

Real Estate Tax Alert



In Rev. Rul. 2012-17, the Internal Revenue Service (“IRS”) has ruled that a REIT’s investment in the shares of a money market fund constitutes an investment in “cash and cash items” for purposes of section 856(c)(4)(A) of the Internal Revenue Code (“Code”).

Background

Money market funds are open-end management investment companies that are regulated by the Securities and Exchange Commission (“SEC”) under the Investment Company Act of 1940 (“1940 Act”). Rule 2a-7 of the 1940 Act restricts the investments that a money market fund may make by quality, maturity, and diversity.

Money market funds are an attractive alternative to interest-bearing checking accounts because they generally offer higher yields while providing similar liquidity and security due to the regulatory safeguards imposed by the SEC. As a result, many companies use investments in shares of money market funds as a regular part of their cash-management strategies.

Despite the prevalent use of money market funds in the day-to-day cash management of many companies, real estate investment trusts (“REITs”) have been constrained in their use of money market funds because of uncertainty about how investments in shares of a money market fund would affect a REIT’s status under section 856 of the Code.¹

Section 856 sets forth certain tests with which a company must comply in order to qualify as a REIT. One such test, set forth in section 856(c)(4)(A), provides that at the end of each quarter at least 75 percent of the company’s assets must consist of real estate, cash and cash items (including receivables), and government securities. This test is commonly referred to as the “75% Asset Test”. If a security does not qualify under the 75% Asset Test then the security is also subject to certain diversification requirements set forth under section 856(c)(4)(B). The diversification requirements generally prohibit a REIT from owning securities of a single issuer that represent more than 5 percent of the value of the REIT’s total assets and from owning securities that represent more than 10 percent of the value or voting power of the outstanding securities of a single issuer.

Prior to the issuance of Rev. Rul. 2012-17, the IRS had not ruled on the issue of whether shares of a money market fund constitute “cash or cash items” for purposes of the 75% Asset Test or a “security” subject to the diversification rules of section 856(c)(4)(B). As a result, REITs needed to monitor any investment in a money market fund to ensure that such investment did not violate these tests. Indeed, several REITs have requested closing agreements from the IRS for violations of the REIT asset tests due to excess holdings of money market funds.

¹ Unless otherwise indicated, all “section” or “§” references are to the Internal Revenue Code of 1986, as amended (the “Code” or “I.R.C.”)

Rev. Rul. 2012-17

In Rev. Rul. 2012-17, the IRS considered the following fact pattern:

R has elected to be treated as a REIT. During the first quarter of its 2011 taxable year, R purchased shares of F, a money market fund. F is subject to regulation under the 1940 Act, and complies with the requirements of Rule 2a-7 under the 1940 Act, as amended in 2010. At the close of the first quarter of its 2011 taxable year, the percentage value of R's total assets for purposes section 856(c)(4) was as follows :

- 20 percent of the value of R's total assets was represented by securities that are neither government securities, real estate assets, nor cash or cash items;
- 7 percent of the value of R's total assets was represented by the shares in F; and
- 73 percent of the value of R's total assets was represented by assets that are real estate assets.

The IRS began its analysis by describing the relevant provisions of the 75% Asset Test set forth in section 856(c)(4)(A) and the securities diversification rules set forth in section 856(c)(4)(B). It noted that the term "cash and cash items" in section 856(c)(4)(A) is not defined in the Code, and that, pursuant to section 856(c)(5)(F), the term shall have the same meaning as when used in the 1940 Act.

The term "cash item" is not defined in either the 1940 Act or the regulations under the Act. However, as noted by the IRS, the staff of the Division of Investment Management at the SEC has issued a no-action letter that is directly on point ("SEC No-Action Letter").² The SEC No-Action Letter was issued in response to a request made by a wide variety of industrial operating companies that sought to treat their investments in shares of money market funds as "cash items" for purposes determining whether such companies constituted investment companies.

According to the IRS, the SEC No-Action Letter concluded that the SEC Division of Investment Management would not object if an issuer calculated the amount of its investment securities without including the shares of money market funds, stating

[T]he essential qualities of a cash item for purposes of section 3(a)(1)(C) and rule 3a-1 . . . [are] a high degree of liquidity and a relative safety of principal. In our view, money market fund shares have these same qualities because of the specific regulatory requirements with which money market funds must comply.

The IRS further observed that the SEC No-Action Letter stated that "treatment of money market fund shares [as a cash item] provides operating companies with appropriate flexibility in managing their cash holdings."

Having summarized the SEC No-Action Letter, the IRS stated that the "conclusion reached in the SEC No-Action Letter is not inconsistent with the language of section 856(c)(4)(A) or its underlying legislative history" and ruled that:

- R's shares in F are described in section 856(c)(4)(A), which includes "cash and cash items (including receivables)";
- R satisfies the 75% Asset Test; and
- R's shares in F are not treated as investments in securities for purposes of section 856(c)(4)(B).

² See Willkie Farr & Gallagher, SEC No-Action Letter, IM Ref. No. 200010241124, File. No. 132-3 (October 23, 2000).

The IRS also added that the conclusions in Rev. Rul. 2012-17 are predicated on provisions of nontax law applicable to money market funds and, thus, are subject to the rules of Rev. Proc. 89-14. This revenue procedure provides, in pertinent part, that if a federal tax law conclusion of a revenue ruling is predicated upon a certain provision or interpretation of law other than federal tax law, then those seeking to rely on that conclusion must check to see whether such relevant nontax law has changed materially from that used in the revenue rulings.

Summary

The IRS has settled a troublesome issue by concluding that shares of a money market fund are “cash items” for purposes of section 856(c)(4)(A). The ruling also serves as a reminder that REIT qualification issues can require the coordinated efforts of 1940 Act counsel and tax advisors since certain terms contained in section 856 have the same meaning as when used in the 1940 Act

For additional information concerning this issue, please contact:

James Guiry

646-471-3620

james.m.guiry@us.pwc.com

Adam Handler

213- 356-6499

adam.handler@us.pwc.com

PwC Real Estate Tax Practice – National and Regional Contacts:

National

Gary Cutson

US RE Tax Technical Issues Leader
New York
646-471-8805
gary.cutson@us.pwc.com

Paul Ryan

US RE Tax Leader
New York
646-471-8419
paul.ryan@us.pwc.com

Regional

Atlanta

Dennis Goginsky

678-419-8528
dennis.goginsky@us.pwc.com

Boston

Timothy Egan

617-530-7120
timothy.s.egan@us.pwc.com

Laura Hewitt

617-530-5331
laura.a.hewitt@us.pwc.com

Chicago

Jill Loftus

312-298-3294
jill.h.loftus@us.pwc.com

Alan Naragon

312-298-3228
alan.naragon@us.pwc.com

Dallas

Colin Stevenson

214-756-1752
colin.stevenson@us.pwc.com

Los Angeles

Adam Handler

213-356-6499
adam.handler@us.pwc.com

Phil Sutton

213-830-8245
philip.c.sutton@us.pwc.com

New York

Martin Doran

646-471-8010
martin.doran@us.pwc.com

James Guiry

646-471-3620
james.m.guiry@us.pwc.com

Christine Lattanzio

646-471-8463
christine.a.lattanzio@us.pwc.com

James Oswald

646-471-4671
james.a.oswald@us.pwc.com

Oliver Reichel*

971 (2) 694 6946
oliver.reichel@us.pwc.com

Steve Tyler

646-471-7904
steve.tyler@us.pwc.com

David Voss

646-471-7462
david.m.voss@us.pwc.com

San Francisco

Kevin Nishioka

415-640-8541
kevin.s.nishioka@us.pwc.com

Neil Rosenberg

415-498-6222
neil.rosenberg@us.pwc.com

Washington DC

Adam Feuerstein

703-918-6802
adam.s.feuerstein@us.pwc.com

Kelly Nobis

703-918-3104
kelly.s.nobis@us.pwc.com

Tim Trifilo

703-918-3338
timothy.j.trifilo@us.pwc.com

* Currently resident in Abu Dhabi

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