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Dear _____ :

This responds to the letter dated March 9, 2011, and supplemental correspondence dated May 24, 2011, submitted by your authorized representative on behalf of Taxpayer. Taxpayer requests that the Internal Revenue Service rule that income Taxpayer receives from an interest rate swap be excluded from its gross income for purposes of applying the gross income tests provided in section 856(c)(2) and 856(c)(3) of the Internal Revenue Code of 1986, as amended (the "Code").

Facts

Taxpayer is a corporation incorporated in State 1 that has elected to be taxed as a real estate investment trust ("REIT") beginning with its first taxable year that ended on Date 1. Taxpayer, through its subsidiary entities, owns and leases to third parties commercial real estate located in the United States. Most of such subsidiary entities are partnerships or entities that are disregarded for federal income tax purposes.

Subsidiary is a corporation incorporated in State 1 that is wholly owned by Taxpayer and has elected to be taxed as a taxable REIT subsidiary under section 856(l).

Taxpayer directly owns a percent of LLC 1, and Subsidiary owns the remaining b percent of LLC 1. Taxpayer also owns c percent of LLC 2, and LLC 1 owns the remaining d percent of LLC 2. Each of LLC 1 and LLC 2 is a State 2 limited liability company treated as a partnership for federal income tax purposes. LLC 3 is a State 2 limited liability company that, for federal income tax purposes, is disregarded as an entity separate from LLC 2.

On Date 3, LLC 3 borrowed \$e from an unrelated party (the "Loan"). The Loan has a fixed-rate portion with a principal amount of \$f and a floating-rate portion with a principal amount of g. The fixed-rate portion bears interest at h percent annually and has a maturity date of Date 4. The proceeds of the Loan were used to acquire or carry real estate assets held by LLC 3, and the Loan is secured by such real estate assets. Because LLC 3 is disregarded as separate from LLC 2, LLC 2 is treated for federal tax purposes as the borrower under the Loan and the owner of the assets securing the Loan.

On Date 5, Taxpayer entered into an interest rate swap (the "Swap") with a third party to manage risk associated with fixing the interest rate on the fixed-rate portion of the Loan. The Swap has a notional principal amount of \$i and an effective date of Date 6. Under the terms of the Swap, from the effective date until Date 4, Taxpayer is obligated make quarterly payments to the counterparty based on a floating rate equal to j and the counterparty is obligated to make monthly payments to Taxpayer based on a fixed rate equal to k percent per annum. Taxpayer therefore has earned and will earn income from the Swap whenever the floating rate is lower than k percent and upon the sale or disposition of the Swap (the "Swap Income").

Taxpayer identified the Swap as a hedge on the day it entered into the agreement and identified the related transaction and risk within the next 35 days, specifying the expected date of issuance of the debt, the expected maturity, the total expected issue price, and the expected interest provision. Taxpayer represents that, within the meaning of section 1221(b)(2)(A)(ii) of the Code and section 1.1221-2(b)(2) of the Income Tax Regulations, it entered into the Swap in the normal course of its trade or business primarily to manage the risk of interest rate fluctuations with respect the Loan.

Taxpayer, rather than LLC 2 or LLC 3, was party to the Swap because Taxpayer is a party to an International Swaps and Derivatives Association agreement with financial counterparties. Taxpayer represents that it did not enter into the Swap (instead of causing LLC 2 or LLC 3 to enter into the Swap) in order to derive U.S. federal income tax benefits.

Law and Analysis

Section 61(a) of the Code provides that, except as otherwise provided, gross income includes all income from whatever source derived.

Section 856(c) provides that, to qualify as a REIT for any taxable year under part II of subchapter M, an entity must derive at least 95 percent of its gross income from sources listed in section 856(c)(2) and at least 75 percent of its gross income from sources listed in section 856(c)(3). Income from swaps is not specifically enumerated in section 856(c)(2) or (3).

Section 856(c)(5)(G)(i) provides that, except to the extent determined by the Secretary, income of a REIT from a hedging transaction (as defined in section 1221(b)(2)(A)(ii) or (iii)) that is clearly identified pursuant to section 1221(a)(7), including gain from the sale or disposition of such a transaction, does not constitute gross income under section 856(c)(2) or (3) to the extent the transaction hedges indebtedness incurred or to be incurred by the REIT to acquire or carry real estate assets.

Section 856(c)(5)(J)(i) authorizes the Secretary to determine, to the extent necessary to carry out the purposes of part II of subchapter M and solely for the purposes of such part, whether any item of income or gain that does not otherwise qualify under paragraph (2) or (3) may be considered as not constituting gross income for purposes of section 856(c)(2) or (3).

Section 1.856-3(g) provides that, for purposes of the regulations under part II, subchapter M, chapter 1 of the Code, a REIT that is a partner in a partnership is deemed to own its proportionate share of each of the assets of the partnership and will be deemed to be entitled to the income of the partnership attributable to such share. For purposes of section 856, the interest of a partner in the partnership's assets is determined by reference to its capital interest in the partnership. The character of the various assets in the hands of the partnership and items of gross income of the partnership remains the same in the hands of the partners for all purposes of section 856.

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 passive income. For example, H.R. Rep. No. 2020, 86th Cong., 2d Sess. 4 (1960) at 6, 1960-2 C.B. 819, at 822-823 states, “[o]ne of the principal purposes of your committee in imposing restrictions on types of income of a qualifying real estate investment trust is to be sure the bulk of its income is from passive income sources and not from the active conduct of a trade or business.”

Under section 1221(b)(2)(A)(ii), a “hedging transaction” includes any transaction entered into by the taxpayer in the normal course of the taxpayer’s trade or business primarily “to manage risk of interest rate or price changes or currency fluctuations with

respect to borrowings made or to be made, or ordinary obligations incurred or to be incurred, by the taxpayer.” Section 1.1221-2(b)(2) of the Income Tax Regulations contains identical language.

Section 1221(a)(7) of the Code and section 1.1221-2(f)(1) of the Income Tax Regulations require a hedging transaction to be clearly identified as such before the close of the day on which it was acquired, originated, or entered into.

Section 1.1221-2(f)(2)(i) requires a taxpayer that enters into a hedging transaction to make a substantially contemporaneous identification of the item, items, or aggregate risk being hedged, and provides that an identification is not substantially contemporaneous if it is made more than 35 days after entering into the hedging transaction.

Section 1.1221-2(f)(3)(iii)(B) provides that, if the hedging transaction relates to the expected issuance of debt by the taxpayer or to accruals or payments under debt that is expected to be issued by the taxpayer, the identification must specify the following information: the expected date of issuance of the debt; the expected maturity or maturities; the total expected issue price; and the expected interest provisions.

The Swap Income constitutes gross income under section 61, and is not of a type of income that is specifically enumerated in section 856(c)(2) or (3). Such income is excluded from gross income for purpose of those provisions, however, if the Swap is a hedge described in section 1221(b)(2)(A)(ii) that is clearly identified pursuant to section 1221(a)(7) and it hedges debt incurred by Taxpayer to acquire or carry real estate assets. The Swap does not meet the definition of a hedging transaction set forth in section 1221(b)(2)(A)(ii) because it was entered into by Taxpayer to manage risks associated with the borrowing incurred by another taxpayer, LLC 2. Solely for purposes of section 856(c)(2) and (3), however, the determination of whether the Swap constitutes a hedging transaction must take into account section 1.856-3(g), which treats Taxpayer as owning $\frac{1}{2}$ percent of the assets and earning $\frac{1}{2}$ percent of the income of LLC 2. While the Loan is a liability rather than an asset of LLC 2, it is consistent with the purposes of part II of subchapter M to attribute to Taxpayer the liability for its proportionate share of the Loan for purposes of section 856(c)(2) and (3).

Conclusion

Based on the facts as represented by Taxpayer, we rule that the Swap Income is not includible in Taxpayer’s gross income for purposes determining whether Taxpayer has satisfied the gross income tests in section 856(c)(2) and 856(c)(3) of the Code.

Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter. In particular, no opinion is expressed on (i) whether the Taxpayer qualifies as a REIT, (ii) whether the Swap is a hedging transaction for

purposes of section 1.1221-2 or section 1.446-4, (iii) the character or timing of the Swap Income, or (iii) the treatment of the Swap or Swap Income for any purpose other than section 856(c)(2) and (3).

This ruling is directed only to the taxpayer requesting it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to your authorized representative.

Sincerely,

Jonathan D. Silver
Jonathan D. Silver
Assistant Branch Chief, Branch 2
Office of Associate Chief Counsel
(Financial Institutions & Products)