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March 12, 2015

LEGEND

Taxpayer =

State =

x =

y =

Dear :

This responds to your letter dated September 19, 2014, submitted on behalf of Taxpayer. Taxpayer requests a ruling that income from certain original and counteracting hedging transactions described below will not constitute gross income for purposes of the real estate investment trust ("REIT") income tests under section 856(c)(2) and (3) of the Internal Revenue Code of 1986 (the "Code").

FACTS

Taxpayer, a State corporation, is a residential mortgage REIT. Taxpayer invests primarily in instruments classified as mortgages on real property within the meaning of section 856(c)(5)(B) ("Mortgages"), including mortgage-backed securities issued by United States Government agencies or Government-sponsored entities. Taxpayer's Mortgages generally are long-term debt instruments that pay a fixed rate of interest.

Taxpayer typically finances its Mortgages with short-term borrowings, including repurchase agreements ("repos") that are treated as short-term secured borrowings for federal income tax purposes. Under a repo, Taxpayer nominally sells certain of its Mortgages to a counterparty and, at the same time, agrees to repurchase those

Mortgages at a fixed date in the future for a fixed price. A repo typically has a term of between x and y days and requires Taxpayer to pay an interest rate based on LIBOR (or a similar interest rate index) at the time the repo is entered into. At maturity, Taxpayer must either repay the repo with cash on hand or enter into a new repo, the proceeds of which are used to repay the old repo.

Because Taxpayer may hold a financed Mortgage for a long period of time and may want to maintain a constant level of short-term financing on that Mortgage, Taxpayer, upon maturity of one repo, may replace the maturing repo with a new short-term repo. Because the interest rate charged by the lender will be newly determined every time one such repo matures and is repaid with the proceeds of a new repo, a series of back-to-back, short-term repos resembles, in economic substance, a long-term loan bearing a variable (or "floating") interest rate adjusting every x to y days.

In addition to repos, Taxpayer may use other types of financing that actually or effectively bear a floating interest rate, such as private loans under credit agreements, bonds or other debt instruments issued to the public or in private placements, and other transactions treated as borrowings for tax purposes under which Taxpayer would pay a floating rate of interest (collectively, with repos, the "Borrowings"). For the purposes of this ruling request, the term Borrowings refers to those Borrowings incurred or to be incurred to finance Taxpayer's Mortgages (including future short-term borrowings, the proceeds of which are anticipated to repay other Borrowings upon maturity, as described previously).

Because Taxpayer finances its acquisition and ownership of Mortgages with floating rate Borrowings or short-term, current Borrowings that are anticipated to be repaid using the proceeds of short-term, future Borrowings, Taxpayer effectively must pay a floating interest rate on its indebtedness. As such, Taxpayer is subject to the risk of changing interest rates with respect to debt incurred (or to be incurred) to acquire or carry such real estate assets.

To hedge the risk of such interest rate changes on its Borrowings for the period during which it intends to finance its Mortgages, Taxpayer enters into various hedging transactions, including interest rate swaps under which Taxpayer pays a fixed rate of interest and receives payments based on a floating rate of interest ("Pay-Fixed Swaps"). In addition to Pay-Fixed Swaps, Taxpayer also hedges its interest rate exposure on the Borrowings by entering into "Pay-Fixed Swaptions," which are options entitling Taxpayer to enter into a Pay-Fixed Swap.

Together, the Pay-Fixed Swaps and Pay-Fixed Swaptions manage Taxpayer's risk of interest rate changes with respect to the Borrowings. These transactions, along with others that similarly function to hedge Taxpayer's exposure to risk resulting from interest rate fluctuations (such as interest rate caps), are referred to collectively as "Original Hedges."

Taxpayer represents that on the date into which each Original Hedge to be covered by the requested ruling is entered, such Original Hedge will be a "hedging transaction" within the meaning of section 1221(a)(7) of the Code and section 1.1221-2(b) of the Regulations. Taxpayer further represents that the identification requirements described in section 1221(a)(7), section 1.1221-2, and section 856(c)(5)(G) will be satisfied with respect to such Original Hedge. Taxpayer further represents that the Original Hedges are used to hedge the interest rate risks of the Borrowings, which are used to finance the Mortgages.

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. Taxpayer may decide to decrease the notional amount of its Original Hedges due to a change in its desired hedging ratio or a decrease in the amount of its Borrowings. Rather than terminating certain of its Original Hedges to achieve the desired level of hedging exposure, Taxpayer may find it commercially or economically desirable to enter into one or more additional hedges that have the effect of counteracting or offsetting all or part of such Original Hedges for all or part of the remaining term of such Original Hedges (each a "Counteracting Hedge"). Taxpayer represents that Counteracting Hedges are commercially preferable to actual termination of an Original Hedge, and thus are commonly used by market participants to achieve the economic effect of terminating an Original Hedge.

The Counteracting Hedges may take the form of swaps requiring Taxpayer to pay a floating rate of interest and receive a fixed rate of interest ("Receive-Fixed Swaps") or options to enter into such swaps ("Receive-Fixed Swaptions"). Depending on prevailing commercial or economic conditions, it is possible that the cash flows of a Counteracting Hedge may not offset on a dollar-for-dollar basis the cash flows of a related Original Hedge. However, Taxpayer represents that even in such instances, the Counteracting Hedge will serve the purposes of achieving a desirable level of hedging exposure such that together, the Original Hedges and Counteracting Hedges will constitute a degree of hedging of Taxpayer's borrowings at a level and on financial terms that Taxpayer deems appropriate in its business judgment.

Taxpayer represents that on the date into which each Counteracting Hedge to be covered by the requested ruling is entered, such Counteracting Hedge will be a "hedging transaction" within the meaning of section 1221(a)(7) and section 1.1221-2(b). Taxpayer further represents that the identification requirements described in section 1221(a)(7), section 1.1221-2, and section 856(c)(5)(G) will be satisfied with respect to such Counteracting Hedge.

RULINGS REQUESTED

Taxpayer seeks the following rulings:

1. Pursuant to the provisions of section 856(c)(5)(G) of the Code, Taxpayer's gross income from the Original Hedges will not constitute gross income for purposes of sections 856(c)(2) and (3).

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

LAW

Section 856(c)(2) of the Code provides that a corporation shall not be considered a REIT unless it derives at least 95 percent of its gross income (excluding gross income from prohibited transactions) from dividends, interest, rents from real property, and certain other items listed in section 856(c)(2).

Section 856(c)(3) provides that a corporation shall not be considered a REIT unless it derives at least 75 percent of its gross income (excluding gross income from prohibited transactions) from rents from real property and certain other items listed in section 856(c)(3).

Section 856(c)(5)(G)(i) provides that income 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 for purposes of the 75 percent or 95 percent 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, provided that such hedging transaction is properly identified pursuant to 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 the 95 percent gross income test. 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 are prospectively generally conformed to the rules included in section 1221. H.R. Rep. No. 108-755 at 333 (2004).

Section 1221(a)(7) requires that for a hedging transaction to be excluded as a capital asset, a 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) of the Income Tax Regulations 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)(i) of the Code provides that, to the extent necessary to carry out the purposes of this part, the Secretary is authorized to determine, solely for purposes of this part, whether any item of income or gain which (i) does not otherwise qualify under sections 856(c)(2) or (c)(3) may be considered as not constituting gross income for purposes of sections 856(c)(2) or (c)(3).

ANALYSIS

Taxpayer represents that income from the Original Hedges entered into by Taxpayer qualify for the exclusion from gross income provided under section 856(c)(5)(G). The requirements of this section 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.

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 properly identified under section 1221(a)(7), as represented, the Counteracting Hedges entered into by Taxpayer also qualify as hedging transactions under section 1.1221-2(d)(3) of the Regulations because, as represented by Taxpayer, they are entered into to offset all or part of the risk management effected by the Original Hedges.

Pursuant to the provisions of section 856(c)(5)(J)(i) of the Code, income from a Counteracting Hedge that qualifies as a hedging transaction under section 1221 may be excluded from gross income for purposes of sections 856(c)(2) or (c)(3). Under the facts of this case, excluding the income from these hedging transactions from gross

income for purposes of sections 856(c)(2) and (c)(3) 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 section 856(c)(5)(G), Taxpayer's gross income from the Original Hedges will not constitute gross income for purposes of section 856(c)(2) and (c)(3). We further rule that, pursuant to section 856(c)(5)(J)(i), Taxpayer's gross income from the Counteracting Hedges will not constitute gross income for purposes of sections 856(c)(2) and (c)(3).

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 or implied concerning whether the Original Hedges or Counteracting Hedges are hedging transactions within the meaning of section 1221(a)(7) and section 1.1221-2(b). We also 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 Original Hedges or the Counteracting Hedges. Additionally, no opinion is expressed with regard to whether Taxpayer qualifies as a REIT under subchapter M of the Code.

This ruling is directed only to the taxpayer requesting it. Its application is limited to the facts, representations, Code sections, and regulations cited herein. Section 6110(k)(3) 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 each of your authorized representatives.

Sincerely,

Andrea M. Hoffenson
Andrea M. Hoffenson
Branch Chief, Branch 2
Office of Associate Chief Counsel
(Financial Institutions & Products)