at the time of the dividend distribution.

At the same time that it issued Rev. Rul. 2007-33, the IRS also issued a notice regarding the application of section 987 to a QBU of a REIT. The notice states that until further guidance is issued, a REIT that has a QBU that uses a functional currency other than the U.S. dollar may apply the principles of proposed regulations issued on September 7, 2006, to determine whether section 987 currency gain is derived from income described in sections 856(c)(2) or (3).[44]

Certain other items

Certain private letter rulings issued to particular taxpayers have permitted various other types of income to be ignored for purposes of the 75-percent or 95-percent income tests, due to the relationship of the income to REIT qualifying assets or income. A few examples include a settlement payment received by a REIT with respect to construction of a mall or a payment received as a "breakup" fee in a proposed merger.[45]

Asset tests

At least 75 percent of the value of a REIT's assets must be real estate assets, cash and cash items (including receivables), and Government securities (the "75-percent asset test"). Real estate assets are real property (including interests in real property and mortgages on real property) and shares (or transferable certificates of beneficial interest) in other REITs.[46] No more than 25 percent of a REIT's assets may be securities other than such real estate assets.[47]

Except with respect to a taxable REIT subsidiary (described further below), not more than 5 percent of the value of a REIT's assets may be securities of any one issuer, and the REIT may not possess securities representing more than 10 percent of the outstanding value or voting power of any one issuer.[48] In addition, (except in the case of certain timber REITs for a limited time period), not more than 20 percent of the value of a REIT's assets may be securities of one or more taxable REIT subsidiaries.[49]

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[44] Notice 2007-42, 2007-1 C.B. 1288. Compare REG-208270-86 (Sept. 7, 2006), which by its terms did not apply to REITs.

[45] PLR 200039027 and PLR 200127024. A private letter ruling may relied upon only by the taxpayer to which the ruling was issued.

[46] Sec. 856(c)(4)(A). Temporary investments in certain stock or debt instruments also can qualify if they are temporary investments of new capital, but only for the one-year period beginning on the date the REIT receives such capital. Sec. 856(c)(5)(B).

[47] Sec. 856(c)(4)(B)(i).

[48] Sec. 856(c)(4)(B)(iii).

[49] Sec. 856(c)(4)(B)(ii). In the case of a "timber REIT" defined as a REIT more than 50 percent of the value of whose assets consists of real property held in connection with the trade or business or producing timber, up to 25 percent of the value of the REITs assets may be securities of one or more taxable REIT subsidiaries. This special rule is in place only for taxable years beginning after the date of

The asset tests must be met as of the close of each quarter of a REIT's taxable year. However, a REIT that has met the asset tests as of the close of any quarter does not lose its REIT status solely because of a discrepancy during a subsequent quarter between the value of the REIT's investments and such requirements, unless such discrepancy exists immediately after the acquisition of any security or other property and is wholly or partly the result of such acquisition.[50]

Taxable REIT subsidiaries

A REIT generally cannot own more than 10 percent of the vote or value of a single entity; however, there is an exception for ownership of a taxable REIT subsidiary ("TRS") that is taxed as a corporation, provided that securities of one or more TRSs do not represent more than 20 percent[51] of the value of REIT assets.

A TRS generally can engage in any kind of business activity except that it is not permitted directly or indirectly to operate either a lodging facility or a health care facility. However, a TRS is permitted to rent hotel, motel, or other transient lodging facilities from its parent REIT and is permitted to hire an independent contractor to operate such facilities.[52]

Furthermore, rent paid to the parent REIT by the TRS with respect to hotel, motel, or other transient lodging facilities operated by an independent contractor is qualified rent for purposes of the REIT's 75-percent and 95-percent income tests. This lodging facility rental rule is an exception to the general rule that rent paid to a REIT by any corporation (including a TRS) in which the REIT owns 10 percent or more of the vote or value is not qualified rental income for purposes of the 75-percent or 95-percent REIT income tests. An exception to the general rule exists in the case of a TRS that rents space in a building owned by its parent REIT if at least 90 percent of the space in the building is rented to unrelated parties and the rent paid by the TRS to the REIT is comparable to the rent paid by the unrelated parties.[53]

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enactment of the Food, Conservation, and Energy Act of 2008 (H.R. 2419, P.L. No. 110-234, enacted on May 22, 2008) and before the date that is one year after such date of enactment.

[50] Sec. 856(c)(4). In the case of such an acquisition, the REIT also has a grace period of 30 days after the close of the quarter to eliminate the discrepancy.

[51] 25 percent for certain timber REITs for a one-year period. See "Asset tests," *supra*.

[52] An independent contractor will not fail to be treated as such for this purpose because the TRS bears the expenses of operation of the facility under the contract, or because the TRS receives the revenues from the operation of the facility, net of expenses for such operation and fees payable to the operator pursuant to the contract, or both. Sec. 856(d)(9)(B).

[53] REITs are also subject to a tax equal to 100 percent of redetermined rents, redetermined deductions, and excess interest. These are defined generally as the amounts of specified REIT transactions with a TRS of the REIT, to the extent such amounts differ from an arm's length amount.

Prohibited transactions tax

REITs are subject to a prohibited transaction tax ("PTT") of 100 percent of the net income derived from prohibited transactions. For this purpose, a prohibited transaction is a sale or other disposition of property by the REIT that is "stock in trade of a taxpayer or other property which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held for sale to customers by the taxpayer in the ordinary course of his trade or business" (sec. 1221(a)(1))[54] and is not foreclosure property. The PTT for a REIT does not apply to a sale if the REIT satisfies certain safe harbor requirements in sections 857(b)(6)(C) or (D), including an asset holding period of at least four years (2 years in the case of certain sales of timber property for a limited time period).[55] If the conditions are met, a REIT may either i) make no more than 7 sales within a taxable year (other than sales of foreclosure property or involuntary conversions under section 1033), or ii) sell no more than 10 percent of the aggregate bases of all its assets as of the beginning of the taxable year (computed without regard to sales of foreclosure property or involuntary conversions under section 1033), without being subject to the PTT tax.

Explanation of Provision

Foreign currency gain

Exclusion of certain foreign currency gain for certain income tests

The provision excludes certain foreign currency gain recognized under section 987 or section 988 from the computation of qualifying income for purposes of the 75-percent income test or the 95-percent income test, respectively.[56] The exclusion is solely for purposes of the computations under these tests.

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[54] This definition is the same as the definition of certain property the sale or other disposition of which would produce ordinary income rather than capital gain under section 1221(a)(1).

[55] Additional requirements for the safe harbor limit the amount of expenditures the REIT can make during the four year period prior to the sale that are includible in the adjusted basis of the property, require marketing to be done by an independent contractor, and forbid a sales price that is based on the income or profits of any person. Under the Food, Conservation, and Energy Act of 2008 (H.R. 2419, P.L. No. 110-234, enacted on May 22, 2008), the four-year holding period is reduced to two years in the case of a sale of timber property under section 857(b)(1)(D), provided the sale is to a qualified organization (as defined in section 170(h)(3)), exclusively for conservation purposes (as defined in section 170(h)(1)(C). The rule is in place only for taxable years beginning after the date of enactment of that Act and before one year following such date of enactment. In addition, for the same one year period, any sale that is exempt from the prohibited transactions provision by virtue of section 857(b)(1)(D) is treated for all purposes of subtitle A of the Code as a sale of property held for investment or use in a trade or business, and not property described in section 1221(a)(1) of the Code.

[56] The excluded amounts are excluded from both the numerator and the denominator in the relevant computations.

The provision defines two new categories of income for purposes of the exclusion rules: "real estate foreign exchange gain" and "passive foreign exchange gain." Real estate foreign exchange gain is excluded from gross income for purposes of both the 75-percent and 95-percent income tests. Passive foreign exchange gain is excluded for purposes of the 95-percent income test but is included in gross income and treated as non-qualifying income to the extent that it is not real estate foreign exchange gain, for purposes of the 75-percent income test.

