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Client Alert

Tax

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IRS Issues Guidance on Treatment of Certain Foreign Income Inclusions for REIT Income Test Purposes

On September 13, 2018, the Internal Revenue Service (the "Service") released Revenue Procedure 2018-48 (the "Revenue Procedure"), which provides guidance on how certain items of foreign-related income are treated for purposes of determining whether a real estate investment trust ("REIT") satisfies the 95% gross income test in section 856(c)(2) of the Internal Revenue Code (the "Code"). Specifically, the Revenue Procedure addresses the application of the 95% gross income test (the "95% test") to amounts required to be included in gross income under sections 951(a)(1), 951A(a), 1291(a), 1293(a)(1), and 1296(a). These Code sections require income inclusions with respect to income derived by domestic shareholders through foreign subsidiaries, including "subpart F income" derived from a "controlled foreign corporation" ("CFC"), "global intangible low-taxed income" ("GILTI"), and income derived from a "passive foreign investment company" ("PFIC"). (Collectively, this Client Alert refers to these types of foreign-source income as "Foreign Inclusions".) The Revenue Procedure also addresses the application of the 95% test to amounts required to be taken into account under section 986(c) as foreign currency gain with respect to distributions of previously taxed earnings and profits.

1. BACKGROUND

a. REIT Income Requirements

Among the requirements a corporation must satisfy to qualify as a REIT are two annual income tests. Under section 856(c)(2), at least 95% of a REIT's gross income must consist of rents from real property, gain from the sale of real property, interest, dividends, and certain other types of income. Under section 856(c)(3), at least 75% of a REIT's gross income must consist of a similar, but narrower set of income types, which are more closely tied to income from real property (the "75% test"). For instance, unless an exception for certain "qualified temporary investment income"

applies, interest income only qualifies for the 75% test if it arises from obligations secured by mortgages on real property and dividends only qualify for the 75% test if they are received from another REIT.

b. Certain Foreign Income Inclusions

A United States person that owns stock in a CFC or PFIC may be required to include in gross income certain types of income of the CFC or PFIC. Apart from one exception, the Code generally does not treat the Foreign Inclusions described in those sections of the Code as qualifying income for purposes of the REIT income tests.[1] Historically, Foreign Inclusions were only required where a U.S. person earned certain kinds of passive or related-party income through foreign subsidiaries (subpart F income), caused a foreign subsidiary to make certain U.S. investments (section 956), or took a minority position in a foreign investment company (the PFIC rules). The 2017 tax reform bill, however, expanded the circumstances where Foreign Inclusions are required. Specifically, under section 951A, most types of income earned by a CFC can be included as GILTI to the extent a U.S. shareholder's total income earned through CFC's exceeds a specified return on its investment in tangible property. For many REITs with foreign operations, the GILTI rules have significantly expanded the amount of Foreign Inclusions required, and consequently have increased the risk that Foreign Inclusions, if treated as nonqualifying income, would cause a violation of one or both income tests.

Under section 986(c)(1), foreign currency gain or loss with respect to distributions of previously taxed earnings and profits that are attributable to movements in exchange rates between the times of the deemed and actual distribution is recognized and treated as additional ordinary income or loss. Section 856(n)(1)(A) provides that certain "passive foreign exchange gain" for any taxable year shall not constitute gross income for purposes of section 856(c)(2). Sections 856(n)(3)(A) and (B) enumerate certain items of foreign currency gain that qualify as passive foreign exchange gain. However, section 986(c)(1) foreign currency gain is not included among those enumerated items.

2. REVENUE PROCEDURE 2018-48

Under section 856(c)(5)(J), the Secretary of the Treasury (the "Secretary") has the discretion to determine that items of income or gain that are not enumerated under sections 856(c)(2) or (3) are either not gross income or constitute qualifying gross income for purposes of either or both income tests. Pursuant to this authority, the Revenue Procedure designates all Foreign Inclusions required to be included in income under sections 951(a)(1), 951A(a), 1291(a), 1293(a)(1), and 1296(a) as qualifying income for purposes of section 856(c)(2), but not for purposes of the 75% test. Because they are not treated as disregarded income, such Foreign Inclusions can now actually assist a REIT in meeting the 95% test by increasing the denominator, thereby increasing the 5% "bad income basket" without taking up room in the basket.

Under section 856(n)(3)(C), the Secretary may designate a type of foreign currency gain as passive foreign exchange gain, even if such foreign currency gain is not enumerated in sections 856(n)(3)(A) and (B). Pursuant to the Secretary's authority under section 856(n)(3)(C), the Revenue Procedure states that any amounts required to be taken into account by a REIT under section 986(c) as foreign currency gain with respect to distributions of previously taxed earnings and profits (as described in sections 959 or 1293(c)) are considered passive foreign exchange gain under section 856(n)(3), and therefore do not constitute gross income for purposes of section 856(c)(2). Such foreign currency gain will therefore not play any role in determining whether a REIT has satisfied the 95% income test.

