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NATIONAL ASSOCIATION OF
REAL ESTATE INVESTMENT TRUSTS®

July 15, 2003

VIA FEDERAL EXPRESS AND E-MAIL

Internal Revenue Service
Courier's Desk
Internal Revenue Service
Attn: CC: PA: RU (Notice 2003-26)
1111 Constitution Avenue, NW
Washington DC 20224
Email: Notice.Comments@irscounsel.treas.gov

Re: 2003-04 Business Plan

Dear Sir or Madam:

The National Association of Real Estate Investment Trusts® ("NAREIT") appreciates the opportunity to offer our suggestions regarding regulatory guidance not on the 2002-03 Business Plan that would carry out Congressional intent while saving both taxpayers and the Administration time and resources in complying with the REIT tax tests. On May 14, 2003, we submitted comments in a letter in which we indicated that we would be submitting a follow-up memorandum concerning the tax treatment of transactions involving foreign currency. We have attached that memorandum to this letter.

Once again, thank you for considering NAREIT's comments about these important issues. Please contact me or Dara Bernstein, NAREIT's REIT Counsel, if you have any questions.

Respectfully submitted,

Tony M. Edwards
Senior Vice President & General Counsel

Enclosure

SSS
1875 Eye Street, NW, Suite 600, Washington, DC 20006-5413
Phone 202-739-9400 Fax 202-739-9401 www.nareit.com

cc: Pamela F. Olson, Esq.
Eric Solomon, Esq.
Helen M. Hubbard, Esq.
Deborah Harrington, Esq.
Lon B. Smith, Esq.
Richard L. Carlisle, Esq.
Alice M. Bennett, Esq.
William E. Coppersmith, Esq.
Elizabeth A. Handler, Esq.
Hall Hicks, Esq.
Kenneth Christman, Esq.
Sharon Galm, Esq.
Jonathan D. Silver, Esq.
P. Anthony Brown

MEMORANDUM ON REIT FOREIGN CURRENCY TRANSACTIONS

This memorandum addresses the treatment of foreign currency gains and foreign investments under section 856.[1] Specifically, this memorandum requests that the Treasury Department include in its 2003-04 Business Plan guidance that certain foreign currency gains and foreign investments not adversely affect a company's compliance with the real estate investment trust ("REIT") asset and income tests.

Executive Summary

REITs have begun to make substantial investments in foreign real estate and, as our economy continues to globalize, REITs are increasingly undertaking transactions with foreign entities using a foreign currency. Uncertainties have arisen in connection with the proper treatment under the REIT rules of foreign currency gains and losses under sections 987 through 989 and of the valuation of foreign assets. Both the government and the REIT industry would benefit by clear regulatory guidance concerning transactions involving foreign currency.

Although there are related issues, the primary issue faced by REITs that invest in non-U.S. real property and mortgages is whether foreign currency gains attributable solely to an exchange rate change should be treated as qualifying income under the REIT gross income tests. Examples include: (1) foreign currency gains attributable to a REIT directly or indirectly collecting rents from property located in the European Union ("EU")[2] that are paid in Euros and then converted into U.S. dollars at a different exchange rate when the funds are repatriated to the U.S.; (2) foreign currency gains from the sale in the EU of property solely attributable to changes in the exchange rate of Euros during the time that the REIT held the property; and (3) foreign currency gains attributable to the repayment of a Euro-denominated loan. Ambiguities also arise in connection with the REIT asset tests if a REIT's foreign real estate "increases" in value solely due to a movement in exchange rates. Finally, REITs that keep foreign currency in connection with their real estate business face uncertainty in determining whether it constitutes a qualifying asset for purposes of the REIT asset tests.

To address these ambiguities, we request that the Treasury consider issuing the following regulatory guidance, the details of which are described within this memorandum:

1. **Foreign Currency Gains Attributable to a REIT's Direct or Indirect Earning of Qualifying Income Through a Pass-Through Entity**. Foreign currency gains such as those earned directly or indirectly by the REIT in Examples 1 and 2 above would be disregarded for purposes of the REIT gross income tests of Sections 856(c)(2) and (c)(3) for any taxable period if at least 75% of the value of the total assets held by the REIT's "qualified business unit" ("QBU") were represented by assets described in section 856(c)(4) at the close of each quarter throughout the QBU's entire existence. As described further below, this type of foreign currency gain is called "Section 987 Gain."

