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PLR-122338-23

Date:

July 03, 2025

LEGEND

Taxpayer =

Operating Partnership =

Subsidiary =

State A =

State B =

Date 1 =

Date 2 =

a =

Dear :

This letter responds to a letter dated November 6, 2023, and subsequent correspondence, requesting the following rulings with respect to the Purchased Caps and Cap Premium described below:

1. Pursuant to § 856(c)(5)(G) of the Internal Revenue Code, Taxpayer's proportionate share of gross income from the Purchased Caps does not constitute gross income for purposes of § 856(c)(2) and (3) (the Income Tests).
2. Pursuant to § 856(c)(5)(J)(i), Taxpayer's proportionate share of gross income with respect to the Cap Premium does not constitute gross income for purposes of the Income Tests.

Facts

Taxpayer is a State A limited liability company that elected to be taxed as a real estate investment trust ("REIT"), beginning with the taxable year ended Date 1. Taxpayer owns an approximately a percent interest in Operating Partnership, a State A limited partnership that is classified as a partnership for U.S. federal income tax purposes. Operating Partnership wholly owns, directly and through a disregarded entity, Subsidiary, a State B limited partnership. Subsidiary wholly owns, through disregarded entities, multiple single-member limited liability companies and limited partnerships (each, a "Propco"). Subsidiary, the Propcos, and the owners of the Propcos are disregarded as entities separate from Operating Partnership for U.S. federal income tax purposes.

Each Propco owns interests in real estate. Taxpayer represents that the real estate owned by each Propco is real property within the meaning of § 1.856-10 of the Income Tax Regulations, and substantially all the income derived from such real property constitutes rents from real property within the meaning of § 856(d).

To finance Operating Partnership's real estate assets, certain Propcos and owners of Propcos (each, a "Borrower") borrow funds from a third party (each, a "Lender") at a floating interest rate (the "Loans"). Each Loan is secured by a Borrower's real estate assets or its ownership interests in a Propco. As a condition of each Loan, the respective Lender requires the respective Borrower to enter into an interest rate cap agreement either at origination or upon certain triggers with specified terms. Accordingly, when a Loan is originated or when a certain trigger event occurs, the Borrower purchases an interest rate cap (a "Purchased Cap") whereby the Borrower's counterparty is obligated to make payments to the Borrower to the extent the floating rate payable by the Borrower under the Loan exceeds the fixed strike rate. Each Purchased Cap typically has a term equal to the then current remaining term of the corresponding Loan and a notional amount equal to the then outstanding principal amount of the Loan. If a Loan's maturity date is extended past the maturity date of the Purchased Cap, the relevant Borrower must enter into a new Purchased Cap to continue to satisfy the Lender's requirement to have a Purchased Cap in place for the duration of the Loan.

Taxpayer represents that the Purchased Caps are required under the terms of the applicable Loan and are entered into by the Borrowers in the normal course of Operating Partnership's trade or business to manage the risk of interest rate changes with respect to the Loans. Taxpayer further represents that each Purchased Cap is identified by the relevant Borrower under § 1221(a)(7) and § 1.1221-2(f) as a hedge of indebtedness incurred or to be incurred to acquire or carry real estate assets.

Based on factors such as its business goals and market conditions, and despite the Lenders' requirement that the Borrowers enter into the Purchased Caps as a condition of making each Loan, Taxpayer prefers that Operating Partnership manage

the aggregate risk of interest rate changes with respect to its multiple Loans and other floating-rate debt on an aggregate basis under § 1.1221-2(c)(3). Accordingly, on Date 2, in the normal course of Operating Partnership's trade or business, Subsidiary entered into a series of interest rate swap agreements with third parties (the "Swaps") pursuant to which Subsidiary is obligated to make payments based on specified fixed rates that are generally lower than the strike rates of the Purchased Caps and is entitled to receive payments from its counterparties based on specified floating rates. Taxpayer represents that the Swaps were entered into in the normal course of Operating Partnership's trade or business to manage the aggregate risk of interest rate changes with respect to the floating rate debt within the meaning of § 1.1221-2(c)(3). Taxpayer further represents that each Swap meets the definition of a "hedging transaction" under § 1221(b)(2)(A)(ii) and § 1.1221-2(b)(2), is identified by Subsidiary under § 1221(a)(7) and § 1.1221-2(f), and is a hedge of indebtedness incurred or to be incurred to acquire or carry real estate assets.

Subsequent to entering into the Swaps, and as part of the same plan to manage the risk of interest rate changes, Subsidiary enters into offsetting caps with third parties (the "Offsetting Caps") in exchange for cash (the "Cap Premium") to counteract the risk management accomplished by the Purchased Caps. Under the terms of the Offsetting Caps, Subsidiary is obligated to make floating-rate payments to its counterparty in excess of a fixed strike rate that matches the strike rate of the corresponding Purchased Cap, thus offsetting all or a portion of the payment that the applicable Propco receives pursuant to the corresponding Purchased Cap. Entering into an Offsetting Cap is intended to have the economic effect of terminating all or a portion of the corresponding Purchased Cap. When Propcos enter into new Purchased Caps to continue to satisfy their Loan conditions, Subsidiary generally enters into new Offsetting Caps to offset the new Purchased Caps. Taxpayer represents that, under § 61, the Cap Premium is includable in the gross income of Operating Partnership. Going forward, Taxpayer generally intends for the Offsetting Caps to fully counteract the Purchased Caps. Taxpayer represents, however, that in no event will the notional amounts of the Offsetting Caps exceed that of the Purchased Caps.

