

Rule	Agency	Subject	Date and page of publication in the FEDERAL REGISTER	Original effective date
1. 20 CFR Part 655	ETA	Labor Certification Process for the Temporary Employment of Aliens in Agriculture: Adverse Effect Wage Rate Methodology.	Jan. 16, 1981, 46 FR 4568.	Feb. 17, 1981.
2. 29 CFR Part 1	ESA W/H Div.	Procedures for Predetermination of Wage Rates.	Jan. 16, 1981, 46 FR 4306.	Feb. 17, 1981.
3. 29 CFR Part 5	ESA W/H Div.	Labor Standards Provisions Applicable to Contracts Covering Federally Financed and Assisted Construction (Also Labor Standards Provisions Applicable to Nonconstruction Contracts Subject to the Contract Work Hours and Safety Standards Act).	Jan. 16, 1981, 46 FR 4380.	Feb. 17, 1981.
4. 29 CFR Part 6	SECY	Rules of Practice for Administrative Proceedings Enforcing Labor Standards in Federal and Federally Assisted Construction Contracts and Federal Service Contracts.	Jan. 16, 1981, 46 FR 4398.	Feb. 17, 1981.
5. 29 CFR Parts 1952 and 1955	OSHA	Proposed Withdrawal of the Indiana State Plan.	Jan. 16, 1981, 46 FR 3919.	Feb. 17, 1981.
6. 41 CFR Part 60-1	OFCCP	Payment of Membership Fees and Other Expenses to Private Organizations.	Jan. 16, 1981, 46 FR 3882.	Feb. 17, 1981.
7. 29 CFR Part 1903	OSHA	Walkaround Compensation.	Jan. 16, 1981, 45 FR 3652.	Feb. 17, 1981.
8. 29 CFR Part 1990	OSHA	Identification, Classification and Regulation of Potential Occupational Carcinogens; Conforming Deletions.	Jan. 19, 1981, 46 FR 4889.	Feb. 18, 1981.
9. 29 CFR 2520.102-5	PWBP	Limited Relief From Reporting, Disclosure, and Claims Procedure Requirements With Respect to Welfare Plans Offering Membership in a Qualified Health Maintenance Organization as an Option.	Jan. 21, 1981, 46 FR 5882.	Feb. 20, 1981.
10. 29 CFR 2520.104-20	PWBP	Limited Relief From Reporting, Disclosure, and Claims Procedure Requirements With Respect to Welfare Plans Offering Membership in a Qualified Health Maintenance Organization as an Option.	Jan. 21, 1981, 46 FR 5882.	Feb. 20, 1981.
11. 29 CFR 2520.104-44	PWBP	Same as items 9 and 10.	Jan. 21, 1981, 46 FR 5882.	Feb. 20, 1981.
12. 29 CFR 2560.503-1	PWBP	Same as items 9 and 10.	Jan. 21, 1981, 46 FR 5882.	Feb. 20, 1981.
13. 29 CFR Part 1910	OSHA	Occupational Exposure to Lead; Supplemental Statement of Reasons; and Amendment of Standard.	Jan. 21, 1981, 46 FR 6134.	Feb. 20, 1981.
14. 29 CFR 2550.414c-3	PWBP	Regulations Relating to Certain Loans, Leases and Dispositions of Property Prior to June 30, 1984.	Jan. 23, 1981, 46 FR 7320.	Feb. 23, 1981.
15. 20 CFR Parts 676, 677, 678, and 679	ETA	Comprehensive Employment and Training Act Regulations; Amendments to Administrative Provisions.	Jan. 23, 1981, 46 FR 7622.	Feb. 23, 1981.
16. 20 CFR Part 676	ETA	Comprehensive Employment and Training Act.	Jan. 23, 1981, 46 FR 7832.	Feb. 23, 1981.

Guide to Agency Abbreviation Code

ETA—Employment and Training Administration.
 ESA—W/H Div.—Employment Standards Administration—Wage and Hour Division.
 OSHA—Occupational Safety and Health Administration.
 PWBP—Pension and Welfare Benefits Program Office.
 OFCCP—Office of Federal Contract Compliance Programs.
 SECY—Office of the Secretary.

FOR FURTHER INFORMATION CONTACT:

Agency and Contact

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2. Employment Standards Administration, Wage/Hour Division (ESA-W/H Div.)—Henry T. White, Jr., Telephone: (202) 523-8305
3. Occupational Safety and Health Administration (OSHA)—James F. Foster, Telephone: (202) 523-8151
4. Pension and Welfare Benefit Programs Office (PWBP)—Robert Doyle, Telephone: (202) 523-8684 or Doris Jacobs, Telephone: (202) 523-6844
5. Office of Federal Contract Compliance Programs (OFCCP)—James W. Cisco, Telephone: (202) 523-9426
6. Office of the Secretary—Gail V. Coleman, Telephone: (202) 523-8268.

Authority: Please refer to the above-mentioned documents in order to ascertain the specific statutory authority for each of the rules.

Signed at Washington, D.C. this 3rd day of February, 1981.

Alfred M. Zuck,

Acting Secretary of Labor.

[FR Doc. 81-4344 Filed 2-5-81; 8:45 am]

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DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 53

[EE-2-79]

Foundation and Similar Exise Taxes; Correction

AGENCY: Internal Revenue Service, Treasury.

ACTION: Correction.

SUMMARY: This document corrects a typographical error in the publication of Treasury Decision 7718 which concerned the treatment of certain elderly care facilities.

EFFECTIVE DATE: This correction is effective as of the same date as

Treasury Decision 7718, which is December 31, 1969.

FOR FURTHER INFORMATION CONTACT:

Charles K. Kerby of the Employee Plans and Exempt Organizations Division, Office of Chief Counsel, Internal Revenue Service, 1111 Constitution Avenue, NW., Washington, D.C. 20224. Attention: CC:LR:T, 202-566-3422.

SUPPLEMENTARY INFORMATION:

Background

On September 4, 1980, the Federal Register published Treasury Decision 7718 (45 FR 58520). The Treasury decision adopted final regulations under section 4942(j)(6) of the Internal Revenue Code of 1954, concerning the treatment of private foundations that maintain certain elderly care facilities.

Need for Correction

A typographical error was made in the amendatory language of paragraph 2 of the Treasury decision. This document corrects the error by changing the section of the regulations being amended from "53.4942(b)-(1)" to "53.4942(b)-1(a)."

Drafting Information

The principal author of this correction is Charles K. Kerby of the Employee Plans and Exempt Organizations Division, Office of Chief Counsel, Internal Revenue Service.

Correction of Treasury Decision

Accordingly, FR Doc. 80-27080 (45 FR 58520) is amended as follows: In the amendatory language of Par. 2 on page 58520, the section of the regulations being amended is changed from "53.4942(b)-(1)" to "53.4942(b)-1(a)."

George H. Jelly,

Director, Employee Plans and Exempt Organizations Division.

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26 CFR Parts 1, 5, 7, 10 and 55

(T.D. 7767)

Real Estate Investment Trusts

AGENCY: Internal Revenue Service, Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations relating to the taxation of real estate investment trusts ("REITs"). Changes to the applicable tax law were made by the Tax Reform Act of 1976 and by the Act of January 3, 1975. All REITs and their shareholders will be affected by these regulations.

DATES: In general, these changes apply to taxable years beginning after October 4, 1976, and, in some cases, to taxable years ending after that date or to determinations occurring after that date. However, the changes made by the Act of January 3, 1975, apply to certain property acquired after December 31, 1973. An excise tax imposed on certain REITs applies to taxable years beginning after December 31, 1979. Moreover, a REIT may apply to the Commissioner before May 8, 1981, to revoke an election for pre-1976 years relating to property held for sale to customers.

FOR FURTHER INFORMATION CONTACT: Charles M. Whedbee of the Legislation and Regulations Division, Office of the Chief Counsel, Internal Revenue Service, 1111 Constitution Avenue, N.W., Washington, D.C. 20224, Attention CC:LR:T (202-566-3487, not a toll-free call).

SUPPLEMENTARY INFORMATION:**Background**

On July 7, 1978, the Federal Register published proposed amendments to the Income Tax Regulations (26 CFR Part 1)

under sections 856, 857, 858, 859, and 860 of the Internal Revenue Code of 1954, relating to REITs (43 FR 29317). That document also proposed amendments to the regulations under Code sections 46, 50B, 164, 172, 275, 316, 381, 441, 442, and 512. Moreover, that document contained a new proposed Part 55 of Title 26 of the Code of Federal Regulations. The new Part 55 consists of procedural and administrative regulations relating to the excise tax imposed on certain REITs by section 4981 of the Code. The proposed amendments published on July 7, 1978, were corrected by a correction notice published in the Federal Register for July 25, 1978 (43 FR 32150). These amendments were proposed to conform the regulations to section 1402(b) and Title XVI of the Tax Reform Act of 1976 (Pub. L. 94-455; 90 Stat. 1731, 1742) and section 6 of Pub. L. 93-625 (88 Stat. 2112), and also to revise certain provisions of the existing regulations.

A public hearing was held on December 20, 1978. After consideration of all comments regarding the proposed amendments, these amendments are adopted as revised by this Treasury decision.

Revenue Act of 1978

A new § 1.856-0 states that the regulations adopted by this document do not reflect the amendments made by the Revenue Act of 1978 (Pub. L. 95-600). However, two sentences in § 1.856-6(g) (relating to an extension of the grace period for foreclosure property) now substitute a general reference to section 856(e)(3) of the Code in place of what was, in effect, a restatement in the proposed regulations of certain specific statutory language that was subsequently amended by the 1978 Act. The two sentences do not effect any substantive change from the rule as proposed.

Also, § 10.3 of the regulations, (temporary regulations relating to an extension of the 2-year grace period with respect to foreclosure property) has been recently amended to clarify the effective date of the 1978 Act amendments. See T.D. 7668, published at 40 FR 6378 (January 28, 1980). Since § 10.3 is withdrawn by this document, the special rules in that section that clarify the effective date of the 1978 Act amendments are preserved by adopting them as a new temporary regulation. This new temporary regulation is included in Part 5 of Title 26 of the Code of Federal Regulations (Temporary Income Tax Regulations under the Revenue Act of 1978) as a new § 5.856-1, since it would be inappropriate to include it in Part 10 (Temporary Income Tax Regulations under Pub. L. 96-325).

Public Law 96-595

Public Law 96-595 (94 Stat. 3464), enacted on December 24, 1980, amended section 172(b)(1)(E) of the Code. This amendment revised the rules for determining net operating loss carryovers of taxpayers that are REITs in the year of the loss or were REITs in a taxable year preceding the loss year. The proposed regulations (§ 1.172-12(a)) under section 172(b)(1)(E), as in effect before amendment, specified the taxable years to which the loss of a REIT (or former REIT) could be carried. Because of the changes made by Pub. L. 96-595, the final regulations reserve the paragraph specifying the taxable years to which the loss may be carried and delete another paragraph relating to a transitional rule that is not longer applicable.

Principal Changes From the Proposed Regulations

The principal changes from the proposed regulations are based on public comments. These changes relate to rents from real property, interest, foreclosure property, reasonable cause for failure to meet certain requirements, and the definition of a "successor" corporation.

Rents From Real Property

Section 1.856-4 (b) (3) disqualifies rent which depends on the income or profits of any person. The final regulations remove a flat prohibition on the renegotiation of a change in the percentage during the term of a percentage rental lease (including any renewal period). As adopted, the restriction only applies if the effect of the renegotiation is to base the rent on income or profits. The final regulations also make clear that an amount consisting, in whole or in part, of one or more percentages of the lessee's receipts or sales in excess of one or more determinable dollar amounts may qualify as "rents from real property".

The existing regulations provide that contingent rent may be based on a fixed percentage of receipts or sales (whether or not receipts or sales are adjusted for returned merchandise, or Federal, State, or local taxes). One commentator asked that it be made clear that the enumerated adjustments are not exclusive, and examples of other adjustments (such as bad debts) be added. It is believed, however, that this question is best addressed outside the regulations. For example, Rev. Rul. 74-134, 1974-1 C.B. 170, holds that certain adjustments to the tenant's gross sales did not disqualify the REIT's rent that

was based on a fixed percentage of such gross sales.

Also, the final regulations (§ 1.856-4 (b) (1)) provide that the submetering of certain utilities and the performance of certain cleaning services may qualify as "customary services" if they meet certain other criteria.

Interest

Interest income is apportioned between qualifying and nonqualifying income where a mortgage covers both real and personal property. The regulations, as adopted, provide two additional exceptions for cases where it would not be appropriate to apply the apportionment rules as proposed. These exceptions apply where the REIT commits itself to provide long-term financing following completion of construction, or where the mortgage on the real property is given as additional security (or as a substitute for other security) for the loan after the REIT's loan commitment is binding.

Foreclosure Property

The final regulations contain several changes in the proposed rules relating to foreclosure property.

Section 1.856-6 (b) (3) provides that property is not eligible for the election to be treated as foreclosure property if the loan or lease was made or entered into when the REIT knew or had reason to know that default would occur (or with an intent to evict or foreclose). An additional sentence in the final regulations applies in a "workout" situation, and would not bar eligibility merely because additional credit is extended or an existing investment is restructured to avoid foreclosure or default.

Section 1.856-6 (c) (1), as proposed, provided that an election to treat property as foreclosure property must include all eligible real property acquired by the REIT on foreclosure of a particular indebtedness or a particular lease. This rule is modified in the final regulations to provide an exception if properties securing the same loan (or under the same lease) are acquired in different taxable years. In this case, the REIT may make a separate election for such properties acquired in the same taxable year, and may (but is not required in certain cases to) make an election for the properties acquired in the other taxable year.

The regulations, as adopted (§ 1.857-3 (e)) also provide rules for apportioning the deduction for interest between foreclosure property and other property for purposes of determining "net income from foreclosure property". These rules

are mandatory for taxable years ending after February 6, 1981.

Two changes in the foreclosure property rules relate to the status of the taxpayer. In general, a taxpayer may make an election only if it is a qualified REIT for the taxable year in which the acquisition occurs. Nevertheless, a nonqualified REIT may make the election if it establishes to the appropriate district director's satisfaction that its failure to be a qualified REIT was due to reasonable cause and not due to willful neglect. The final regulations add a similar exception for a nonqualified taxpayer seeking to extend the general 2-year foreclosure property grace period. The regulations, as adopted (§ 1.856-6 (c) (4)), also provide that property will not lose its status as foreclosure property solely because the taxpayer is not a qualified REIT for a taxable year subsequent to the year the election is made.

The regulations (§ 1.856-6 (e) (5)), as adopted, also clarify the rules relating to what constitutes permissible repair and maintenance as opposed to impermissible construction of foreclosure property.

Reasonable Cause

The regulations (§ 1.856-7 (c)), as adopted, revise and clarify the rules relating to reliance on an opinion as reasonable cause under section 856(c) (7) of the Code for failure to meet the percentage-of-income requirements of Code section 856(c) (2) and (3) or to avoid certain other sanctions. As proposed, the regulation provided that the good faith reliance on a reasoned, written opinion of legal counsel (including house counsel) as to the characterization for purposes of section 856 of gross income to be derived (or being derived) from a particular transaction (or series of transactions) generally will constitute "reasonable cause" in a case where the trust fails to meet the percentage-of-income requirements and income from the transaction contributes to the failure. Good faith reliance exists where the trust has no reason to believe that the opinion of counsel is incorrect and where the trust has concluded that the income from the transaction, in the context of the trust's overall portfolio, reasonably cannot be expected to cause a source-of-income requirement to be failed.

Commentators suggested that the regulation provide that REITs could rely on opinions from certified public accountants and others authorized to practice before the Service as reasonable cause to the same extent that it could rely on an opinion of

counsel. Another commentator asked that house counsel of the REIT's advisor be specifically included.

It has been decided not to prescribe a specific list of persons whose opinions may constitute reasonable cause. Rather, the regulation, as adopted, provides that the opinion must be rendered by a tax advisor (including house counsel) whose opinion would be relied on by a person exercising ordinary business care and prudence in the circumstances of the particular transaction. This rule is in keeping with the general overall requirement that the REIT must exercise ordinary business care and prudence in attempting to satisfy the requirements of sections 856 (c) (2) and (3) in order to have reasonable cause for failure to do so.

The final regulations also make clear that the opinion may relate to a standard operating procedure or standard form of transaction if such form or procedure is in fact used or followed.

The regulations, as adopted, also delete the term "good faith reliance" and substitute "reasonable reliance" to better describe the substantive rule.

Successor Corporation

If an election to be a REIT has been revoked or terminated, the taxpayer is ineligible to make a new REIT election for the next four taxable years. Under § 1.856-8 (c) (2), a successor exists if there is common ownership of 50 percent or more of the shares between the predecessor and successor entities. Because there may be more than one class of shares, the final regulations define share ownership in terms of value.

Principal Suggested Changes Not Adopted

The principal suggestions which were not adopted relate to certain options, to foreclosure property held for sale to customers, to an effective date for rules relating to rents, and to the effect of the net operating loss on the amount of capital gain dividends which may be paid.

Options

Several commentators objected to § 1.856-2 (c) (2) of the proposed regulations which does not treat income from lapse of certain options as "qualified income" for purposes of the 75-percent and 90-percent gross income tests. Involved is income recognized by a REIT upon the lapse of an option it wrote which gave the holder the right to acquire land, improvements, or a leasehold of either.

The commentators argue that the final regulations should provide that whether income resulting from the lapse of such an option is "qualified income" depends on the character of the property to which the option in question relates, in a manner similar to the present test under section 1234 of the Code. The commentators point out that, if the option is exercised, any income realized is "qualified income". They argue that to treat income from lapse of an option in a different manner is an artificial distinction which would make it impossible for a REIT to know, at the time of writing an option, whether any income realized would be "qualified".

The commentators also cite the Report of the Committee on Ways and Means on H.R. 12224 (H. Rep. No. 94-1192, 94th Cong., 2d Sess. 1 (1976), 1976-3 C.B. (Vol. 3) 19). This Ways and Means Committee report was adopted by reference in the conference report on the 1976 Act (S. Rep. No. 94-1236, 94th Cong., 2d Sess. 544 (1976), 1976-3 C.B. (Vol. 3) 948). The Ways and Means Committee report, in discussing the amendments to section 1234, makes clear at page 10 the intent that income derived by regulated investment companies upon the lapse of "puts" and "calls" is to be treated as "qualifying" income for purposes of the 90-percent "source of income" requirement of section 851(b)(2). The commentators urge that the same rules should apply to the analogous REIT provisions of section 856.

Because there is no clear indication of congressional intent to the contrary, the final regulations, for REIT purposes, follow the general rule that income from the lapse of an option is not gain from the sale or other disposition of either the option itself or the underlying asset. To effect a different result in a particular case, Congress has made specific statutory exceptions to this general rule. Thus, section 1234 (relating to options to buy or sell stock, securities, commodities and commodities futures) was amended by section 2136 of the 1976 Act. Section 512(b)(5), which excludes gains from the sale or other disposition of certain property from unrelated business taxable income, was specifically amended by Pub. L. 94-396 (90 Stat. 1201) to also exclude gain from the lapse of an option to sell certain securities. Moreover, as noted by the commentators, the Committee on Ways and Means has expressed its intention that gain on the lapse of an option to sell stock or securities should be considered qualified income for the 90-percent source-of-income requirement of a regulated investment company.

Foreclosure Property Held for Sale to Customers

Section 856(e)(4)(C) provides that property ceases to be foreclosure property if, after the 90th day following its acquisition, it is used in a trade or business conducted by the REIT, other than through an independent contractor from whom the REIT does not derive or receive any income. Section 1.856-6(f)(2), as proposed, provides that foreclosure property held by the REIT primarily for sale to customers in the ordinary course of a trade or business is considered to be property used in a trade or business under section 856(e)(4)(C). Accordingly, foreclosure property held by a REIT for such a sale after the appropriate 90 days must be sold through an independent contractor, failing which the property will cease to be foreclosure property and the REIT will be faced with "prohibited transactions" under section 857(b)(6). The temporary regulation relating to foreclosure property (26 CFR 10.1(b)(3)) is identical.

The commentators disagree with this position, citing the Senate Finance Committee Report on Pub. L. 93-635. In discussing the use of the foreclosure property in a trade or business, that report refers to the need to use an independent contractor in the operation of a business acquired through foreclosure, such as a hotel (S. Rep. No. 93-1357, 93d Cong., 2d Sess. 16 (1975), 1975-1 C.B. 526). The commentators distinguish between the operation of property and its sale.

In addition, the commentators argue that because of the difficulty in determining if property is held for sale to customers, counsel to some REITs advise the use of an independent contractor for virtually every sale of foreclosure property.

Alternatively, the commentators urge that if the "independent contractor" requirement for sales of foreclosure property is retained in some form, the regulations should provide a "reasonable cause" rule. Thus, foreclosure property status would not be lost if a REIT sells foreclosure property directly and has reasonable cause to believe that it is not holding the property for sale to customers but is engaged in disposing of an investment property, even if it is ultimately determined that the property was held for sale to customers. This "reasonable cause" rule, say the commentators, could be limited by excluding from its coverage the direct disposition by a REIT of individual condominium units or subdivided land parcels, which are the type of direct sales by a REIT which

Congress clearly intended to preclude. (See the legislative history of the "prohibited transactions" tax under section 857(b)(6) of the Code.)

Notwithstanding these objections, the rule requiring the independent contractor is retained in the final regulations. It is not believed that Congress intended the requirement of an independent contractor to be limited to an ongoing business that is acquired on foreclosure. The regulation is in accord with the general theory that a REIT is intended to be a passive investment medium. Furthermore, to adopt a reasonable cause test would be tantamount to exempting property from the rules of section 856(e)(4)(C) if a favorable opinion had been received with respect to its character in the hands of the REIT.

Section 857(b)(6)(C), enacted by the Revenue Act of 1978, provides a "safe harbor" from the prohibited transaction tax which may, in a particular case, ensure that such tax will not apply, notwithstanding that foreclosure property status is lost because the sale is not through an independent contractor.

Effective Date of Certain Rules Relating to Rents From Real Property

Based on a statutory amendment to Code section 856(d)(1) by section 1604(b) of the 1976 Act, § 1.856-4(b), as proposed, provided that for taxable years beginning after October 4, 1976, the term "rents from real property" includes charges for services customarily furnished or rendered in connection with the rental of real property, whether or not the charges are separately stated. (Prior to the 1976 Act, the regulations provided that if a separate charge is made for customary services, the amount of the charge must be received and retained by an independent contractor and not by the REIT.) Commentators, citing legislative history, urge that the change in the "separate charge" rule should be retroactive to pre-1976 years. The change is explained in the report of the Senate Finance Committee (S. Rep. No. 94-938, 94th Cong., 2d Sess. 473 (1976), 1976-3 C.B. (Vol. 3) 511). It states that the income tax regulations take the position that the amount of the charge must be received and retained by the independent contractor (and not by the REIT), and that this restriction on separate charges for customarily furnished services often does not follow normal commercial practice.

However, section 1603(d)(1) of the 1976 Act provides that this amendment to section 856(d) of the Code is applicable to taxable years beginning

after October 4, 1976. Moreover, the report of the Senate Finance Committee does not clearly evidence an intent to make the amendment retroactive. Accordingly, the final regulations retain the effective date as proposed.

Capital Gains Dividends and Net Operating Loss Carryovers

Several commentators suggest there is a conflict between sections 172(d)(7)(B) and 857(b)(3)(C). Under section 172(d)(7)(B), a net operating loss carryover to a taxable year is, in effect, offset against REIT taxable income as first reduced by the dividends paid deduction. Thus, generally to the extent of the dividends paid deduction in the current year, a net operating loss carryover will not be used but will be available as a carryover to a subsequent year. On the other hand, the last sentence of section 857(b)(3)(C) provides that, for purposes of determining the amount of capital gain dividends which may be paid, the REIT's net capital gain does not exceed REIT taxable income (determined without the deduction for dividends paid). According to the commentators, in computing a REIT's net capital gain, this latter sentence seems to require application of the net operating loss carryover as a deduction against REIT taxable income determined before the dividends paid deduction.

This would have the effect of reducing the amount of REIT taxable income solely for the purpose of determining the amount of the capital gain dividend, notwithstanding that the net operating loss carryover, to the extent of the dividends paid deduction, would not have been used in determining the balance of the loss available as a carryover to subsequent years. The commentators urge that the regulations resolve this suggested conflict by providing, in effect, that the net operating loss deduction is not taken into account in determining the limitation on the amount of the capital gains dividends which may be distributed.

The commentators' suggestion was not adopted because there is no conflict. The last sentence of section 857(b)(3)(E) was added by section 1607(b) of the 1976 Act in connection with a new alternative tax computation for REITs. The effect of that sentence is to prevent a REIT from paying a capital gain dividend out of accumulated earnings and profits in a year when the REIT has a net capital gain and an ordinary loss. There is no evidence that Congress intended a different result to obtain depending on whether the "ordinary loss" consists of deductions paid or

accrued in the current year or of a loss carryover to the current year.

It should be noted that if the REIT pays a capital gain dividend as limited by the last sentence of section 857(b)(3)(C) and also pays an ordinary dividend, both dividends are taken into account in determining how much of the net operating loss carryover is available as a carryover to a subsequent taxable year.

These points are clarified in the regulations as adopted, and are illustrated in a new example in § 1.172-5.

Construction on Foreclosure Property

With respect to foreclosure property, § 1.856-6(e)(4), as proposed, provides that where a REIT acquires a housing subdivision in which some of the houses are more than 10% complete and others are not, the REIT may not complete construction of houses which were only 10% (or less) complete, nor may the REIT begin construction of other houses planned for the subdivision on which construction has not begun. Two commentators suggest that a more realistic rule would apply the 10% completion test to the entire subdivision, which would avoid potential marketing problems. They further suggest that if a subdivision is to be built in phases, it would be appropriate to preclude the REIT from commencing construction on a phase which had not been started at the time of foreclosure. However, the suggestion was not adopted because the rule is based on S. Rep. No. 93-1357, 93d Cong., 2d Sess., 18 (1975), 1975-1 C.B. 526, and is consistent with legislative intent.

REIT as a Partner

One commentator suggested that the final regulations revise § 1.856-3(g), relating to the determination of the qualifying income and assets of a REIT that is a partner in a partnership, notwithstanding that the notice of proposed rulemaking published on July 7, 1978, contained no proposed amendments to that section. However, it is believed that amendments in the nature of those suggested by the commentator, if adopted, should be preceded by a notice of proposed rulemaking. Accordingly, no amendments are made to that section by this document.

Deletion of Temporary Regulations

The following sections of Title 26 of the Code of Federal Regulations are hereby deleted: Sections 10.1 (election by real estate investment trust to treat certain property as foreclosure property) and 10.3 (extension of 2-year grace

period with respect to foreclosure property held by a real estate investment trust) of Part 10 and section 7.856(g)-1 (special rule for real estate investment trusts) of Part 7. These sections provided temporary regulations for real estate investment trusts that are no longer required because of the regulations adopted by this document.

Drafting Information

The principal author of this regulation is Charles M. Whedbee of the Legislation and Regulations Division, Office of Chief Counsel, Internal Revenue Service. However, personnel from other offices of the Internal Revenue Service and Treasury Department participated in developing the regulation both on matters of substance and style.

Adoption of Amendments to the Regulations

Accordingly, a new Part 55, Excise Tax on Certain Real Estate Investment Trusts, is added to Title 26 of the Code of Federal Regulations and the amendments to Parts 1 and 55 of such Title 26 published with notice of proposed rulemaking in the *Federal Register* for July 7, 1978 (43 FR 29317), are adopted, subject to the following changes.

Paragraph 1. Paragraph (a)(1)(iv), (viii), and (ix) of § 1.172-4, as amended by paragraph 8 of the notice of proposed rulemaking, is amended by striking out "§ 1.172-12(a)(2)" each place it appears and inserting in lieu thereof "§ 1.172-12(a)".

Par. 1a. Section 1.172-5(a)(5), as added by paragraph 9 of the notice of proposed rulemaking, is amended as follows:

1. The fourth sentence is amended by striking out "example" and inserting in lieu thereof "examples".

2. The example immediately following the fourth sentence is redesignated "Example (1)." instead of "Example."

3. The third sentence of Example (1), as so redesignated, is amended by inserting ", all of which consists of ordinary income" after "of \$150,000".

4. A new Example (2) is added at the end thereof, to read as follows:

§ 1.172-5 Taxable income which is subtracted from net operating loss to determine carryback or carryover.

(a) Taxable year subject to the Internal Revenue Code of 1954. * * *

(5) Qualified real estate investment trust. * * *

Example (2). (i) Assume the same facts as in example (1), except that the \$150,000 of real estate investment trust taxable income (determined without the net operating loss deduction or the dividends paid deduction) consists of \$80,000 of ordinary income and

\$70,000 of net capital gain. The amount of capital gain dividends which may be paid for 1978 is limited to \$50,000, that is, the amount of the real estate investment trust taxable income for 1978, determined by taking into account the net operating loss deduction for the taxable year, but not the deduction for dividends paid (\$150,000 minus \$100,000). See § 1.857-6(e)(1)(ii).

(ii) X designated \$50,000 of the \$120,000 of dividends paid as capital gains dividends (as defined in section 857(b)(3)(C) and § 1.857-6(e)). Thus, \$70,000 is an ordinary dividend. Since both ordinary dividends and capital gains dividends are taken into account in computing the deduction for dividends paid under section 857(b)(2)(B), the result will be the same as in example (1): that is, the portion of the 1977 net operating loss available as a carryover to 1979 and subsequent years is \$70,000.

Par. 2. Section 1.172-12, as added by paragraph 10 of the notice of proposed rulemaking, is amended as follows:

1. Paragraph (a)(1), (2), (3), and (4) is deleted and a new paragraph (a)(1) is inserted in lieu thereof to read as set forth below.

2. Paragraph (a)(5) is redesignated as paragraph (a)(2) and is amended by striking out "the last sentence of" in the third sentence.

3. Paragraph (c) is deleted.

4. Paragraph (d) is redesignated as paragraph (c) and is amended by adding a new sentence at the end thereof, to read as set forth below.

§ 1.172-12 *Net operating losses of real estate investment trusts.*

(a) *Taxable years to which a loss may be carried.* (1) [reserved]

(c) *Cross references.* * * * See § 1.857-2(a)(5), which provides that for a taxable year ending before October 5, 1976, the net operating loss deduction is not allowed in computing the real estate investment trust taxable income of a qualified real estate investment trust.

Par. 3. Example (7), as added at the end of § 1.316-1(e) by paragraph 16 of the notice of proposed rulemaking, is amended by striking out "\$48,000" in the first sentence and inserting in lieu thereof, "\$46,000".

Par. 4. Section 1.381(c)(25)-1, as added by paragraph 18 of the notice of proposed rulemaking, is amended by striking out "857(b) or 1201(a)" in paragraph (a)(2) and inserting in lieu thereof "857(b)(1), 857(b)(3)(A), or 1201(a)", and by striking out "in duplicate" in the first sentence of paragraph (c).

Par. 5. Paragraph 21 of the notice of proposed rulemaking is revised to read as follows:

Par. 21. Section 1.443-1(e)(5) is amended by striking out "857(b)(2)(D)"

and inserting in lieu thereof "857(b)(2)(c)".

Par. 6. Paragraph 24 of the notice of proposed rulemaking is revised to read as follows:

Par. 24. Section 1.856 is deleted and a new § 1.856-0 is added to read as follows:

§ 1.856-0 *Revenue Act of 1978 amendments not included.*

The regulations under part II of subchapter M of the Code do not reflect the amendments made by the Revenue Act of 1978.

Par. 7. Section 1.856-2(c)(2), as revised by paragraph 26 of the notice of proposed rulemaking, is amended by striking out "section 85(c)(6)(C)" in the first sentence and inserting in lieu thereof "section 856(c)(6)(C)".

Par. 8. Section 1.856-4, as revised by paragraph 28 of the notice of proposed rulemaking, is revised as follows:

1. Paragraph (b)(1) is revised by deleting the third, fourth and fifth sentences, and inserting in lieu thereof 3 new sentences, to read as set forth below.

2. Paragraph (b)(3) is amended by striking out "renewal periods of the lease" in the third sentence and inserting in lieu thereof "renewal periods of the lease" in a manner which has the effect of basing the rent on income or profits", and by striking out "sublease" in the fourth sentence and inserting in lieu thereof "sublessee".

3. Paragraph (b)(3) is further amended by deleting the ninth sentence and inserting three new sentences in lieu thereof, to read as set forth below, and by inserting "and 10 percent of such gross receipts in excess of \$10,000 x" immediately after "\$5,000 x" in the second sentence of the example.

4. Paragraph (b)(5) is amended by striking out "(ii) *Trustee functions.* The trustees" and inserting in lieu thereof "(ii) *Trustee or director functions.* The trustees."

§ 1.856-4 *Rents from real property.*

(b) *Amounts specifically included or excluded.*—(1) *Charges for customary services.* * * * The furnishing of water, heat, light, and air-conditioning, the cleaning of windows, public entrances, exits, and lobbies, the performance of general maintenance and of janitorial and cleaning services, the collection of trash, and the furnishing of elevator services, telephone answering services, incidental storage space, laundry equipment, watchman or guard services, parking facilities, and swimming pool facilities are examples of services which are customarily furnished to the tenants of a particular class of buildings in many geographic marketing areas. Where it is customary, in a particular geographic marketing area to furnish electricity or other

utilities to tenants in buildings of a particular class, the submetering of such utilities to tenants in such buildings will be considered a customary service. To qualify as a service customarily furnished, the service must be furnished or rendered to the tenants of the real estate investments trust or, primarily for the convenience or benefit of the tenant, to the guests, customers, or subtenants of the tenant. * * *

(3) *Disqualification of rent which depends on income or profits of any person.* * * * An amount received or accrued as rent for the taxable year which consists, in whole or in part, of one or more percentages of the lessee's receipts or sales in excess of determinable dollar amounts may qualify as "rents from real property", but only if two conditions exist. First, the determinable amounts must not depend in whole or in part on the income or profits of the lessee. Second, the percentages and, in the case of leases entered into after July 7, 1978, the determinable amounts, must be fixed at the time the lease is entered into and a change in percentages and determinable amounts is not renegotiated during the term of the lease (including any renewal periods of the lease) in a manner which has the effect of basing rent on income or profits. * * *

Par. 9. Section 1.856-5 (c), as added by paragraph 29 of the notice of proposed rulemaking, is revised to read as follows:

§ 1.856-5 *Interest.*

(c) *Apportionment of interest.*—(1) *In general.* Where a mortgage covers both real property and other property, an apportionment of the interest income must be made for purposes of the 75-percent requirement of section 856 (c)(3). For purposes of the 75-percent requirement, the apportionment shall be made as follows:

(i) If the loan value of the real property is equal to or exceeds the amount of the loan, then the entire interest income shall be apportioned to the real property.

(ii) If the amount of the loan exceeds the loan value of the real property, then the interest income apportioned to the real property is an amount equal to the interest income multiplied by a fraction, the numerator of which is the loan value of the real property, and the denominator of which is the amount of the loan. The interest income apportioned to the other property is an amount equal to the excess of the total interest income over the interest income apportioned to the real property.

(2) *Loan value.* For purposes of this paragraph, the loan value of the real property is the fair market value of the property, determined as of the date on which the commitment by the trust to make the loan becomes binding on the trust. In the case of a loan purchased by the trust, the loan value of the real property is the fair market value of the property, determined as of the date on which the commitment by the trust to purchase the loan becomes binding on the trust. However, in the case of a construction

loan or other loan made for purposes of improving or developing real property, the loan value of the real property is the fair market value of the land plus the reasonably estimated cost of the improvement or developments (other than personal property) which will secure the loan and which are to be constructed from the proceeds of the loan. The fair market value of the land and the reasonably estimated cost of improvements or developments shall be determined as of the date on which a commitment to make the loan becomes binding on the trust. If the trust does not make the construction loan but commits itself to provide long-term financing following completion of construction, the loan value of the real property is determined by using the principles for determining the loan value for a construction loan. Moreover, if the mortgage on the real property is given as additional security (or as a substitute for other security) for the loan after the trust's commitment is binding, the real property loan value is its fair market value when it becomes security for the loan (or, if earlier, when the borrower makes a binding commitment to add or substitute the property as security).

(3) *Amount of loan.* For purposes of this paragraph, the amount of the loan means the highest principal amount of the loan outstanding during the taxable year.

Par. 10. Section 1.865-8, as added by paragraph 29 of the notice of proposed rulemaking, is revised as follows:

1. Paragraph (b) (2) and (3) is revised to read as set forth below.

2. Paragraph (c)(1) is revised to read as set forth below.

3. Paragraph (c)(4) is amended by striking out "advice of counsel" in the third sentence and inserting in lieu thereof "expert advice", and by deleting the last sentence and inserting in lieu thereof two new sentences, to read as set forth below.

4. So much of paragraph (d)(1) as precedes "(i) Enters into a lease with respect to" is revised to read as set forth below.

5. Paragraph (d)(1) is further amended by striking out "acquires a shopping center" in the second sentence, and inserting in lieu thereof, "acquires, in a particular taxable year, a shopping center".

6. Paragraph (e)(1) is amended by striking out "Under section 856(e)(4)(B) property ceases to be foreclosure property on the first day (occurring on or after the day on which the trust acquired the property)" in the first sentence and inserting in lieu thereof "Under section 856(e)(4)(B), all real property (and any incidental personal property) for which a particular election has been made (see paragraph (c)(1) of this section) shall cease to be foreclosure property on the first day (occurring on or after the day on which the trust acquired the property)".

7. Paragraph (e)(3) is amended by striking out "The preceding sentence applies" in the sixth sentence and inserting in lieu thereof "Subdivision (ii) of the preceding sentence applies".

8. Paragraph (e)(5) is revised to read as set forth below.

9. Paragraph (f)(1) is revised to read as set forth below.

10. Paragraph (g)(1) is amended by striking out the third sentence and inserting a new sentence in lieu thereof to read as set forth below.

11. Paragraph (g)(5) is amended by striking out "if the trust previously has been granted two extensions with respect to the property, or" and by adding a new sentence at the end of paragraph (g)(5), to read as set forth below.

12. A new paragraph (g)(7) is added after paragraph (g)(6) to read as set forth below.

§ 1.856-8 Foreclosure property.

(b) *Property eligible for the election.* * * *
(2) *Personal property.* Personal property (including personal property not subject to a mortgage or lease of the real property) will be considered incident to a particular item of real property if the personal property is used in a trade or business conducted on the property or the use of the personal property is otherwise an ordinary and necessary corollary of the use to which the real property is put. In the case of a hotel, such items as furniture, appliances, linens, china, food, etc., would be examples of incidental personal property. Personal property incident to the real property is eligible for the election even though it is acquired after the real property is acquired or is placed in the building or other improvement in the course of the completion of construction.

(3) *Property with respect to which default is anticipated.* Property is not eligible for the election to be treated as foreclosure property if the loan or lease with respect to which the default occurs (or is imminent) was made or entered into (or the lease or indebtedness was acquired) by the trust with an intent to evict or foreclose, or when the trust knew or had reason to know that default would occur ("improper knowledge"). For purposes of the preceding sentence, a trust will not be considered to have improper knowledge with respect to a particular lease or loan if the lease or loan was made pursuant to a binding commitment entered into by the trust at a time when it did not have improper knowledge. Moreover, if the trust, in an attempt to avoid default or foreclosure, advances additional amounts to the borrower in excess of amounts contemplated in the original loan commitment or modifies the lease or loan, such advance or modification will be considered not to have been made with an intent to evict or foreclose, or with improper knowledge, unless the original loan or lease was entered into with that intent or knowledge.

(c) *Election—(1) In general.* (i) An election to treat property as foreclosure property

applies to all of the eligible real property acquired in the same taxable year by the trust upon the default (or as a result of the imminence of default) on a particular lease (where the trust is the lessor) or on a particular indebtedness owed to the trust. For example, if a loan made by a trust is secured by two separate tracts of land located in different cities, and in the same taxable year the trust acquires both tracts on foreclosure upon the default (or imminence of default) of the loan, the trust must include both tracts in the election. For a further example, the trust may choose to make a separate election for only one of the tracts if they are acquired in different taxable years or were not security for the same loan. If real property subject to the same election is acquired at different times in the same taxable year, the grace period for a particular property begins when that property is acquired.

(ii) If the trust acquires separate pieces of real property that secure the same indebtedness (or are under the same lease) in different taxable years because the trust delays acquiring one of them until a later taxable year, and the primary purpose for the delay is to include only one of them in an election, then if the trust makes an election for one piece it must also make an election for the other piece. A trust will not be considered to have delayed the acquisition of property for this purpose if there is a legitimate business reason for the delay (such as an attempt to avoid foreclosure by further negotiations with the debtor or lessee).

(iii) All of the eligible personal property incident to the real property must also be included in the election.

(4) *Status of taxpayer.* * * * If a taxpayer makes a valid election to treat property as foreclosure property, the property will not lose its status as foreclosure property solely because the taxpayer is not a qualified real estate investment trust for a subsequent taxable year (including a taxable year which encompasses an extension of the grace period). However, the rules relating to the termination of foreclosure property status in section 856(e)(4) (but not the tax on income from foreclosure property imposed by section 857(b)(4)) apply to the year in which the property is acquired and all subsequent years, even though the taxpayer is not a qualified real estate investment trust for such year.

(d) *Termination of 2-year grace period: subsequent leases—(1) In general.* Under section 856(e)(4)(A), all real property (and any incidental personal property) for which a particular election has been made (see paragraph (c)(1) of this section) shall cease to be foreclosure property on the first day (occurring on or after the day on which the trust acquired the property) on which the trust either—

(e) *Termination of 2-year grace period: completion of construction—* * * *

(5) *Repair and maintenance.* Under this paragraph (e), "construction" does not include—

(i) The repair or maintenance of a building or other improvement, such as the replacement of worn or obsolete furniture

and appliances to offset normal wear and tear or obsolescence and the restoration of property required because of damage from fire, storm, vandalism or other casualty.

(ii) The preparation of leased space for a new tenant which does not substantially extend the useful life of the building or other improvement or significantly increase its value, even though, in the case of commercial space, this preparation includes adapting the property to the conduct of a different business, or

(iii) The performing of repair or maintenance described in paragraph (e)(5)(i) of this section after property is acquired that was deferred by the defaulting party and that does not constitute renovation under paragraph (e)(2) of this section.

(f) *Termination of 2-year grace period; use of foreclosure property in a trade or business.*—(1) *In general.* Under section 856(e)(4)(C), all real property (and any incidental personal property) for which a particular election has been made (see paragraph (c)(1) of this section) shall cease to be foreclosure property on the first day (occurring more than 90 days after the day on which the trust acquired the property) on which the property is used in a trade or business conducted by the trust, other than a trade or business conducted by the trust through an independent contractor from whom the trust itself does not derive or receive any income. (See section 856(d)(3) for the definition of independent contractor.).

(g) *Extension of 2-year grace period.*—(1) *In general.* * * * See section 856(e)(3) (as in effect with respect to the particular extension) for rules relating to the maximum length of an extension, and the number of extensions which may be granted. * * *

(5) *Automatic extension.* * * * Moreover, this subparagraph shall not operate to allow any period of extension that is prohibited by the last sentence of section 856(e)(3) (as in effect with respect to the particular extension).

(7) *Status of taxpayer.* The reference to "real estate investment trust" or "trust" in this paragraph (g) shall be considered to include a taxpayer that is not a qualified real estate investment trust, if the taxpayer establishes to the satisfaction of the district director that its failure to be a qualified real estate investment trust for the taxable year was due to reasonable cause and not due to willful neglect. The principles of § 1.856-7(c) and § 1.856-8(d) (including the principles relating to expert advice) shall apply for determining reasonable cause (and absence of willful neglect) for this purpose.

Par. 11. Section 1.856-7, as added by paragraph 29 of the notice of proposed rulemaking, is amended by revising paragraph (c)(2) to read as set forth below.

§ 1.856-7 *Certain corporations, etc., that are considered to meet the gross income requirements.*

(c) *Reasonable cause.* * * *

(2) *Expert advice.*—(i) *In general.* The reasonable reliance on a reasoned, written opinion as to the characterization for purposes of section 856 of gross income to be derived (or being derived) from a transaction generally constitutes "reasonable cause" if income from that transaction causes the trust to fail to meet the requirements of paragraph (2) or (3) of section 856(c) (or of both paragraphs). The absence of such a reasoned, written opinion with respect to a transaction does not, by itself, give rise to any inference that the failure to meet a percentage of income requirement was without reasonable cause. An opinion as to the character of income from a transaction includes an opinion pertaining to the use of a standard form of transaction or standard operating procedure in a case where such standard form or procedure is in fact used or followed.

(ii) If the opinion indicates that a portion of the income from a transaction will be nonqualified income, the trust must still exercise ordinary business care and prudence with respect to the nonqualified income and determine that the amount of that income, in the context of its overall portfolio, reasonably cannot be expected to cause a source-of-income requirement to be failed. Reliance on an opinion is not reasonable if the trust has reason to believe that the opinion is incorrect (for example, because the trust withholds facts from the person rendering the opinion).

(iii) *Reasoned written opinion.* For purposes of this subparagraph (2), a written opinion means an opinion, in writing, rendered by a tax advisor (including house counsel) whose opinion would be relied on by a person exercising ordinary business care and prudence in the circumstances of the particular transaction. A written opinion is considered "reasoned" even if it reaches a conclusion which is subsequently determined to be incorrect, so long as the opinion is based on a full disclosure of the factual situation by the real estate investment trust and is addressed to the facts and law which the person rendering the opinion believes to be applicable. However, an opinion is not considered "reasoned" if it does nothing more than recite the facts and express a conclusion.

Par. 12. Section 1.856-8, as added by paragraph 29 of the notice of proposed rulemaking is amended as follows:

1. Paragraph (b) is amended by inserting a new sentence after the first sentence to read as set forth below.

2. The second sentence of paragraph (c)(2) is amended by striking out "indirectly, 50 percent or more of its shares" and inserting in lieu thereof "indirectly, 50 percent or more in value of its outstanding shares", and by striking out "effective, 50 percent or more of the shares", and inserting in lieu thereof, "effective, 50 percent or more in value of the outstanding shares".

3. Paragraph (d) is amended by striking out "advice of counsel" in the fourth sentence and inserting in lieu thereof "expert advice".

§ 1.856-8 *Revocation or termination of election.*

(b) *Termination of election to be a real estate investment trust.* * * * (This election terminates whether the failure to be a qualified real estate investment trust is intentional or inadvertent.) * * *

Par. 13. Section 1.857-2, as redesignated and revised by paragraph 33 of the notice of proposed rulemaking, is amended by striking out "investment taxable income" in the second sentence of paragraph (a) and inserting in lieu thereof "investment trust taxable income."

Par. 14. Section 1.857-3, as added by paragraph 34 of the notice of proposed rulemaking, is amended by adding new paragraphs (d) and (e) at the end thereof, to read as follows:

§ 1.857-3 *Net income from foreclosure property.*

(d) *Gross income not subject to tax on foreclosure property.* If the gross income derived from foreclosure property consists of two classes, a deduction directly connected with the production of both classes (including interest attributable to the carrying of the property) must be apportioned between them. The two classes are:

(1) Gross income which is taken into account in computing net income from foreclosure property and

(2) Other income (such as income described in subparagraph (A), (B), (C), (D), or (G) of section 856(c)(3)).

The apportionment may be made on any reasonable basis.

(e) *Allocation and apportionment of interest.* For purposes of determining the amount of interest attributable to the carrying of foreclosure property under paragraph (b) of this section, the following rules apply:

(1) *Deductible interest.* Interest is taken into account under this paragraph (e) only if it is otherwise deductible under chapter 1 of the Code.

(2) *Interest specifically allocated to property.* Interest that is specifically allocated to an item of property is attributable only to the carrying of that property. Interest is specifically allocated to an item of property if (i) the indebtedness on which the interest is paid or accrued is secured only by that property, (ii) such indebtedness was specifically incurred for the purpose of purchasing, constructing, maintaining, or improving that property, and (iii) the proceeds of the borrowing were applied for that purpose.

(3) *Other interest.* Interest which is not specifically allocated to property is apportioned between foreclosure property and other property under the principles of § 1.861-8(e)(2)(v).

(4) *Effective date.* The rules in this paragraph (e) are mandatory for all taxable years ending after February 6, 1981.

Par. 15. Section 1.857-5, as added by paragraph 34 of the notice of proposed

rulemaking, is amended by striking out "should be" in the first sentence of paragraph (b) and inserting in lieu thereof "are".

Par. 16. Section 1.857-6, as redesignated by paragraph 34 and amended by paragraph 35 of the notice of proposed rulemaking, is amended by striking out "(1) A capital gain" immediately after the title of paragraph (e), and inserting in lieu thereof "(1)(i) A capital gain", and by adding a new subdivision (ii) at the end of paragraph (e), to read as follows:

(c) *Definition of capital gain dividend.* (1)

(ii) For purposes of section 857(b)(3)(C) and this paragraph, the net capital gain for a taxable year ending after October 4, 1976, is deemed not to exceed the real estate investment trust taxable income determined by taking into account the net operating loss deduction for the taxable year but not the deduction for dividends paid. See example (2) in § 1.172-5(a)(5).

Par. 16a. Subparagraphs 1 and 2 of paragraph 35 of the notice of proposed rulemaking are revised to read as follows:

1. The first sentence of paragraph (b) is amended by striking out "an investment trust for" and inserting in lieu thereof "a corporation, trust, or association for".

2. Paragraph (c)(1) is amended by striking out "857(b)(4)" and inserting in lieu thereof "857(b)(7)".

Par. 17. A new paragraph 44 is added to the notice of proposed rulemaking, to read as follows:

Par. 44. Section 1.857-6, as redesignated by Par. 34 of this document, is amended by striking out "December 1" in the example in paragraph (c)(3) and inserting in lieu thereof, "December 31".

Par. 18. Section 1.859-3, as added by paragraph 42 of the notice of proposed rulemaking, is amended by inserting "(computed without the dividends paid deduction)" after "income of corporation X" in the sixth sentence of Example (1) in paragraph (c).

Par. 19. The date of publication of this Treasury decision in the *Federal Register* is substituted for the date the notice of proposed rulemaking is adopted as a Treasury decision wherever the later date was specified in the notice of proposed rulemaking.

Title 26 of the Code of Federal Regulations is further amended by adding a new section 5.856-1 to Part 5, Temporary Income Tax Regulations under the Revenue Act of 1978, to read as follows:

§ 5.856-1 Extensions of the grace period for foreclosure property by a real estate investment trust.

(a) *In general.* Under section 856(e), a real estate investment trust ("REIT") may elect to treat as foreclosure property certain real property (including interests in real property), and any personal property incident to such real property, that the REIT acquires after December 31, 1973. In general, the REIT must acquire the property as the result of having bid in the property at foreclosure, or having otherwise reduced the property to ownership or possession by agreement or process of law, after there was default (or default was imminent) on a lease of such property (where the REIT was the lessor) or on an indebtedness owed to the REIT which such property secured. Property that a REIT elects to treat as foreclosure property ceases to be foreclosure property with respect to such REIT at the end of a grace period. The grace period ends on the date which is 2 years after the date on which the REIT acquired the property, unless the REIT has been granted an extension or extensions of the grace period. If the grace period is extended, the property ceases to be foreclosure property on the day immediately following the last day of the grace period, as extended.

(b) *Rules for extensions of the grace period.* In general, § 1.856-6(g) prescribes rules regarding extensions of the grace period. However, in order to reflect the amendment of section 856(e)(3) of the Code by section 363(c) of the Revenue Act of 1978, the following rules also apply:

(1) In the case of extensions granted after November 6, 1978, with respect to extension periods beginning after December 31, 1977, the district director may grant one or more extensions of the grace period for the property, subject to the limitation that no extension shall extend the grace period beyond the date which is 6 years after the date the REIT acquired the property. In any other case, an extension shall be for a period of not more than 1 year, and not more than two extensions can be granted with respect to the property.

(2) In the case of an extension period beginning after December 31, 1977, a request for an extension filed on or before March 28, 1980, will be considered to be timely if the limitation on the number and length of extensions in section 856(e)(3), as in effect before the amendment made by section 363(c) of the Revenue Act of 1978, would have barred the extension.

This Treasury decision is issued under the authority contained in the following sections of the Internal Revenue Code of 1954: section 856(d)(4) (90 Stat. 1750, 26 U.S.C. 856(d)(4)); section 856(e)(5) (88 Stat. 2113; 26 U.S.C. 856(e)(5)); section 856(f)(2) (90 Stat. 1751; 26 U.S.C. 856(f)(2)); section 856(g)(2) (90 Stat. 1753; 26 U.S.C. 856(g)(2)); section 858(a) (74 Stat. 1008; 26 U.S.C. 858(a)); section 859(c) (90 Stat. 1743; 26 U.S.C. 859(c)); section 859(e) (90 Stat. 1744; 26 U.S.C. 859(e)); section 6001 (68A Stat. 731, 26 U.S.C. 6001); section 6011 (68A Stat. 732, 26 U.S.C. 6011); section 6071. (68A Stat.

749, 26 U.S.C. 6071); section 6091 (68A Stat. 752, 26 U.S.C. 6091); section 7805 (68A Stat. 917, 26 U.S.C. 7805). The amendments are also issued under the authority contained in section 1608(d)(2) of the Tax Reform Act of 1976 (90 Stat. 1758).

Dated: January 19, 1981.

William E. Williams,

Acting Commissioner of Internal Revenue.

Emil M. Sunley,

Acting Assistant Secretary of the Treasury.

26 CFR Parts 1, 5, 7, 10, and 55 are amended as follows:

PART 1—INCOME TAX; TAXABLE YEARS BEGINNING AFTER DECEMBER 31, 1953

Paragraph 1. Section 1.46 is removed.

Par. 2. Section 1.46-4(b)(2) is amended by striking out "857(b)(2)(C)" in subdivision (ii) and inserting in lieu thereof "857(b)(2)(B) (section 857(b)(2)(C), as then in effect, for taxable years ending before October 5, 1976)" and by adding three new sentences after the second sentence, to read as set forth below.

§ 1.46-4 Limitations with respect to certain persons.

(b) Regulated investment companies and the real estate investment trusts.

(2) * * * In the case of a taxable year ending after October 4, 1976, real estate investment trust taxable income, for purposes of section 46(e) and this paragraph, is determined by excluding any net capital gain, and by computing the deduction for dividends paid without regard to capital gains dividends (as defined in section 857(b)(3)(C)). In the case of a real estate investment trust, the amount of the deduction for dividends paid includes the amount of deficiency dividends (other than capital gains deficiency dividends) taken into account in computing real estate investment trust taxable income for the taxable year. See section 859(d) for the definition of deficiency dividends. * * *

Par. 3. Section 1.50B-5(b)(2) is amended by striking out "857(b)(2)(C)" in subdivision (ii) and inserting in lieu thereof "857(b)(2)(B) (section 857(b)(2)(C), as then in effect, for taxable years ending before October 5, 1976)" and by adding three new sentences after the second sentence, to read as set forth below.

§ 1.50B-5 Limitations with respect to certain persons.

(b) Regulated investment companies and real estate investment trusts. * * *

(2) * * * In the case of a taxable year ending after October 4, 1976, real estate investment trust taxable income, for purposes of this paragraph, is determined by excluding any net capital gain, and by computing the deduction for dividends paid without regard to capital gains dividends (as defined in section 857(b)(3)(C)). In the case of a real estate investment trust, the amount of the deduction for dividends paid includes the amount of deficiency dividends (other than capital gains deficiency dividends) taken into account in computing real estate investment trust taxable income for the taxable year. See section 859(d) for the definition of deficiency dividends.

§ 1.116-1 [Amended]

Par. 4. Section 1.116-1(d)(2)(iv) is amended by striking out "1.857-4" and inserting in lieu thereof "1.857-6".

Par. 5. Section 1.164-2 is amended by striking out "or (c) of this section" in paragraph (f) and inserting in lieu thereof "(c), or (h) of this section", and by adding a new paragraph (h) at the end thereof to read as set forth below.

§ 1.164-2 Deduction denied in case of certain taxes.

(h) *Excise tax on real estate investment trusts.* The excise tax imposed on certain real estate investment trusts by section 4981.

§ 1.172 [Removed]

Par. 6. Section 1.172 is removed.

Par. 7. A new paragraph (e) is added at the end of § 1.172-2 to read as set forth below.

§ 1.172-2 Net operating loss in case of a corporation.

(e) *Qualified real estate investment trusts.* For taxable years ending after October 4, 1976, the net operating loss of a qualified real estate investment trust (as defined in § 1.172-12(b)) is computed by taking into account the adjustments described in section 857(b)(2) (other than the deduction for dividends paid, as defined in section 561), as well as the modifications required by paragraph (a)(1) of this section. Thus, for example, the special deductions for dividends received, etc., provided in part VIII of subchapter B (other than section 248), as well as the net operating loss deduction under section 172, are not allowed in computing the net operating loss of a qualified real estate investment trust.

§ 1.172-4 [Amended]

Par. 8. Section 1.172-4 is amended as follows:

1. Paragraph (a)(1)(ii) is amended by inserting "§ 1.172-12(a)," immediately after "of this subparagraph,".

2. Paragraph (a)(1)(iii) is amended by striking out "and § 1.172-9" and inserting in lieu thereof ", § 1.172-9, and the exception in § 1.172-12(a)".

3. Paragraph (a)(1)(iv) is amended by inserting "and § 1.172-12(a)" after "Except as provided in subdivision (v) of this subparagraph".

4. Paragraphs (a)(1)(viii) and (a)(1)(ix) are each amended by inserting "(except as provided in § 1.172-12(a))" after "be carried back".

Par. 9. Paragraph (a) of § 1.172-5 is amended by adding a new subparagraph (5) at the end thereof, to read as set forth below.

§ 1.172-5 Taxable income which is subtracted from net operating loss to determine carryback or carryover.

(a) *Taxable year subject to the Internal Revenue Code of 1954.* * * *

(5) *Qualified real estate investment trust.* Where a net operating loss is carried over to a qualified taxable year (as defined in § 1.172-12(b)) ending after October 4, 1976, the real estate investment trust taxable income (as defined in section 857(b)(2)) shall be used as the "taxable income" for that taxable year to determine, under section 172(b)(2), the balance of the net operating loss available as a carryover to a subsequent taxable year. The real estate investment trust taxable income, however, is computed by applying the rules applicable to corporations in paragraph (a)(3) of this section. Thus, in computing real estate investment trust taxable income for purposes of section 172(b)(2), the net operating loss deduction for the taxable year shall be computed in accordance with paragraph (a)(3)(i) of this section. The principles of this subparagraph may be illustrated by the following examples:

Example (1). Corporation X, a calendar year taxpayer, is formed on January 1, 1977. X incurs a net operating loss of \$100,000 for its taxable year 1977, which under section 172(b)(2), is a carryover to 1978. For 1978 X is a qualified real estate investment trust (as defined in § 1.172-12(b)) and has real estate investment trust taxable income (determined without regard to the deduction for dividends paid or the net operating loss deduction) of \$150,000, all of which consists of ordinary income. X pays dividends in 1978 totaling \$120,000 that qualify for the deduction for dividends paid under section 857(b)(2)(B). The portion of the 1977 net operating loss available as a carryover to 1979 and subsequent years is \$70,000 (i.e., the excess of the amount of the net operating loss

(\$100,000) over the amount of the real estate investment trust taxable income for 1978 (\$30,000), determined by taking into account the deduction for dividends paid allowable under section 857(b)(2)(B) and without taking into account the net operating loss of 1977).

Example (2). (i) Assume the same facts as in example (1), except that the \$150,000 of real estate investment trust taxable income (determined without the net operating loss deduction or the dividends paid deduction) consists of \$80,000 of ordinary income and \$70,000 of net capital gain. The amount of capital gain dividends which may be paid for 1978 is limited to \$50,000, that is, the amount of the real estate investment trust taxable income for 1978, determined by taking into account the net operating loss deduction for the taxable year, but not the deduction for dividends paid (\$150,000 minus \$100,000). See § 1.857-6(e)(1)(ii).

(ii) X designated \$50,000 of the \$120,000 of dividends paid as capital gains dividends (as defined in section 857(b)(3)(C) and § 1.857-6(e)). Thus, \$70,000 is an ordinary dividend. Since both ordinary dividends and capital gains dividends are taken into account in computing the deduction for dividends paid under section 857(b)(2)(B), the result will be the same as in example (1); that is, the portion of the 1977 net operating loss available as a carryover to 1979 and subsequent years is \$70,000.

Par. 10. A new § 1.172-12 is added after § 1.172-11 to read as follows:

§ 1.172-12 Net operating losses of real estate investment trusts.

(a) *Taxable years to which a loss may be carried.* (1) [reserved]

(2) A qualified taxable year is a taxable year preceding or following the taxable year of the net operating loss, for purposes of section 172(b)(1), even though the loss may not be carried to, or allowed as a reduction in, such qualified taxable year. Thus, a qualified taxable year ending before October 5, 1976 (for which no net operating loss deduction is allowable) is nevertheless a preceding or following taxable year for purposes of section 172(b)(1). Moreover, a qualified taxable year ending after October 4, 1976 (to which a net operating loss cannot be carried back because of section 172(b)(1)(E)) is nevertheless a preceding taxable year for purposes of section 172(b)(1). For purposes of determining, under section 172(b)(2), the balance of the loss available as a carryback or carryover to other taxable years, however, the net operating loss is not reduced on account of such qualified taxable year being a preceding or following taxable year.

(b) *Definitions.* For purposes of this section and §§ 1.172-2 and 1.172-5—

(1) The term "qualified real estate investment trust" means, with respect to any taxable year, a real estate investment trust within the meaning of part II of subchapter M which is taxable

for such year under that part as a real estate investment trust, and

(2) The term "qualified taxable year" means a taxable year for which the taxpayer is a qualified real estate investment trust.

(c) *Cross references.* See §§ 1.172-2(e) and 1.172-5(a)(5) for the computation of the net operating loss of a qualified real estate investment trust for a taxable year ending after October 4, 1976, and the amount of a net operating loss which is absorbed when carried over to a qualified taxable year ending after October 4, 1976. See § 1.857-2(a)(5), which provides that for a taxable year ending before October 5, 1976, the net operating loss deduction is not allowed in computing the real estate investment trust taxable income of a qualified real estate investment trust.

§ 1.243-2 [Amended]

Par. 11. Section 1.243-2(c) is amended by striking out "1.857-4" and inserting in lieu thereof "1.857-6".

§ 1.246-1 [Amended]

Par. 12. Section 1.246-1(d) is amended by striking out "1.857-4" and inserting in lieu thereof "1.857-6".

§ 1.275 [Removed]

Par. 13. Section 1.275 is removed.

§ 1.275-1 [Amended]

Par. 14. Section 1.275-1 is amended by striking out "and (e)" and inserting in lieu thereof "(e) and (h)".

§ 1.316 [Removed]

Par. 15. Section 1.316 is removed.

Par. 16. Section 1.316-1 is amended as follows:

1. Paragraph (d) of § 1.316-1 is redesignated as paragraph (e) and a new paragraph (d) is inserted immediately after paragraph (c), to read as set forth below:

2. A new example (7) is added at the end of paragraph (e) (as redesignated), to read as set forth below.

§ 1.316-1 Dividends.

(d) In the case of a corporation which, under the law applicable to the taxable year in respect of which a distribution is made under section 859 (relating to deficiency dividends), was a real estate investment trust (within the meaning of section 856), the term "dividend," in addition to the meaning set forth in paragraphs (a) and (b) of section 316, means a distribution of property to its shareholders which constitutes a "deficiency dividend" as defined in section 859(d).

(e) * * *

Example (7). In 1979, a deficiency of \$46,000 in the tax on real estate investment trust taxable income is established against corporation R for the taxable year 1977, based on an increase in real estate investment trust taxable income of \$100,000. Corporation R complied with the provisions of section 859 and in December 1979 distributed to its stockholders \$100,000, which qualified as "deficiency dividends" under section 859(d). The distribution of \$100,000 is a taxable dividend. It is immaterial whether corporation R is a real estate investment trust for the taxable year 1979 or whether it had accumulated or current earnings and profits in 1979.

§ 1.381(c)(17)-(1) [Amended]

Par. 17. The example in § 1.381(c)(17)-(1)(f) is amended by striking out "paragraph (d) of § 1.316-1" in the sixth sentence and inserting in lieu thereof "paragraph (e) of § 1.316-1".

Par. 18. A new § 1.381(c)(25)-1 is added after § 1.381(c)(24)-1, to read as follows:

§ 1.381(c)(25)-1 Deficiency dividend of real estate investment trust.

(a) *Carryover requirement.* If a distributor or transferor corporation in a transaction to which section 381(a) applies—

(1) Was a real estate investment trust (within the meaning of section 856, as in effect for the applicable taxable year) for any taxable year ending on or before the date of distribution or transfer, and

(2) A determination (as defined in section 859(c)) establishes that the transferor or distributor corporation is liable for the tax imposed by section 11(a), 56(a), 857(b)(1), 857(b)(3)(A), or 1201(a) for such taxable year,

then in determining the liability for such tax the deduction described in section 859 shall be allowed pursuant to section 381(c)(25) to such corporation for the amount of deficiency dividends paid by the acquiring corporation with respect to the distributor or transferor corporation. Except as otherwise provided in this section, the provisions of section 859 and the regulations thereunder apply with respect to a deficiency dividend deduction allowable pursuant to section 381(c)(25).

(b) *Deficiency dividends paid by the acquiring corporation with respect to the distributor or transferor corporation.* A deficiency dividend paid by the acquiring corporation with respect to the distributor or transferor corporation must be a distribution that would satisfy the definition of a deficiency dividend under section 859(d) if paid by the distributor or transferor corporation to its own shareholders. The distribution, however, shall be paid by the acquiring corporation to its own shareholders. The distribution also shall be paid after the

date of distribution or transfer and on, or within 90 days after, the date of the determination but before the acquiring corporation files a claim under paragraph (c) of this section.

(c) *Claim for deduction.* A claim for deduction under this section shall be made by the acquiring corporation on form 976 and shall be filed within 120 days after the date of the determination. The form shall contain, or be accompanied by, the information required under paragraph (b)(2) of § 1.859-2 in sufficient detail to properly identify the facts with respect to the distributor or transferor corporation and the acquiring corporation. The required certified copy of the resolution authorizing the payment of the dividend shall be that of the trustees, board of directors, or other authority, of the acquiring corporation. Necessary changes may be made in form 976 in order to carry out the provisions of this paragraph. The claim shall be filed with the district director, or director of the internal revenue service center, with whom the return of the distributor or transferor corporation to which the claim relates was filed.

(d) *Effect on dividends paid deduction.* A deficiency dividend paid by the acquiring corporation that is allowable as a deduction to a distributor or transferor corporation pursuant to section 381(c)(25) shall not become a part of the dividends paid deduction of the acquiring corporation under section 561 for any taxable year.

(e) *Successive transactions to which section 381(a) applies.* The provisions of this section shall apply in the case of successive transactions to which section 381(a) applies. Thus, if X corporation transfers its assets to Y corporation in a transaction to which section 381(a) applies and if Y corporation transfers its assets to Z corporation in a subsequent transaction to which section 381(a) applies, then, subject to the provisions of this section, X corporation may take a deficiency dividend deduction for the amount of deficiency dividends paid by Z corporation with respect to X corporation.

Par. 19. Section 1.441-1(b)(3) is amended by adding a new sentence at the end thereof, to read as set forth below.

§ 1.441-1 Period for computation of taxable income.

* * * * *

(b) *Taxable year.* * * *

(3) * * * For rules applicable to the adoption of a taxable year by a real

estate investment trust, see section 860 and § 1.860-1.

Par. 20. Section 1.442-1 is amended by adding a new sentence at the end of paragraph (a)(1), to read as set forth below, and by striking out "A corporation (other than a corporation to which subparagraphs (4) or (5) of this paragraph applies)" in the first sentence of paragraph (c)(1) and inserting in lieu thereof "Except as otherwise provided in paragraph (c)(4) and (5) of this section and § 1.860-1, a corporation".

§ 1.442-1 Change of annual accounting period.

(a) *Manner of effecting such change.*—(1) *In general.* * * * For special rules relating to real estate investment trusts, see section 860 and § 1.860-1.

§ 1.443-1 [Amended]

Par. 21. Section 1.443-1(e)(5) is amended by striking out "857(b)(2)(D)" and inserting in lieu thereof "857(b)(2)(C)".

§ 1.512(b)-1 [Amended]

Par. 22. Section 1.512(b)-1(c)(2)(iii)(b) is amended by striking out "paragraph (b)(1)" and inserting in lieu thereof "paragraph (b)(3) and (6) (other than paragraph (b)(6)(ii))".

§ 1.562-1 [Amended]

Par. 23. The example in § 1-562-1(b)(2)(iii) is amended by striking out "paragraph (d)" in the last sentence and inserting in lieu thereof "paragraph (e)".

§ 1.856 [Removed]

Par. 24. Section 1.856 is removed and a new § 1.856.0 is added to read as follows:

§ 1.856-0 Revenue Act of 1978 amendments not included.

The regulations under part II of subchapter M of the Code do not reflect the amendments made by the Revenue Act of 1978.

Par. 25. Section 1.856-1 is amended as follows:

1. Paragraph (a) is amended by striking out "The term 'real estate investment trust' means an unincorporated trust or unincorporated association" and inserting in lieu thereof "The term 'real estate investment trust' means a corporation, trust, or association".

2. Paragraph (a) is further amended by adding a new sentence at the end thereof, to read as set forth below.

3. So much of paragraph (b) as precedes subparagraph (1) is amended by striking out "unincorporated".

4. Paragraph (b)(1) is amended by inserting "or directors" before the comma at the end thereof.

5. Paragraph (b)(4) is amended by inserting ", in the case of a taxable year beginning before October 5, 1976," after "Which" and by inserting "(other than foreclosure property)" after "property".

6. Paragraph (b) is amended by redesignating subparagraphs (5) and (6) as (6) and (7), respectively, and inserting a new subparagraph (5) to read as set forth below.

7. Paragraph (c) is amended by striking out "(4)" in the first sentence and inserting in lieu thereof "(5)", and by striking out "(5)" in the first and third sentences and inserting in lieu thereof "(6)".

8. So much of paragraph (d) as precedes paragraph (1) is amended by striking out "unincorporated".

9. The second sentence of paragraph (d)(2) is amended by striking out "trust instrument" and inserting in lieu thereof "trust instrument or corporate charter or bylaws", by striking out "trustee" each place it appears and inserting in lieu thereof "trustee or directors", and by striking out "believes" and inserting "believe" in lieu thereof.

10. The last sentence of paragraph (d)(2) is amended by striking out "investment trust and" and inserting in lieu thereof "investment trust," and by striking out the period at the end thereof and inserting in lieu thereof ", and the term 'shares' includes shares of stock."

11. The first sentence of paragraph (d)(4) is amended by striking out "A real" and inserting in lieu thereof "In the case of a taxable year beginning before October 5, 1976, a real" and by inserting "(other than foreclosure property)" after "property".

12. Paragraph (d)(5) is amended by striking out "An unincorporated organization" in the first sentence and inserting in lieu thereof "A corporation, trust, or association", and by striking out "§ 1.857-6" in the last sentence and inserting in lieu thereof "§ 1.857-8".

13. Paragraph (e) is amended by striking out "unincorporated trust" and inserting in lieu thereof "organization".

14. A new paragraph (f) is added to read as set forth below.

§ 1.856-1 Definition of real estate investment trust.

(a) *In general.* * * * [See, however, paragraph (f) of this section, relating to the requirement that, for taxable years beginning before October 5, 1976, a real estate investment trust must be an unincorporated trust or unincorporated association].

(b) *Qualifying conditions.* * * *

(5) Which is neither (i) a financial institution to which section 585, 586, or 593 applies, nor (ii) an insurance company to which subchapter L applies.

(f) *Unincorporated status required for certain taxable years.* In the case of a taxable year beginning before October 5, 1976, a real estate investment trust must be an unincorporated trust or unincorporated association. Accordingly, in applying the regulations under part II of subchapter M of the Code with respect to such a taxable year, the term "an unincorporated trust or unincorporated association" is to be substituted for the term "a corporation, trust, or association" each place it appears, and the references to "directors" and "corporate charter or bylaws" are to be disregarded.

Par. 26. Section 1.856-2 is amended as follows:

1. Paragraph (b) is amended by striking out "which began after December 31, 1960" and inserting in lieu thereof "which has not been terminated or revoked under section 856(g) (1) or (2)", and by striking out the last sentence and inserting three new sentences in lieu thereof, to read as set forth below.

2. Paragraph (c) is revised to read as set forth below.

§ 1.856-2 Limitations.

(b) *Election.* * * * An election cannot be revoked with respect to a taxable year beginning before October 5, 1976. Thus, the failure of an organization to be a qualified real estate investment trust for a taxable year beginning before October 5, 1976, does not have the effect of revoking a prior election by the organization to be a real estate investment trust, even though the organization is not taxable under part II of subchapter M for such taxable year. See section 856(g) and § 1.856-8 for rules under which an election may be revoked with respect to taxable years beginning after October 4, 1976.

(c) *Gross income requirements.* Section 856(c) (2), (3), and (4), provides that a corporation, trust, or association is not a "real estate investment trust" for a taxable year unless it meets certain requirements with respect to the sources of its gross income for the taxable year. In determining whether the gross income of a real estate investment trust satisfies the percentage requirements of section 856(c) (2), (3), and (4), the following rules shall apply:

(1) *Gross income.* 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.

(2) *Lapse of options.* Under section 856(c)(6)(C), the term "interests in real property" includes options to acquire land or improvements thereon, and options to acquire leaseholds of land and improvements thereon. However, where a corporation, trust, or association writes an option giving the holder the right to acquire land or improvements thereon, or writes an option giving the holder the right to acquire a leasehold of land or improvements thereon, any income that the corporation, trust, or association recognizes because the option expires unexercised is not considered to be gain from the sale or other disposition of real property (including interests in real property) for purposes of section 856(c) (2)(D) and (3)(C). The rule in the preceding sentence also applies for purposes of section 856(c)(4)(C) in determining gain from the sale or other disposition of real property for the 30-percent-of-gross-income limitation.

(3) *Commitment fees.* For purposes of section 856(c) (2)(G) and (3)(G), if consideration is received or accrued for an agreement to make a loan secured by a mortgage covering both real property and other property, or for an agreement to purchase or lease both real property and other property, an apportionment of the consideration is required. The apportionment of consideration received or accrued for an agreement to make a loan secured by a mortgage covering both real property and other property shall be made under the principles of § 1.856-5(c), relating to the apportionment of interest income.

(4) *Holding period of property.* For purposes of the 30-percent limitation of section 856(c)(4), the determination of the period for which property described in such section has been held is governed by the provisions of section 1223 and the regulations thereunder.

(5) *Rents from real property and interest.* See §§ 1.856-4 and 1.856-5 for rules relating to rents from real property and interest.

Par. 27. Section 1.856-3 is amended by adding a new sentence at the end of paragraph (c) and by adding a new paragraph (h) at the end thereof, to read as set forth below.

§ 1.856-3 Definitions.

(c) *Interests in real property.* * * * The term "interests in real property" also includes options to acquire land or improvements thereon, and options to acquire leaseholds of land or improvements thereon.

(h) *Net capital gain.* The term "net capital gain" means the excess of the net long-term capital gain for the taxable year over the net short-term capital loss for the taxable year.

Par. 28. Section 1.856-4 is amended as follows:

1. Paragraph (a) is amended by deleting the last two sentences and by striking out "limitations" in the first sentence and inserting in lieu thereof "exceptions".

2. Paragraphs (b) (1), (2), (3), and (4) are redesignated as paragraph (b) (3), (4), (5), and (7), respectively, and so much of paragraph (b) as precedes paragraph (b)(3), as redesignated, is revised to read as set forth below.

3. Paragraph (b)(3), as redesignated, is revised to read as set forth below.

4. The title and first sentence of paragraph (b)(4), as redesignated, are revised to read as set forth below.

5. Paragraph (b)(5), as redesignated, is amended by redesignating subdivisions (ii) and (iii) as subdivisions (iii) and (iv), respectively.

6. So much of paragraph (b)(5), as redesignated, as precedes subdivision (iii) thereof, as redesignated, is revised to read as set forth below.

7. A new paragraph (6) is added to read as set forth below.

§ 1.856-4 Rents from real property.

(b) *Amounts specifically included or excluded.*—(1) *Charges for customary services.* For taxable years beginning after October 4, 1976, the term "rents from real property", for purposes of paragraphs (2) and (3) of section 856(c), includes charges for services customarily furnished or rendered in connection with the rental of real property, whether or not the charges are separately stated. Services furnished to the tenants of a particular building will be considered as customary if, in the geographic market in which the building is located, tenants in buildings which are of a similar class (such as luxury apartment buildings) are customarily provided with the service. The furnishing of water, heat, light, and air-conditioning, the cleaning of windows, public entrances, exits, and lobbies, the performance of general maintenance and of janitorial and cleaning services, the collection of trash, and the furnishing of elevator services, telephone answering services, incidental

storage space, laundry equipment, watchman or guard services, parking facilities, and swimming pool facilities are examples of services which are customarily furnished to the tenants of a particular class of buildings in many geographic marketing areas. Where it is customary, in a particular geographic marketing area, to furnish electricity or other utilities to tenants in buildings of a particular class, the submetering of such utilities to tenants in such buildings will be considered a customary service. To qualify as a service customarily furnished, the service must be furnished or rendered to the tenants of the real estate investment trust or, primarily for the convenience or benefit of the tenant, to the guests, customers, or subtenants of the tenant. The service must be furnished through an independent contractor from whom the trust does not derive or receive any income. See paragraph (b)(5) of this section. For taxable years beginning before October 5, 1976, the rules in paragraph (b)(3) of 26 CFR 1.856-4 (revised as of April 1, 1977), relating to the furnishing of services, shall continue to apply.

(2) *Amounts received with respect to certain personal property.*—(i) *In general.* In the case of taxable years beginning after October 4, 1976, rent attributable to personal property that is leased under, or in connection with, the lease of real property is treated under section 856(d)(1)(C) as "rents from real property" (and thus qualified for purposes of the income source requirements) if the rent attributable to the personal property is not more than 15 percent of the total rent received or accrued under the lease for the taxable year. If, however, the rent attributable to personal property is greater than 15 percent of the total rent received or accrued under the lease for the taxable year, then the portion of the rent from the lease that is attributable to personal property will not qualify as "rents from real property".

(ii) *Application.* In general, the 15-percent test in section 856(d)(1)(C) is applied separately to each lease of real property. However, where the real estate investment trust rents all (or a portion of all) the units in a multiple unit project under substantially similar leases (such as the leasing of apartments in an apartment building or complex to individual tenants), the 15-percent test may be applied with respect to the aggregate rent received or accrued for the taxable year under the similar leases of the property, by using the average of the trust's aggregate adjusted bases of all of the personal property subject to such leases, and the average

of the trust's aggregate adjusted bases of all real and personal property subject to such leases. A lease of a furnished apartment is not considered to be substantially similar to a lease of an unfurnished apartment (including an apartment where the trust provides only personal property, such as major appliances, that is commonly provided by a landlord in connection with the rental of unfurnished living quarters).

(iii) *Taxable years beginning before October 5, 1976.* In the case of taxable years beginning before October 5, 1976, any amount of rent that is attributable to personal property does not qualify as rent from real property.

(3) *Disqualification of rent which depends on income or profits of any person.* Except as provided in paragraph (b)(6)(ii) of this section, no amount received or accrued, directly or indirectly, with respect to any real property (or personal property leased under, or in connection with, real property) qualifies as "rents from real property" where the determination of the amount depends in whole or in part on the income or profits derived by any person from the property. However, any amount so accrued or received shall not be excluded from the term "rents from real property" solely by reason of being based on a fixed percentage or percentages of receipts or sales (whether or not receipts or sales are adjusted for returned merchandise, or Federal, State, or local sales taxes). Thus, for example, "rents from real property" would include rents where the lease provides for differing percentages or receipts or sales from different departments or from separate floors of a retail store so long as each percentage is fixed at the time of entering into the lease and a change in such percentage is not renegotiated during the term of the lease (including any renewal periods of the lease in a manner which has the effect of basing the rent on income or profits. See paragraph (b)(6) of this section for rules relating to certain amounts received or accrued by a trust which are considered to be based on the income or profits of a sublessee of the prime tenant. The amount received or accrued as rent for the taxable year which is based on a fixed percentage or percentages of the lessee's receipts or sales reduced by escalation receipts (including those determined under a formula clause) will qualify as "rents from real property". Escalation receipts include amounts received by a prime tenant from subtenants by reason of an agreement that rent shall be increased to reflect all or a portion of an increase in real estate taxes, property insurance,

operating costs of the prime tenant, or similar items customarily included in lease escalation clauses. Where in accordance with the terms of an agreement an amount received or accrued as rent for the taxable year includes both a fixed rental and a percentage of all or a portion of the lessee's income or profits, neither the fixed rental nor the additional amount will qualify as "rents from real property". However, where the amount received or accrued for the taxable year under such an agreement includes only the fixed rental, the determination of which does not depend in whole or in part on the income or profits derived by the lessee, such amount may qualify as "rents from real property". An amount received or accrued as rent for the taxable year which consists, in whole or in part, of one or more percentages of the lessee's receipts or sales in excess of determinable dollar amounts may qualify as "rents from real property", but only if two conditions exist. First, the determinable amounts must not depend in whole or in part on the income or profits of the lessee. Second, the percentages and, in the case of leases entered into after July 7, 1976, the determinable amounts, must be fixed at the time the lease is entered into and a change in percentages and determinable amounts is not renegotiated during the term of the lease (including any renewal periods of the lease) in a manner which has the effect of basing rent on income or profits. In any event, an amount will not qualify as "rents from real property" if, considering the lease and all the surrounding circumstances, the arrangement does not conform with normal business practice but is in reality used as a means of basing the rent on income or profits. The provisions of this subparagraph may be illustrated by the following example:

Example. A real estate investment trust owns land underlying an office building. On January 1, 1975, the trust leases the land for 50 years to a prime tenant for an annual rental of \$100x plus 20 percent of the prime tenant's annual gross receipts from the office building in excess of a fixed base amount of \$5,000x and 10 percent of such gross receipts in excess of \$10,000x. For this purpose the lease defines gross receipts as all amounts received by the prime tenant from occupancy tenants pursuant to leases of space in the office building reduced by the amount by which real estate taxes, property insurance, and operating costs related to the office building for a particular year exceed the amount of such items for 1974. The exclusion from gross receipts of increases since 1974 in real estate taxes, property insurance, and other expenses relating to the office building reflects the fact that the prime tenant passes on to occupancy tenants by way of a

customary lease escalation provision the risk that such expenses might increase during the term of an occupancy lease. The exclusion from gross receipts of these expense escalation items will not cause the rental received by the real estate investment trust from the prime tenant to fail to qualify as "rents from real property" for purposes of section 856(c).

(4) *Disqualification of amounts received from persons owned in whole or in part by the trust.* "Rents from real property" does not include any amount received or accrued, directly or indirectly, from any person in which the real estate investment trust owns, at any time during the taxable year, the specified percentage or number of shares of stock (or interest in the assets or net profits) of that person. * * *

(5) *Furnishing of services or management of property must be through an independent contractor—(i) In general.* No amount received or accrued, directly or indirectly, with respect to any real property (or any personal property leased under, or in connection with, the real property) qualifies as "rents from real property" if the real estate investment trust furnishes or renders services to the tenants of the property or manages or operates the property, other than through an independent contractor from whom the trust itself does not derive or receive any income. The prohibition against the trust deriving or receiving any income from the independent contractor applies regardless of the source from which the income was derived by the independent contractor. Thus, for example, the trust may not receive any dividends from the independent contractor. The requirement that the trust not receive any income from an independent contractor requires that the relationship between the two be an arm's-length relationship. The independent contractor must be adequately compensated for any services which are performed for the trust. Compensation to an independent contractor determined by reference to an unadjusted percentage of gross rents will generally be considered to be adequate where the percentage is reasonable taking into account the going rate of compensation for managing similar property in the same locality, the services rendered, and other relevant factors. The independent contractor must not be an employee of the trust (i.e., the manner in which he carries out his duties as independent contractor must not be subject to the control of the trust). Although the cost of services which are customarily rendered or furnished in connection with the rental of real property may be borne by the trust, the services must be furnished

or rendered through an independent contractor. Furthermore, the facilities through which the services are furnished must be maintained and operated by an independent contractor. For example, if a heating plant is located in the building, it must be maintained and operated by an independent contractor. To the extent that services (other than those customarily furnished or rendered in connection with the rental of real property) are rendered to the tenants of the property by the independent contractor, the cost of the services must be borne by the independent contractor, a separate charge must be made for the services, the amount of the separate charge must be received and retained by the independent contractor, and the independent contractor must be adequately compensated for the services.

(ii) *Trustee or director functions.* The trustees or directors of the real estate investment trust are not required to delegate or contract out their fiduciary duty to manage the trust itself, as distinguished from rendering or furnishing services to the tenants of its property of managing or operating the property. Thus, the trustees or directors may do all those things necessary, in their fiduciary capacities, to manage and conduct the affairs of the trust itself. For example, the trustees or directors may establish rental terms, choose tenants, enter into and renew leases, and deal with taxes, interest, and insurance, relating to the trust's property. The trustees or directors may also make capital expenditures with respect to the trust's property (as defined in section 263) and may make decisions as to repairs of the trust's property (of the type which would be deductible under section 162), the cost of which may be borne by the trust.

(6) *Amounts based on income or profits of subtenants.* (i) Except as provided in paragraph (b)(6)(ii) of this section, if a trust leases real property to a tenant under terms other than solely on a fixed sum rental (for example, a percentage of the tenant's gross receipts), and the tenant subleases all or a part of such property under an agreement which provides for a rental based in whole or in part on the income or profits of the sublessee, the entire amount of the rent received by the trust from the prime tenant with respect to such property is disqualified as "rents from real property".

(ii) *Exception.* For taxable years beginning after October 4, 1976, section 856(d)(4) provides an exception to the general rule that amounts received or

accrued, directly or indirectly, by a real estate investment trust do not qualify as rents from real property if the determination of the amount depends in whole or in part on the income or profits derived by any person from the property. This exception applies where the trust rents property to a tenant (the prime tenant) for a rental which is based, in whole or in part, on a fixed percentage or percentages of the receipts or sales of the prime tenant, and the rent which the trust receives or accrues from the prime tenant pursuant to the lease would not qualify as "rents from real property" solely because the prime tenant receives or accrues from subtenants (including concessionaires) rents or other amounts based on the income or profits derived by a person from the property. Under the exception, only a proportionate part of the rent received or accrued by the trust does not qualify as "rents from real property". The proportionate part of the rent received or accrued by the trust which is non-qualified is the lesser of the following two amounts:

(A) The rent received or accrued by the trust from the prime tenant pursuant to the lease, that is based on a fixed percentage or percentages of receipts or sales, or

(B) The product determined by multiplying the total rent which the trust receives or accrues from the prime tenant pursuant to the lease by a fraction, the numerator of which is the rent or other amount received by the prime tenant that is based, in whole or in part, on the income or profits derived by any person from the property, and the denominator of which is the total rent or other amount received by the prime tenant from the property.

For example, assume that a real estate investment trust owns land underlying a shopping center. The trust rents the land to the owner of the shopping center for an annual rent of \$10x plus 2 percent of the gross receipts which the prime tenant receives from subtenants who lease space in the shopping center. Assume further that, for the year in question, the prime tenant derives total rent from the shopping center of \$100x and, of that amount, \$25x is received from subtenants whose rent is based, in whole or in part, on the income or profits derived from the property. Accordingly, the trust will receive a total rent of \$12x, of which \$2x is based on a percentage of the gross receipts of the prime tenant. The portion of the rent which is disqualified is the lesser of \$2x (the rent received by the trust which is based on a percentage of gross receipts), or \$3x. (\$12x multiplied by \$25x/\$100x).

Accordingly, \$10x of the rent received by the trust qualifies as "rents from real property" and \$2x does not qualify.

Par. 29. New §§ 1.856-5, 1.856-6, 1.856-7, 1.856-8, and 1.856-9, as set forth below, are added after section 1.856-4.

§ 1.856-5 Interest.

(a) *In general.* In computing the percentage requirements in section 856(c) (2)(B) and (3)(B), the term "interest" includes only an amount which constitutes compensation for the use or forbearance of money. For example, a fee received or accrued by a lender which is in fact a charge for services performed for a borrower rather than a charge for the use of borrowed money is not includable as interest.

(b) *Where amount depends on income or profits of any person.* Except as provided in paragraph (d) of this section, any amount received or accrued, directly or indirectly, with respect to an obligation is not includable as interest for purposes of section 856(c) (2)(B) and (3)(B) if, under the principles set forth in paragraph (b)(3) and (6)(i) of § 1.856-4, the determination of the amount depends in whole or in part on the income or profits of any person (whether or not derived from property secured by the obligation). Thus, for example, if in accordance with a loan agreement an amount is received or accrued by the trust with respect to an obligation which includes both a fixed amount of interest and a percentage of the borrower's income or profits, neither the fixed interest nor the amount based upon the percentage will qualify as interest for purposes of section 856(c) (2)(B) and (3)(B). This paragraph and paragraph (d) of this section apply only to amounts received or accrued in taxable years beginning after October 4, 1976, pursuant to loans made after May 27, 1976. For purposes of the preceding sentence, a loan is considered to be made before May 28, 1976, if it is made pursuant to a binding commitment entered into before May 28, 1976.

(c) *Apportionment of interest.*—(1) *In general.* Where a mortgage covers both real property and other property, an apportionment of the interest income must be made for purposes of the 75-percent requirement of section 856(c)(3). For purposes of the 75-percent requirement, the apportionment shall be made as follows:

(i) If the loan value of the real property is equal to or exceeds the amount of the loan, then the entire interest income shall be apportioned to the real property.

(ii) If the amount of the loan exceeds the loan value of the real property, then the interest income apportioned to the real property is an amount equal to the interest income multiplied by a fraction, the numerator of which is the loan value of the real property, and the denominator of which is the amount of the loan. The interest income apportioned to the other property is an amount equal to the excess of the total interest income over the interest income apportioned to the real property.

(2) *Loan value.* For purposes of this paragraph, the loan value of the real property is the fair market value of the property, determined as of the date on which the commitment by the trust to make the loan becomes binding on the trust. In the case of a loan purchased by the trust, the loan value of the real property is the fair market value of the property, determined as of the date on which the commitment by the trust to purchase the loan becomes binding on the trust. However, in the case of a construction loan or other loan made for purposes of improving or developing real property, the loan value of the real property is the fair market value of the land plus the reasonably estimated cost of the improvements or developments (other than personal property) which will secure the loan and which are to be constructed from the proceeds of the loan. The fair market value of the land and the reasonably estimated cost of improvements or developments shall be determined as of the date on which a commitment to make the loan becomes binding on the trust. If the trust does not make the construction loan but commits itself to provide long-term financing following completion of construction, the loan value of the real property is determined by using the principles for determining the loan value for a construction loan. Moreover, if the mortgage on the real property is given as additional security (or as a substitute for other security) for the loan after the trust's commitment is binding, the real property loan value is its fair market value when it becomes security for the loan (or, if earlier, when the borrower makes a binding commitment to add or substitute the property as security).

(3) *Amount of loan.* For purposes of this paragraph, the amount of the loan means the highest principal amount of the loan outstanding during the taxable year.

(d) *Exception.* Section 856(f)(2) provides an exception to the general rule that amounts received, directly or indirectly, with respect to an obligation do not qualify as "interest" where the

determination of the amounts depends in whole or in part on the income or profits of any person. The exception applies where the trust receives or accrues, with respect to the obligation of its debtor, an amount that is based in whole or in part on a fixed percentage or percentages of receipts or sales of the debtor, and the amount would not qualify as interest solely because the debtor has receipts or sale proceeds that are based on the income or profits of any person. Under this exception only a proportionate part of the amount received or accrued by the trust fails to qualify as interest for purposes of the percentage-of-income requirements of section 856(c) (2) and (3). The proportionate part of the amount received or accrued by the trust that is non-qualified is the lesser of the following two amounts:

(1) The amount received or accrued by the trust from the debtor with respect to the obligation that is based on a fixed percentage or percentages of receipts or sales, or

(2) The product determined by multiplying by a fraction the total amount received or accrued by the trust from the debtor with respect to the obligation. The numerator of the fraction is the amount of receipts or sales of the debtor that is based, in whole or in part, on the income or profits of any person and the denominator is the total amount of the receipts or sales of the debtor. For purposes of the preceding sentence, the only receipts or sales to be taken into account are those taken into account in determining the payment to the trust pursuant to the loan agreement.

§ 1.856-6 Foreclosure property.

(a) *In general.* Under section 856(e) a real estate investment trust may make an irrevocable election to treat as "foreclosure property" certain real property (including interests in real property), and any personal property incident to the real property, acquired by the trust after December 31, 1973. This section prescribes rules relating to the election, including rules relating to property eligible for the election. This section also prescribes rules relating to extensions of the general two-year period (hereinafter the "grace period") during which property retains its status as foreclosure property, as well as rules relating to early termination of the grace period under section 856(e)(4). The election to treat property as foreclosure property does not alter the character of the income derived therefrom (other than for purposes of section 856(c)(2)(F) and (3)(F)). For example, if foreclosure property is sold, the determination of whether it is property described in

section 1221(1) will not be affected by the fact that it is foreclosure property.

(b) *Property eligible for the election—*

(1) *Rules relating to acquisitions.* In general, the trust must acquire the property after December 31, 1973, as the result of having bid in the property at foreclosure, or having otherwise reduced the property to ownership or possession by agreement or process of law, after there was default (or default was imminent) on a lease of the property (where the trust was the lessor) or on an indebtedness owed to the trust which the property secured. Foreclosure property which secured an indebtedness owed to the trust is acquired for purposes of section 856(e) on the date on which the trust acquires ownership of the property for Federal income tax purposes. Foreclosure property which a trust owned and leased to another is acquired for purposes of section 856(e) on the date on which the trust acquires possession of the property from its lessee. A trust will not be considered to have acquired ownership of property for purposes of section 856(e) where it takes control of the property as a mortgagee-in-possession and cannot receive any profit or sustain any loss with respect to the property except as a creditor of the mortgagor. A trust may be considered to have acquired ownership of property for purposes of section 856(e) even though legal title to the property is held by another person. For example, where, upon foreclosure of a mortgage held by the trust, legal title to the property is acquired in the name of a nominee for the exclusive benefit of the trust and the trust is the equitable owner of the property, the trust will be considered to have acquired ownership of the property for purposes of section 856(e). Generally, the fact that under local law the mortgagor has a right of redemption after foreclosure is not relevant in determining whether the trust has acquired ownership of the property for purposes of section 856(e). Property is not ineligible for the election solely because the property, in addition to securing an indebtedness owed to the trust, also secures debts owed to other creditors. Property eligible for the election includes a building or other improvement which has been constructed on land owned by the trust and which is acquired by the trust upon default of a lease of the land.

(2) *Personal property.* Personal property (including personal property not subject to a mortgage or lease of the real property) will be considered incident to a particular item of real property if the personal property is used in a trade or business conducted on the

property or the use of the personal property is otherwise an ordinary and necessary corollary of the use to which the real property is put. In the case of a hotel, such items as furniture, appliances, linens, china, food, etc. would be examples of incidental personal property. Personal property incident to the real property is eligible for the election even though it is acquired after the real property is acquired or is placed in the building or other improvement in the course of the completion of construction.

(3) *Property with respect to which default is anticipated.* Property is not eligible for the election to be treated as foreclosure property if the loan or lease with respect to which the default occurs (or is imminent) was made or entered into (or the lease or indebtedness was acquired) by the trust with an intent to evict or foreclose, or when the trust knew or had reason to know that default would occur ("improper knowledge"). For purposes of the preceding sentence, a trust will not be considered to have improper knowledge with respect to a particular lease or loan, if the lease or loan was made pursuant to a binding commitment entered into by the trust at a time when it did not have improper knowledge. Moreover, if the trust, in an attempt to avoid default or foreclosure, advances additional amounts to the borrower in excess of amounts contemplated in the original loan commitment or modifies the lease or loan, such advance or modification will be considered not to have been made with an intent to evict or foreclose, or with improper knowledge, unless the original loan or lease was entered into with that intent or knowledge.

(c) *Election—(1) In general.* (i) An election to treat property as foreclosure property applies to all of the eligible real property acquired in the same taxable year by the trust upon the default (or as a result of the imminence of default) on a particular lease (where the trust is the lessor) or on a particular indebtedness owed to the trust. For example, if a loan made by a trust is secured by two separate tracts of land located in different cities, and in the same taxable year the trust acquires both tracts on foreclosure upon the default (or imminence of default) of the loan, the trust must include both tracts in the election. For a further example, the trust may choose to make a separate election for only one of the tracts if they are acquired in different taxable years or were not security for the same loan. If real property subject to the same election is acquired at different times in the same taxable year, the grace period

for a particular property begins when that property is acquired.

(ii) If the trust acquires separate pieces of real property that secure the same indebtedness (or are under the same lease) in different taxable years because the trust delays acquiring one of them until a later taxable year, and the primary purpose for the delay is to include only one of them in an election, then if the trust makes an election for one piece it must also make an election for the other piece. A trust will not be considered to have delayed the acquisition of property for this purpose if there is a legitimate business reason for the delay (such as an attempt to avoid foreclosure by further negotiations with the debtor or lessee).

(iii) All of the eligible personal property incident to the real property must also be included in the election.

(2) *Time for making election.* The election to treat property as foreclosure property must be made on or before the due date (including extensions of time) for filing the trust's income tax return for the taxable year in which the trust acquires the property with respect to which the election is being made, or April 3, 1975, whichever is later.

(3) *Manner of making the election.* An election made after February 6, 1981, shall be made by a statement attached to the income tax return for the taxable year in which the trust acquired the property with respect to which the election is being made. The statement shall indicate that the election is made under section 856(e) and shall identify the property to which the election applies. The statement shall also set forth—

(i) The name, address, and taxpayer identification number of the trust.

(ii) The date the property was acquired by the trust, and

(iii) A brief description of how the real property was acquired, including the name of the person or persons from whom the real property was acquired and a description of the lease or indebtedness with respect to which default occurred or was imminent.

An election made on or before February 6, 1981 shall be filed in the manner prescribed in 26 CFR 10.1(f) (revised as of April 1, 1977) (temporary regulations relating to the election to treat property as foreclosure property) as in effect when the election is made.

(4) *Status of taxpayer.* In general, a taxpayer may make an election with respect to an acquisition of property only if the taxpayer is a qualified real estate investment trust for the taxable year in which the acquisition occurs. If, however, the taxpayer establishes, to

the satisfaction of the district director for the internal revenue district in which the taxpayer maintains its principal place of business or principal office or agency, that its failure to be a qualified real estate investment trust for a taxable year was due to reasonable cause and not due to willful neglect, the taxpayer may make the election with respect to property acquired in such taxable year. The principles of §§ 1.856-7(c) and 1.856-8(d) (including the principles relating to expert advice will apply in determining whether, for purposes of this subparagraph, the failure of the taxpayer to be a qualified real estate investment trust for the taxable year in which the property is acquired was due to reasonable cause and not due to willful neglect. If a taxpayer makes a valid election to treat property as foreclosure property, the property will not lose its status as foreclosure property solely because the taxpayer is not a qualified real estate investment trust for a subsequent taxable year (including a taxable year which encompasses an extension of the grace period). However, the rules relating to the termination of foreclosure property status in section 856(e)(4) [but not the tax on income from foreclosure property imposed by section 857(b)(4)] apply to the year in which the property is acquired and all subsequent years, even though the taxpayer is not a qualified real estate trust for such year.

(d) *Termination of 2-year grace period; subsequent leases—(1) In general.* Under section 856(e)(4)(A), all real property (and any incidental personal property) for which a particular election has been made (see paragraph (c)(1) of this section) shall cease to be foreclosure property on the first day (occurring on or after the day on which the trust acquired the property) on which the trust either—

(i) Enters into a lease with respect to any of the property which, by its terms, will give rise to income of the trust which is not described in section 856(c)(3) (other than section 856(c)(3)(F)), or

(ii) Receives or accrues, directly or indirectly, any amount which is not described in section 856(c)(3) (other than section 856(c)(3)(F)) pursuant to a lease with respect to any of the real property entered into by the trust on or after the day the trust acquired the property.

For example, assume the trust acquires, in a particular taxable year, a shopping center upon the default of an indebtedness owed to the trust. Also assume that the trust subsequently enters into a lease with respect to one of several stores in the shopping center

that requires the lessee to pay rent to the trust which is not income described in section 856(c)(3) (other than section 856(c)(3)(F)). In such case, the entire shopping center will cease to be foreclosure property on the day the trust enters into the lease.

(2) *Extensions or renewals of leases.* Generally, the extension or renewal of a lease of foreclosure property will be treated as the entering into of a new lease only if the trust has a right to renegotiate the terms of the lease. If, however, by operation of law or by contract, the acquisition of the foreclosure property by the trust terminates a preexisting lease of the property, or gives the trust a right to terminate the lease, then for purposes of section 856(e)(4)(A), a trust, in such circumstances, will not be considered to have entered into a lease with respect to the property solely because the terms of the preexisting lease are continued in effect after foreclosure without substantial modification. The letting of rooms in a hotel or motel does not constitute the entering into a lease for purposes of section 856(e)(4)(A).

(3) *Rent attributable to personal property.* Solely for the purposes of section 856(e)(4)(A), if a trust enters into a lease with respect to real property on or after the day upon which the trust acquires such real property by foreclosure, and a portion of the rent from such lease is attributable to personal property which is foreclosure property incident to such real property, such rent attributable to the incidental personal property will not be considered to terminate the status of such real property (or such incidental personal property) as foreclosure property.

(e) *Termination of 2-year grace period; completion of construction—(1) In general.* Under section 856(e)(4)(B), all real property (and any incidental personal property) for which a particular election has been made (see paragraph (c)(1) of this section) shall cease to be foreclosure property on the first day (occurring on or after the day on which the trust acquired the property) on which any construction takes place on the property, other than completion of a building (or completion of any other improvement) where more than 10 percent of the construction of the building (or other improvement) was completed before default became imminent. If more than one default occurred with respect to an indebtedness or lease in respect of which there is an acquisition, the more-than-10-percent test (including the rule prescribed in this paragraph relating to the test) will not be applied at the time a

particular default became imminent if it is clear that the acquisition did not occur as the result of such default. For example, if the debtor fails to make four consecutive payments of principal and interest on the due dates, and the trust takes action to acquire the property securing the debt only after the fourth default becomes imminent, the 10-percent test is applied at the time the fourth default became imminent (even though the trust would not have foreclosed on the property had not all four defaults occurred).

(2) *Determination of percentage of completion.* The determination of whether the construction of a building or other improvement was more than 10 percent complete when default became imminent shall be made by comparing the total direct costs of construction incurred with respect to the building or other improvement as of the date default became imminent with the estimated total direct costs of construction as of such date. If the building or other improvement qualifies as more than 10 percent complete under this method, the building or other improvement shall be considered to be more than 10 percent complete. For purposes of this subparagraph, direct costs of construction include the cost of labor and materials which are directly connected with the construction of the building or improvement.

Thus, for example, direct costs of construction incurred as of the date default became imminent would include amounts paid, or for which liability has been incurred, for labor which has been performed as of such date that is directly connected with the construction of the building or other improvement and for building materials and supplies used or consumed in connection with the construction as of such date. For purposes of applying the 10-percent test the trust may also take into account the cost of building materials and supplies which have been delivered to the construction site as of the date default became imminent and which are to be used or consumed in connection with the construction. On the other hand, architect's fees, administrative costs of the developer or builder, lawyers' fees, and expenses incurred in connection with obtaining zoning approval or building permits are not considered to be direct costs of construction. Any construction by the trust as mortgagee-in-possession is considered to have taken place after default resulting in acquisition of the property became imminent. Generally, the trust's estimate of the total direct costs of completing construction as of the date the default

became imminent will be accepted, provided that the estimate is reasonable, in good faith, and is based on all of the data reasonably available to the trust when the trust undertakes completion of construction of the building or other improvement. Appropriate documentation which shows that construction was more than 10 percent complete when default became imminent must be available at the principal place of business of the trust for inspection in connection with an examination of the income tax return. Construction includes the renovation of a building, such as the remodeling of apartments, or the renovation of an apartment building to convert rental units to a condominium. The renovation must be more than 10 percent complete (determined by comparing the total direct cost of the physical renovation which has been incurred when default became imminent with the estimated total direct cost of renovation as of such date) when default became imminent in order for the property not to lose its status as foreclosure property if the trust undertakes the renovation.

(3) *Modification of a building or improvement.* Generally, the terms "building" and "improvement" in section 856(e)(4)(B) mean the building or improvement (including any integral part thereof) as planned by the mortgagor or lessee (or other person in possession of the property, if appropriate) as of the date default became imminent. The trust, however, may estimate the total direct costs of construction and complete the construction of the building or other improvement by modifying the building or other improvement as planned as of the date default became imminent so as to reduce the estimated direct cost of construction of the building or improvement. If the trust does so modify the planned construction of the building or improvement, the 10-percent test is to be applied by comparing the direct costs of construction incurred as of the date default became imminent that are attributable to the building or improvement as modified, with the estimated total direct costs (as of such date) of construction of the building or other improvement as modified. The trust, in order to meet the 10-percent test, may not, however, modify the planned building or improvement by reducing the estimated direct cost of construction to such an extent that the building or improvement is not functional.

Also, the trust may make subsequent modifications which increase the direct

cost of construction of the building or improvement if such modifications—

(i) Are required by a Federal, State, or local agency, or

(ii) Are alterations that are either required by a prospective lessee or purchaser as a condition of leasing or buying the property or are necessary for the property to be used for the purpose planned at the time default became imminent.

Subdivision (ii) of the preceding sentence applies, however, only if the building or improvement, as modified, was more than 10 percent complete when default became imminent. A building completed by the trust will not cease to be foreclosure property solely because the building is used in a manner other than that planned by the defaulting mortgagor or lessee. Thus, for example, assume a trust acquired on foreclosure a planned apartment building which was 20 percent complete when default became imminent and that the trust completes the building without modifications which increase the direct cost of construction. The property will not cease to be foreclosure property by reason of section 856(e)(4)(B) solely because the trust sells the dwelling units in the building as condominium units, rather than holding them for rent as planned by the defaulting mortgagor. (See, however, section 856(e)(4)(C) and paragraph (f)(2) of this section for rules relating to the requirement that where foreclosure property is used in a trade or business (including a trade or business of selling the foreclosure property), the trade or business must be conducted through an independent contractor after 90 days after the property is acquired.)

(4) *Application on building-by-building basis.* Generally the more than 10 percent test is to be applied on a building-by-building basis. Thus, for example, if a trust has foreclosed on land held by a developer building a housing subdivision, the trust may complete construction of the houses which were more than 10 percent complete when default became imminent. The trust, however, may not complete construction of houses which were only 10 percent (or less) complete, nor may the trust begin construction of other houses planned for the subdivision on which construction has not begun. The trust, however, may construct an additional building or improvement (whether or not the construction thereof has begun) which is an integral part of another building or other improvement that was more than 10 percent complete when default became imminent if the additional building or improvement and the other building or improvement,

taken together as a unit, meet the more than 10 percent test. For purposes of this paragraph, an additional building or other improvement will be considered to be an integral part of another building or improvement if—

(i) It is ancillary to the other building or improvement and its principal intended use is to furnish services or facilities which either supplement the use of such other building or improvement or are necessary for such other building or improvement to be utilized in the manner or for the purpose for which it is intended, or

(ii) The buildings or improvements are intended to comprise constituent parts of an interdependent group of buildings or other improvements.

However, a building or other improvement will not be considered to be an integral part of another building or improvement unless the buildings or improvements were planned as part of the same overall construction plan or project before default became imminent. An additional building or other improvement (such as, for example, an outdoor swimming pool or a parking garage) may be considered to be an integral part of another building or improvement, even though the additional building or improvement was also intended to be used to provide facilities or services for use in connection with several other buildings or improvements which will not be completed. If the trust chooses not to undertake the construction of an additional building or other improvement which qualifies as an integral part of another building or improvement, so much of the costs of construction (including both the direct costs of construction incurred before the default became imminent and the estimated costs of completion) as are attributable to that "integral part" shall not be taken into account in determining whether any other building or improvement was more than 10 percent complete when default became imminent. For example, assume the trust acquires on foreclosure a property on which the defaulting mortgagor has begun construction of a motel. The motel, as planned by the mortgagor, was to consist of a two-story building containing 30 units, and two detached one-story wings, each of which was to contain 20 units. At the time default became imminent, the defaulting mortgagor had completed more than 10 percent of the construction of the two-story structure but the two wings, an access road, a parking lot, and an outdoor swimming pool planned for the motel were each less than 10 percent

complete. The trust may construct the two wings of the motel, the access road, the parking lot, and the swimming pool: *Provided*, That the motel and the other improvements which the trust undertakes to construct, taken together as a unit, were more than 10 percent complete when default became imminent. If, however, the trust chooses not to undertake construction of the swimming pool, the cost of construction attributable to the swimming pool, whether incurred before default became imminent or estimated as the cost of completion, shall not be taken into account in determining whether the trust can complete construction of the other buildings and improvements. For another example, assume that the trust acquires a planned shopping center on foreclosure. At the time default became imminent several large buildings intended to house shops and stores in the shopping center were more than 10 percent complete. Less than 10 percent of the construction, however, had been completed on a separate structure intended to house a bank. The bank was planned as a component of the shopping center in order to provide, in conjunction with the other shops and stores, a specific range and variety of goods and services with which to attract customers to the shopping center. The trust may complete construction of the bank: *Provided*, That the bank and the other buildings and improvements which the trust undertakes to complete, taken together as a unit, were more than 10 percent complete when default became imminent. If the trust chooses not to construct the bank, no actual or estimated construction costs attributable to the bank are to be taken into account in applying the 10-percent test with respect to the other buildings and improvements in the shopping center. For a third example, assume that a defaulting mortgagor had planned to construct two identical apartment buildings, A and B, on the same tract of land, that neither building is to provide substantial facilities or services to be used in connection with the other, and that only building A was more than 10 percent complete when default became imminent. The trust, in this case, may not complete building B. On the other hand, if the facts are the same except that pursuant to the plans of the defaulting mortgagor, one of the buildings is to contain the furnace and central air conditioning machinery for both buildings A and B, the trust may complete both buildings A and B: *Provided*, That, taken together as a unit, the two buildings meet the more-than-10-percent test.

(5) *Repair and maintenance.* Under this paragraph (e), "construction" does not include—

(i) The repair or maintenance of a building or other improvement (such as the replacement of worn or obsolete furniture and appliances) to offset normal wear and tear or obsolescence, and the restoration of property required because of damage from fire, storm, vandalism or other casualty,

(ii) The preparation of leased space for a new tenant which does not substantially extend the useful life of the building or other improvement or significantly increase its value, even though, in the case of commercial space, this preparation includes adapting the property to the conduct of a different business, or

(iii) The performing of repair or maintenance described in paragraph (e)(5)(i) of this section after property is acquired that was deferred by the defaulting party and that does not constitute renovation under paragraph (e)(2) of this section.

(6) *Independent contractor required.* If any construction takes place on the foreclosure property more than 90 days after the day on which such property was acquired by the trust, such construction must be performed by an independent contractor (as defined in section 856(d)(3) and § 1.856-4(b)(5)(iii)) from whom the trust does not derive or receive any income. Otherwise, the property will cease to be foreclosure property.

(7) *Failure to complete construction.* Property will not cease to be foreclosure property solely because a trust which undertakes the completion of construction of a building or other improvement on the property that was more than 10 percent complete when default became imminent does not complete the construction. Thus, for example, if a trust continues construction of a building that was 20 percent complete when default became imminent, and the trust constructs an additional 40 percent of the building and then sells the property, the property will not lose its status as foreclosure property solely because the trust fails to complete construction of the building.

(f) *Termination of 2-year grace period; use of foreclosure property in a trade or business—(1) In general.* Under section 856(e)(4)(C), all real property (and any incidental personal property) for which a particular election has been made (see paragraph (c)(1) of this section) shall cease to be foreclosure property on the first day (occurring more than 90 days after the day on which the trust acquired the property) on which the property is used in a trade or business conducted

by the trust, other than a trade or business conducted by the trust through an independent contractor from whom the trust itself does not derive or receive any income. (See section 856(d)(3) for the definition of independent contractor.)

(2) *Property held primarily for sale to customers.* For the purposes of section 856(e)(4)(C), foreclosure property held by the trust primarily for sale to customers in the ordinary course of a trade or business in considered to be property used in a trade or business conducted by the trust. Thus, if a trust holds foreclosure property (whether real property or personal property incident to real property) for sale to customers in the ordinary course of a trade or business more than 90 days after the day on which the trust acquired the real property, the trade or business of selling the property must be conducted by the trust through an independent contractor from whom the trust does not derive or receive any income. Otherwise, after such 90th day the property will cease to be foreclosure property.

(3) *Change in use.* Foreclosure property will not cease to be foreclosure property solely because the use of the property in a trade or business by the trust differs from the use to which the property was put by the person from whom it was acquired. Thus, for example, if a trust acquires a rental apartment building on foreclosure, the property will not cease to be foreclosure property solely because the trust converts the building to a condominium apartment building and, through an independent contractor from whom the trust derives no income, engages in the trade or business of selling the individual condominium units.

(g) *Extension of 2-year grace period—*

(1) *In general.* A real estate investment trust may apply to the district director of the internal revenue district in which is located the principal place of business (or principal office or agency) of the trust for an extension of the 2-year grace period. If the trust establishes to the satisfaction of the district director that an extension of the grace period is necessary for the orderly liquidation of the trust's interest in foreclosure property, or for an orderly renegotiation of a lease or leases of the property, the district director may extend the 2-year grace period. See section 856(e)(3) (as in effect with respect to the particular extension) for rules relating to the maximum length of an extension, and the number of extensions which may be granted. An extension of the grace period may be granted by the district director either before or after the date

on which the grace period, but for the extension, would expire. The extension shall be effective as of the date on which the grace period, but for the extension, would expire.

(2) *Showing required.* Generally, in order to establish the necessity of an extension, the trust must demonstrate that it has made good faith efforts to renegotiate leases with respect to, or dispose of, the foreclosure property. In certain cases, however, the trust may establish the necessity of an extension even though it has not made such efforts. For example, if the trust demonstrates that, for valid business reasons, construction of the foreclosure property could not be completed before the expiration of the grace period, the necessity of the extension could be established even though the trust had made no effort to sell the property. For another example, if the trust demonstrates that due to a depressed real estate market, it could not sell the foreclosure property before the expiration of the grace period except at a distress price, the necessity of an extension could be established even though the trust had made no effort to sell the property. The fact that property was acquired as foreclosure property prior to January 3, 1975 (the date of enactment of section 856(e)), generally will be considered as a factor (but not a controlling factor) which tends to establish that an extension of the grace period is necessary.

(3) *Time for requesting an extension of the grace period.* A request for an extension of the grace period must be filed with the appropriate district director more than 60 days before the day on which the grace period would otherwise expire. In the case of a grace period which would otherwise expire before August 6, 1976, a request for an extension will be considered to be timely filed if filed on or before June 7, 1976.

(4) *Information required.* The request for an extension of the grace period shall identify the property with respect to which the request is being made and shall also include the following information:

(i) The name, address, and taxpayer identification number of the trust.

(ii) The date the property was acquired as foreclosure property by the trust.

(iii) The taxable year of the trust in which the property was acquired.

(iv) If the trust has been previously granted an extension of the grace period with respect to the property, a statement to that effect (which shall include the date on which the grace period, as extended, expires) and a copy of the

information which accompanied the request for the previous extension.

(v) A statement of the reasons why the grace period should be extended.

(vi) A description of any efforts made by the trust after the acquisition of the property to dispose of the property or to renegotiate any lease with respect to the property, and

(vii) A description of any other factors which tend to establish that an extension of the grace period is necessary for the orderly liquidation of the trust's interest in the property, or for an orderly renegotiation of a lease or leases of the property.

The trust shall also furnish any additional information requested by the district director after the request for extension is filed.

(5) *Automatic extension.* If a real estate investment trust files a request for an extension with the district director more than 60 days before the expiration of the grace period, the grace period shall be considered to be extended until the end of the 30th day after the date on which the district director notifies the trust by certified mail sent to its last known address that the period of extension requested by the trust is not granted. In no event, however, shall the rule in the preceding sentence extend the grace period beyond the expiration of (i) the period of extension requested by the trust, or (ii) the 1-year period following the date that the grace period (but for the automatic extension) would expire. The date of the postmark on the sender's receipt is considered to be the date of the certified mail for purposes of this subparagraph. This subparagraph does not apply, however, if the date of the notification by certified mail described in the first sentence is more than 30 days before the date that the grace period (determined without regard to this subparagraph) expires. Moreover, this subparagraph shall not operate to allow any period of extension that is prohibited by the last sentence of section 856(e)(3) (as in effect with respect to the particular extension).

(6) *Extension of time for filing.* If a real estate investment trust fails to file the request for an extension of the grace period within the time provided in paragraph (g)(3) of this section, then the district director shall grant a reasonable extension of time for filing such request, provided (i) it is established to the satisfaction of the district director that there was reasonable cause for failure to file the request within the prescribed time and (ii) a request for such extension is filed within such time as the district director considers reasonable under the circumstances.

(7) *Status of taxpayer.* The reference to "real estate investment trust" or "trust" in this paragraph (g) shall be considered to include a taxpayer that is not a qualified real estate investment trust, if the taxpayer establishes to the satisfaction of the district director that its failure to be a qualified real estate investment trust for the taxable year was due to reasonable cause and not due to willful neglect. The principles of § 1.856-7(c) and § 1.856-8(d) (including the principles relating to expert advice) shall apply for determining reasonable cause (and absence of willful neglect) for this purpose.

§ 1.856-7 Certain corporations, etc., that are considered to meet the gross income requirements.

(a) *In general.* A corporation, trust, or association which fails to meet the requirements of paragraph (2) or (3) of section 856(c), or of both such paragraphs, for any taxable year nevertheless is considered to have satisfied these requirements if the corporation, trust, or association meets the requirements of subparagraphs (A), (B), and (C) of section 856(c)(7) (relating to a schedule attached to the return, the absence of fraud, and reasonable cause).

(b) *Contents of the schedule.* The schedule required by subparagraph (A) of section 856(c)(7) must contain a breakdown, or listing, of the total amount of gross income falling under each of the separate subparagraphs of section 856(c) (2) and (3). Thus, for example, the real estate investment trust, for purposes of listing its income from the sources described in section 856(c)(2), would list separately the total amount of dividends, the total amount of interest, the total amount of rents from real property, etc. The listing is not required to be on a lease-by-lease, loan-by-loan, or project-by-project basis, but the real estate investment trust must maintain adequate records on such a basis with which to substantiate each total amount listed in the schedule.

(c) *Reasonable cause—(1) In general.* The failure to meet the requirements of paragraph (2) or (3) of section 856(c) (or of both paragraphs) will be considered due to reasonable cause and not due to willful neglect if the real estate investment trust exercised ordinary business care and prudence in attempting to satisfy the requirements. Such care and prudence must be exercised at the time each transaction is entered into by the trust. However, even if the trust exercised ordinary business care and prudence in entering into a transaction, if the trust later determines that the transaction results in the receipt

or accrual of nonqualified income and that the amounts of such nonqualified income, in the context of the trust's overall portfolio, reasonably can be expected to cause a source-of-income requirement to be failed, the trust must use ordinary business care and prudence in an effort to renegotiate the terms of the transaction, dispose of property acquired or leased in the transaction, or alter other elements of its portfolio. In any case, failure to meet an income source requirement will be considered due to willful neglect and not due to reasonable cause if the failure is willful and the trust could have avoided such failure by taking actions not inconsistent with ordinary business care and prudence. For example, if the trust enters into a lease knowing that it will produce nonqualified income which reasonably can be expected to cause a source-of-income requirement to be failed, the failure is due to willful neglect even if the trust has a legitimate business purpose for entering into the lease.

(2) *Expert advice—(i) In general.* The reasonable reliance on a reasoned, written opinion as to the characterization for purposes of section 856 of gross income to be derived (or being derived) from a transaction generally constitutes "reasonable cause" if income from that transaction causes the trust to fail to meet the requirements of paragraph (2) or (3) of section 856(c) (or of both paragraphs). The absence of such a reasoned, written opinion with respect to a transaction does not, by itself, give rise to any inference that the failure to meet a percentage of income requirement was without reasonable cause. An opinion as to the character of income from a transaction includes an opinion pertaining to the use of a standard form of transaction or standard operating procedure in a case where such standard form or procedure is in fact used or followed.

(ii) If the opinion indicates that a portion of the income from a transaction will be nonqualified income, the trust must still exercise ordinary business care and prudence with respect to the nonqualified income and determine that the amount of that income, in the context of its overall portfolio, reasonably cannot be expected to cause a source-of-income requirement to be failed. Reliance on an opinion is not reasonable if the trust has reason to believe that the opinion is incorrect (for example, because the trust withholds facts from the person rendering the opinion).

(iii) *Reasoned written opinion.* For purposes of this subparagraph (2), a written opinion means an opinion, in writing, rendered by a tax advisor (including house counsel) whose opinion would be relied on by a person exercising ordinary business care and prudence in the circumstances of the particular transaction. A written opinion is considered "reasoned" even if it reaches a conclusion which is subsequently determined to be incorrect, so long as the opinion is based on a full disclosure of the factual situation by the real estate investment trust and is addressed to the facts and law which the person rendering the opinion believes to be applicable. However, an opinion is not considered "reasoned" if it does nothing more than recite the facts and express a conclusion.

(d) *Application of section 856(c)(7) to taxable years beginning before October 5, 1976.* Pursuant to section 1608(b) of the Tax Reform Act of 1976, paragraph (7) of section 856(c) and this section apply to a taxable year of a real estate investment trust which begins before October 5, 1976, only if as the result of a determination (as defined in section 859(c)) occurring after October 4, 1976, the trust does not meet the requirements of paragraph (2) or (3) of section 856(c), or both paragraphs, as in effect for the taxable year. The requirement that the schedule described in subparagraph (A) of section 856(c)(7) be attached to the income tax return of a real estate investment trust in order for section 856(c)(7) to apply is not applicable to taxable years beginning before October 5, 1976. For purposes of section 1608(b) of the Tax Reform Act of 1976 and this paragraph, the rules relating to determinations prescribed in § 1.859-2(b)(1) (other than the second sentence and the last sentence of § 859-2(b)(1)(iv)) shall apply. However, a determination consisting of an agreement between the taxpayer and the district director (or other official to whom authority to sign the agreement is delegated) shall set forth the amount of gross income for the taxable year to which the determination applies, the amount of the 90 percent and 75 percent source-of-income requirements for the taxable year to which the determination applies, and the amount by which the real estate investment trust failed to meet either or both of the requirements. The agreement shall also set forth the amount of tax for which the trust is liable pursuant to section 857(b)(5). The agreement shall also contain a finding as to whether the failure to meet the requirements of paragraph (2) or (3) of section 856(c) (or of both paragraphs)

was due to reasonable cause and not due to willful neglect.

§ 1.856-8 Revocation or termination of election.

(a) *Revocation of an election to be a real estate investment trust.* A corporation, trust, or association that has made an election under section 856(c)(1) to be a real estate investment trust may revoke the election for any taxable year after the first taxable year for which the election is effective. The revocation must be made by filing a statement with the district director for the internal revenue district in which the taxpayer maintains its principal place of business or principal office or agency. The statement must be filed on or before the 90th day after the first day of the first taxable year for which the revocation is to be effective. The statement must be signed by an official authorized to sign the income tax return of the taxpayer and must—

- (1) Contain the name, address, and taxpayer identification number of the taxpayer,
- (2) Specify the taxable year for which the election was made, and
- (3) Include a statement that the taxpayer, pursuant to section 856(g)(2), revokes its election under section 856(c)(1) to be a real estate investment trust.

The revocation may be made only with respect to a taxable year beginning after October 4, 1976, and is effective for the taxable year in which made and for all succeeding taxable years. A revocation with respect to a taxable year beginning after October 4, 1976, that is filed before February 6, 1981, in the time and manner prescribed in § 7.856(g)-1 of this chapter (as in effect when the revocation was filed) is considered to meet the requirements of this paragraph.

(b) *Termination of election to be a real estate investment trust.* An election of a corporation, trust, or association under section 856(c)(1) to be a real estate investment trust shall terminate if the corporation, trust, or association is not a qualified real estate investment trust for any taxable year (including the taxable year with respect to which the election is made) beginning after October 4, 1976. (This election terminates whether the failure to be a qualified real estate investment trust is intentional or inadvertent.) The term "taxable year" includes a taxable year of less than 12 months for which a return is made under section 443. The termination of the election is effective for the first taxable year beginning after October 4, 1976, for which the corporation, trust, or association is not a

qualified real estate investment trust and for all succeeding taxable years.

(c) *Restrictions on election after termination or revocation.*—(1) *General rule.* Except as provided in paragraph (d) of this section, if a corporation, trust, or association has made an election under section 856(c)(1) to be a real estate investment trust and the election has been terminated or revoked under section 856(g)(1) or (2), the corporation, trust, or association (and any successor corporation, trust, or association) is not eligible to make a new election under section 856(c)(1) for any taxable year prior to the fifth taxable year which begins after the first taxable year for which the termination or revocation is effective.

(2) *Successor corporation.* The term "successor corporation, trust, or association", as used in section 856(g)(3), means a corporation, trust, or association which meets both a continuity of ownership requirement and a continuity of assets requirement with respect to the corporation, trust, or association whose election has been terminated under section 856(g)(1) or revoked under section 856(g)(2). A corporation, trust, or association meets the continuity of ownership requirement only if at any time during the taxable year the persons who own, directly or indirectly, 50 percent or more in value of its outstanding shares owned, at any time during the first taxable year for which the termination or revocation was effective, 50 percent or more in value of the outstanding shares of the corporation, trust, or association whose election has been terminated or revoked. A corporation, trust, or association meets the continuity of assets requirement only if either (i) a substantial portion of its assets were assets of the corporation, trust, or association whose election has been revoked or terminated, or (ii) it acquires a substantial portion of the assets of the corporation, trust, or association whose election has been terminated or revoked.

