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Putting at Ease the GILTI Conscience: IRS Treats Cross-Border Income Inclusions as Qualifying Income

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Recent IRS guidance is good news for real estate investment trusts ("REITs") for several reasons. This article describes a revenue procedure that allows certain cross-border income—including the new global intangible low-taxed income ("GILTI")—to be treated as qualifying income for purposes of a REIT qualifying gross income test. Perhaps more importantly, the revenue procedure is the first time the IRS used REIT-related discretionary authority to issue general guidance instead of private rulings.

On September 13, 2018, the IRS published Revenue Procedure 2018-48 (the "Revenue Procedure"), which confirmed that income described in section 951A(a)[1] (so-called "GILTI"), as well as certain other types of cross-border income, would constitute qualifying income for purposes of the 95 percent gross income test applicable to real estate investment trusts ("REITs") (the "95% test"). In so doing, the IRS resolved uncertainty that had existed for years as to the treatment, for purposes of the gross income tests applicable to REITs (the "gross income tests"), of some of these categories of income. This will come as a relief to practitioners, who had in the past been guided almost entirely by private letter rulings issued under the discretionary authority granted to the IRS by section 856(c)(5)(J). Importantly,

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1 Unless otherwise indicated, section references are to the Internal Revenue Code of 1986, as amended (the "Code") or the applicable regulations promulgated pursuant to the Code (the "regulations").

moreover, this was the first instance in which the IRS used its discretionary authority under section 856(c)(5)(J) to issue general guidance (as opposed to private letter rulings) that addresses the treatment of categories of income for purposes of the gross income tests.

Enacted in 2008, section 856(c)(5)(J) gives the Treasury Secretary (and therefore the IRS) authority to treat gross income that is otherwise not qualifying income for purposes of section 856(c)(2) or (c)(3) as qualifying income for purposes of one or both gross income tests.[2] It also allows the IRS to disregard otherwise nonqualifying income for purposes of one or both gross income tests. The IRS has issued dozens of these rulings, addressing income resulting from, among other things, positive adjustments under section 481,[3] state "brownfields" tax credits,[4] solar tax credits,[5] and, as described in greater detail below, subpart F inclusions and certain other types of cross-border income.

H.R. 1, the bill enacted at the end of 2017 and commonly referred to as "tax reform," introduced section 951A.[6] This new provision requires "United States shareholders" of a controlled foreign corporation (a "CFC") to include in income the tax year "global intangible low-taxed income," gleefully known as GILTI. Since late December 2017, GILTI has meant uncertainty for REITs. GILTI is not listed in either section 856(c)(2) or (c)(3). And unlike the repatriation inclusion under section 965, which a specific statutory provision treats as qualifying income for purpose of the 95% test,[7] tax reform included no such blessing for GILTI. The Revenue Procedure does the same for GILTI, treating it as 95% test qualifying income and thereby aligning its treatment with that of the inclusion provided by section 965 and corporate dividend income more broadly.[8] The Revenue Procedure is effective for tax years beginning after September 13, 2018, but can be relied upon with respect to any prior years.

The Revenue Procedure also lifts the cloud that has covered other types of cross-border income inclusions. Subpart F income, like GILTI income, is not one of the enumerated categories of income described in section 856(c)(2) or (c)(3). This had meant that its treatment for purposes of the gross income tests, like GILTI, was uncertain.

For years, the IRS has issued private letter rulings, explicitly based on its authority under section 856(c)(5)(J), treating subpart F income as qualifying income for purposes of the 95% test. It did the same for income inclusions described in section 956, which generally relates to investments by a CFC in United States property, but only in cases in which the inclusions at issue were generated by the CFC's guarantees (or a pledge of the CFC's equity) as credit support for obligations of U.S. borrowers.[9]

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2 This authority extends to tax years beginning after July 30, 2008.

3 *See* PLR 201537020 (May 22, 2015).

4 *See* PLR 201518010 (Jan. 29, 2015).

5 *See* PLR 201742008 (July 20, 2017).

6 Pub. L. No. 115-97, § 14201, 131 Stat. 2054, 2208 (2017).

7 *See* section 965(m)(1)(A).

8 *See* section 856(c)(2)(A).

9 *See* section 956(d); section 1.956-2(c).

But for a number of reasons, this approach left taxpayers—other than those to whom the rulings were issued—less satisfied. First, it is not entirely clear how much reliance generally can be placed on rulings based on the IRS's authority under section 856(c)(5)(J). While private letter rulings can be relied upon only by those shareholders to whom they are issued, other taxpayers (and their advisers) often take direction and comfort from these illuminations of the IRS's analysis of a given issue. The exercise of the IRS's authority for a given category of income could be interpreted to mean, however, that in the absence of that exercise, the income would be treated as nonqualifying income for purposes of both gross income tests. This left many REITs and their advisers less than fully certain as to whether, absent receipt of their own ruling, they could treat those types of income as qualifying or disregard them for purposes of the gross income tests.

Second, those rulings left some ambiguity as their scope. For instance, some of the rulings addressing subpart F income generally were limited to subpart F income generated by foreign personal holding company income ("FPHCI"); the rulings typically reasoned that the source of the subpart F income (*i.e.*, the FPHCI) was similar to those categories of income that are described in the 95% test—such as rents from real property and interest.[10] At least one other ruling could have been read to suggest that the income underlying the subpart F inclusion, in addition to being FPHCI, also would need to constitute qualifying income for purposes of the 95% test if earned directly by the REIT in question.[11] And in another ruling, the taxpayer represented that its subpart F inclusions had a "close nexus to [its] business of investing in real property assets."[12] This lead to a question as to whether the income generating the subpart F , in order to fall within the rationale set forth in the rulings, would need to be qualifying income for purposes of the 95% test; for instance, whether subpart F income could be treated as qualifying income when it was generated by rental income that would be treated as "impermissible tenant services income" under section 856(d)(2)(C) if earned directly by the relevant REIT.

