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Department of the Treasury
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Person To Contact:
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Telephone Number:

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CC:FIP:B03
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Date:
February 09, 2024

LEGEND:

Taxpayer =

Funds =

Company A =

Company B =

Counterparty =

Property =

State =

Law Firm =

Accounting Firm =

Date 1 =

Date 2 =

Date 3 =

Date 4 =

Date 5 =

Date 6 =

Date 7 =

Date 8 =

Date 9 =

a =

b =

c =

d =

e =

Dear :

This letter responds to a letter dated August 8, 2023, and subsequent correspondence, requesting a ruling on behalf of Taxpayer. Taxpayer requests a ruling that its failure to identify an interest rate cap as a hedging transaction under § 1.1221-2(f)(1) and (2) of the Income Tax Regulations (the "Regulations") was due to Taxpayer's inadvertent error.

FACTS

Taxpayer is a State limited liability company that was formed on Date 1. Taxpayer elected to be treated as a real estate investment trust ("REIT") under §§ 856 through 859 of the Internal Revenue Code (the "Code") beginning with its initial taxable

year that ended Date 2. Since Date 1, Funds have collectively owned 100 percent of the common shares of Taxpayer.

Company A, a State limited liability company, also formed on Date 1, is a wholly owned subsidiary of Taxpayer. At all times since its formation, Company A has been classified as a disregarded entity of Taxpayer for federal income tax purposes.

On Date 3 (the “Note Execution Date”), Company A issued a debt instrument (the “Note") to Company B (the “Lender”). The terms of the Note provide for a principal commitment amount of a, a term of b years, and a floating interest rate equal to c basis points plus the applicable d average of the secured overnight financing rate. Company A issued the Note to the Lender to obtain financing to acquire or carry real estate assets, which are the land and improvements thereon located at Property. Additionally, Taxpayer represents that in each taxable year, beginning with Taxpayer’s first REIT taxable year, at least e percent of the gross income derived from Property has qualified as rents from real property within the meaning of § 856(d) of the Code.

Under the terms of the Note, Company A was required to enter into an interest rate cap agreement as a condition precedent for issuing the Note. Accordingly, on the Note Execution Date, Company A entered into an interest rate cap agreement with a duration of b years with Counterparty to manage the risk of interest rate fluctuations with respect to the floating interest rate payments Company A is required to make under the Note (the “Interest Rate Cap”). Under the terms of the Interest Rate Cap, Counterparty is obligated to pay Company A certain amounts to the extent the market interest rate rises above a target interest rate.

Starting Date 4, the floating interest rate payable by Company A to Company B under the Note has exceeded the target interest rate under the Interest Rate Cap. Accordingly, under the terms of the Interest Rate Cap, beginning on Date 5, Counterparty has made monthly payments to Company A (“Interest Rate Cap Income").

Law Firm provides Funds with REIT tax advice. During Date 6, in connection with a due diligence inquiry conducted by Law Firm for Funds on another entity besides Taxpayer, Law Firm raised an issue about the proper identification of certain hedging transactions similar to Taxpayer’s Interest Rate Cap. Funds informed Law Firm that they were unaware of any hedge identification requirements and, therefore, none of their entities had identified similar interest rate caps.

Members of Accounting Firm, the external accountants for Funds, are generally familiar with and knowledgeable about the rules regarding REIT compliance matters. Nevertheless, Accounting Firm erroneously believed at the time of the Note Execution Date, that identification of a hedging transaction was not required because the Interest Rate Cap was not a separate, strategic investment from the Note, but rather was entered into by Taxpayer as a condition precedent for Lender to make the loan.

On Date 7, Funds provided Law Firm with a description of the Interest Rate Cap entered into by Taxpayer, and informed Law Firm that Taxpayer had not identified the Interest Rate Cap in accordance with the federal tax hedge identification requirements of § 1221(f)(7) of the Code and § 1.1221-2(f) of the Regulations ("Hedge Identification Requirements"). Upon learning that Taxpayer had not identified the Interest Rate Cap in accordance with the Hedge Identification Requirements, Law Firm promptly notified Funds and Taxpayer that they were required to comply with the Hedge Identification Requirements so that amounts that may become payable under the Interest Rate Cap are excluded from gross income for purposes of the REIT gross income tests. Law Firm advised Funds and Taxpayer to promptly identify the Interest Rate Cap as a hedge in order to comply as closely as possible with the Hedge Identification Requirements.

On Date 8, Taxpayer executed a hedge identification for the Interest Rate Cap dated as of the Note Execution Date, that satisfied the Hedge Identification Requirements (except for the timing requirements).

Taxpayer represents that it treated the Interest Rate Cap as a hedging transaction within the meaning of § 1221(b)(2)(A) for all open years and that the Interest Rate Cap is the only hedging transaction within the meaning of § 1221(b)(2)(A) entered into by Taxpayer during any taxable year open under the statute of limitations on assessment. Taxpayer further represents that it has (i) accounted for and will continue to account for gain or loss resulting from the Interest Rate Cap in accordance with § 1.446-4(e)(4) of the Regulations, and (ii) accounted for and intends to continue to account for gain or loss resulting from the Interest Rate Cap as excluded from the definition of gross income for purposes of applying § 856(c)(2) and (3).

Furthermore, to avoid another failure to timely identify a hedge in the future, after Law Firm informed Funds and Taxpayer of the Hedge Identification Requirements, Funds and Taxpayer established a procedure whereby any subsequent hedge entered into by Taxpayer will result in the completion of a form provided by Law Firm (the "Hedge Identification Form") that is designed to ensure that the Hedge Identification Requirements are satisfied. The procedure requires Taxpayer to execute the Hedge Identification Form on the day the applicable hedge is entered into by Taxpayer.

On Date 9, the controller of Funds prepared an internal memorandum on behalf of Taxpayer memorializing Taxpayer's belief that its failure to identify the Interest Rate Cap as a hedging transaction and the applicable interest rate risk with respect to the interest rate on the Note as a hedged item in accordance with the Hedge Identification Requirements was due to inadvertent error. Accounting Firm believed that entering into a tax identification consistent with the Hedge Identification Requirements was not necessary because the Interest Rate Cap was not a strategic investment separate from the Note, but was only entered into because it was required by Lender. Because Taxpayer relied on Accounting Firm's expertise and advice, Taxpayer did not follow the Hedge Identification Requirements at the time it entered into the Interest Rate Cap. The memorandum concludes that consequently, Taxpayer's failure to identify the Interest

Rate Cap as a hedging transaction was not deliberate, but rather was an accidental oversight. The memorandum also states that Taxpayer has accounted for and will continue to account for gain or loss attributable to the Interest Rate Cap in accordance with § 1.446-4(e)(4).

LAW AND ANALYSIS

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

Section 856(c)(2) provides that at least 95 percent of a REIT's gross income (excluding gross income from prohibited transactions) must be derived from dividends, interest, rents from real property, and certain other specifically enumerated items.

Section 856(c)(3) provides that at least 75 percent of a REIT's gross income (excluding gross income from prohibited transactions) must be derived from rents from real property and certain other specifically enumerated items (together with § 856(c)(2), the "REIT Gross Income Tests").

Section 856(c)(5)(G)(i) generally provides that any income from a hedging transaction (as defined in clause (ii) or (iii) of § 1221(b)(2)(A)) including gain from the sale or disposition of such a transaction, shall not constitute gross income for purposes of the REIT Gross Income Tests to the extent that the transaction hedges any indebtedness incurred or to be incurred by the REIT to acquire or carry real estate assets.

Section 856(c)(5)(G)(iv) provides that § 856(c)(5)(G) shall not apply with respect to any transaction unless such transaction satisfies the identification requirement described in § 1221(a)(7) (determined after taking into account any curative provisions provided under the Regulations referred to therein).

Section 1221(a)(7) provides that the term "capital asset" does not include a hedging transaction which 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 by regulations prescribe).

Section 1221(b)(2)(A) provides that the term "hedging transaction" means any transaction entered into by the taxpayer in the normal course of the taxpayer's trade or business primarily (i) to manage risk of price changes or currency fluctuations, with respect to ordinary property which is held or to be held by the taxpayer, (ii) 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, or (iii) to manage such other risks as the Secretary may prescribe in regulations.

Section 1.1221-2(d)(2) provides that a transaction that economically converts an interest rate from a fixed rate to a floating rate or that converts an interest rate from a floating rate to a fixed rate manages risk.

Section 1.1221-2(f)(1) provides that a taxpayer that enters into a hedging transaction must clearly identify it as a hedging transaction before the close of the day on which the taxpayer acquired, originated, or entered into the transaction.

Section 1.1221-2(f)(2)(i) provides that a taxpayer that enters into a hedging transaction must identify the item, items, or aggregate risk being hedged. Identification of an item being hedged generally involves identifying a transaction that creates risk, and the type of risk that the transaction creates.

Section 1.1221-2(f)(2)(ii) provides that an identification required by § 1.1221-2(f)(2) must be made substantially contemporaneously with entering into the hedging transaction. A hedge identification is not substantially contemporaneous for this purpose if it is made more than 35 days after entering into the hedging transaction.

Section 1.1221-2(g)(2)(i) provides that except as provided in § 1.1221-2(g)(2)(ii) and (iii), the absence of an identification that satisfies the requirements of § 1.1221-2(f)(1) is binding and establishes that a transaction is not a hedging transaction.

Section 1.1221-2(g)(2)(ii) provides that if a taxpayer does not make an identification that satisfies the requirements of § 1.1221-2(f), the taxpayer may treat gain or loss from the transaction as ordinary income or loss under § 1.1221-2(a)(1) or (2) if (A) the transaction is a hedging transaction (as defined in § 1.1221-2(b)), (B) the failure to identify the transaction was due to inadvertent error, and (C) all of the taxpayer's hedging transactions in all open years are being treated on either original or, if necessary, amended returns as provided in a § 1.1221-2(a)(1) and (2).

Although Taxpayer represents that the Interest Rate Cap meets the definition of a hedging transaction within the meaning of § 1.1221-2(b), Taxpayer did not timely identify the swap in accordance with § 1.1221-2(f). Under § 1.1221-2(g)(2), failure to identify a hedge as such generally prohibits the transaction from being treated as a tax hedge, unless the failure was inadvertent and other requirements are met.

The issue here is the meaning of the term "inadvertent error" in the context of § 1.1221- 2(g)(2)(ii). Section 1.1221-2(g)(2)(ii) does not define the term. In the absence of a specific definition in the regulations, the term "inadvertent error" should be given its ordinary meaning. See McClelland Farm Equipment Co. v. United States, 601 F.2d 365, 368 (8th Cir. 1979) ("The words of regulations … should be interpreted where possible in their ordinary, everyday senses."); Bookwalter v. Mayer, 345 F.2d 476, 479

(8th Cir. 1965). The ordinary meaning of the term "inadvertence" is "[a]n accidental oversight; a result of carelessness." Black's Law Dictionary (11th ed. 2019).

Furthermore, the determination as to whether an act or omission constitutes inadvertent error must be based on all relevant facts and circumstances. Taxpayer represents that it relied on the advice and expertise of Accounting Firm. Accounting Firm mistakenly believed that entering into a tax identification consistent with the Hedge Identification Requirements was not necessary because the Interest Rate Cap was not a strategic investment separate from the Note, but was only entered into because it was required by Lender.

Additionally, promptly upon learning that Taxpayer had not properly identified the Interest Rate Cap, Taxpayer made reasonable and substantial efforts to correct the unidentified Interest Rate Cap in accordance with the Hedge Identification Requirements (other than with respect to the timing requirements).

Moreover, upon becoming aware of the Hedge Identification Requirements and their applicability to the Interest Rate Cap, Funds and Taxpayer established a procedure to properly and timely identify any future hedge, as required by the Hedge Identification Requirements.

Accordingly, after considering all the relevant facts and circumstances, we conclude that Taxpayer's failure to identify the Interest Rate Cap was due to inadvertent error within the meaning of § 1.1221-2(g)(2)(ii).

CONCLUSIONS

Based on the facts and representations submitted, we rule that Taxpayer's failure to identify the Interest Rate Cap as required by the Hedge Identification Requirements was due to Taxpayer's inadvertent error, within the meaning of § 1.1221-2(g)(2)(ii)(B), and, therefore, the timing of Taxpayer's identification will not cause the hedging transaction to be treated as not identified under § 1.1221-2(g)(2)(i). Accordingly, if the Hedge Identification Requirements have been otherwise properly satisfied, Taxpayer may treat, for purposes of § 856(c)(5)(G)(iv), the late identification of the Interest Rate Cap as satisfying the Hedge Identification Requirements, beginning with the date Taxpayer entered into the Interest Rate Cap.

Except as expressly provided herein, no opinion is expressed or implied concerning the federal income tax consequences of the transactions described above. In particular, no opinion is expressed or implied as to whether Taxpayer otherwise qualifies as a REIT under § 856. Also, no opinion is expressed or implied regarding whether Taxpayer's Interest Rate Cap hedges the interest rate risk of the Note. Additionally, no opinion is expressed or implied regarding whether the Interest Rate Cap is a hedging transaction as defined in § 1.1221-2(b), if Taxpayer has treated on federal income tax returns its hedging transactions in all open years as provided in § 1.1221-

2(a)(1) and (2), and if Taxpayer met the non-timing requirements of the hedge identification rules of § 1221(a)(7) and § 1.1221-2. Furthermore, no opinion is expressed or implied regarding whether Taxpayer's method of accounting for the Interest Rate Cap is a method that clearly reflects income under § 1.446-4.

The ruling contained in this letter is based upon information submitted and representations made by Taxpayer and accompanied by penalties of perjury statements executed by the appropriate party. While this office has not verified any of the material submitted in support of the request for a ruling, it is subject to verification on examination.

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

Sincerely,

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Andrea M. Hoffenson
Senior Technician Reviewer, Branch 3
Office of the Associate Chief Counsel
(Financial Institutions & Products)

cc: