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Date:
October 6, 2025

Legend

Taxpayer	=
State A	=
Date 1	=
a	=
b	=

Dear :

This letter responds to a letter dated June 16, 2025, and subsequent correspondence, requesting rulings with respect to the Hedges and the Counteracting Hedges described below.

Facts

Taxpayer is a State A corporation that elected to be taxed as a real estate investment trust ("REIT"), beginning with the taxable year ended Date 1.

Substantially all of Taxpayer's assets consist of obligations secured by mortgages on real property as that phrase is used in section 856 of the Internal Revenue Code (the "Mortgage Assets"). The Mortgage Assets are generally long-term debt instruments that pay a fixed rate of interest. Taxpayer finances its acquisition and holding of the Mortgage Assets through sale-repurchase transaction indebtedness secured by the Mortgage Assets (the “REPOs”). The REPOs bear interest at a variable rate tied to the Secured Overnight Financing Rate (“SOFR”). At the time Taxpayer incurred the indebtedness to finance its acquisition of the Mortgage Assets, the all-in cost of its financing was approximately a%. Thus, if SOFR remains unchanged for the duration of the time that the financing incurred by Taxpayer remains outstanding, Taxpayer expects to earn a spread of approximately b% on the financed portion of the Mortgage Assets. However, the REPOs are short-term debt, and the duration mismatch between the long-term Mortgage Assets and the short-term REPOs creates an interest rate risk for Taxpayer.

Since the short-term REPOs renew with changes in objective interest rate indices and the interest rates on the long-term Mortgage Assets are fixed, if the interest rate indices rise, Taxpayer is at risk of incurring interest expense that equals or exceeds the interest payable on the Mortgage Assets. Some of the REPOs require Taxpayer to hedge against this interest rate risk. To hedge against the risk that interest payable on the REPOs could exceed the interest received on the Mortgage Assets, Taxpayer has entered into interest rate swaps (the “Swap Hedges”). Under each Swap Hedge, Taxpayer pays the product of a fixed rate of interest and the notional amount of the Swap Hedge. In exchange, Taxpayer is entitled to receive the product of a “qualified floating rate” within the meaning of section 1.1275-5(b) of the Income Tax Regulations and the notional amount of the Swap Hedge. These are colloquially referred to as pay-fixed swaps.

In addition to the Swap Hedges, Taxpayer plans to enter into options that allow it to enter into swaps with specified terms (the “Swaption Hedges,” together with the Swap Hedges, the “Hedges”). The Swaption Hedges will provide Taxpayer with the right to enter into a pay-fixed swap within a certain period of time. Under each Swaption Hedge, the fixed payment obligations of the resulting pay-fixed swap are determined at the time that Taxpayer acquires the Swaption Hedge; however, the variable payment leg will be determined based on an objective interest rate index at the time that the Swaption Hedge is exercised and, thereafter, will vary with such objective interest rate index.

Based on its business goals, market conditions, and other factors, Taxpayer will have a desired hedging ratio: that is, a ratio of (i) the notional principal amount of its outstanding Hedges to (ii) the principal amount of its borrowings (“Hedging Ratio”). Taxpayer may wish to decrease the notional amount of its Hedges due to a change in its desired Hedging Ratio or a decrease in the amount of the REPOs used to finance the Mortgage Assets.

The counterparties to Taxpayer’s Hedges are generally established financial institutions who are also hedging their own interest rate exposure. Thus, if Taxpayer sought to terminate (in whole or in part) a Hedge prior to its stated term, the terms of the

Hedge require Taxpayer to pay breakage costs to the counterparty. Generally, the costs incurred by a Hedge counterparty in terminating a position that are passed on to Taxpayer are substantial relative to the benefit of terminating the Hedge. While cleared swaps might offer easier and cheaper terminations, the higher margin requirements on cleared swaps versus bilateral swaps makes them costly for Taxpayer.

As a result of the breakage costs of the Hedges and the higher margin requirements of cleared swaps, in situations where Taxpayer desires to terminate a Hedge, it is commercially preferable to enter into a counteracting notional principal contract or swaption (each a “Counteracting Hedge”) to achieve the same economic effect as termination of the Hedge.

Taxpayer represents that both the Hedges and the Counteracting Hedges meet the definition of a hedging transaction under section 1221 and section 1.1221-2(b) and are identified by Taxpayer under section 1221(a)(7) and section 1.1221-2. Taxpayer represents that the Hedges manage the interest rate risk of indebtedness incurred or to be incurred to acquire or carry real estate assets.

Taxpayer represents that Hedging Ratio is always less than 1. Thus, in no event will the notional amounts of the Hedges exceed the principal amount of the Mortgage Assets, and in no event will the notional amounts of the Counteracting Hedges exceed the notional principal amounts of the Hedges. In short, neither the Hedges nor the Counteracting Hedges will “over-hedge.”

Law & Analysis

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, interest on obligations secured by mortgages on real property or on interests in real property, and certain other specifically enumerated items.

Section 856(c)(5)(B) defines the term “real estate assets” to include real property, including interests in mortgages on real property or on interests in real property.

Section 856(c)(5)(G)(i) provides that any income of a REIT from a hedging transaction (as defined in clause (ii) or (iii) of section 1221(b)(2)(A)), including gain from the sale or disposition of such a transaction, shall not constitute gross income under section 856(c)(2) or (3) 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 section 856(c)(5)(G) shall not apply with respect to any transaction unless such transaction satisfies the identification requirement described in section 1221(a)(7).