Real estate foreign exchange gain is foreign currency gain (as defined in section 988(b)(1)) which is attributable to (i) any item of income or gain described in section 856(c)(3) (i.e., described in the 75-percent income test), (ii) the acquisition or ownership of obligations secured by mortgages on real property or interests in real property; or (iii) becoming or being the obligor under obligations secured by mortgages on real property or on interests in real property. Real estate foreign exchange gain also includes section 987 gain attributable to a qualified business unit ("QBU") of the REIT if the QBU itself meets the 75-percent income test for the taxable year, and meets the 75-percent asset test at the close of each quarter of the REIT that has directly or indirectly held the QBU. The QBU is not required to meet the 95-percent income test in order for this 987 gain exclusion to apply. Real estate foreign exchange gain also includes any other foreign currency gain as determined by the Secretary of the Treasury.

Passive foreign exchange gain includes all real estate foreign exchange gain, and in addition includes foreign currency gain which is attributable to (i) any item of income or gain described in section 856(c)(2) (i.e., described in the 95-percent income test), (ii) the acquisition or ownership of obligations, (iii) becoming or being the obligor under obligations, and (iv) any other foreign currency gain as determined by the Secretary of the Treasury.

Notwithstanding the foregoing rules, except in the case of certain income that is excluded under the hedging rules of section 856(c)(5)(G) (as amended by the provision), any section 988 gain derived from engaging in dealing, or substantial and regular trading, in securities (as defined in section 475(c)(2)) shall constitute gross income that does not qualify under either the 75-percent or 95-percent income test.

The effect of these rules is to change the result of Rev. Rul. 2007-33 in the case of foreign currency gain attributable to an item of REIT income that qualifies under sections 856(c)(2) or 856(c)(3), respectively, because the provision excludes such gain (solely for purposes of the relevant income test) rather than treating such gain as qualified income for purposes of that test. The provision in addition excludes foreign currency gain attributable to principal payments received on certain REIT assets, or to principal or interest payments with respect to certain liabilities of a REIT, situations not addressed in the revenue ruling.

The rules of the provision also supersede Notice 2007-42 in the case of remittances from a QBU that uses a functional currency other than the dollar. The provision excludes section 987 gain on a remittance from such a QBU to the REIT from the computation of both the 75-percent and the 95-percent income tests of the REIT, provided the QBU itself both meets the 75-percent income test for the taxable year and meets the 75-percent asset test at the close of each quarter of the taxable year. If the QBU meets these requirements, the 987 gain is excluded entirely for purposes of the REIT gross income tests, and no tracing-type rules with respect to 987 gain are imposed, as would have been the case under Notice 2007-42. For this purpose, the QBU is

tested as if it were a separate entity that is independently required to meet the 75-percent income test and the 75-percent asset test applicable to REIT qualification. However, the QBU need not meet any of the other REIT requirements, nor itself be treated as a REIT. It is expected that the Treasury Department will use its regulatory authority[57] to provide appropriate rules with respect to the treatment of section 987 currency gain for purposes of the REIT gross income tests if a QBU does not meet the requirements of the provision.

In the case of a section 988 transaction, it is intended that the provision only apply to foreign currency gain that is directly attributable to income items that otherwise are treated as qualifying income for purposes of the 75-percent and 95-percent income tests, respectively, (or directly attributable to the acquisition or ownership of, or to becoming the obligor under, obligations secured by mortgages on real property or on interests on real property). As one example, foreign currency gain attributable to exchange rate fluctuations between the time of the accrual of interest income on a foreign-currency denominated obligation secured by a mortgage on real property and the time of payment, would constitute excluded income for purposes of both the 75-percent and 95-percent income tests. However, any additional foreign currency gain arising from subsequent disposition of the foreign currency received upon payment of the accrued interest would be attributable to holding the foreign currency after its receipt and would not constitute excluded income under either test; rather it would be non-qualifying income.

Similarly, in the case of section 987 foreign currency gain on remittances, only section 987 gain as of the time of, and resulting from, the remittance is attributable to the QBU and is excluded income. Any currency gain arising from holding currency after remittance is not attributable to the QBU. Such gain is not excluded income for purposes of the 75-percent or 95-percent income tests and is not qualifying income for purposes of those tests.

The following examples demonstrate the operation of the distinction between "real estate foreign exchange gain", which is excluded for purposes of both the 75-percent and 95-percent income tests, and "passive foreign exchange gain," which is excluded only for purposes of the 95-percent income test and which is non-qualifying income for purposes of the 75-percent income test.

Example 1.–Assume that a REIT whose functional currency is the dollar holds an obligation that is secured by a mortgage on real property, which instrument pays interest at a date later than the date the interest is accrued by the REIT. The obligation is denominated in a foreign currency. Under sections 856(c)(3) and 856(c)(2), the REIT's interest income accrued on such a mortgage obligation is qualified income for purposes of the 75-percent and 95-percent income tests. Under the provision, any section 988 gain attributable to currency fluctuations between the time the interest is accrued by the REIT and the time the interest is paid to the REIT is real estate foreign exchange gain because it is directly attributable to the qualified interest income, and thus the section 988 gain is excluded for purposes of the 75-percent and 95-percent income tests.

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[57] *See, e.g.* Sec. 989(c).

Example 2.–Assume the same facts as in Example 1, except that the instrument held by the REIT is a debt instrument that is not an obligation secured by a mortgage on real property or an interest in real property. Under sections 856(c)(3) and 856(c)(2), interest income accrued by the REIT is qualified income for purposes of the 95-percent income test but is not qualified income for purposes of the 75-percent income test. Under the provision, any section 988 gain attributable to currency fluctuations between the time the interest is accrued and the time the interest is paid is passive foreign exchange gain because it is directly attributable to the interest income that is qualified for purposes of the 95-percent income test. Such passive foreign exchange gain is excluded for purposes of the 95-percent income test but is not excluded (and is not qualified income) for purposes of the 75-percent income test.

Example 3.–Assume the same facts as in Example 1, and further assume that the REIT receives a repayment of the principal on the obligation. Under the provision, any section 988 gain attributable to the receipt of principal is real estate foreign exchange gain because it is attributable to the acquisition or ownership of an obligation secured by a mortgage on real property. Such section 988 gain is excluded for purposes of both the 75-percent and 95-percent income tests.

Example 4.–Assume the same facts as in Example 2, and further assume that the REIT receives a repayment of the principal on the obligation. Under the provision, any section 988 gain attributable to the receipt of principal is passive foreign exchange gain because it is attributable to the acquisition or ownership of an obligation not secured by a mortgage on real property or an interest in real property. Such section 988 gain is excluded for purposes of the 95-percent income test but is not excluded, and is not qualified income, for purposes of the 75-percent income test.

Other rules

The provision makes several changes to other REIT provisions.

First, the provision extends the present law rule of section 856(c)(5)(G), which excludes certain hedging income from the computation of the 95-percent income test, to exclude such hedging income from the computation of the 75-percent income test as well. As under present law, except to the extent determined by the Secretary of the Treasury, such income is income of a REIT from a hedging transaction (as defined in clause (ii) or (iii) of section 1221(b)(2)(A)), which is clearly identified pursuant to section 1221(a)(7), including gain from the sale or disposition of such a transaction, to the extent that the transaction hedges any indebtedness incurred or to be incurred by the REIT to acquire or carry real estate assets.

Second, the provision extends section 856(c)(5)(G) to encompass, (except to the extent determined by the Secretary of the Treasury), income of a REIT from a transaction entered into by the REIT primarily to manage risk of currency fluctuations with respect to any item of income or gain that would be qualified income under the 75-percent or 95-percent income tests, (or any property which generates such income or gain) provided the transaction is clearly identified as such before the close of the day on which it was acquired, originated, or entered into (or such other time as the Secretary may prescribe). Such income is excluded from gross income for purposes of both the 75-percent and 95-percent income tests.

Third, the rule that if a REIT has met the asset tests as of the close of any quarter it will not fail them solely because of a discrepancy due to variations in value that are not attributable to the acquisition of investments is clarified to include a discrepancy caused solely by the change in the foreign currency exchange rate used to value a foreign asset.[58]

Fourth, the term "cash" for purposes of the REIT asset qualification rules is defined to include foreign currency[59] if the REIT[60] or its QBU uses such currency as its functional currency, but only to the extent such foreign currency is held for use in the normal course of the activities of the REIT or the QBU giving rise to income or gain described in sections 856(c)(2) or (3), or directly related to acquiring or holding assets described in section 856(c)(4), and is not held in connection with a trade or business of trading or dealing in securities (as defined in section 475(c)(2).[61]

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[58] For example, suppose a REIT meets the 75-percent asset test as of the close of a quarter, but as of the close of the following quarter, a change in the foreign currency exchange rate has increased the value of certain foreign currency-denominated securities that are not qualifying assets for purposes of that test, such that the value of those securities exceeds the 25 percent permitted amount. If the REIT does not acquire any other asset during that next quarter, the REIT will not lose its status by reason of failure to meet the 75-percent asset test. However, if in that next quarter the REIT acquires another foreign-currency denominated (or any other) asset that is not a qualifying asset, and immediately after that acquisition the total value of non-qualifying assets, including the new acquisition, fails the test, then the REIT has until 30 days after the end of that quarter to adjust its asset value so that it satisfies the test.

[59] Although foreign currency thus may be considered a qualified asset for purposes of the 75-percent asset test of section 856(c)(4), foreign currency gain with respect to such currency is excluded income for purposes of the 75-percent or 95-percent income tests only to the extent such gain is attributable to the income items or other specific 988 transactions described in the rules of the provision that govern such income exclusions.

[60] Because a REIT must be a U.S. entity, it is normally required to use the dollar as its functional currency. However, under private rulings, the IRS has permitted REITs to use a functional currency other than the dollar where the operations and record-keeping requirements for treatment as a QBU that uses a functional currency other than the dollar are met. *See, e.g.,* PLR 200625019 and PLR 200550025. A private letter ruling may be relied upon only by the taxpayer to which the ruling was issued.

[61] This test applies to a REIT in determining whether it meets the 75-percent asset test. This test also independently applies to any QBU of a REIT in determining whether such QBU meets the 75-percent asset requirement. If that 75 percent asset requirement (along with the 75 percent income test) is met, then section 987 gain of the REIT attributable to that QBU is excluded from the REIT's gross income for the 75-percent and 95-percent income tests. In applying the 75-percent asset test to the REIT or a QBU, respectively, it is intended that currency held by such REIT or QBU, respectively, is treated as cash only to the extent used in the normal course of the activities of such REIT or QBU giving rise to income or gain described in sections 856(c)(2) or (3) or directly related to acquiring or holding assets described in section 856(c)(4) (other than such cash), and not held in connection with a trade or business of trading or dealing in securities (as defined in section 475(c)(2)).

Fifth, permitted foreclosure property income also includes foreign currency gain that is attributable to otherwise permitted income from foreclosure property.[62]

Finally, foreign currency gain under section 988(b)(1), or loss under section 988(b)(2), that is attributable to any prohibited transaction is taken into account in determining the amount of prohibited transaction net income subject to the 100-percent tax.

Treasury authority regarding other items of income

The provision authorizes the Treasury Department to issue guidance that would allow other items of income to be excluded for purposes of the computation of qualifying gross income under either the 75 percent or the 95 percent test, respectively, or to be included as qualifying income for either of such tests, respectively, in appropriate cases consistent with the purposes of the REIT provisions.[63]

Taxable REIT subsidiary limit increase

The provision increases the percentage of the value of REIT assets that can be held in securities of a taxable REIT subsidiary to 25 percent from the present 20 percent.[64]

Holding period under safe harbor for prohibited transactions

The provision shortens from four years to two years the minimum holding period under the prohibited transactions tax safe harbors of 857(b)(6)(C) and 857(b)(6)(D). The requirement that timber property under section 857(b)(6)(D) be sold to a qualified organization (as defined in section 170(h)(3)) exclusively for conservation purposes (as defined in section 170(h)(1)(C)) in order for the 2-year holding period to apply under the safe harbor, and the one-year limited application of the 2-year holding period rule under 857(b)(6)(D), are generally removed. The provision makes clear that the safe harbor is an exception from the prohibited transactions tax only, and does not cause a gain on a sale that otherwise does not qualify for capital gains treatment (i.e., because it was a sale of property held for sale to customers in the ordinary course of business under section 1221(a)(1)) to become a capital gain transaction.[65] Consequently, such

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[62] Such foreign currency gain is also included as foreclosure property income for purposes of any tax on such income under section 857(b)(4)(B)(i).