The section 956-focused rulings, as mentioned above, generally were limited only to situations in which the inclusion was generated by a CFC's guarantee (or the use of the CFC's equity) as credit support for U.S. borrowers under section 956(d).[13] They generally did not address inclusions resulting from investments of CFC earnings in United States property. Moreover, oddly, the IRS seemed to

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[10] *See* PLR 201537020 (May 22, 2015) ("[W]e rule that under section 856(c)(5)(J)(ii), Subpart F Inclusions attributable to the FPHCI that is passive income are considered as gross income that qualifies for purposes of section 856(c)(2)."). Other rulings used a slightly different formulation. *See* PLR 201503010 (July 9, 2014) ("[W]e rule that Taxpayer's Subpart F Inclusion income inclusions attributable to the FPHCI earned by Taxpayer's CFCs are qualifying income for purposes of section 856(c)(2)…"); PLR 201431020 (Apr. 16, 2014) (same); PLR 201423011 (Feb. 20, 2014) (same); PLR 201314002 (Oct. 9, 2012) (same); PLR 201251005 (Sep. 4, 2012); PLR 201246013 (Aug. 20, 2012) (same); PLR 201226004 (Mar. 20, 2012) (same); PLR 201129007 (Apr. 6, 2011); PLR 201119001 (Feb. 4, 2011) (same).

[11] *See* PLR 201828008 (Apr. 18, 2018); *see also* PLR 201605005 (Oct. 26, 2015); PLR 201649013 (Aug. 24, 2016).

[12] See PLR 201431018 (Apr. 22, 2014).

[13] *See* PLR 201431020 (Apr. 16, 2014) ("The Section 956 Inclusion recognized in connection with the production of otherwise qualifying income is treated as qualified income for purposes of section 856(c)(2) to the extent that the underlying income so qualifies."); *see also* PLR 201828008 (Apr. 18, 2018); PLR 201537020 (May 22, 2015); PLR 201503010 (July 9, 2014); PLR 201431018 (Apr. 22, 2014); PLR 201423011 (Feb. 20, 2014); PLR 201301007 (Oct. 2, 2012); PLR 201226004 (Mar. 20, 2012); PLR 201119001 (Feb. 4, 2011).

characterize the section 956 inclusion not by looking to the compatibility of the CFC's income and activities with the REIT tests (as it seemingly had done when analyzing subpart F inclusions) but rather with regard to the compatibility with those tests of the income and activities of the borrower.

Fortunately, the Revenue Procedure resolves those uncertainties, and offers blanket treatment as qualifying income for purposes of the 95% test both to subpart F income and inclusions under section 956. As mentioned above, this is the first and, to date, only time the IRS has issued guidance, relying upon its authority under section 856(c)(5)(J), that is applicable to taxpayers generally.

The Revenue Procedure also treats as qualifying income for purposes of the 95% test certain inclusions related to passive foreign investment companies ("PFICs"). These include "excess distributions" by PFICs and gain from the sale of PFIC stock, in either case as described in section 1291(a), inclusions from qualified electing funds described in section 1293(a)(1), and PFIC "marketable stock" inclusions described in section 1296(a). The treatment as qualifying income of section 1291(a)-inclusions and QEF-inclusions had previously been the subject of private letter rulings.[14] The more recent rulings seemed to condition the ruling on the PFIC's income being limited only to specific types of income—interest, dividends, gain recognized from the sale of stock and securities, and rents from real property.[15] By contrast, earlier rulings appeared only to reason that, as PFICs typically earned passive income, it was appropriate to treat PFIC-related inclusions as qualifying income for purposes of the 95% test. No rulings seem to have been issued (or at least have yet been released) regarding inclusions generated by "mark-to-market" elections under section 1296.

Lastly, the Revenue Procedure allows taxpayers to disregard, for purposes of both gross income tests, foreign currency gain described in section 986(c) (generally relating to shifts in exchange rates between the date of deemed and actual distributions from foreign corporations). The IRS had previously issued a number of private letter rulings, again using its authority under section 856(c)(5)(J), that gain under section 986(c) would not be taken into account as gross income for purposes of the 95% test.[16]

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[14] *See* PLR 201605005 (Oct. 26, 2015); PLR 201649013 (Aug. 24, 2016); PLR 201537020 (May 22, 2015); PLR 201503010 (July 9, 2014); PLR 201431018 (Apr. 22, 2014); PLR 201423011 (Feb. 20, 2014); PLR 201314002 (Oct. 9, 2012); PLR 201246013 (Aug. 20, 2012); PLR 201226004 (Mar. 20, 2012); PLR 201129007 (Apr. 6, 2011); PLR 201119001 (Feb. 4, 2011).

[15] *See* PLR 201605005 (Oct. 26, 2015); PLR 201649013 (Aug. 24, 2016).

[16] *See* PLR 201828008 (Apr. 18, 2018); PLR 201605005 (Oct. 26, 2015); PLR 201649013 (Aug. 24, 2016); PLR 201537020 (May 22, 2015); PLR 201503010 (July 9, 2014); PLR 201301007 (Oct. 2, 2012); PLR 201251005 (Sept. 24, 2012).