Section 856(c)(5)(G) was amended by the American Jobs Creation Act of 2004 to provide for the exclusion from gross income of income from hedging transactions, including income from the sale or disposition of such a transaction, for purposes of section 856(c)(2). Pub. L. 108-357 (Oct. 22, 2004). (Prior law had provided that such income was treated as qualifying income, as opposed to being excluded, for purposes of this test). The accompanying legislative history explains that the rules governing the tax treatment of arrangements engaged in by a REIT to reduce certain interest rate risks were amended to generally conform to the rules included in section 1221. H.R. Rep. No. 108-755 at 333 (2004). Section 856(c)(5)(G) was amended further by the Housing Assistance Tax Act of 2008 to provide for the exclusion from gross income of income from certain hedging transactions, including income from the sale or disposition of such a transaction, for purposes of section 856(c)(3). Pub. L. 110-289 (July 30, 2008).

Section 1221(a)(7) requires that for a hedging transaction to be excluded as a capital asset, the hedging transaction must be 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) defines a “hedging transaction” as 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)(3) provides that if a transaction is entered into primarily to offset all or any part of the risk management effected by one or more hedging transactions, the transaction is a hedging transaction.

Section 856(c)(5)(J) provides that, to the extent necessary to carry out the purposes of part II of subchapter M of chapter 1 of the Code, the Secretary is authorized to determine, solely for purposes of such part, (i) whether any item of income or gain which does not otherwise qualify under section 856(c)(2) or (3) may be considered as not constituting gross income for purposes of section 856(c)(2) or (3), or (ii) whether any item of income or gain which otherwise constitutes gross income not qualifying under section 856(c)(2) or (3) may be considered as gross income which qualifies under section 856(c)(2) or (3).

Legislative history indicates that Congress intended part II of subchapter M of chapter 1 of the Code to apply to certain “organizations specializing in investments in real estate and real estate mortgages.” H.R. Rep. No. 2020, 86th Cong., 2d Sess. 4

(1960), 1960-2 C.B. 819, 820. Congress intended to restrict the beneficial tax treatment of part II of subchapter M of chapter 1 of the Code to “what is clearly passive income from real estate investments, as contrasted to income from the active operation of businesses involving real estate.” Id.

The requirements of section 856(c)(5)(G) are satisfied where, as here represented, a hedging transaction entered into by a REIT is properly identified under section 1221(a)(7), meets the definitional requirements of a hedging transaction under section 1221(b)(2)(A), and, in the case of an interest rate hedge, is a hedge of indebtedness incurred or to be incurred to acquire or carry real estate assets. Thus, based on Taxpayer’s representations, Taxpayer’s income from the Hedges qualifies for the exclusion from gross income provided under section 856(c)(5)(G).

The legislative history accompanying the 2004 amendments to section 856(c)(5)(G) makes clear the intent of Congress that the REIT hedging rules are generally to be conformed to the rules set forth in section 1221. If the identification requirements described in section 1221(a)(7) are satisfied, the Counteracting Hedges entered into by Taxpayer also qualify as hedging transactions under section 1.1221-2(d)(3) because, as represented by Taxpayer, they are entered into to offset all or part of, the risk management effected by the Hedges. There is nothing in the legislative history or any statutory interpretation indicating that, by imposing parameters on the sources from which REITs may derive income, Congress intended to discourage REITs from managing its interest rate risk with the Hedges and the Counteracting Hedges.

Pursuant to the provisions of section 856(c)(5)(J)(i), income associated with a Counteracting Hedge that qualifies as a hedging transaction under section 1221 and that satisfies the identification requirements described in section 1221(a)(7) may be excluded from gross income for purposes of section 856(c)(2) and (3). Under the facts of this case, because the Counteracting Hedges will fully or partially offset the corresponding Hedges, but in no event hedge notional amounts in excess of the Hedges, excluding Taxpayer’s income with respect to the Counteracting Hedges from gross income for purposes of section 856(c)(2) and (3) is consistent with the purposes of part II of subchapter M of chapter 1 of the Code.

Conclusion

Based on the information submitted and the representations made, we rule that

1. Pursuant to section 856(c)(5)(G) of the Internal Revenue Code, Taxpayer’s gross income from the Hedges does not constitute gross income for purposes of section 856(c)(2) and (3).

2. Pursuant to section 856(c)(5)(J)(i), Taxpayer's gross income with respect to the Counteracting Hedges does not constitute gross income for purposes of section 856(c)(2) and (3).

This ruling's application is limited to the facts, representations, Code sections, and regulations cited herein. Except as specifically ruled upon above, no opinion is expressed concerning any Federal income tax consequences related to the facts herein under any other provisions of the Code. Specifically, we express no opinion whether Taxpayer qualifies as a REIT under part II of subchapter M of chapter 1 of the Code. We express no opinion concerning whether the Hedges or the Counteracting Hedges are hedging transactions within the meaning of section 1221(b)(2)(A) and section 1.1221-2(b). We express no opinion whether the identification requirements described in section 1221(a)(7), section 1.1221-2, and section 856(c)(5)(G) have been, or will be, satisfied with respect to the Hedges or the Counteracting Hedges.

This ruling is directed only at the taxpayer that requested it. Section 6110(k)(3) provides that it may not be used or cited as precedent. In accordance with the provisions of a Power of Attorney on file, we are sending a copy of this letter ruling to your authorized representatives.

Sincerely,

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

cc: