NATIONAL ASSOCIATION OF
REAL ESTATE INVESTMENT TRUSTS®

June 29, 2005

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Internal Revenue Service
1111 Constitution Avenue, N.W., Room 4312
Washington, D.C. 20224

Re: <u>Treatment of Foreign Exchange Gains for REITs</u>

Dear Bill:

We appreciate the opportunity to meet with you and others within the Service on June 1, 2005, to discuss regulatory guidance that would address some of the issues under the REIT gross income and asset tests that confront REITs that invest in real estate assets located outside of the United States.

As we discussed in the June 1 meeting, this submission highlights some of the macroeconomic and structural issues faced by REITs that invest overseas. First, this letter describes some typical REIT domestic investment structures. Second, the letter describes the foreign currency issues raised by the use of these structures overseas. Third, the letter explains that the structure used by a REIT in PLR 200519007 provides at best a temporary solution to the foreign currency issues experienced by REITs that invest in non-U.S. properties.

We recognize the significance of the Service's willingness to issue PLR 200519007, which allowed a U.S. REIT planning to issue securities to the public to form a subsidiary REIT in every overseas jurisdiction in which it planned to invest, each using the relevant foreign currency as its functional currency for purposes of the foreign currency gain and loss rules. We also appreciate the Service's consideration of issuing a revenue procedure creating a safe harbor for the REIT subsidiary structure. However, this potential "solution" would create a new set of REIT compliance difficulties, which would be particularly onerous for a publicly traded company endeavoring to ensure it has satisfied the requirements of the Sarbanes-Oxley Act.

We continue to believe that the most appropriate course of action would be the Service's issuance of one or more revenue procedures that would not penalize a REIT from owning and operating overseas property via a branch.

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Need For Guidance

As we have noted in prior submissions, it is important to frame the issue. U.S. REITs that desire to compete effectively for capital with other U.S. and non-U.S. real estate companies must be positioned to pursue real estate opportunities both inside and outside of the U.S. For example, a number of U.S. REITs have developed successful "brand name" products that are recognizable both by potential tenants and customers, whether through a certain style of factory outlet stores, shopping malls, services to tenants, etc. that they view as a successful business model for properties outside of the U.S. Other REITs may have developed long-term relationships with multinational tenants that would like to expand their businesses outside of the U.S. to other properties owned and operated in a similar manner by the same REITs. The current ambiguities in application of the foreign currency rules in the REIT context limit the ability of these REITs from fully capitalizing on these opportunities.

Under Rev. Rul. 74-191, U.S. REITs are entitled to invest in foreign real estate to the same extent as U.S. real estate. If and to the extent that a U.S. REIT invests outside of the U.S., the REIT inevitably will experience gains and losses with respect to its investment activities that are attributable to fluctuations in the value of the currencies of the countries in which it invests relative to the U.S. dollar. Absent clarification of the tax treatment of foreign currency gains and losses for purposes of the REIT gross income tests,[1] U.S. REITs are constrained from fully pursuing opportunistic investments in foreign countries. As further described below, while there are some potential structures that may allow a U.S. REIT to invest in non-U.S. properties, these structures are at best a short-term solution and raise many potential difficulties.

## I. REIT Investment Structures

Set forth below is a discussion of some the potential investment structures used by REITs both in the domestic and foreign context as well as the potential difficulties raised by some of the potential overseas structures.

### A. Domestic Investment

As you know, between one-half and two-thirds of all publicly traded REITs operate through what is known as an "umbrella partnership REIT" or "UPREIT" format, meaning that these REITs own a large interest in an operating partnership, and the operating partnership owns all of the REIT's investments.[2] Regardless of whether a REIT is in the UPREIT format, most REITs acquire their domestic investments through direct or indirect ownership in pass-through entities such as partnerships or limited liability companies. REITs that are not in the UPREIT format also may acquire properties through qualified REIT subsidiaries (which must be 100% owned by the REIT), which also are disregarded entities for federal (and most state) tax purposes. The specific

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[1] As we noted in the meeting, we do not dispute that foreign currency gains and losses are taken into account for purposes of determining REIT taxable income under § 857. Rather, we are requesting guidance regarding the treatment of foreign currency gains and losses for purposes of the REIT gross income tests in §§ 856(c)(2) and (3).
[2] *See*, *e.g.*, PLRs 200518063 and 200403023 for examples of recent private rulings involving REITs structures in the UPREIT format. *Cf.* Treas. Reg. § 1.701-2(d), Example 4 (illustrating the UPREIT structure generally is not considered "abusive" for purposes of the partnership anti-abuse rules).

structure of a particular investment may vary depending upon a particular state's property and/or tax law. For example, Texas taxes limited liability companies as corporations; thus, investment through a partnership is more typical in Texas.

There are three main reasons for using a pass-through entity investment structure. First, using a special purpose entity limits the REIT's potential tort and other liability with respect to the investment. Second, the income and assets of the pass-through entity flow through to the REIT,[3] enabling the REIT to meet the gross income and asset tests. Third, the REIT asset tests limit the percentage of a corporate subsidiary's securities that a REIT may own to a fairly small amount. In addition, investment in real estate through a taxable corporate subsidiary contravenes Congressional intent that a REIT should own and operate real estate in a single tax regime.

### B. Foreign Investment

For the reasons described above, REITs want to invest in foreign properties in much the same way as they invest in domestic properties: through the direct or indirect ownership of flow-through entities. Most likely the REIT would use a foreign-qualified entity as the actual property owner because the local governments and citizens (as well as possible joint venture partners) are most familiar with a local entity. In some countries, investments can be made only through a locally-based entity because of legal restrictions.

However, as you know, and as we have described in prior submissions, direct or indirect ownership of foreign property through flow-through entities raises a number of potential uncertainties with respect to the realization of foreign currency gains and losses. Specifically, there is the potential for gains under section 987 for income when it is repatriated to the United States.[4] Furthermore, there is the potential for gains under section 988 with respect to foreign currency gains attributable to section 988 transactions.[5] Because there is uncertainty as to whether section 987 and 988 gains can constitute qualifying REIT income under § 856(c)(2) and (c)(3), REITs are unlikely to invest through this type of structure because of the possibility that section 987 or 988 gains could cause them to fail to meet the REIT gross income tests.

We discussed in the June 1 meeting two potential alternatives: investment through subsidiary REITs as described in PLR 200519007 and investment through a TRS. As we noted, while these structures may address the issue of section 987 and 988 gains, both raise serious difficulties and negative consequences.

[3] Treas. Reg. § 1.856-3(g).
[4] The potential for § 987 gains exists if the REIT invests directly, through a disregarded entity such as a qualified REIT subsidiary or single-member limited liability company, or through flow-through entities.
[5] Section 988 transactions include: 1) the acquisition of or becoming the obligor under a debt instrument (*e.g.*, a loan by a U.S-based REIT denominated in Euros); 2) the accrual of an item of expense or gross income which is to be paid or received after the date on which so accrued (*e.g.*., the accrual of a payment in Euros by a U.S.-based REIT to a service provider); and 3) any forward contract, futures contract, option, or similar financial instrument.

**1. Foreign Investment Through Subsidiary REITs**

By holding foreign property through a subsidiary REIT, the parent REIT should not recognize section 987 gains when the subsidiary REIT repatriates funds. However, unless the subsidiary obtains a private letter ruling that permits it to use the relevant foreign currency as its "functional currency", the subsidiary REIT will face its own section 987 gains when it returns funds to the United States. Additionally, absent such a ruling, the subsidiary REIT could face potential section 988 gains on every section 988 transaction because such transactions would be denominated in the relevant foreign currency, rather than in the U.S. dollar. If the subsidiary REIT obtains a ruling allowing it to use the foreign currency as its "functional currency," it can avoid both section 987 and 988 gains. As described below, however, the use of a subsidiary REIT is at best a temporary solution.

The use of a separate subsidiary REIT for the currency of every jurisdiction in which a REIT plans to operate creates serious compliance issues for any publicly traded REIT. Public REITs already expend considerable resources in order to ensure that they remain in compliance with the REIT requirements. If these companies were to form a subsidiary REIT for each foreign jurisdiction in which they planned to operate, the extent of the efforts and cost of these resources could be magnified tremendously by the need to locate 100 shareholders for each REIT, meet the income and asset tests for each subsidiary REIT, and to satisfy the whole host of other REIT requirements for each REIT. A multi-subsidiary REIT structure would greatly increase a publicly traded company's significant compliance burdens under the Sarbanes-Oxley Act and the potential risk of large penalties and adverse shareholder reaction in the event of any mistake.

Furthermore, any failure to satisfy any of the REIT rules at any subsidiary REIT level potentially could cause the parent REIT to lose REIT status because the REIT would own more than 10% of a corporation other than a REIT or TRS; this failure could result in a corporate-level tax and loss of REIT status for five years, a devastating result. The trading price of many publicly traded REITs is based on a multiple of earnings, and when earnings decrease (as the result of additional tax liability), stock price can fall dramatically.

An additional negative consequence that could result from the requirement to use subsidiary REITs would be confusion in the market and analyst community which accompanies overly complex corporate structures. Introducing, for example, twenty-three subsidiary REITs as in PLR 200519007 not only greatly magnifies the tax and Sarbanes-Oxley compliance burden, but it also makes for a more difficult explanation to lenders, underwriters and market analysts who need to understand the overall structure. The advent of the taxable REIT subsidiary in 2001 helped simplify these discussions. Numerous subsidiary REITs would likely do the reverse.

**2. Foreign Investment Through TRSs**

Another solution suggested at the meeting was the use of a taxable REIT subsidiary to hold foreign real estate. This solution also would not be appropriate. The Congressional intent behind the creation of REITs was to allow investors from all walks of life to pool income through an entity that would own professionally-managed income-producing real estate and taxed only at the shareholder level if the REIT requirements were met. The Congressional intent behind the creation of TRSs was to allow REITs, the real estate owning entities, to be able to provide noncustomary services to tenants and third parties, provided a corporate-level tax was paid, and safeguards were met to ensure income and/or deductions were not inappropriately shifted. While a TRS is not prohibited from owning real estate, it is not the appropriate use of a TRS.

Furthermore, the value of all TRS securities may only constitute 20% of a REIT's total assets. Thus, REITs that invested overseas through TRSs would be limited significantly in the value of assets that they could own.

Finally, investment through a TRS would require the REIT and TRSs to demonstrate, either through expensive arm's length pricing studies or otherwise that they are dealing with one another on an arm's length basis. Failure to do so could result in imposition of a 100% excise tax, also an inappropriate result when the TRS is doing nothing other than those activities clearly permitted – and intended – for the REIT.

## II. Potential Solutions

We have previously discussed with you two different suggested solutions for REITs that invest in non-U.S. real estate. Both potential solutions would permit REITs to acquire foreign properties either directly or indirectly through some form of pass-through (or disregarded) entity. Thus, the REIT would not be required to form subsidiary REITs (or to use TRSs) to invest in non-U.S. property.[6]

One option would be to ignore foreign currency gains and losses to the extent that certain criteria were met to ensure that the foreign currency gains and losses were derived from appropriate REIT activities. Another option would be to treat foreign currency gains and losses as qualifying income to the extent that certain criteria were met to ensure that the foreign currency gains and losses were derived from appropriate REIT activities. Although we initially believed that the IRS would prefer to ignore foreign currency gains and losses for purposes of the REIT gross income tests,[7] we understand following a series of meetings with IRS and Treasury officials that the preferred solution may be to treat certain foreign currency gains and losses as qualifying income for purposes of the REIT gross income tests.

Accordingly, we continue to suggest that the IRS consider a revenue procedure that would provide the following with respect to the REIT gross income tests[8]:

1. Section 987 gains would be treated as qualifying income under Sections 856(c)(2)(H) and (3)(H) provided the "qualified business unit" ("QBU") meets the asset tests set forth in

[6] As an aside, we note that by investing in non-U.S. properties through pass-through entities as opposed to through TRSs, the REIT would have to recognize income when earned, rather than when repatriated, thus resulting in greater revenue flows for the U.S. government.
[7] Again, the foreign currency gains and losses would be ignored only for purposes of the REIT gross income tests under § 856(c); they would be taken into account for determining REIT taxable income under § 857.
[8] As you may recall, on May 12, 2004, we also have previously submitted a draft revenue procedure to the IRS concerning foreign currency issues in the context of the REIT asset tests.

Section 856(c)(4)(A) of the Code (that is, if at least 75% of the total assets of the QBU consist of real estate assets, cash, cash items and Government securities);

2. Section 988 gains attributable to the acquisition of a debt instrument would be qualifying income under Section 856(c)(2)(D) if it is not secured by real property and would be qualifying income under Sections 856(c)(2)(D) and (3)(C) if it is secured by real property; and
3. Section 988 gains attributable to a REIT becoming an obligor under a debt instrument would be treated as qualifying income under § 856(c)(2)(H) and (c)(3)(H), provided that the indebtedness was incurred by the REIT to acquire or carry real estate assets.

Again, if it would be preferable to disregard for purposes of the REIT gross income tests under § 856(c)(2) and (c)(3) the foreign currency gains described above, we would be supportive of such a solution. Issuing a revenue procedure along the lines of either of these two alternatives would provide much needed certainty in this area.

As we have mentioned in prior submissions, we believe that the Service has the authority to interpret statutory provisions like §§ 987 and 988 as they relate to §§ 856(c)(2) and (c)(3). For example, the regulations under § 988 currently provide a favorable tracing concept for determining the nature of income from a § 988 transaction.[9] Further, Congress provided authority to the Secretary under § 987(3) to provide guidance as to the source of income under § 987.[10] Additionally, the IRS clearly has authority to issue guidance in this area under § 856 even without express statutory discretion.[11]

We further believe that the IRS has the authority to propose "bright line" safe harbors for administrative convenience and simplicity even though the statute does not contain safe harbors.

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[9] Treas. Reg. § 1.988-2(a)(ii)(B) provides that the exchange of nonfunctional currency for property shall be treated as: 1) an exchange of the units of the 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 for such units of functional currency. Accordingly, gains recognized under § 988(c)(1) attributable to the sale of property are sourced in accordance with the nature of the property.

[10] Section 987(3) provides that the IRS may prescribe proper adjustments for transfers of property between qualified business units of the taxpayer having different functional currencies, including, among other things, sourcing § 987 gain or loss by reference to the source of income "giving rise to post-1986 accumulated earnings and profits."

[11] *See, e.g.*, Preamble to Prop. Reg. § 1.7704-3(a)(1), 62. Fed. Reg. 66575 (explaining that the IRS expanded the types of income that constituted "qualifying income" for purposes of the publicly traded partnership rules in proposed – and ultimately final – regulations beyond the statutory list because of the "several new types of financial instruments [that] have been developed [since section 7704 was enacted] that generate passive-type investment income similar to interest and dividends…") and the Preamble to Prop. Reg. § 1.1362-2(c)(5) explaining the reason that the IRS expanded the types of income that constituted "passive investment income" for purposes of the S corporation rules beyond those listed in the statute was in order to be consistent with Congressional intent for purposes of the proposed – then final – regulations. 53 Fed. Reg. 52190 (Dec. 27, 1988). Both cases illustrate circumstances in which the IRS prudently sought to include specific types of income not expressly stated in the relevant statutory provisions as qualifying income in order to be consistent with legislative intent and the development of new financial instruments. The IRS also has evidenced this type of prudent evaluation of certain income types not specifically listed as qualifying income under § 856(c)(2) and (c)(3) in private letter rulings issued to REITs. *See*, *e.g.*, Private Letter Ruling 9308013 (Nov. 24, 1992) (litigation recovery and attorneys fees constituted rental income) and Private Letter Ruling 200127024 (April 4, 2001) (receipt of "break-up fee" in connection with the termination of a proposed merger should be disregarded for purposes of the REIT gross income tests).