[1] For purposes of this memorandum, "section" refers to a section of the Internal Revenue Code of 1986, as amended (the "Code").

[2] Location in the EU is for illustration only; the property could be located in any non-U.S. jurisdiction.

2. **Foreign Currency Gains Attributable to Certain Lending Transactions.** Foreign currency gain such as that faced by a REIT from a loan denominated in foreign currency would be treated as qualifying income described under sections 856(c)(2)(D) and 856(c)(3)(C) if the debt instrument were secured by a mortgage on real property or on interests in real property and only is qualifying income under section 856(c)(2)(D) if the debt instrument were not secured by a mortgage on real property or on interests in real property. As described further below, this type of foreign currency gain is called gain attributable to "Section 988 Lending Transactions."
3. **Change In Asset Value Due to Currency Fluctuation**. A mere change in the foreign currency exchange rate used to value a REIT's foreign assets would be considered a change in the value of the assets and thus, in and of itself, could not cause a failure of the REIT asset test in section 856(c)(4).
4. **Foreign Currency Under the Asset Tests.** Foreign currency would be considered a cash and cash item for purposes of section 856(c)(4)(A) for any entity to the extent such entity conducted a significant part of its activities in this currency and kept its books and records in such currency. In technical terms, the foreign currency must be considered the "functional currency" of such entity under section 985(b). As a result, a REIT that engaged in business in Euros would not fail to satisfy the asset test of section 856(c)(4) merely by keeping a bank account denominated in Euros.

I. ANALYSIS

A. Background

A REIT is an entity taxed as a domestic corporation that makes investments in real estate or mortgages secured by real estate. Congress enacted the REIT provisions of the Code in 1960 in order to make the advantages of investing in large-scale, income-producing real estate and mortgages accessible to smaller investors: greater diversification through investing in a portfolio of properties rather than a single building and management by experienced real estate professionals.[3] Congress decided that a way for average investors to invest in these properties was the same way they invest in other industries, through the purchase of equity.

In order to ensure that a REIT's business be primarily real estate-focused, Congress imposed a number of requirements on REITs, such as the requirement that at least 75% of their annual gross income be from real estate sources like rents and interest on mortgages secured by real property, and the requirement that at least 75% of their assets, measured quarterly, be from real estate sources like real property or interest on obligations secured by mortgages on real property. REITs that satisfy these and other complex requirements, including a requirement that they distribute most of their taxable income, are entitled to a dividends paid deduction, which can eliminate completely their taxable income.

REITs have begun to undertake more and more transactions that involve the use of foreign currency. The Internal Revenue Service ("IRS") has long approved foreign investment by

[3] See H.R. Rep. No. 2020, 86th Cong., 2d Sess. 4, 6 (1960).

REITs. See Rev. Rul. 74-191, 1974-1 C.B. 170.[4] An investment in foreign real estate or foreign mortgages is consistent with the Congressional mandate that a REIT's gross income should largely be composed of real estate-related items and, to a lesser amount, passive income.[5]

As noted above, to maintain REIT status, a company must meet many statutory tests. One category of these statutory tests is the gross income tests (the "Gross Income Tests"). Under section 856(c)(2), at least 95% of a REIT's gross income must be derived from rents from real property, gains from the disposition of property and mortgages on real property, interest, dividends, and other sources deemed passive (the "95% Gross Income Test").

In addition, under section 856(c)(3), at least 75% of a REIT's gross income must be derived from a variety of real estate-related income sources such as rents from real property; interest on obligations secured by mortgages on real property or on interests in real property; and gain from the sale or other disposition of real property (including interests in real property and interests in mortgages on real property) (the "Real Estate Income Test").

Another category of these statutory tests applicable to REITs is the asset tests described in section 856(c)(4) (the "Asset Tests"). Most notably for this memorandum, at the close of each calendar quarter, at least 75% of the value of a REIT's assets must be represented by real estate assets, cash and cash items (including receivables), and Government securities (the "Real Estate Assets").

For purposes of these Asset Tests, section 856(c)(4) also provides that a REIT that meets these Assets Tests at the close of any quarter shall not lose its status as a REIT because of a discrepancy during a subsequent quarter between the value of its various 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 (the "Revaluation Rule"). The Asset Tests do not expressly address how assets are to be valued when assets are denominated in a foreign currency. Nor do they address specifically whether foreign currency is cash or a cash item.