While the Revenue Procedure states that it is effective for taxable years beginning after September 13, 2018, it also states that REITs can apply these favorable rules to any prior taxable year as well.

3. DISCUSSION

REIT practitioners have argued that, as a policy matter, Foreign Inclusions derived by a REIT from its CFC subsidiaries ought to be treated as qualifying income under the 95% test because they can be viewed as a substitute for dividend

income, which is qualifying 95% test income. Subpart F is an anti-deferral regime that is intended to patrol the timing of income from CFCs, but there is no sound policy reason why the anti-deferral rules should have any bearing on the classification of CFC income for REIT testing purposes. However, the Tax Court and the Fifth Circuit have ruled that subpart F income is *not* dividend income for purposes of the preferential individual tax rates applied to such income.[2] Under these circumstances, many REITs have conservatively treated Foreign Inclusions as nonqualifying income or sought private rulings from the Service under section 856(c)(5)(J).

The Service has ruled privately on a number of occasions that subpart F income and section 956 inclusions constitute qualifying income under the 95% test.[3] Since private letter rulings cannot be relied on by other taxpayers, these authorities were of limited comfort to other REITs. Moreover, the taxpayers in rulings relating to subpart F income have generally made representations indicating that the CFC activities that gave rise to the income inclusions would have constituted qualifying income if earned by the REIT directly.[4] The inclusion of these representations created concern that the IRS might view subpart F income as nonqualifying income in situations where the relevant CFC was engaged in an activity that would produce bad income for the REIT if engaged in directly. For example, where a CFC that is a taxable REIT subsidiary ("TRS") provides noncustomary services to tenants, a REIT might previously have worried that any subpart F income from that TRS would constitute nonqualifying income even if it was able to get comfortable that it should otherwise be treated like dividend income. Under the Revenue Procedure, these concerns will no longer trouble REITs and their advisors for purposes of the 95% test.

The Revenue Procedure may also free REITs to be more creative with their financing arrangements. Very generally, section 956 of the Code can require income inclusions if a CFC makes certain actual or deemed investments in U.S. property, such as making a loan to a U.S. affiliate. For this purpose, a CFC's guarantee of debt of a U.S. affiliate or even a U.S. parent's pledge of all of the stock of a CFC can be treated as an investment in U.S. property and trigger a Foreign Inclusion. When the status of section 956 inclusions under the 95% test was unclear, REITs would often shy away from any transaction that might give rise to such inclusions or be forced to seek a ruling from the IRS. Under the Revenue Procedure, financing structures that trigger section 956 inclusions should no longer threaten compliance with the 95% test. This may permit REITs to make more effective use of their overseas assets as collateral for their borrowings. It should be noted, though, that section 956 itself is not affected by the Revenue Procedure, and such transactions may increase the REIT's taxable income.

The Revenue Procedure only provides relief for the 95% test. Foreign Inclusions must still be treated as nonqualifying gross income for purposes of the 75% test. For most REITs, though, Foreign Inclusions have presented a much greater concern under the 95% test than the 75% test. As a result, the Revenue Procedure should reduce or eliminate a significant concern that many REITs with international operations face as a result of the various Foreign Inclusion regimes, particularly as they have expanded under tax reform.

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[1] Section 965(m)(1)(A) provides that amounts required to be included in gross income under section 951(a) by reason of section 965(a) are not taken into account as gross income for purposes of section 856(c)(2).
[2] *Rodriguez v. Commissioner*, 137 T.C. 174 (2011), *aff'd.* 722 F.3d 306 (5th Cir. 2013); *SIH Partners LLLP v. Commissioner*, 150 T.C. No. 3 (Jan. 18, 2018).
[3] *See*, *e.g.*, PLR 201649013 (Dec. 2, 2016); PLR 201503010 (Jan. 16, 2015); PLR 201431018 (Aug. 1, 2014).
[4] *E.g.*, PLR 201828008 (July 13, 2018). In this ruling, a healthcare REIT operated certain facilities through foreign TRSs, and expected to have subpart F income and section 956 inclusions. The Service concluded that these items would qualify for the 95% test, but based this holding on the fact that “[b]ased upon the representations made by Taxpayer, the items of rental income underlying the subpart F income would be qualifying rents from real property if Taxpayer were earning the income directly rather than leasing the Foreign Facilities to its TRSs.” The Service also received representations that section 956 inclusions related to “debt of the Taxpayer that is used to finance the acquisition, improvement, or development of real property from which income is derived that qualifies under [the 95% test].”