[63] Income that is statutorily excluded from gross income computations under the provision is not intended to be within the authority to include as qualifying income. In all cases, the Treasury regulatory authority applies solely for purposes of applying the relevant percentage tests for REIT qualification, and does not affect the substantive characterization of an item as income for purposes of computing the REIT's taxable income.

[64] The special 25 percent rule for timber REITs is made permanent under the provision, since timber REITs are treated in the same manner as other REITs for this purpose.

[65] In the case of a sale of timber property that qualifies for the safe harbor under section 857(b)(1)(D), for the one year period prescribed in the Food, Conservation and Energy Act of 2008, such a sale is considered to be a sale of property held for investment or use in a trade or business, and not of

capital gain treatment continues to be determined based on all the facts and circumstances as under present law, without regard to the prohibited transactions tax safe harbor. However, in the case of timber property under section 857(b)(6)(D), the provision retains for the one-year period prescribed in the Food, Energy and Conservation Act of 2008 the rule that qualification of the sale under the safe harbor also means that the sale is considered to be a sale of property held for investment or use in a trade or business, and not of property described in section 1221(a)(1), for all purposes of subtitle A of the Code, but only if the sale would have qualified under section 857(b)(6)(D) as in effect prior to the enactment of the provision.

Permitted extent of sales under safe harbor for prohibited transactions

The provision changes the prohibited transactions tax safe harbor provisions concerning maximum amount of sales within a taxable year that are consistent with the alternative prohibited transactions tax safe harbor (that is an alternative to the test for no more than 7 sales). Instead of the present alternative limit of 10-percent of the aggregate bases of all the assets of the REIT as of the beginning of the taxable year, the limit under the provision is either 10-percent of such aggregate basis or 10 percent of the aggregate fair market value of all the assets of the REIT as of such time.

Health care facilities held by a taxable REIT subsidiary

The provision expands the taxable REIT subsidiary exception for hotel, motel, and other transient facilities so that it also applies to health care facilities. Thus, a taxable REIT subsidiary is permitted to rent a health care facility from its parent REIT and hire an independent contractor to operate such a facility; the rents paid to the parent REIT are qualifying rental income for purposes of the 75-percent and 95-percent income tests.

Rules regarding operating a health care or lodging facility through an independent contractor

Under the provision, a taxable REIT subsidiary is not to be considered to be operating or managing a qualified health care property or a qualified lodging facility other than through an independent contractor solely because the taxable REIT subsidiary directly or indirectly possesses a license, permit, or similar instrument enabling it to do so.

Under the provision, a taxable REIT subsidiary is not to be considered to be operating or managing a qualified health care property or qualified lodging facility solely because it employs individuals working at such property or facility located outside the United States, but only if an eligible independent contractor is responsible for the daily supervision and direction of such individuals on behalf of the taxable REIT subsidiary pursuant to a management agreement or similar service contract.

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property described in section 1221(a)(1), for all purposes of subtitle A of the Code, for such one-year period.

Effective Date

The provision generally is effective for taxable years beginning after the date of enactment. However, the rules treating certain foreign currency gain as excluded income for purposes of the income tests apply to gain and items of income recognized after the date of enactment. The new rules of section 856(c)(5)(G), relating to hedging and managing risk, are effective for transactions entered into after such date of enactment. The Treasury authority to exclude items from income or to add items of qualifying income for purposes of the income qualification tests applies to gains and items of income recognized after the date of enactment. The foreign currency amendment relating to gain from foreclosure property applies to gain recognized after the date of enactment, and the provision relating to net prohibited transactions income applies to gain and deductions recognized after the date of enactment. The provisions relating to the prohibited transactions tax safe harbor apply to sales made after the date of enactment.