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Part III – Administrative, Procedural, and Miscellaneous

Taxation and Reporting of REIT Excess Inclusion Income

Notice 2006-XX

SECTION 1. PURPOSE

This notice provides interim guidance relating to excess inclusion income of a real estate investment trust (REIT) that is a taxable mortgage pool or that has a qualified REIT subsidiary that is a taxable mortgage pool.

This notice also requests comments and suggestions for further guidance, including guidance regarding the tax and reporting obligations of regulated investment companies (RICs) that hold stock of affected REITs.

SECTION 2. BACKGROUND

Enacted under the Tax Reform Act of 1986 (the 1986 Act), the real estate mortgage investment conduit (REMIC) provisions of the Internal Revenue Code permit a qualifying entity or arrangement, which finances mortgages by issuing multiple classes of interests, to elect REMIC status. In general, a REMIC is not treated as a taxable entity. Instead, the holders of a residual interest in a REMIC take into account the REMIC's net income or net loss.

A REMIC issues regular interests and residual interests. Regular interests in a REMIC are treated as debt, and holders of such interests must include income from the regular interests under the accrual method. The REMIC deducts interest accruals on the regular interests in computing its net income or net loss. A holder of a residual interest in a REMIC takes into account the net income or net loss of the REMIC. A portion of the net income allocated to holders of residual interests is referred to as excess inclusion income (within the meaning of section 860E(c)). Such income may not be offset by net operating losses, is treated as unrelated business taxable income (UBTI) by certain tax-exempt organizations, and is not eligible for any reduction in withholding tax (by treaty or otherwise) in the case of a nonresident holder.

In addition, the REMIC provisions seek to ensure that excess inclusion income does not escape current taxation. Some of these provisions are designed to prevent certain tax-exempt entities (disqualified organizations) from being direct holders of a REMIC residual interest. Others impose tax on certain pass-through entities (pass-thru entities) that have excess inclusion income to the extent that those entities have REMIC excess inclusion income and allocate it to an equity owner that is a disqualified organization. For this purpose, pass-thru entities (as defined in section 860E(e)(6)(B)) include nominees, and disqualified organizations (as defined in section 860E(e)(5)(B)) include tax exempt entities that are also exempt from unrelated business income tax under section 511. Rev. Rul. 2006-XX illustrates the application of these provisions to a REIT (or a partnership) that has a charitable remainder trust as a shareholder (or a partner).

Section 860E(d) addresses the tax consequences when a REIT holds a REMIC residual interest. This section provides that, if residual interests in a REMIC are held by a REIT, then, under regulations prescribed by the Secretary, the excess of the aggregate excess inclusions determined with respect to such interests over the REIT's taxable income shall be allocated among the shareholders of the REIT in proportion to the dividends received from the REIT. Any such amounts allocated to a shareholder shall be treated as an excess inclusion with respect to a residual interest held by such shareholder. Section 860E(d) further provides that similar rules will apply to regulated investment companies (RICs), common trust funds, and certain cooperative organizations. Regulations issued under section 860E reserve the portion of the regulations dealing with the application of section 860E(d). *See* § 1.860E-1(b). Under section 860E(d), a REIT that owns REMIC residual interests must allocate its excess inclusion income to its shareholders and must pay any tax imposed by section 860E(e)(6) with respect to excess inclusion income allocated to disqualified organizations. *See* Rev. Rul. 2006-XX.

Congress intended the REMIC regime to be the exclusive vehicle for securitizations issuing multiple-maturity mortgage-backed debt securities. Accordingly, the 1986 Act also enacted taxable mortgage pool provisions, which require an entity that issues such securities without making the REMIC election to be taxed as a separate corporation.

Section 7701(i) defines a taxable mortgage pool (TMP) as any entity (other than a REMIC) if—

(i) Substantially all of the assets of the entity consist of debt obligations or interests in debt obligations, and more than 50% of these debt obligations or interests are real estate mortgages or interests in real estate mortgages;

(ii) The entity is the obligor under debt obligations that have two or more maturities; and

(iii) The required payments on the debt obligations that the entity issued bear a relationship to the payments to be received by the entity on the debt obligations that it holds as assets.

A portion of an entity may also be a TMP under this definition.

Section 7701(i)(3) provides a special rule for a REIT that is a TMP. Congress generally intended for an equity interest in a REIT TMP to be subject to rules similar to those that apply to a residual interest in a REMIC. Accordingly, section 7701(i)(3) provides that if a REIT, or a qualified REIT subsidiary, is a TMP, then, under regulations prescribed by the Secretary, adjustments similar to the adjustments provided in section 860E(d) are to apply to the shareholders of the REIT. Regulations under section 7701(i) have been issued, but these regulations specifically reserve on the treatment of REIT TMPs. *See* § 1.7701(i)–4(b).

The Treasury Department and the Service have been advised that a growing number of REITs have recently begun securitizing mortgages by issuing debt instruments that cause the REITs to be TMPs. These securitizations may be effected through a qualified REIT subsidiary or a disregarded entity, such as a securitization trust. In these arrangements, not all of the REIT's income is attributable to a TMP.

The Treasury Department and the Service have also been advised that, in the absence of regulations or other guidance under section 7701(i)(3), taxpayers are uncertain about how to apply section 7701(i)(3) to REIT TMPs and to REIT shareholders. Taxpayers are similarly uncertain about how to apply section 860E(d) to RICs (and other pass-thru entities) that hold shares of a REIT that is required by sections 7701(i)(3) and 860E(d) to allocate excess inclusion income to its shareholders.

SECTION 3. REQUESTS FOR GUIDANCE AND RELIEF

Representatives of REITs and RICs have requested guidance on the tax treatment of excess inclusion income of a REIT that either is a TMP or has a qualified REIT subsidiary that is a TMP. Some of the questions and issues they have raised are:

- The proper computation of excess inclusion income of a REIT (or qualified REIT subsidiary) that is a TMP under section 7701(i)(3);
- The proper method for allocating excess inclusion income among the dividends paid by REITs and RICs during the taxable year;
- The reporting obligations of REITs, RICs, and their shareholders with respect to excess inclusion income;

- If excess inclusion income is allocated to, or otherwise recognized by, an organization that is subject to tax under section 511, whether section 512(b)(12) reduces the amount that is taxed as UBTI by $1000;

- Whether there is or will be, a *de minimis* exception that applies to REITs, RICs (and other pass-thru entities) that have only small amounts of excess inclusion income.

Taxpayers have requested that the Treasury Department and the Service issue an announcement that sections 860E(d) and 7701(i)(3) do not apply before the issuance of the regulations authorized by those sections. Taxpayers have also requested that any such regulations apply only to REIT distributions made some period after the issuance of regulations or other guidance.

SECTION 4. REQUEST FOR COMMENTS

The Treasury Department and the Service are concerned that the purposes of the REMIC excess inclusion provisions may be avoided through the use of REIT TMPs if the resulting excess inclusion income is not properly reported to, and accounted for, by direct and indirect shareholders of the REITs that create TMPs. At the same time, the Treasury Department and the Service are mindful that many RICs and other investors hold stock in REITs that do not own REMIC residual interests or create TMPs.

Accordingly, it is appropriate to weigh the potential administrative burden and complexity for all investors in REITs in developing further guidance dealing with REIT excess inclusion income. The Treasury Department and the Service invite comments and suggestions on the issues summarized in Section 3 above and on any other matters that may be relevant in achieving the purposes of the REMIC provisions without imposing undesirable administrative burdens on REIT investors.

SECTION 5. INTERIM GUIDANCE

The Treasury Department and the Service have concluded that, while the issuance of regulations may be appropriate or necessary to provide detailed guidance on certain issues identified by concerned parties, sections 860E(d) and 7701(i)(3) establish certain basic principles that are applicable even in the absence of regulations. Pending the issuance of further guidance, the IRS will apply the following principles in administering sections 860E(d) and 7701(i):

- If a REIT or a qualified REIT subsidiary (or a portion of either) is a TMP, the REIT must—

  - Calculate the excess inclusion income of the TMP under a reasonable method.

  - Allocate such income to its shareholders in proportion to dividends paid (determined without regard to any special allocation of the expense for any tax paid under section 860E(e)(6)) and inform the shareholders that are not disqualified organizations of the amount and character of the excess inclusion income that has been allocated to them.

  - Pay the tax imposed by section 860E(e)(6) on the excess inclusion income that is allocated to its shareholders that are disqualified organizations.

  - Apply the withholding tax provisions with respect to dividends paid to foreign persons without regard to any treaty exception or reduction in tax rate as provided by section 860G(b)(2).

- With respect to TMP excess inclusion income allocated to pass-thru entities (either directly from a REIT or indirectly through a pass-thru entity), the pass-thru entities (other than nominees or RICs) must—

  - Allocate such income and report the amount and character of the income to its partners, shareholders, beneficiaries or patrons (that are not disqualified organization) in accordance with applicable provisions (section 584, section 702, or part I of subchapter T).

  - Pay the tax imposed by section 860E(e)(6) on excess inclusion income that is allocated to disqualified organizations.

  - Apply the withholding tax provisions with respect to payments made to foreign persons without regard to any treaty exception or reduction in tax rate as provided by section 860G(b)(2).

- With respect to TMP excess inclusion income allocated to RICs, the RICs must—

  - Allocate such income to its shareholders in proportion to dividends paid (determined without regard to any special allocation of the expense for any tax paid under section 860E(e)(6)).

  - Pay the tax imposed by section 860E(e)(6) on excess inclusion income that is allocated to record shareholders that are disqualified organizations.

  - Apply the withholding tax provisions to the excess inclusion portion of dividends paid to foreign shareholders without regard to any exemption or reduction in tax rate as provided by section 860G(b)(2).

  - Inform shareholders who are nominees of the amount and character of the excess inclusion income that has been allocated to them.

- With respect to TMP excess inclusion income allocated to nominees (either directly from a REIT, or indirectly through a pass-thru entity (including a RIC)), the nominees must—

  - Pay the tax imposed by section 860E(e)(6) on the excess inclusion income if the beneficial owner is a disqualified organization.

  - Apply the withholding tax provisions to the excess inclusion income without regard to any treaty exemption or reduction in tax rate as provided by section 860G(b)(2) if the beneficial owner is a foreign person.

  - Inform other beneficial owners of the amount and character of the excess inclusion income.

- Pending the issuance of further guidance, RICs will not be required to inform their shareholders other than nominees of the amount and character of TMP excess inclusion income that has been allocated to them, except as provided in this paragraph. For RIC taxable years beginning after January 1, 2007, a RIC must provide:

  - information to all of its shareholders regarding the amount and character of the TMP excess inclusion income allocated to them if the excess inclusion income received by the RIC from all sources (including investments in REMIC residual interests) exceeds one percent of the gross income of the RIC.

  - information to all of its shareholders regarding the amount and character of excess inclusion income received from investment in stock of REITs that have reported to their shareholders that, for the REIT taxable year ending with or in the RIC's second preceding taxable year, (1) a portion of the dividends constitutes excess inclusion income (including investments in REMIC residual interests), and (2) such excess inclusion exceeded three percent of the REIT's total dividends. For example, the reporting obligation described in this bullet would apply to a calendar year RIC for its 2007 taxable year with respect to stock of a REIT with a September 30 taxable year, if the REIT had reported for its taxable year ending

September 30, 2005, that its excess inclusion income exceeded three percent of its total dividends for that year.

SECTION 6. Paperwork Reduction Act

The collection of information contained in this notice has been reviewed and approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act (44 U.S.C. 3507) under control number 1545- _____.

An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless the collection of information displays a valid OMB control number.

The collection of information in this notice is in sections 860E(d) and 7701(i)(3). This information is required to allow the recipients of the information to properly report and pay taxes on excess inclusion income allocable to them. The collection of information is mandatory. The likely respondents are business or other for-profit institutions.

The estimated total annual reporting and/or recordkeeping burden is two hours. The estimated annual burden per respondent/recordkeeper varies from one to three hours, depending on individual circumstances, with an estimated average of two hours. The estimated number of respondents and/or recordkeepers is 50.

The estimated annual frequency of responses (used for reporting requirements only) is once.

Books or records relating to a collection of information must be retained as long as their contents may become material in the administration of any internal revenue law. Generally, tax returns and tax return information are confidential, as required by 26 U.S.C. 6103.

DRAFTING INFORMATION

The principal author of this revenue ruling is Anna Kim of the Office of the Associate Chief Counsel (Financial Institutions and Products). For further information regarding this revenue ruling, contact Anna Kim at (202) 622- 3735.