*See, e..g.*, Treas. Reg. § 301.7701-13A(c)(2) (treating an association's business as consisting "principally of acquiring the savings of the public" pursuant to the requirement of § 7701(a)(19)(B) if, among other things, "more than 75% of the dollar amount of the total deposits, withdrawable shares, and other obligations of the association are held during the taxable year by the general public," a requirement not stated in the statute); Rev. Proc. 2003-65, 2003-2 C.B. 336 (safe harbor under which loan from REIT secured by a partnership or disregarded entity interest will constitute a qualifying REIT asset that generates qualifying income if, among other things, the value of the real property held by the partnership or disregarded entity on each "testing date" is at least 85% of the value of all of the assets of the partnership or disregarded entity); Rev. Proc. 2000-37, 2000-2 C.B. 308 (safe harbor for "reverse § 1031 exchanges"); Rev. Proc. 96-32 , 1996-1 C.B. 717 (safe harbor under which organizations that provide low-income housing will be considered charitable as described in section 501(c)(3) based on specific percentages of housing units' being occupied by residents that are "low income" and various other specific requirements); Rev. Proc. 93-27, 1993-2 C.B. 343 ( treating receipt of a compensatory partnership profits interest as a non-taxable event unless certain specified criteria are met), clarified by Rev. Proc. 2001-43, 2001-34 I.R.B. 19, proposed to be obsoleted by Notice 2005-43, 2005 I.R.B. 24 (proposing regulations that would treat the transferee of a compensatory partnership interest as realizing income generally equal to the fair market value of the transferred interest and proposing a safe harbor for determining that value); Rev. Proc. 92-64, 1992-2 C.B. 422 (safe harbor for adoption of "rabbi trusts" in connection with unfunded deferred compensation arrangements); Rev. Proc. 88-53, 1988-2 C.B. 712 (safe harbor for trust to meet definition of "pooled income fund" for purposes of § 642(c)); *See also* Rev. Proc. 2002-22, 2002-14 I.R.B. 733 (conditions under which the Internal Revenue Service will consider a request for a ruling that an undivided fractional interest in rental real property is not an interest in a business entity, within the meaning of § 301.7701-2(a) if, among other things, number of co-owners must be limited to no more than 35 persons and no loans may be made to co-owners other than recourse loans with terms not to exceed 31 days) and Rev. Proc. 89-12, 1989-1 C.B. 798 (prior to the "check-the box" regulations, requiring the interests of all the general partners, taken together, in each material item of partnership income, gain, loss, deduction, or credit be equal to at least 1% of each such item at all times during the existence of the partnership for purposes of obtaining a private ruling that an entity should be characterized as a partnership).[12]

We would appreciate the opportunity to meet further with appropriate personnel within the Service and Treasury in an effort to fashion guidance relating to exchange gains and losses that would meet both the needs of the industry and the needs of the Government.

As always, we welcome your willingness to work with NAREIT in developing constructive solutions to interpreting and applying the very complex statutory regime applicable to REITs. In addition, we continue to appreciate the decision of the Treasury Department and the Service to include these issues in its 2004-2005 Business Plan, and we hope that Treasury Department and the Service will include these issues in the 2005-2006 Business Plan.

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[12] In the case of § 988 gains specifically, in accordance the grant of regulatory authority under § 988(a)(2), Treas. Reg. § 1.988-3(c)(1) states that the IRS may treat gains or losses realized on a § 988 transaction as interest income or expense through "administrative pronouncements."

Please call me at (202) 739-9408 at your convenience to discuss the appropriate next steps in this process.

Respectfully submitted,

Tony M Edwards

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