Failure to satisfy the Gross Income and Asset Tests can lead to disqualification from REIT status. As a result, even minor uncertainties concerning the classification of income or assets for purposes of these tests are greatly magnified due to the potentially draconian consequences. Because there are some uncertainties involving the treatment of transactions giving rise to foreign currency gains and losses, there is concern about how REITs that engage in these types of legitimate transactions can be comfortable that they are complying with the Gross Income and Asset Tests.

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[4] "Neither section 856 of the Code nor the regulations thereunder restrict the term "real estate assets" to those located within the United States… [F]or purposes of section 856(c), the term "real property" includes land or improvements thereon located outside the United States and the term "mortgages on real property" includes a security interest which, under the laws of the jurisdiction in which the property is located, is the legal equivalent of a mortgage or deed of trust in the United States."

[5] See H.R. Rep. No. 2020, 86th Cong., 2d Sess. 4, 6 (1960).

B. Foreign Currency Transactions

Foreign currency gains and losses are determined under subpart J of part III of subchapter N of the Code. Section 985(a) provides in general that all determinations for federal income tax purposes shall be made in the taxpayer's functional currency. Section 985(b)(1)(B) defines functional currency as the dollar except in the case of a 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." Section 989(a) defines QBU as any separate and clearly identified unit of a trade or business of a taxpayer that maintains separate books and records. Treas. Reg. § 1.985-1(b)(1)(iii) states that except as otherwise provided by ruling or administrative pronouncement, the dollar shall be the functional currency of a QBU that has the United States as its residence as defined in section 988(a)(3)(B).

Section 988(a)(3)(B)(i)(II) states that the residence of a corporation or partnership which is a United States person as defined in section 7701(a)(30), *i.e.*, generally, a corporation or partnership created or organized in the United States, or under the laws of the United States, shall be the United States. Section 988(a)(3)(B)(i)(III) states that generally the residence of a corporation or partnership that is not a United States person shall be a country other than the United States. Section 988(a)(3)(B)(ii) states an exception to the above rule, that in the case of a QBU of any taxpayer, the residence of such unit shall be the country in which the principal place of business of the QBU is located.

A U.S. taxpayer recognizes an exchange gain or loss under section 987 ("Section 987 Gain or Loss") when it invests in foreign property through a QBU that is considered a branch for federal tax purposes. For this purpose, an entity treated as a disregarded entity or partnership for federal tax purposes would be considered a branch. A Section 987 Gain occurs when the QBU remits funds to the U.S. taxpayer. Generally, the measure of the Section 987 Gain (or Loss) is the difference between the current dollar value of the remitted funds and the dollar value of the remitted funds at the time such funds were contributed to, or earned by, the QBU. In other words, the U.S. taxpayer realizes a Section 987 Gain when exchange rates on the date of remittance differ from the exchange rate applicable when funds were contributed to the QBU or the U.S. taxpayer accounts for its share of the QBU's income.

While Section 987 Gains are derived from the remittance of proceeds resulting from foreign currency investments and earnings on such properties, section 988 requires that foreign exchange gains be realized in connection with certain specified transactions. The transactions covered by section 988 include: (1) the acquisition of or becoming the obligor under a debt instrument (a "Section 988 Lending Transaction") (*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 ("Non-Functional Currency Accrued Transactions") (*e.g*., the accrual of a payment in Euros by a U.S.-based REIT to a service provider); (3) any forward contract, futures contract, option, or similar financial instrument and (4) certain dispositions of non-functional currency (*e.g.*, the sale of foreign currency that has been held as an investment rather than for working capital needs).

C. Application of Foreign Currency Transaction Rules to the REIT Rules

Although sections 985 through 989 do address certain aspects of foreign currency transactions, they do not describe how foreign currency gains and losses should be treated for REIT tax purposes. Similarly, section 856(c) does not address the tax treatment for REIT purposes of foreign currency gains and losses resulting from the repatriation of non-dollar denominated rental income, gains from foreign property holdings, or payments with respect to non-dollar denominated loans. Ambiguities exist under the current REIT rules concerning how a variety of transactions involving foreign currency gains and losses should be treated, including Section 987 Gains resulting from a QBU branch's distribution of operating or capital proceeds of a foreign investment to a REIT, a REIT's lending to related or unrelated persons (Section 988 Lending Transactions); the accrual of expenses or gross income in a foreign currency that is to be paid or received after the date of accrual (Non-Functional Accrued Transactions); and the treatment of certain derivative instruments denominated in a foreign currency. NAREIT requests guidance only with respect to the areas of greatest concern: Section 987 Gains, Section 988 Lending Transactions, and asset valuation issues under the REIT Asset Tests.

To illustrate several of the significant events that can create gains under sections 987 and 988 for a REIT, the following examples are provided. Assume the following facts: (1) a REIT forms a foreign entity ("Newco") in Europe and Newco makes an election under Treas. Reg. § 301.7701-3 to be treated as a disregarded entity; (2) Newco is treated as a QBU using the Euro as its functional currency under section 985; (3) the REIT purchases 10,000,000 Euros at an exchange rate of $1 per Euro[6] and immediately contributes the Euros to the capital of Newco; (4) Newco purchases land located in Europe for 10,000,000 Euros; and (5) Newco leases the land for ten years, and the land rent exactly offsets the operating expenses with respect to the land. Ten years after the purchase of the land, Newco sells the land for 10,000,000 Euros and distributes the proceeds of the sale to the REIT at a time when the exchange rate is $2. Under these facts, Newco will have no gain or loss on the sale of the land since the sale price of the land (10,000,000 Euros) equals the tax basis of the land in the hands of the QBU (10,000,000 Euros). However, the REIT will recognize a Section 987 Gain in the amount of $10,000,000 upon the remittance of the sale proceeds solely as a result of the change in the value of the Euro over the ten-year holding period of the land.

As an additional example, assume the following facts: (1) a REIT forms a foreign entity ("Newco") in Europe, and Newco makes an election under Treas. Reg. § 301.7701-3 to be a disregarded entity; (2) Newco is treated as a QBU using the Euro as its functional currency under section 985; (3) Newco borrows 10,000,000 Euros; (4) Newco purchases a rental project located in Europe for 10,000,000 Euros; (5) Newco leases the project to tenants; (6) Newco earns net income in the first taxable year in the amount of 100,000 Euros and the "weighted average exchange rate"[7] in the first taxable year is $1; and (7) Newco distributes 100,000 Euros to the REIT six months after the end of the first taxable year when the current exchange rate is $2.

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[6] Under Treas. Reg. § 1.988-1(d), the exchange rate is formally called the "spot rate."

[7] Under Treas. Reg. § 1.989(b)-1, this term means the simple average of the daily exchange rates, excluding nonbusiness days for the taxable year. Under Prop. Treas. Reg. § 1.987-1(b), the taxable income of a QBU is computed by converting the QBU's taxable income denominated in its functional currency into dollars using the weighted average exchange rate.

Under these facts, Newco will report taxable income in the first taxable year in the amount of $100,000 by translating the net income in Euros into dollars using the weighted average exchange rate for the first taxable year. In addition, the REIT will recognize a Section 987 Gain in the amount of $100,000 in the second taxable year upon the remittance of the net income solely as a result of the change in the value of the Euro between the date the net income was earned and when the net income was distributed.

In a final example, assume the following facts: (1) a REIT loans 10,000,000 Euros to an owner of real estate located in Europe when the current exchange rate is $1; (2) the loan is secured by the real estate so that it qualifies as a Real Estate Asset; and (3) the loan is repaid to the REIT at the end of five years when the current exchange rate is $2. Under these facts, the REIT will recognize a gain under section 988 in the amount of $10,000,000 upon the repayment of the loan solely as a result of the change in the value of the Euro over the previous five years.

D. REITs Should Not Face Potential Disqualification Merely Due To Engaging in Approved REIT Activities Overseas

As noted above, while the IRS explicitly has acknowledged that REITs may invest in and operate real estate assets located overseas consistent with the REIT tax rules, the Gross Income and Asset Tests in general do not explicitly address the treatment for REIT tax purposes of transactions involving foreign currency and foreign currency gains. Accordingly, REITs that engage in permissible overseas investment face potential disqualification due to failing to satisfy the Gross Income or Asset Tests merely due to movements in exchange rates, an event wholly outside of a REIT's control.

As described in the following section, we are seeking regulatory guidance that would clarify that income attributable to foreign currency gains arising out of a REIT's permissible activities overseas either would be ignored for purposes of the REIT Gross Income Test (when tracing the income to a specific activity would be difficult) or considered qualifying income (when tracing the income to a specific activity would be possible). Similarly, we are seeking published guidance that would clarify that a REIT's holding of foreign currency or a foreign currency-denominated asset, if part of the REIT's permissible activities overseas, would be valued and categorized in such a way so that the mere holding of the currency or asset would not jeopardize REIT status.

Case law, legislative history, and prior IRS rulings in similar contexts are instructive in this context. For example, the "relation back" doctrine first described in the Supreme Court case of Arrowsmith v. Commissioner, 344 U.S. 6 (1952) represents the concept that a subsequent occurrence that is so integrally related to a prior occurrence that they are effectively the same event should retain the same character as the prior event. Thus, foreign currency gain arising out of permissible REIT activities should be treated as part of those activities either by ignoring such income (so as not to affect REIT status negatively) or by considering it qualifying income. The doctrine essentially holds that the tax consequences should be the same as though the subsequent event had occurred at the same time as the prior event. Furthermore, as noted below, part of the legislative history to section 856(c)(5)(G) demonstrates Congressional intent that foreign currency gain attributable to qualifying hedges, while not specifically described in section

856(c)(5)(G), should give rise to qualifying income. Finally, there are a number of IRS rulings in the REIT and the regulated investment company ("RIC") area in which the IRS ruled that income attributable to permissible activities, while not specifically listed as qualifying income for purposes of the REIT Gross Income Tests, nevertheless constituted either qualifying income or was ignored for purposes of such tests.

While the treatment of all foreign currency transactions and foreign currency gains is not explicitly addressed, there are provisions in the REIT rules that could govern the treatment at least of certain foreign currency gains. Additionally, the legislative history surrounding the REIT rules and several recent private letter rulings can be instructive in evaluating the tax treatment of foreign currency gains and losses.

1. Arrowsmith Doctrine

In Arrowsmith, the taxpayers liquidated their corporation and reported all of their profits resulting from the liquidation as a capital gain. Seven years after the adoption of the plan of liquidation and four years after the final liquidating distribution, the taxpayers paid a judgment assessed against the corporation and reported the payment as an ordinary deduction. The Supreme Court ruled that the payment should be reported as a capital loss. The Supreme Court stated that "it is not even denied that had this judgment been paid after liquidation, but during the year 1940 [the year of the final liquidating distribution], the losses would have been properly treated as capital ones. For payment during 1940 would simply have reduced the amount of capital gains taxpayers received during that year."

Essentially, the Court adopted a "relation back" doctrine to determine the appropriate character of the payment of the judgment. While not directly on point, the Supreme Court's decision in Arrowsmith implies that foreign currency gains attributable to investments in real estate should be viewed as arising out of qualifying income and therefore should either be ignored or considered qualifying income.

2. Legislative History

As indicated above, the legislative history underlying the tax treatment of REITs indicates that the central concern behind the gross income restrictions is that a REIT's gross income should largely be composed of real estate-related items and, to a lesser amount, passive income. An investment in foreign real estate or foreign mortgages is consistent with this mandate. That is, excluding any foreign currency gains, investments in foreign real estate assets will produce gross income that qualifies under the Real Estate Income Test and the 95% Gross Income Test.

Although the Gross Income Tests do not expressly address the classification of foreign currency gains, section 856(c)(5)(G) does apply to payments to REITs attributable to derivative instruments and gains from such derivative instruments to hedge interest rate risks attributable to debt incurred by or to be incurred by the REIT to acquire real estate assets. Added to the Code in 1997 by H.R. 1150, this provision states that "any (i) payment to [REIT] under an interest rate swap or cap agreement, option, futures contract, forward contract, forward rate agreement, or any similar financial instrument, entered into by the [REIT] in a transaction to reduce the interest rate

risks with respect to any indebtedness incurred or to be incurred by the [REIT] to acquire or carry real estate assets, and (ii) gain from the sale or other disposition of any such investment" shall be treated as income that qualifies under the 95% Gross Income Test. In his statement introducing the language that contained this provision, Representative Clay Shaw (R-FL) stated "H.R. 1150 would extend the REIT variable interest hedging rule to permit a REIT to treat as qualifying any income from the hedge of any REIT liability secured by real property or used to acquire or improve real property. **For example, this provision would apply to hedging a REIT's unsecured corporate debenture or the currency risk of a debt offering denominated in a foreign currency.**" 143 Cong. Rec. E559 (Daily ed. March 21, 1997) ("1997 Shaw Remarks") (emphasis added).

Accordingly, the legislative history clearly allows REITs to invest in foreign real estate assets. Further, the legislative history implies that foreign currency gains should not prevent otherwise qualifying activities of an entity from qualifying as a real estate investment trust. REITs that invest in income-producing real property and mortgages overseas are acting consistently with Congressional intent that their income and activities be primarily from real estate-related sources. Penalizing them, by putting their REIT status at risk, as a result of their deriving foreign currency gains from permissible REIT activity or by allowing variations in exchange rates to cause them to fail the Asset Tests, would thwart the Congressional goal of providing small investors the ability to diversify their investment portfolios through professionally managed, income-producing real estate owned by REITs.[8]

3. <u>Private Letter Rulings: Income Attributable to Permitted REIT Activities Either Ignored Or Considered Qualifying Income</u>

In a number of private letter rulings, the IRS has addressed various situations in which a REIT has engaged in activities from which it earned income as part of its underlying mission of being a real estate company, but the Code was silent on how such income was treated for purposes of the REIT rules. In these rulings, the IRS has correctly looked at the larger context and has concluded that the activities should not harm the REIT. In cases involving the classification of non-specified types of income, the IRS has issued private letter rulings that have achieved results that are appropriate and consistent with Congressional intent. These rulings either treat certain non-listed sources of income as qualifying income or disregard non-listed sources of income when applying the Gross Income Tests, depending upon the circumstances. The guidance NAREIT proposes would treat foreign currency gains in accordance with these methods – that is, it would look to the nature of the underlying activity giving rise to the income.

One example of a private letter ruling that treated non-listed sources of income as qualifying income is Private Letter Ruling 9308013 (November 24, 1992). In that ruling, a REIT engaged in litigation (1) against a sublessee for damages to its property (including reimbursement for attorney's fees and costs), (2) against another party for breach of a services contract, and (3) against a third party for breach of contract for damages to real property. With respect to the suit filed against the sublessee, the IRS ruled that the recovery of fair rental damages from the sublessee would be a substitute for rent and a recovery of attorney's fees or court costs would be

[8] <u>See</u> H.R. Rep. No. 2020, 86th Cong., 2d Sess. 4, 6 (1960).

considered as rents "since the [REIT's] **rental activities are the source from which the recovery would be derived**." (Emphasis added).

In Private Letter Ruling 9640011 (June 28, 1996), the IRS focused on the legislative history to the REIT rules in reaching its holding that the income at issue was qualifying income. The IRS noted that the legislative history had indicated a Congressional intent that a REIT's income be derived from passive sources, rather than from the active conduct of a trade or business. The IRS concluded that the income at issue was from passive sources and not the active conduct of a trade or business. Therefore, although not explicitly described in the REIT Gross Income Tests, it nevertheless constituted qualifying income.

In PLR 9640011, a REIT sought clarification of certain amounts that it would receive as a result of a transaction entered into by a developer that the REIT had acquired. The developer had entered into an agreement with a local government agency (the "Agency") for the development of a shopping center on land located within the jurisdiction of the Agency. The Agency desired the addition of a fourth anchor tenant to the shopping center, the cost of which the developer believed would not be justified by a corresponding increase in operating income. To induce the developer to add the fourth anchor and to make other improvements, the Agency agreed to acquire the underlying land and improvements associated with the fourth anchor and to lease the property back to the REIT. The purchase was made through the issuance of two notes that were secured by certain designated taxes received by the Agency. In its analysis, the IRS concluded that the installments on the notes were designed as a supplement to the developer's operating income and thereby were fully includible in gross income and, that for the same reason, the installments on the notes should be viewed as primarily coming from a passive source (the lease of real estate and improvements) rather than from an active trade or business. Thus, the installments should be considered as income described in Section 856(c)(2).

An example of a private letter ruling that disregards non-listed sources of income when applying the Gross Income Tests is Private Letter Ruling 200115023 (January 11, 2001). In that ruling, the IRS ruled that a positive Section 481 adjustment should not affect its REIT status because any income from this adjustment would not be taken into account for purposes of the Gross Income Tests.

Another example of a private letter ruling that disregards non-listed sources of income when applying the Gross Income Tests is Private Letter Ruling 200127024 (April 4, 2001). In that ruling, the IRS ruled that the receipt of a "break-up fee" in connection with the termination of a proposed merger should be disregarded for purposes of the Gross Income Tests. Noting that the legislative history indicates that Congress intended to equate the tax treatment of REITs with the treatment accorded regulated investment companies ("RICs"), the IRS cited Revenue Ruling 64-247, 1964-2 C.B. 179, and Revenue Ruling 74-248, 1974-1 C.B. 167 and noted that "there is nothing in the legislative history or any statutory interpretation that would indicate that by imposing parameters on the sources from which REITs and RICs may derive income Congress intended to discourage REITs and RICs from pursuing legal remedies."

In conclusion, the case law, legislative history and private rulings described above provide support for the proposition that foreign currency gains that are derived either from passive or real

estate related activities should not prevent a REIT from satisfying the Gross Income Tests. To achieve this result, Section 987 Gains would be disregarded and foreign currency gains resulting from Section 988 Lending Transactions would be classified in the same manner as gain from the disposition of the underlying debt instrument with the result that the foreign currency gain would be qualifying income under the 95% Income Test on all occasions and qualifying income for purposes of the 75% Gross Income Test if the debt is considered a real estate asset. Set forth below is a detailed discussion of proposed guidance concerning foreign currency transactions.

II. DISCUSSION OF PROPOSED RULINGS RELATING TO GROSS INCOME TESTS

As discussed above, foreign currency considerations arise in the context of a REIT that owns foreign property or holds mortgages denominated in a foreign currency. The two most common circumstances that might result in significant amounts of foreign currency gain are:

(1) Remittance of operating or capital proceeds (such as rental income or gain from sale of real property) from a QBU to the REIT ("Section 987 Gains"), and

(2) Receipt of a principal payment on a loan by the REIT in a currency other than the REIT's "functional currency"[9] ("Section 988 Lending Transactions").

Each of these issues is further explored below.

A. Section 987: Ignore Foreign Currency Gain from the Distribution of Proceeds from a Qualified Business Unit If Such QBU Would Satisfy the REIT Asset Test if It Were A REIT

As discussed above, Section 987 Gains result from holding investments in foreign property through a QBU. Generally, the measure of the Section 987 Gain or Loss is the difference between the current dollar value of a remittance from the QBU and the dollar value of the remitted funds at the time such funds were contributed to, or earned by, the QBU. As the REIT contributes amounts to the QBU or as the QBU recognizes income from the operation or disposition of the foreign property, the REIT establishes a basis in its investment or share of income based on a specified exchange ratio applicable at that time. When the QBU remits funds to the REIT, the distributions represents a remittance of a share of the contributions and previously recognized income of the REIT. The differences in the exchange rates applicable to the investment, recognition of income and the remittance result in the Section 987 Gain.

Section 987 Gain represents the translation of the REIT's interest in the underlying assets and income from the foreign, or "non-functional", currency to the dollar. Section 987 Gain would be derived directly from the holding of foreign property and the income derived therefrom. Ideally, Section 987 Gains could be treated as qualifying income based on whether the income would

[9] A U.S.-based REIT is presumed to have the functional currency of the dollar. Thus, this issue arises when the REIT lends money in, for example, Euros, and receives payments in Euros that must be converted to dollars. Variations in the exchange rate could cause foreign currency gain. This issue could arise for any REIT that loans money in a currency other than its "functional currency."

have been qualifying income if earned directly by the REIT. Unfortunately, because cash is fungible, it would be difficult to trace Section 987 Gains from the REIT's QBU to a specific activity. In order to prevent inappropriate results, the proposed guidance would ignore such foreign currency gains if the QBU meets the REIT Asset Tests for calendar quarter. Specifically, the proposed guidance should provide that as long as the QBU satisfies the REIT Asset Tests as though the QBU were a REIT, Section 987 Gains attributable to distributions from the QBU should be ignored by the REIT for purposes of satisfying the REIT Gross Income Tests.

The reasoning applied in PLR 200127024 should apply equally here – that there is nothing in the legislative history that indicates that Congress intended to discourage REITs from owning and operating non-U.S. property. As a result, even if the type of income earned by the REIT is not listed specifically in the REIT Gross Income Tests, the IRS similarly should ignore such income when applying the REIT Gross Income Tests. When Congress wanted to limit the types of entities that could be formed as REITs to those taxable as domestic corporations, it did so expressly in the REIT statute. Furthermore, the IRS expressly has acknowledged a REIT's ability to own and operate foreign real property. A rule that included foreign currency gains as nonqualifying gross income could thwart Congressional intent to allow investors from all walks of life the ability to diversify their investment portfolios through the ownership of professionally managed, income-producing real estate.

Such a test would be consistent with that applied under Treas. Reg. § 1.856-3(g) to determine how a REIT accounts for its share of the assets and income of a flow-through entity in which it has an interest when determining its compliance with the Gross Income and Asset Tests. Under these regulations, a REIT is treated as owning its proportionate share of the income and assets of the flow-through entity. Because a QBU is, by definition, a flow-through entity or a branch, the rules of the REIT Gross Income and Asset Tests already would apply to limit the REIT's ability to engage in a non-real estate business. Any nonqualified income sourced to the property held by the QBU would be accounted for in the REIT's Gross Income Test in the same manner that income from a domestic investment would be considered by the REIT if held in a pass-through solution.

B. Section 988(c)(1)(B)(i): Treat Foreign Currency Gains Attributable to Section 988 Lending Transactions As Qualifying Income According to Whether the Instrument is Secured By Real Property

Because Foreign Currency Gains attributable to Section 988 Lending Transactions can be traced specifically to such transactions, it would be appropriate for such income to be considered qualifying income depending upon whether the relevant loans are secured by real property.

An equity REIT investing in foreign real property may hold a portion of its investment as a lender. Additionally, a mortgage REITs may make loans in a currency other than the dollar[10]. A REIT lending in such circumstances would recognize foreign currency gains as payments of

[10] Specifically, the issue of foreign currency gains arises when a mortgage REIT makes loans in currency that is not its "functional currency" under section 985. Thus, a mortgage REIT whose functional currency is the dollar faces this issue when lending in currency other than the dollar just as a mortgage REIT whose functional currency was the Euro would face this issue when lending in dollar-denominated debt.

principal are made. Consistent with the methodology of section 988, our proposal looks at each Section 988 Lending Transaction separately. Accordingly, if the debt obligation is secured by a mortgage on real property or on interests in real property, the guidance should conclude that the foreign currency gain would be treated as qualifying income described under sections 856(c)(2)(D) and 856(c)(3)(C). However, if the debt obligation is not secured by a mortgage on real property or on interests in real property, the guidance should conclude that the foreign currency gain only would be treated as qualifying income described under section 856(c)(2)(D).

III. PROPOSED RULINGS RELATED TO ASSET TESTS

A. Ignore Changes in Asset Valuations Due to Change in Exchange Rate For Asset Test Purposes

Under the proposed guidance, assets that are held by a QBU such as a qualified REIT subsidiary that operated overseas would be valued initially using the functional currency of the QBU. Then, the values of such assets would be converted into the REIT's functional currency using the then current exchange rate. Any change in the exchange rate used in valuing the REIT's assets would be treated as a change in the value of the REIT's assets for purposes of the Revaluation Rule so that mere changes in the foreign currency exchange rate would not cause a loss of REIT status. Instead, under the Revaluation Rule, a REIT which meets these Assets Tests at the close of any quarter shall not lose its status as a REIT because of a discrepancy during a subsequent quarter between the value of its various 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.

B. Treat Foreign Currency As a Cash or Cash Item Under Section 856(c)(4)(A)

Under the proposed guidance, foreign currency would be treated as cash or a cash item under section 856(c)(4)(A). Although foreign currency is a liquid asset, section 856(c)(4)(A) does not address specifically whether foreign currency is considered a cash or cash item. The dictionary defines "cash" as "ready money," which presumably would include foreign currency. Nevertheless, to dispel all doubt, it would be helpful for this area to be clarified. As noted above, Rev. Rul. 74-191, in addressing whether foreign real property constitutes real property for purposes of the REIT asset test held that "[n]either section 856 of the Code nor the regulations thereunder restrict the term "real estate assets" to those located within the United States. Accordingly, it is held that, for purposes of section 856(c), the term "real property" includes land or improvements thereon located outside the United States and the term "mortgages on real property" includes a security interest which, under the laws of the jurisdiction in which the property is located, is the legal equivalent of a mortgage or deed of trust in the United States." The IRS should rule similarly with respect to whether foreign currency is a "cash or cash item", at the very least when such asset is held as an integral part of the REIT's business as a real estate company. Thus, the REIT would not be penalized for conducting its real estate business directly or indirectly in a foreign currency.

IV. SUMMARY

Guidance concerning the above-described foreign currency transactions would provide clear rules for the treatment of foreign currency gains under the Gross Income Tests and the treatment of foreign investments under the Asset Tests. These clear rules would reduce the amount of resources that the IRS would be required to expend in the future in providing private guidance to taxpayers. The proposed guidance would achieve results that are appropriate and consistent with Congressional intent and prior IRS guidance.