Taxation and Reporting of Excess Inclusion Income by REITs, RICs, and Other Pass-Through Entities

Notice 2006–97

SECTION 1. PURPOSE

This notice provides interim guidance relating to excess inclusion income of pass-through entities, particularly real estate investment trusts (REITs). A growing number of REITs are generating excess inclusion income by engaging in mortgage securitization transactions that cause the REIT to be a taxable mortgage pool (TMP) or have a qualified REIT subsidiary that is a TMP. The interim guidance applies to excess inclusion income both from REMIC residual interests and from REIT TMPs, whether received directly or allocated from another pass-through entity.

This notice also requests comments and suggestions for further guidance, especially guidance regarding the tax and reporting obligations of regulated investment companies (RICs) and other entities that hold stock of REIT TMPs or that receive excess inclusion income in other ways.

SECTION 2. BACKGROUND

Enacted by 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 the residual interests in a REMIC take into account the REMIC's net income or net loss.

A REMIC issues regular interests and a single class of residual interests. Regular interests in a REMIC are treated as debt, and holders of these interests must include interest income from the regular interests under an accrual method. The REMIC deducts interest accruals on the regular interests in computing its net income or net loss. The holders of the residual interests in a REMIC take into account the net income or net loss of the REMIC. A portion of the net income allocated to the residual interest holders may be an excess inclusion within the meaning of section 860E(c). An excess inclusion 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.

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 that have excess inclusion income allocable to a record owner that is a disqualified organization. For this purpose, pass-through entities (as defined in section 860E(e)(6)(B)) include REITs, RICs, and nominees; and disqualified organizations (as defined in section 860E(e)(5)(B)) include tax exempt entities that are not subject to unrelated business income tax under section 511. For example, a REIT that owns REMIC residual interests must pay any tax imposed by section 860E(e)(6) with respect to excess inclusion income allocable to a shareholder that is a disqualified organization. Rev. Rul. 2006–58, 2006–46 I.R.B. 876 (November 13, 2006), 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 to a REIT's shareholders when the REIT holds a REMIC residual interest. The section provides that, if a REIT holds one or more REMIC residual interests, then, under regulations prescribed by the Secretary, the excess of the aggregate excess inclusions determined with respect to those 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 the shareholder. Section 860E(d) further provides that similar rules apply to 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).

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 TMP 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 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 equity interests in REIT TMPs to be subject to rules similar to those that apply to residual interests in REMICs. 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 obligations 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 shareholders of REIT TMPs. Taxpayers are similarly uncertain about how to apply section 860E(d) to RICs (and other pass-through entities) that receive excess inclusion income (for example, a RIC holding 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 the $1,000 deduction provided by section 512(b)(12) is available;
- Whether there is or will be, a *de minimis* exception that applies to REITs, RICs, and other pass-through entities that have only small amounts of excess inclusion income.

Taxpayers have requested the Treasury Department and the Service to issue an announcement providing 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, in developing further guidance dealing with the excess inclusion income of pass-through entities (especially that of REIT TMPs), it is appropriate to weigh the potential administrative burden and complexity for all direct and indirect investors in these entities. 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 investors.

SECTION 5. INTERIM GUIDANCE

The Treasury Department and the Service have concluded that, although the issuance of regulations may be appropriate to provide detailed guidance on certain issues identified by concerned parties, sections 860E(d) and 7701(i)(3) establish basic principles that are applicable even in the absence of regulations. Pending the issuance of further guidance, in administering sections 860E(d), 860E(e)(6), and 7701(i), the IRS will apply the following principles, which are applicable to all excess inclusion income, whether from TMPs or from REMIC residual interests:

- A REIT must—
  - Determine whether it or its qualified REIT subsidiary (or a portion of either) is a TMP, and if so, calculate the excess inclusion income of the TMP under a reasonable method.
  - Allocate its excess inclusion 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 allocated to them.
  - Pay the tax imposed by section 860E(e)(6) on the excess inclusion income that is allocable to its shareholders that are disqualified organizations.
  - As provided by section 860G(b)(2), apply the withholding tax provisions with respect to the excess inclusion portion of dividends paid to foreign persons without regard to any treaty exception or reduction in tax rate.
- With respect to its excess inclusion income, a pass-through entity, other than a REIT, RIC, or nominee, must—
  - Allocate its excess inclusion income to its partners, participants, beneficiaries, or patrons (collectively, "owners") in accordance with applicable provisions (section 702, section 584, subchapter J, or part I of subchapter T) and inform any owners 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 excess inclusion income that is allocable to disqualified organizations.
  - As provided by section 860G(b)(2), apply the withholding tax provisions with respect to the excess inclusion portion of the payments made to foreign persons without regard to any treaty exception or reduction in tax rate.
- With respect to excess inclusion income, a nominee must—

- Inform the beneficial owners that are not disqualified organizations of the amount and character of their excess inclusion income.

- Pay the tax imposed by section 860E(e)(6) on the excess inclusion income of beneficial owners that are disqualified organizations.

- As provided by section 860G(b)(2), apply the withholding tax provisions to the excess inclusion portion of the payments made to foreign persons without regard to any treaty exemption or reduction in tax rate.

- With respect to its excess inclusion income, a RIC must—

  - Allocate its excess inclusion 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)).

  - Inform shareholders who are nominees 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 excess inclusion income that is allocable to record shareholders that are disqualified organizations.

  - As provided by section 860G(b)(2), 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.

- Pending the issuance of further guidance, except as provided in this paragraph, a RIC is not required to report the amount and character of the excess inclusion income allocated to its shareholders who are not nominees. For RIC taxable years beginning on or after January 1, 2007—

  - A RIC must inform all of its shareholders that are not nominees regarding the amount and character of the excess inclusion income allocated to those shareholders 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.

  - A RIC that is not subject to the reporting requirement in the preceding bullet must inform all of its shareholders that are not nominees regarding the amount and character of excess inclusion income allocated to those shareholders, taking into account only excess inclusion income allocated to the RIC from REITs described in the following sentence. A REIT is described in this sentence if it reported to its shareholders for the most recent REIT taxable year ending not later than nine months before the first day of the RIC's taxable year that—

    1. A portion of the REIT's dividends for the year was excess inclusion income, and

    2. This excess inclusion income exceeded three percent of the REIT's total dividends for the year.

As an example, the reporting obligation described in this bullet applies to a fiscal year RIC for its taxable year beginning February 1, 2007, with respect to excess inclusion income allocated to the RIC by that REIT for the REIT's taxable year ending December 31, 2007, if the REIT had reported for its taxable year ending December 31, 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 1545–2036.

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.

2007 Limitations Adjusted As Provided in Section 415(d), etc.[1]

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Section 415 of the Internal Revenue Code (the Code) provides for dollar limitations on benefits and contributions under qualified retirement plans. Section 415 also requires that the Commissioner annu-

[1] Based on News Release IR–2006–162 dated October 18, 2006.