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It is unclear from a statutory perspective whether a REIT with no gross income satisfies the Gross Income Tests. The statute itself is open to different interpretations and there is a dearth of authority on the application of the Gross Income Tests under these unfortunate circumstances. Addressing this issue in practice, therefore, can be challenging.

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Background

An entity must satisfy a number of complex and technical tests to qualify as a real estate investment trust ("REIT") for federal income tax purposes. These tests include two gross income tests (the "Gross Income Tests") that are designed to ensure that most of a REIT's income is from passive sources and not from the conduct of an active trade or business. More specifically, to qualify as a REIT in any taxable year, at least 75 percent of an entity's gross income must be derived from (i) rents from real property; (ii) interest on loans secured by mortgages on real property; (iii) gain from the disposition of real property, mortgages, or stock of other REITs; (iv) dividends from other REITs; (v) qualified temporary investment income; and (vi) certain other real estate-related items (the "75 Percent Gross Income Test"). [1] Moreover, at least 95 percent of the entity's gross income must be derived from (i) items that satisfy the 75 Percent Gross Income Test, and (ii) other dividends, interest, and gains from sales of stock and securities (the "95 Percent Gross Income Test"). [2]

Based on these rules, the Gross Income Tests seem to contemplate a fully operational real estate company that generates various types of primarily passive income. But how would the Gross Income Tests apply to an entity that has no gross income during a taxable year? For instance, consider a newly formed REIT that acquires a single, undeveloped parcel of property that does not generate any income during the REIT's first taxable year. The REIT does not own any other income-generating assets and therefore does not report any gross income in its first taxable year. The REIT completes development of the property in the subsequent year, at which point the property starts generating good rental income. Under these facts, did the REIT satisfy the Gross Income Tests during its first taxable year? Or did the REIT fail the Gross Income Tests on account of having no gross income? Should the Gross Income Tests even apply under these facts?

Unfortunately, it is not possible to answer these questions with complete certainty, as there is a general dearth of authority on the application of the Gross Income Tests to a REIT with no gross income during a taxable year, and the statute itself is open to different interpretations. However, for the reasons discussed in this article, it is the authors' position that a REIT should not be viewed as having failed to satisfy the Gross Income Tests on account of having no gross income during a taxable year. Rather, the better position is that the Gross Income Tests should not apply under these circumstances, and that the statute should be read as necessitating or presupposing the existence of gross income in its application. A more narrow statutory application requiring gross income is inconsistent with the legislative history and statutory purpose and would lead to anomalous results.

This article discusses the policy considerations, as well as some analogous rulings, that suggest that the Gross Income Tests should not apply to a REIT with no gross income during a taxable year. [3]

Avoid the Issue

While there are good arguments to support the position that the Gross Income Tests should not apply to a REIT with no gross income during a taxable year, as noted above, it is exceedingly challenging to address this issue with complete certainty due to the general dearth of authority. This lack of certainty is especially problematic if there is a desire to sell the stock of the REIT at some point in the future. Most sophisticated buyers will require a clean "bill of health" for a target company that is taxable as a REIT, and any concerns over REIT qualification matters are especially sensitive and are likely to complicate negotiations. [4] For instance, if there is any doubt as to whether a REIT satisfied the Gross Income Tests in a particular taxable year (and therefore qualified as a REIT for federal income tax purposes), the buyer could demand a broad indemnity against any losses (which could be substantial).

Accordingly, to avoid these complications, it is important to emphasize that this issue should never arise in practice, as simple planning can effectively resolve the problem. More specifically, if there is any doubt whatsoever as to whether a REIT will generate gross income during a taxable year, the REIT can resolve the issue by acquiring shares of publicly traded REIT stock or collateralized mortgage-backed securities ("CMBS"). [5] Each asset qualifies as a real estate asset [6] and generates income that satisfies the Gross Income Tests. [7] Therefore, if the REIT's primary or core assets are not expected to generate gross income during a taxable year, this strategy will alleviate all doubts with respect to the satisfaction of the Gross Income Tests.

For instance, in the above example involving a REIT whose sole asset is a parcel of undeveloped property, the REIT could and should have acquired shares of publicly traded REIT stock or CMBS during its first taxable year. In doing so, the REIT would be in a position to satisfy both the 75 Percent Asset Test and Gross Income Tests, and the property's failure to generate gross income would not present any issues from a REIT qualification perspective.

The Gross Income Tests

The issue becomes much more challenging if a REIT fails to follow the strategy outlined above and there is no gross income during a taxable year. **8** In this unhappy event, one must first look to the statute. **9** In the case of the 95 Percent Gross Income Test, **Section 856(c)(2) 10** provides in pertinent part as follows:

> "at least 95 percent . . . of [the entity's] gross income (excluding gross income from prohibited transactions) is derived from -" **11**

Similarly, the 75 Percent Gross Income Test provides as follows:

> "at least 75 percent of [the entity's] gross income (excluding gross income from prohibited transactions) is derived from -" **12**

In each case, the statute then proceeds to enumerate the items of passive income listed above.

It is notable that the statute does not expressly state that a REIT must have gross income. Rather, under one reading of the Gross Income Tests, one could simply multiply the amount of gross income (i.e., zero) by the relevant percentage (i.e., 95 percent or 75 percent) and compare that product with the amount of passive income. Under this approach, 75 percent of zero equals zero, and 95 percent of zero equals zero, which could suggest that a REIT with no gross income satisfies the Gross Income Tests.

The Treasury Regulations under **Section 856** , however, seem to cast some doubt on this approach. The Treasury Regulations provide in pertinent part as follows:

> "For purposes of both the numerator and denominator in the computation of the specified percentages, the term "gross income" has the same meaning as that term has under **Section 61** and the regulations thereunder. Thus, in determining the gross income requirements under **Section 856(c)** (2), (3), and (4), a loss from the sale or other disposition of stock, securities, real property, etc. does not enter into the computation." **13**

The reference to the "numerator and denominator" implicates another possible interpretation of the statute. Under this reading, in determining whether a REIT satisfies the Gross Income Tests, the REIT would use a fraction, with the numerator being the amount of passive income in a taxable year and the denominator being the amount of total gross income in a taxable year. The taxpayer would satisfy the test as long as the fraction is "at least" 95 percent or 75 percent, as the case may be. However, in the case of a REIT with no gross income, both the numerator and denominator would be zero, which would appear to produce an inconclusive result from a mathematical perspective. **14**

The statute, therefore, seems to be open to different interpretations. At a minimum, it is generally unclear from a statutory perspective whether a REIT with no gross income satisfies the Gross Income Tests. Accordingly, as the U.S. Supreme Court has noted, it is at this point appropriate to consider the legislative history when a statute is ambiguous or unclear in its application. **15**

Legislative history and policy considerations

Congress established REITs in 1960 to provide small investors with the ability to pool assets and gain investment exposure to certain passive real estate investments without being subject to a corporate level tax. **16** At the time of enactment, the Code included similar provisions for regulated investment companies ("RICs"), which allowed pooling arrangements in the case of certain stocks and securities. Congress largely modeled the REIT rules after the RIC rules and intended to provide substantially the same treatment to investors as the RIC rules provided, but with respect to real estate investments. **17**

One of the concerns in enacting the proposed REIT legislation was that real estate operating companies might be able to take advantage of the REIT provisions and thereby circumvent the corporate level tax. Accordingly, each of the House and Senate committee reports stressed that the special tax treatment afforded to REITs should be limited to passive real estate investments, as contrasted to the active operation of businesses involving real estate. **18** In acknowledging the validity of the operating business concern, the REIT rules include specific safeguards to prevent such businesses from inappropriately availing themselves of REIT benefits. The Gross Income Tests are examples of such safeguards. For instance, according to the legislative history, "[o]ne of the principal purposes of . . . imposing restrictions on types of income of a qualifying real estate investment trust is to be sure the bulk of its income is from passive income sources and not from the active conduct of a trade or business." **19**

Presumably due to the rigidity of the Gross Income Tests, Congress added a savings provision that provides relief to an entity that fails to satisfy the Gross Income Tests (the "Savings Provision"). **20** Under **Section 856(c)(6)** , if a REIT fails to satisfy either or both of the Gross Income Tests for any taxable year, the REIT may still qualify as a REIT in that year if (i) following the REIT's identification of the failure to meet the requirements of either or both of the Gross Income Tests for a taxable year, a description of each item is set forth in a schedule for such taxable year, and the REIT pays a penalty tax based on the income that caused the failure, and (ii) the failure to meet the Gross Income Tests was due to reasonable cause and not due to willful neglect. **21** The failure, however, to meet an "income source requirement" is nonetheless considered due to willful neglect and not due to reasonable cause if the failure is willful and the REIT could have avoided the failure by taking actions not inconsistent with ordinary business care and prudence. **22**

The legislative history of **Section 856(c)(6)** provides as follows:

> If a REIT fails to meet the source of income requirements, but has set out the income it did receive in a schedule and any error in the schedule is not due to fraud with intent to evade tax, then the REIT does not lose its REIT status, provided that the failure to meet the 95-percent or 75-percent test is due to reasonable cause and not to willful neglect. If the REIT qualifies for this relief, the REIT must pay the disallowed income as a tax to the Treasury. **23**

While the legislative history does not include significant discussion of the Savings Provision, its inclusion nevertheless suggests that Congress recognized that it would be inappropriate to terminate an entity's REIT status for violations of the Gross Income Tests, so long as the REIT was acting reasonably and the interests of the government are not imperiled.

In the case of a REIT with no gross income during a taxable year, there has been no income from the active conduct of a trade or business or, for that matter, any non-qualifying income in general. For instance, using the above example of a REIT whose sole asset is a parcel of undeveloped property, the lack of gross income in these circumstances should not be viewed as running afoul of the policy considerations underlying the Gross Income Tests. In other words, zero gross income should not be considered tantamount to either non-qualifying income or income from the active conduct of a trade or business.

Concluding that an entity with no gross income fails to satisfy the Gross Income Tests also can lead to anomalous results. As previously discussed, Congress enacted the Savings Provision to provide a cure for a REIT that fails to satisfy either or both of the Gross Income Tests, thereby suggesting that Congress considered the loss of REIT status to be a harsh or inequitable result under these circumstances. Moreover, the Savings Provision does not include any specific limitations with respect to the amount of non-qualifying income. A REIT, therefore, could presumably have substantial non-qualifying income and remain a REIT, as long as it satisfies the requirements of the statute. The Savings Provision, however, does not specifically address or otherwise seem to contemplate a scenario in which a REIT does not have any gross income during a taxable year, and it is unclear how or whether a REIT can avail itself of the Savings Provision under these circumstances. Assuming a failure to satisfy the Gross Income Tests is due to reasonable cause and not due to willful neglect, it would be illogical for an entity to be able to continue to qualify as a REIT when it generates substantial non-qualifying income, but to lose its REIT status solely because it had no gross income during a taxable year. This result is as anomalous as the result that the IRS describes in the Technical Advice Memorandum discussed below.

Accordingly, when looking to the purpose of the Gross Income Tests, there should be no reason to conclude that an entity with no gross income fails to satisfy the Gross Income Tests. Rather, based on the purpose and legislative history of the Gross Income Tests and REIT provisions in general, the better argument is that the Gross Income Tests should not apply when a REIT has no gross income in a taxable year. We further note that a REIT is subject to other qualification tests, such as the asset tests under **Section 856(c)(4)** , which are designed to carry out the legislative intent of the REIT rules. The statutory purpose of these rules, therefore, should not be viewed as being circumvented solely because one takes the position that the Gross Income Tests should not apply when an entity has no gross income during a taxable year.

Analogous rulings

There are at least two private rulings that are instructive to a reading of the statute that the Gross Income Tests should not apply when an entity has no gross income during a taxable year. **24**

TAM 200914021 25 addresses the application of the "gross receipts test" of **Section 165(g)(3)** . By way of background, under **Section 165(g)(3)** , a domestic corporation can claim an ordinary loss deduction for worthless securities of an "affiliated" corporation. A corporation is affiliated for these purposes if (i) the taxpayer satisfies the requirements of **Section 1504(a)(2)** (i.e., the taxpayer owns at least 80 percent of the voting power and value of the affiliated corporation's stock), and (ii) the affiliated corporation must have derived more than 90 percent of its aggregate gross receipts for all taxable years from certain non-passive sources (the "Gross Receipts Test"). **26** As further described below, the purpose of **Section 165(g)(3)** is to allow a corporation to claim an ordinary loss deduction when a subsidiary's stock becomes worthless, but only if the subsidiary is an operating business, as opposed to an investment or holding company.

Under the facts of the TAM, the taxpayer's wholly owned subsidiary never received any gross receipts, and the issue was whether the Gross Receipts Test precludes an ordinary loss deduction under these circumstances. Both the IRS and the taxpayer, however, agreed that the subsidiary functioned as an operating company and would have generated substantial gross receipts from operations if its operations had been successful.

The Large and Mid-Size Business Operating Division of the IRS ("LMSB") argued that the numerical Gross Receipts Test of **Section 165(g)(3)(B)** necessarily requires some amount of gross receipts and precludes ordinary loss treatment when a company has no gross receipts. LMSB further contended that the Gross Receipts Test is exclusive and that the taxpayer may not resort to an alternative, subjective test to determine whether a subsidiary is an operating company or an investment or holding company. The taxpayer, however, argued that the Gross Receipts Test should be inapplicable when a subsidiary becomes worthless without ever receiving any gross receipts. In that case, according to the taxpayer, the appropriate approach is to look to the purpose of the statute, which is to provide ordinary loss treatment for subsidiaries that are truly operating companies, rather than investment or holding companies.

The IRS sided with the taxpayer and noted that **Section 165(g)(3)(B)** should not be read narrowly to impose an exclusive minimum gross receipts requirement as a condition for claiming an ordinary loss deduction for worthless stock. Rather, the Gross Receipts Test should govern only when a company has gross receipts. According to the IRS, when a company has no gross receipts, reading the statute to preclude an ordinary loss deduction would produce anomalous results that are clearly contrary to the statutory purpose. The ruling states:

> LMSB's approach (categorical denial in the absence of gross receipts) would deny ordinary loss treatment for a company ... with no disqualifying passive investment income but would allow ordinary loss treatment for a very large company with millions of dollars of passive investment income as long as the amount of passive income was less than 10 percent of the company's gross receipts. We think the legislative history supports a broader reading of the operating company exception to capital loss treatment. **27**

In arriving at its conclusion, the IRS looked to the legislative history to determine the intent of the statute. The IRS noted that the legislative history suggests that Congress designed the Gross Receipts Test to determine whether a subsidiary is an operating company (for which an ordinary loss is allowed) or a holding or investment company (for which an ordinary loss is not allowed). **28** As part of an amendment to what is now **Section 165(g)(3)** , Senator James Davis noted that Congress' intent in enacting the then gross income test **29** was to permit an ordinary loss deduction for worthless subsidiary stock only when the subsidiary was an operating company, as opposed to an investment or holding company. **30**

Based on these considerations, the IRS concluded that the numerical Gross Receipts Test was intended to implement the statutory intent and the test should not apply to deny an ordinary loss deduction to a true operating company "that just happens to have no gross receipts." **31**

Ltr. Rul. 9447016 **32** also is instructive. Under the facts of the ruling, a foreign corporation, which was engaged in the manufacture and sale of certain products, recognized interest income from time deposits. The foreign corporation, however, did not have gross income because its losses from active business operations exceeded the sum of its passive and non-passive income. The ruling addresses the application of the passive foreign investment company ("PFIC") rules to a foreign corporation that does not have gross income during a taxable year.

Section 1297(a) provides two disjunctive tests for determining whether a foreign corporation is a PFIC - an asset test and an income test. Under the income test, a foreign corporation will be treated as a PFIC if 75 percent or more of its gross income is passive income (the "PFIC Income Test"). **33** Alternatively, under the asset test, a foreign corporation will be treated as a PFIC if 50 percent or more of the average value of its gross assets consists of assets that would produce passive income (the "PFIC Asset Test"). **34**

The foreign corporation represented that it did not qualify as a PFIC under the PFIC Asset Test, but was concerned about the application of the PFIC Income Test in light of the fact that it primarily generated passive income during the taxable years at issue. After noting that the PFIC rules do not specify how to determine gross income for purposes of the PFIC Income Test, the ruling explains that it is appropriate to adopt the principles of **Sections 11** and **61** and treat the foreign corporation as a domestic corporation. Accordingly, gross income for these purposes should mean total sales less the costs of goods sold, plus any income from investments and from incidental or external operations or sources. [35]

The IRS ruled that the PFIC Income Test does not apply when a foreign corporation has no gross income pursuant to the principles of **Section 61** and Subpart F. In the case of the foreign corporation, its non-passive losses exceeded its passive and non-passive income for the taxable year, and therefore the foreign corporation had no gross income.

The IRS' reasoning in both the TAM and ruling suggest that it should be inappropriate to simply conclude that an entity with no gross income fails to satisfy the Gross Income Tests. Rather, in the case of the ruling, the IRS specifically determined that the PFIC Income Test, which is similar to the Gross Income Tests, does not apply when a corporation has no gross income.

The IRS reached a similar conclusion in the TAM, but looked to the legislative history of **Section 165(g)(3)(B)** to determine whether an ordinary loss deduction is appropriate. In doing so, the IRS noted that "when a company has no gross receipts, the categorical denial of . . . operating company status can produce anomalous results clearly contrary to the statutory purpose." [36] The IRS goes on to note that such an approach would deny ordinary loss treatment for a company with no passive income, but would allow ordinary loss treatment for a company with millions of dollars of passive income, so long as the amount of passive income is less than 10 percent of the company's gross receipts.

Accordingly, when looking to the purpose of the Gross Income Tests, there should be no reason to conclude that an entity with no gross income fails to satisfy the Gross Income Tests. Rather, based on the reasoning in the TAM and ruling, as well as the purpose and legislative history of the Gross Income Tests and REIT provisions, we believe that the better position is that the Gross Income Tests should not apply when a REIT has no gross income in a taxable year.

Conclusion

It is unclear from a statutory perspective whether a REIT with no gross income satisfies the Gross Income Tests. The statute itself is open to different interpretations and there is a dearth of authority on the application of the Gross Income Tests under these unfortunate circumstances. Addressing this issue in practice, therefore, can be challenging. Nevertheless, this article hopes to establish that, while it is not possible to address this issue with complete certainty, applying the statute to require gross income is inconsistent with the legislative history and statutory purpose of the Gross Income Tests and would lead to anomalous results.

In any event, unless and until the IRS issues guidance, if there is any doubt as to whether a REIT will generate gross income during a taxable year, the best course of practice is to resolve the issue in advance by acquiring shares of publicly traded REIT stock or CMBS.

1 Section 856(c)(2) .

2 Section 856(c)(3) .

3 In addition to the Gross Income Tests, a REIT also must satisfy certain asset tests at the close of each quarter of its taxable year to qualify as a REIT. For instance, under **Section 856(c)(4)(A)** , at least 75 percent of a REIT's assets must consist of real estate assets, cash and cash items (including receivables), and government securities (the "75 Percent Asset Test"). Similar to a REIT with no gross income during a taxable year, it is unclear whether a REIT with no assets at the end of a quarter (e.g., a newly formed entity or a REIT that has disposed of all of its assets) satisfies the 75 Percent Asset Test. This issue, however, may be less acute than a REIT with no gross income during a taxable year. For instance, some commentators believe that a REIT, which satisfies the 75 Percent Asset Test in one quarter and subsequently sells all of its assets without making any new acquisitions, would fall within the flush language at the end of **Section 856(c)(4)** . *See* Bloomberg Tax Management Portfolio, No. 742-4th, Section III(B)(6) (2019). However, while there may be some relief for a REIT with no assets at the end of a quarter, based on the lack of clear guidance, it would be advisable for a REIT to follow the strategy discussed in this article.

4 In many cases, the buyer will require a tax opinion that the target entity has been organized and operated in conformity with the requirements for qualification as a REIT. An opinion level of less than "will" is likely to be problematic for the buyer.

5 *See* Bloomberg Tax Management Portfolio, No. 742-4th, Section IV.A (2019) ("By far the better practice ... is to avoid the issue entirely by having the REIT acquire another asset that reliably produces income that qualifies for the 75% income test...").

6 *See* **Section 856(c)(5)(B)** (shares in other REITs); **Ltr. Rul. 200513002 (April 1, 2005)** (a warehouse line of credit secured by mortgages is a real estate asset rather than a security for purposes of the REIT asset tests); *see also* **Rev. Rul. 84-10, 1984-1 C.B. 155** (Fannie Mae pass-through certificates qualify as real estate assets).

7 Sections 856(c)(2)(A) , (c)(3)(D) (dividends); **Rev. Rul. 84-10, 1984-1 C.B. 155** (interest on pass-through certificates issued by Fannie Mae constitutes "interest on obligations secured by mortgages on real property" within the meaning of **Section 856(c)(3)(B)**).

8 We note that the same issue would be implicated even if the REIT owns interest-bearing bank accounts. While the interest would satisfy the 95 Percent Gross Income Test, there would be no gross income to satisfy the 75 Percent Gross Income Test.

9 According to the United States Supreme Court, the "first step in interpreting a statute is to determine whether the language at issue has a plain and unambiguous meaning with regard to the particular dispute in the case."*Robinson v. Shell Oil Co*., 519 U.S. 337 340 (1997).

10 Unless otherwise noted, all references to "section" refer to the Internal Revenue Code of 1986, as amended (the "Code"), or the Treasury Regulations thereunder.

11 Section 856(c)(2) .

12 Section 856(c)(3) .

13 Reg. 1.856-2(c)(1) .

14 *See, e.g.,* Michael J. Neely, "Why we cannot divide by zero," University of South Carolina (last visited October 4, 2019).

15 *Begier v. Internal Revenue Service*, 496 U.S. 53 (1990).

16 Pub. L. No. 86-779.

17 H.R. Rep. No. 2020, 86th Cong., 2d Sess. (1960).

18 H.R. Rep. No. 2842, 84th Cong. 2d Sess. 3 (1956); S. Rep. No. 2797, 84th Cong. 2d Sess. 1 (1956).

19 H.R. Rep. No. 2020, 86th Cong., 2d Sess. 4 (1960) at 6, 1960-2 C.B. 819, at 822-23.

20 The Savings Provision was initially added by the Tax Reform Act of 1976 (Pub. L. No. 94-455) and was later amended by the American Jobs Creation Act of 2004 (Pub. L. No. 108-357).

21 Reg. 1.856-7(c)(1) . "Reasonable cause" for these purposes requires that the REIT exercise ordinary business care and prudence in attempting to satisfy the gross income requirements of **Section 856(c)** .

22 *Id*. We note that the Internal Revenue Service (the "IRS") has not updated **Reg. 1.856-7** to reflect changes made to **Section 856(c)(6)** as part of the American Jobs Creation Act of 2004.

23 H.R. Rep. No. 108-548(I), 108th Cong., 2d Sess. (2004).

24 While we recognize that **Section 6110(k)(3)** precludes taxpayers from relying on private rulings, they are nonetheless instructive and generally indicative of the position of the IRS.

25 **TAM 200914021 (April 3, 2009)** .

26 **Section 165(g)(3)(A)** and (B).

27 **TAM 200914021 (April 3, 2009)** .

28 The Revenue Act of 1942, Pub. L. No. 754, 56 Stat. 798.

29 The test was originally a gross income test, but was later changed to a gross receipts test.

30 90 Cong. Rec. S121-122 (daily ed. Jan. 12, 1944) (statement of Sen. Davis).

31 **TAM 200914021 (April 3, 2009)** .

32 **Ltr. Rul. 9447016 (November 25, 1994)** .

33 **Section 1297(a)(1)** .

34 **Section 1297(a)(2)** .

35 *See also* **Reg. 1.61-3(a)** .

36 **TAM 200914021 (April 3, 2009)** .