Revenue Ruling 2008-31

Notional Principal Contract Was Not a USRPI

X maintains and widely publishes an index (the "Index") that seeks to measure the appreciation and depreciation of residential or commercial real estate values within a metropolitan statistical area ("MSA"), a combined statistical area ("CSA") (both as defined by the United States Office of Management and Budget), or a similarly large geographic area within the United States. The MSA, CSA or similarly large geographic area has a population exceeding one million people. The Index is calculated by reference to (1) sales prices (obtained from various public records), (2) appraisals and reported income, or (3) similar objective financial information, each with respect to a broad range of real property holdings of unrelated owners within the relevant geographic area during a relevant testing period. Using proprietary methods, this information is weighted, aggregated, and mathematically translated into the Index.

FC
(Foreign)

Gain if index rises
Loss if index falls

Notional Principal Contract

Gain/ Loss Calculated by reference to broad based index measured real estate values within the U.S.

DC
(U.S.)

No material ownership of real estate measured by the index

Because of the broad-based nature of the Index, an investor cannot, as a practical matter, directly or indirectly, own or lease a material percentage of the real estate, the values of which are reflected by the Index.

On January 1, Year 1, FC, a foreign corporation, enters into a notional principal contract ("NPC"), within the meaning of Reg. 1.446-3(c)(1) and 1.863-7(a)(1), with unrelated counterparty DC, a domestic corporation. Neither FC nor DC is related to X. Pursuant to the NPC, FC profits if the Index appreciates (that is, to the extent the underlying United States real property in the particular geographic region appreciates in value) over certain levels. Conversely, FC suffers a loss if the Index depreciates (or fails to appreciate more than at a specified rate). During the term of the NPC, DC does not, directly or indirectly, own or lease a material percentage of the real property, the values of which are reflected by the Index.

Section 897(a) provides that gain or loss from the disposition of a USRPI of a nonresident alien individual or a foreign corporation shall be taken into account as effectively connected income under section 871(b)(1) or section 882(a)(1), respectively, as if the taxpayer were engaged in a trade or business within the United States during the taxable year and as if such gain or loss were effectively connected with such trade or business. A USRPI is generally defined under section 897(c)(1)(A) as either an interest in real property located in the United States or the Virgin Islands, or any interest (other than an interest solely as a creditor) in any domestic corporation unless the taxpayer establishes that such corporation was at no time a USRPHC during certain periods. The term "interest in real property" under section 897(c)(6)(A) includes fee ownership and co-ownership of land or improvements thereon, leaseholds of land or improvements thereon, options to acquire land or improvements thereon, and options to acquire leaseholds of land or improvements thereon. Reg. 1.897-1(c)(1) generally defines USRPIs to include any interest, other than an interest solely as a creditor, in real property located in the United States or the Virgin Islands. Reg. 1.897-1(d)(2)(i) provides that an interest in real property other than solely as a creditor includes a fee ownership, co-ownership, or leasehold interest in real property, a time sharing interest in real property, and a life estate, remainder, or reversionary interest in such real property. The term also includes any direct or indirect right to share in the appreciation in the value, or in the gross or net proceeds or profits generated by, the real property.

Because of the broad-based nature of the Index, the NPC does not represent a "direct or indirect right to share in the appreciation in the value … [of] the real property" within the meaning of Reg. 1.897-1(d)(2). Accordingly, FC's interest in the NPC calculated by reference to the Index is not a USRPI under section 897(c)(1).