Taxpayer represents that the Offsetting Caps are entered into in the normal course of Operating Partnership's trade or business primarily to offset all or any part of the risk management effected by the corresponding Purchased Cap within the meaning of § 1.1221-2(d)(3) and are identified under § 1221(a)(7) and § 1.1221-2(f). Taxpayer also represents that counteracting hedges are commonly used by market participants to achieve the economic effect of terminating original hedges.

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 and certain other specifically enumerated items.

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 § 1221(b)(2)(A)), including gain from the sale or disposition of such a transaction, shall not constitute gross income under § 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 § 856(c)(5)(G) shall not apply with respect to any transaction unless such transaction satisfies the identification requirement described in § 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 § 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 § 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 § 856(c)(3). Pub. L. 110-289 (July 30, 2008).

Section 1.856-3(g) states that in the case of a real estate investment trust which is a partner in a partnership, as defined in § 7701(a)(2) and the regulations thereunder, the trust will be 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 § 856, the interest of a partner in the partnership's assets shall be determined in accordance with his 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 shall retain the same character in the hands of the partners for all purposes of § 856. Thus, for example, if the trust owns a 30-percent capital interest in a partnership which owns a piece of rental property, the trust will be treated as owning 30 percent of such property and as being entitled to 30 percent of the rent derived from the property by the partnership. Similarly, if the partnership holds any property primarily for sale to customers in the ordinary course of its trade or business, the trust will be treated as holding its proportionate share of such property primarily for such purpose. Also, for example, where a partnership sells real property or a trust sells its interest in a partnership which owns real property, any gross income realized from such sale, to the extent that it is attributable to the real property, shall be deemed gross income from the sale or disposition of real property held for either the period that the

partnership has held the real property or the period that the trust was a member of the partnership, whichever is the shorter.

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 that does not otherwise qualify under § 856(c)(2) or (3) may be considered as not constituting gross income for purposes of § 856(c)(2) or (3), or (ii) whether any item of income or gain that otherwise constitutes gross income not qualifying under § 856(c)(2) or (3) may be considered as gross income that qualifies under § 856(c)(2) or (3).

The legislative history underlying the tax treatment of REITs indicates that a central concern behind the gross income restrictions is that a REIT’s gross income should largely be derived from passive sources. 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.”

The requirements of § 856(c)(5)(G) are met when a hedging transaction entered into by a REIT satisfies the identification requirement described in § 1221(a)(7), meets the definitional requirements of a hedging transaction under § 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. In this case, Taxpayer represents that the Purchased Caps are required under the terms of the applicable Loan and are entered into in the normal course of Operating Partnership’s trade or business to manage the risk of interest rate changes with respect to the Loans. Taxpayer further represents that each Purchased Cap is identified by the relevant Borrower under § 1221(a)(7) and

§ 1.1221-2(f) and is a hedge of indebtedness incurred or to be incurred to acquire or carry real estate assets. As a result, Taxpayer's proportionate share, within the meaning of § 1.856-3(g), of gross income from the Purchased Caps qualifies for the exclusion from gross income provided under § 856(c)(5)(G).

The legislative history accompanying the 2004 amendments to § 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 § 1221. If the identification requirements described in § 1221(a)(7) are satisfied, the Offsetting Caps entered into by Taxpayer also qualify as hedging transactions under § 1.1221-2(d)(3) because, as represented by Taxpayer, they are entered into primarily to offset all or part of, the risk management effected by the Purchased Caps.

Pursuant to the provisions of § 856(c)(5)(J)(i), income associated with an Offsetting Cap that qualifies as a hedging transaction under § 1221 and that satisfies the identification requirements described in § 1221(a)(7) may be excluded from gross income for purposes of the Income Tests. Under the facts of this case, because the Offsetting Caps will fully or partially offset the corresponding Purchased Caps, but in no event hedge notional amounts in excess of the Purchased Caps, excluding Taxpayer's income with respect to the Cap Premium from gross income for purposes of the Income Tests does not interfere with Congressional policy objectives in enacting the income tests under those provisions.

Conclusion

Based on the information submitted and the representations made, we rule that, pursuant to § 856(c)(5)(G), Taxpayer's proportionate share of gross income from the Purchased Caps does not constitute gross income for purposes of the Income Tests. We further rule that, pursuant to § 856(c)(5)(J)(i), Taxpayer's proportionate share of gross income with respect to the Cap Premium does not constitute gross income for purposes of the Income Tests to the extent that the corresponding Offsetting Caps offset the corresponding Purchased Caps but in no event hedge notional amounts in excess of the Purchased Caps.

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 Offsetting Caps are hedging transactions within the meaning of § 1221(b)(2)(A) and § 1.1221-2(b). We express no opinion whether the identification requirements described in § 1221(a)(7), § 1.1221-2, and § 856(c)(5)(G) have been, or will be, satisfied with respect to the Purchased Caps or the Offsetting Caps. We express no opinion regarding any Purchased Caps to the extent they are not fully offset by Offsetting Caps or any Offsetting Caps that hedge

notional amounts in excess of the Purchased Caps. Additionally, we express no opinion regarding Operating Partnership's method of accounting for hedges or whether any method change has occurred.

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,

Jason Kristall
Branch Chief, Branch 3
Office of Associate Chief Counsel
(Financial Institutions & Products)

cc: