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REIT rules—temporary investments

In private letter ruling (PLR) 200740004, the IRS addressed the issue of whether temporary investments held indirectly by a real estate investment trust (REIT), through its ownership interest in a limited partnership, generate qualifying income for purposes of the REIT income tests under Internal Revenue Code (IRC) Section 856(c).

In the PLR, REIT is the managing general partner of a limited partnership. The limited partnership owns and operates real property throughout the United States through business entities classified as partnerships or disregarded entities for federal income tax purposes.

During the year, REIT raised capital through a public offering of senior convertible debt. The net proceeds from the debt offering were loaned to the limited partnership, with the REIT receiving convertible debt from the limited partnership that mirrored the terms of the REIT's convertible debt. The limited partnership used the proceeds to purchase real estate assets and fund working capital. However, in the interim, the limited partnership made temporary investments in money market funds.

IRC Section 856(c)(2) provides that at least 95 percent of a REIT's gross income must be derived from, among other sources, rents from real property, interest and dividends. IRC Section 856(c)(3) provides that at least 75 percent of a REIT's gross income must be derived from, among other sources, rents from real property and qualified temporary investment income.

IRC Section 856(c)(5)(D)(i) defines qualified temporary investment income as any income which (I) is attributable to issuance of stock or certain debt instruments; (II) is attributable to the temporary investment of new capital;

and (III) is received or accrued during the one year period beginning on the date on which the REIT receives the capital.

Treasury Regulation Section 1.856-3(g) provides that a REIT is considered to own its proportionate share of each of the assets of the partnership and to be entitled to income from the partnership attributable to that share.

For REIT qualification purposes, REIT will be treated as owing its proportional share of the limited partnership's assets and deriving its proportional share of the limited partnership's income. Therefore, the character and attributes of the income and assets from the limited partnership pass through to the REIT and are treated the same at the REIT level. This means that the partnership income must satisfy the definition of qualified temporary investment income to be treated as such by REIT. In the PLR, the IRS concluded that any property attributable to the temporary investments of new capital, whether held directly by REIT or through its interest in the limited partnership, should be treated as a real estate asset for the one year period beginning on the date(s) on which REIT receives the proceeds from the debt. Therefore, the limited partnership's investments in money market shares should generate qualified temporary investment income for purposes of IRC Section 856(c).

Foreign currency gains and losses

Rev. Rul. 2007-33, IRB 2007-21, allows for a REIT that recognized income from rents denominated in euros and interest income on euro denominated mortgage loans to treat the IRC Section 988 foreign currency gain with respect to such income as REIT qualifying income under IRC Sections 856(c)(2) and (3).

The REIT collected both rents and interest income from notes secured by real property. The rents were payable in euros. In some cases, rent was accrued and included in income prior to the actual receipt of cash. Because of the fluctuations in the value of the euro, REIT generated foreign currency gains or losses on the payment of the rent. REIT had a similar issue in relation to interest accrued on mortgages denominated in euros.

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Rev. Rul. 74-191, 1974-1 CB 170, holds that otherwise qualifying assets do not fail to satisfy the REIT asset tests merely because the assets are foreign. The ruling however does not address the treatment of foreign currency gains that may result from investing in real property or other assets that produce income denominated in a currency other than the taxpayer's functional currency. Although IRC Section 856(c) describes the source of REIT qualifying income, neither the statute nor regulations described what is meant by the income "derived from" those sources. However, Rev. Rul. 2007-33 made it clear that if there is a close nexus between the IRC Section 988 gain on payments received by a REIT and the qualifying income from which that payment is derived, the IRC Section 988 gain should qualify under the 75 percent gross income test and the 95 percent gross income test to the extent that the underlying income does.

The foreign currency gains arise only as a result of the fluctuation in the US dollar relative to the foreign currency from the time the REIT accrues the income to the time the cash payment is actually received. Because the rent and interest are qualifying REIT income, and the foreign currency gains are derived from those sources as a result of cash payments, the foreign currency gains should be treated as qualifying REIT income.

IRS announcement—proposed Form 8926, Disqualified Corporate Interest Expense Disallowed Under Section 163(j) and Related Information

Announcement 2007-114 released on November 28, 2007 revealed the new proposed Form 8926, Disqualified Corporate Interest Expense Disallowed Under Section 163(j) and Related Information. The proposed form is

posted on the IRS Web site under Draft Tax Forms and is applicable for the 2008 tax year and beyond (once finalized). Corporate taxpayers who either paid or accrued disqualified interest for the taxable year or carried forward disallowed disqualified interest from prior taxable years under IRC Section 163(j) are required to include information regarding the application of IRC Section 163(j) limitations and the related computations.

IRC Section 163(j) imposes a limitation on the deduction for interest paid or accrued by corporations to related persons where the interest is exempt or partially exempt from tax. The limitation is generally imposed when the paying corporation is "thinly capitalized" (i.e., has a debt-to-equity ratio greater than 1.5:1). If the corporation is thinly capitalized, then the amount of the interest expense the corporation can deduct is generally limited to 50 percent of the corporation's adjusted taxable income. The excess interest expense is then carried forward indefinitely.

The rules of IRC Section 163(j) apply to (i) any interest paid or accrued to a related person if no tax is imposed with respect to such interest; (ii) any interest paid or accrued to an unrelated party if (a) the interest is not subject to a gross basis tax¹ and (b) the guarantor is a related person who is either a foreign person or a tax-exempt organization; and (iii) any interest paid or accrued by a taxable REIT subsidiary of a REIT.

The new form is in response to an IRS study conducted by the Treasury Department on earnings stripping. The study advised that the tax forms should include more information about earnings stripping. Form 8926 was created to capture that information. Specifically, the proposed form requests the following information:

- Calculation of the taxpayer's debt-to-equity ratio;
- Net interest expense;
- Adjusted taxable income;
- Excess interest expense;
- Total disqualified interest for the tax year;
- Amount of interest deduction disallowed under IRC Section 163(j); and
- Information regarding the related persons receiving the disqualified interest.

¹ Gross basis tax is defined as any tax imposed which is determined by reference to the gross amount of any item of income without any reduction for any deduction allowed by the IRC.

IRC Section 470—loss disallowance rule

Generally, IRC Section 470 disallows a current deduction attributable to tax-exempt use property. Unfortunately, because the way IRC Section 470 is drafted, many real estate partnerships get caught in the IRC Section 470 loss limitation rule because their allocations are not “qualified” or “straight up” allocations.

Relief from Section 470 had previously been granted by the IRS via Notice 2005-29, Notice 2006-2 and Notice 2007-4. The relief only applied to disallowed losses associated with property that was treated as tax-exempt use property solely as a result of the application of IRC Section 168(h)(6) (because the partnership has both tax-exempt and taxable partners and allocations are not “qualified” allocations).

In November 2007, the House Ways & Means and Senate Finance Committees released H.R. 4195/S. 2374, the Tax Technical Corrections Act of 2007 (the Act). The Act would solve the issues raised by IRC Section 470 when a real estate partnership (and perhaps a REIT) has a tax-exempt partner/investor and the partnership/REIT uses an allocation method other than “straight up” allocations. The tax technical corrections have been added to HR 3997, The Heroes Earnings Assistance and Relief Act of 2007.

The Act would amend IRC Section 470 by excluding from its application any property which would be tax-exempt use property solely by reason of IRC Section 168(h) (6), which is how the application of IRC Section 470 applies to many of the real estate partnerships. Further, the Act would apply the rules of IRC Section 470 only to partnerships that are considered lease arrangements under IRC Section 7701(e). Some factors the IRS will consider in determining whether a partnership will be considered a leasing arrangement are whether:

- The partnership is the entity providing the services related to the property;
- The partnership has no or minimal risk of ownership over the property;
- The service recipient still has physical possession of the property;
- The service recipient controls the property; and
- There is insignificant equity investment by the partners.

In addition, the Joint Committee Report added other factors such as whether the transfer of the property

would result in a change in use and that such property is necessary for the provision of governmental services. Based on these factors, it is hopeful that many real estate partnerships will not be considered leasing arrangements under IRC Section 7701(e).

Disallowance of passive activity losses

In *Carolyn D. Fenderson v. Commissioner*,² the Tax Court determined that an individual taxpayer cannot deduct a loss from her real estate activities based on the facts presented in the case.

Carolyn Fenderson (the Taxpayer) worked for Symantec Corporation as an account manager. In her role as account manager, the Taxpayer was primarily responsible for servicing eight existing customers. Her compensation from Symantec included a base salary, stock options and sales commissions. While her salary for 2002 was \$186,487, Taxpayer tracked the amount of time she spent working at Symantec as only 15 hours a week; these records were kept contemporaneously with when the work was performed.

The Taxpayer also owned a number of residential rental units that she held for rent during that year. She performed personal services for the rental units. During 2002, Taxpayer generated losses from her real estate activity of \$57,506. She claimed to have spent 1,062 hours during 2002 in the rental real estate business. No contemporaneous records were prepared and the records used to support the real estate activities appear to have been recreated after the end of 2002.

The Taxpayer reported the rental income and expenses of the rental units on her Schedule E, Supplemental Income and Loss. The aggregate rental loss was deducted from the other income on the Taxpayer’s return. The Taxpayer later sent a second return for the same taxable year meant to be an amended return to the IRS. The IRS did not process the second return. This second return showed on Schedule C, Profit or Loss From Business, the income and expenses originally reported on Schedule E.

The issue before the Tax Court was whether the Taxpayer spent more than one-half of her time performing personal services during such taxable year in real property trades or businesses in which she materially participated. If she spent more than one-half of her time in the real estate trade or business, then she could take a current deduction for the losses generated from that trade or

² T.C. Summary Opinion 2007-191 (November 13, 2007).

business. Otherwise, she would be subject to the general material participation rule that would treat the amounts as passive activity losses. A taxpayer can establish personal services performed in an activity by any reasonable means, which may include identification of services performed over a period of time, based on appointment books, calendars or narrative summaries.

The only evidence the Taxpayer had to support her time allocation was her calendar. Upon examination, the Tax Court found that there were many inconsistencies between her tax return, her calendar and other exhibits created during the course of the IRS audit. The calendar did not reflect total actual hours spent because the calendar did not have a concise record of actual time or events relating to the rental units. The review of the calendar led the Tax Court to determine that less than half of her hours were spent performing personal services for her real estate trade or business as compared with the hours spent performing personal services as an employee of Symantec. Therefore, IRC Section 467(c)(7) did not apply and the Taxpayer was forced to treat all of her rental activities as passive activities without regard to whether she materially participated or not. The deduction for her rental losses was disallowed as a passive activity loss.

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