(3) *Effective date.* Section 856(g)(3) does not apply to the termination of an election that was made by a taxpayer pursuant to section 856(c)(1) on or before October 4, 1976, unless the taxpayer is a qualified real estate investment trust for a taxable year ending after October 4, 1976, for which the pre-October 5, 1976, election is in effect. For example, assume that Trust X, a calendar year taxpayer, files a timely election under section 856(c)(1) with respect to its taxable year 1974, and is a qualified real estate investment trust for calendar years 1974 and 1975.

Assume further that Trust X is not a qualified real estate investment trust for 1976 and 1977 because it willfully fails to meet the asset diversification requirements of section 856(c)(5) for both years. The failure (whether or not willful) to meet these requirements in 1977 terminates the election to be a real estate investment trust made with respect to 1974. (See paragraph (b) of this section.) The termination is effective for 1977 and all succeeding taxable years. However, under section 1608(d)(3) of the Tax Reform Act of 1976, Trust X is not prohibited by section 856(g)(3) from making a new election under section 856(c)(1) with respect to 1978.

(d) *Exceptions*—Section 856(g)(4) provides an exception to the general rule of section 856(g)(3) that the termination of an election to be a real estate investment trust disqualifies the corporation, trust, or association from making a new election for the 4 taxable years following the first taxable year for which the termination is effective. This exception applies where the corporation, trust, or association meets the requirements of section 856(g)(4)(A), (B) and (C) (relating to the timely filing of a return, the absence of fraud, and reasonable cause, respectively) for the taxable year with respect to which the termination of election occurs. In order to meet the requirements of section 856(g)(4)(C), the corporation, trust, or association must establish, to the satisfaction of the district director for the internal revenue district in which the corporation, trust, or association maintains its principal place of business or principal office or agency, that its failure to be a qualified real estate investment trust for the taxable year in question was due to reasonable cause and not due to willful neglect. The principles of § 1.856-7(c) (including the principles relating to expert advice will apply in determining whether, for purposes of section 856(g)(4), the failure of a corporation, trust, or association to be a qualified real estate investment trust for a taxable year was due to reasonable cause and not due to willful neglect. Thus, for example, the corporation, trust, or association must exercise ordinary business care and prudence in attempting to meet the status conditions of section 856(a) and the distribution and recordkeeping requirements of section 857(a), as well as the gross income requirements of section 856(c). The provisions of section 856(g)(4) do not apply to a taxable year in which the corporation, trust, or association makes a valid revocation,

under section 856(g)(2), of an election to be a real estate investment trust.

§ 1.856-9 Election with respect to property held for sale in a taxable year beginning before October 5, 1976.

(a) *In general.* Section 856(a)(4), as in effect with respect to taxable years beginning before October 5, 1976, provided that a real estate investment trust could not hold any property (other than foreclosure property) primarily for sale to customers in the ordinary course of its trade or business. Section 1603 of the Tax Reform Act of 1976 (the Act) repealed the prohibition on holding property primarily for sale to customers, effective for taxable years beginning after October 4, 1976, and imposed the tax on net income from prohibited transactions under section 857(b)(6). Section 1608(d)(2) of the Act provides that if as a result of a determination (as defined in section 859(c)) occurring after October 4, 1976, a real estate investment trust does not meet the requirement of section 856(a)(4) (as in effect before amendment by the Act) for any taxable year beginning before October 5, 1976, the trust may elect to have the provisions of section 1603 (other than paragraphs (1), (2), (3), and (4) of section 1603(c)) of the Act apply with respect to the taxable year.

(b) *Election.* The election provided by section 1608(d)(2) of the Act shall be made by filing a statement with the district director for the internal revenue district in which the taxpayer maintains its principal place of business or principal office or agency. The statement shall be signed by the taxpayer and shall include the following information:

- (1) The name, address, and taxpayer identification number of the taxpayer;
- (2) The taxable year (or years) to which the election applies;
- (3) A statement that the taxpayer, pursuant to section 1608(d)(2) of the Tax Reform Act of 1976, elects to have the provisions of section 1603 (other than paragraphs (1), (2), (3), and (4) of section 1603(c)) of the Act apply to such taxable year (or years); and
- (4) A description of the determination and the date upon which the determination became final.

A copy of the closing agreement, the Tax Court decision, the judgement, decree, or other order, or the agreement with the district director (or other official) which constitutes the determination shall be attached to the statement.

(c) *Time for filing the election.* The election must be filed within 60 days after the date of the determination. The date of a determination described in

section 859(c) (1) or (2) shall be determined in accordance with section 859(c) and subdivision (i), (ii), or (iii) of § 1.859-2(b)(1). The date of a determination which is an agreement with the district director (or other official) under section 859(c)(3) shall be determined in accordance with paragraph (e) of this section.

(d) *Revocation*—(1) *In general.* An election made by a taxpayer pursuant to section 1608(d)(2) of the Tax Reform Act of 1976 after February 6, 1981 is irrevocable.

(2) *Elections made under temporary regulations.* A taxpayer who has made an election under section 1608(d)(2) of the Act on or before February 6, 1981 in accordance with § 7.0(c)(1) of this chapter may apply to the Commissioner for consent to revoke the election. The application for consent must be filed with the Commissioner after February 6, 1981 and before May 8, 1981.

(e) *Determination.* For purposes of section 1608(d)(2) of the Tax Reform Act of 1976, a determination under section 859(c)(3) may be made by an agreement signed by the district director or such other official to whom authority to sign the agreement is delegated, and by or on behalf of the taxpayer. The agreement shall identify the taxable year (or years) to which it applies and shall state that the taxpayer, during such taxpayer year (or years), held property (other than foreclosure property) primarily for sale to customers in the ordinary course of its trade or business, within the meaning of section 856(a)(4), as in effect before amendment by the Act. The agreement further shall set forth, for each taxable year to which it applies, the amount, if any, of the net income (or net loss) from prohibited transactions, and the amount, if any, of the tax imposed by paragraph (6) of section 857(b). An agreement under this subparagraph shall be sent to the taxpayer at its last known address by either registered or certified mail. If registered mail is used, the date of registration shall be treated as the date of determination. If certified mail is used, the date of the postmark on the sender's receipt shall be treated as the date of determination. However, if the statement described in paragraph (b) of this section is filed by the taxpayer before the registration or postmark date but on or after the date the agreement is signed by the district director (or the other official to whom authority to sign the agreement is delegated), the date of determination shall be the date of signing.

(f) *Rules relating to refunds, credits, assessment, and collection.* In a case

where an election to have section 1603 of the Act apply results in an overpayment of tax, the taxpayer, in order to secure credit or refund of the overpayment, must file a claim on Form 1120X. See section 1608(d)(2) of the Act for special rules relating to the period of limitations on filing the claim and to assessment and collection of any deficiency established by the determination.

§ 1.857 [Removed]

Par. 30. Section 1.857 is removed.

Par. 31. Section 1.857-1 is amended as follows:

1. So much of paragraph (a) as precedes subparagraph (1) is amended by deleting "than section" and by inserting "than sections 856(g), relating to the revocation or termination of an election, and" in lieu thereof.

2. Paragraph (a)(1) is amended to read as set forth below.

3. Paragraph (a)(2) is amended by striking out "§ 1.857-6" and inserting in lieu thereof "§ 1.857-8".

4. Paragraph (b) is amended by striking out "section 857(d)" and inserting in lieu thereof "sections 856(g) and 857(d)" and by striking out "§ 1.857-5" and inserting in lieu thereof "§ 1.857-7".

§ 1.857-1 Taxation of real estate investment trusts.

(a) *Requirements applicable thereto.* * * *

(1) The deduction for dividends paid for the taxable year as defined in section 561 (computed without regard to capital gain dividends) equals or exceeds the amount specified in section 857(a)(1), as in effect for the taxable year; and * * *

§ 1.857-2 [Removed]

Par. 32. Section 1.857-2 is removed.

Par. 33. Section 1.857-3 is redesignated as § 1.857-2 and is revised to read as follows:

§ 1.857-2 Real estate investment trust taxable income and net capital gain.

(a) *Real estate investment trust taxable income.* Section 857(b)(1) imposes a normal tax and surtax, computed at the rates and in the manner prescribed in section 11, on the "real estate investment trust taxable income", as defined in section 857(b)(2). Section 857(b)(2) requires certain adjustments to be made to convert taxable income of the real estate investment trust to "real estate investment trust taxable income". The adjustments are as follows:

(1) *Net capital gain.* In the case of taxable years ending before October 5,

1976, the net capital gain, if any, is excluded.

(2) *Special deductions disallowed.*

The special deductions provided in part VIII, subchapter B, chapter 1 of the Code (except the deduction under section 248) are not allowed.

(3) *Deduction for dividends paid—(i) General rule.* The deduction for dividends paid (as defined in section 561) is allowed. In the case of taxable years ending before October 5, 1976, the deduction for dividends paid is computed without regard to capital gains dividends.

(ii) *Deduction for dividends paid if there is net income from foreclosure property.* If for any taxable year the trust has net income from foreclosure property (as defined in section 857(b)(4)(B) and § 1.857-3), the deduction for dividends paid is an amount equal to the amount which bears the same proportion to the total dividends paid or considered as paid during the taxable year that otherwise meet the requirements for the deduction for dividends paid (as defined in section 561) as the real estate investment trust taxable income (determined without regard to the deduction for dividends paid) bears to the sum of—

(A) The real estate investment trust taxable income (determined without regard to the deduction for dividends paid), and

(B) The amount by which the net income from foreclosure property exceeds the tax imposed on such income by section 857(b)(4)(A).

For purposes of the preceding sentence, the term "total dividends paid or considered as paid during the taxable year" includes deficiency dividends paid with respect to the taxable year that are not otherwise excluded under this subdivision or section 857(b)(3)(A). The term, however, does not include either deficiency dividends paid during the taxable year with respect to a preceding taxable year or, in the case of taxable years ending before October 5, 1976, capital gains dividends.

(iii) *Deduction for dividends paid for purposes of the alternative tax.* The rules in section 857(b)(3)(A) apply in determining the amount of the deduction for dividends paid that is taken into account in computing the alternative tax. Thus, for example, if a real estate investment trust has net income from foreclosure property for a taxable year ending after October 4, 1976, then for purposes of determining the partial tax described in section 857(b)(3)(A)(i), the amount of the deduction for dividends paid is computed pursuant to paragraph (a)(3)(ii) of this section, except that

capital gains dividends are excluded from the dividends paid or considered as paid during the taxable year, and the net capital gain is excluded in computing real estate investment trust taxable income.

(4) *Section 443(b) disregarded.* The taxable income is computed without regard to section 443(b). Thus, the taxable income for a period of less than 12 months is not placed on an annual basis even though the short taxable year results from a change of accounting period.

(5) *Net operating loss deduction.* In the case of a taxable year ending before October 5, 1976, the net operating loss deduction provided in section 172 is not allowed.

(6) *Net income from foreclosure property.* An amount equal to the net income from foreclosure property (as defined in section 857(b)(4)(B) and paragraph (a) of § 1.857-3), if any, is excluded.

(7) *Tax imposed by section 857(b)(5).* An amount equal to the tax (if any) imposed on the trust by section 857(b)(5) for the taxable year is excluded.

(8) *Net income or loss from prohibited transactions.* An amount equal to the amount of any net income derived from prohibited transactions (as defined in section 857(b)(6)(B)(i)) is excluded. On the other hand, an amount equal to the amount of any net loss derived from prohibited transactions (as defined in section 857(b)(6)(B)(ii)) is included. Because the amount of the net loss derived from prohibited transactions is taken into account in computing taxable income before the adjustments required by section 857(b)(2) and this section are made, the effect of including an amount equal to the amount of the loss is to disallow a deduction for the loss.

(b) *Net capital gain in taxable years ending before October 5, 1976.* The rules relating to the taxation of capital gains in 26 CFR 1.857-2(b) (revised as of April 1, 1977) apply to taxable years ending before October 5, 1976.

Par. 34. Sections 1.857-4, 1.857-5, 1.857-6, 1.857-7, 1.857-8 are redesignated as §§ 1.857-6, 1.857-7, 1.857-8, 1.857-9, and 1.857-10, respectively, and new §§ 1.857-3, 1.857-4, and 1.857-5 are inserted immediately after § 1.857-2 (as redesignated by par. 29 of this document), to read as follows:

§ 1.857-3 Net income from foreclosure property.

(a) *In general.* For purposes of section 857(b)(4)(B), net income from foreclosure property means the aggregate of—

(1) All gains and losses from sales or other dispositions of foreclosure

property described in section 1221(1), and

(2) The difference (hereinafter called "net gain or loss from operations") between (1) the gross income derived from foreclosure property (as defined in section 856(e)) to the extent such gross income is not described in subparagraph (A), (B), (C), (D), (E), or (G) of section 856(c)(3), and (ii) the deductions allowed by chapter 1 of the Code which are directly connected with the production of such gross income.

Thus, the sum of the gains and losses from sales or other dispositions of foreclosure property described in section 1221(1) is aggregated with the net gain or loss from operations in arriving at net income from foreclosure property. For example, if for a taxable year a real estate investment trust has gain of \$100 from the sale of an item of foreclosure property described in section 1221(1), a loss of \$50 from the sale of an item of foreclosure property described in section 1221(1), gross income of \$25 from the rental of foreclosure property that is not gross income described in subparagraph (A), (B), (C), (D), or (G) of section 856(c)(3), and deductions of \$35 allowed by chapter 1 of the Code which are directly connected with the production of the rental income, the net income from foreclosure property for the taxable years is \$40 $[(\$100 - \$50) + (\$25 - \$35)]$.

(b) *Directly connected deductions.* A deduction which is otherwise allowed by chapter 1 of the Code is "directly connected" with the production of gross income from foreclosure property if it has a proximate and primary relationship to the earning of the income. Thus, in the case of gross income from real property that is foreclosure property, "directly connected" deductions would include depreciation on the property, interest paid or accrued on the indebtedness of the trust (whether or not secured by the property) to the extent attributable to the carrying of the property, real estate taxes, and fees paid to an independent contractor hired to manage the property. On the other hand, general overhead and administrative expenses of the trust are not "directly connected" deductions. Thus, salaries of officers and other administrative employees of the trust are not "directly connected" deductions. The net operating loss deduction provided by section 172 is not allowed in computing net income from foreclosure property.

(c) *Net loss from foreclosure property.* The tax imposed by section 857(b)(4) applies only if there is net income from foreclosure property. If there is a net

loss from foreclosure property (that is, if the aggregate computed under paragraph (a) of this section results in a negative amount) the loss is taken into account in computing real estate investment trust taxable income under section 857(b)(2).

(d) *Gross income not subject to tax on foreclosure property.* If the gross income derived from foreclosure property consists of two classes, a deduction directly connected with the production of both classes (including interest attributable to the carrying of the property) must be apportioned between them. The two classes are:

(1) Gross income which is taken into account in computing net income from foreclosure property and

(2) Other income (such as income described in subparagraph (A), (B), (C), (D), or (G) of section 856(c)(3)).

The apportionment may be made on any reasonable basis.

(e) *Allocation and apportionment of interest.* For purposes of determining the amount of interest attributable to the carrying of foreclosure property under paragraph (b) of this section, the following rules apply:

(1) *Deductible interest.* Interest is taken into account under this paragraph (e) only if it is otherwise deductible under chapter 1 of the Code.

(2) *Interest specifically allocated to property.* Interest that is specifically allocated to an item of property is attributable only to the carrying of that property. Interest is specifically allocated to an item of property if (i) the indebtedness on which the interest is paid or accrued is secured only by that property, (ii) such indebtedness was specifically incurred for the purpose of purchasing, constructing, maintaining, or improving that property, and (iii) the proceeds of the borrowing were applied for that purpose.

(3) *Other interest.* Interest which is not specifically allocated to property is apportioned between foreclosure property and other property under the principles of § 1.861-8(e)(2)(v).

(4) *Effective date.* The rules in this paragraph (e) are mandatory for all taxable years ending after February 6, 1981.

§ 1.857-4 Tax imposed by reason of the failure to meet certain source-of-income requirements.

Section 857(b)(5) imposes a tax on a real estate investment trust that is considered, by reason of section 856(c)(7), as meeting the source-of-income requirements of paragraph (2) or (3) of section 856(c) (or both such paragraphs). The amount of the tax is

determined in the manner prescribed in section 857(b)(5).

§ 1.857-5 Net income and loss from prohibited transactions.

(a) *In general.* Section 857(b)(6) imposes, for each taxable year, a tax equal to 100 percent of the net income derived from prohibited transactions. A prohibited transaction is a sale or other disposition of property described in section 1221(1) that is not foreclosure property. The 100-percent tax is imposed to preclude a real estate investment trust from retaining any profit from ordinary retailing activities such as sales to customers of condominium units or subdivided lots in a development tract. In order to prevent a trust from receiving any tax benefit from such activities, a net loss from prohibited transactions effectively is disallowed in computing real estate investment trust taxable income. See § 1.857-2(a)(8). Such loss, however, does reduce the amount which a trust is required to distribute as dividends. For purposes of applying the provisions of the Code, other than those provisions of part II of subchapter M which relate to prohibited transactions, no inference is to be drawn from the fact that a type of transaction does not constitute a prohibited transaction.

(b) *Special rules.* In determining whether a particular transaction constitutes a prohibited transaction, the activities of a real estate investment trust with respect to foreclosure property and its sales of such property are disregarded. Also, if a real estate investment trust enters into a purchase and leaseback of real property with an option in the seller-lessee to repurchase the property at the end of the lease period, and the seller exercises the option pursuant to its terms, income from the sale generally will not be considered to be income from a prohibited transaction solely because the purchase and leaseback was entered into with an option in the seller to repurchase and because the option was exercised pursuant to its terms. Other facts and circumstances, however, may require a conclusion that the property is held primarily for sale to customers in the ordinary course of a trade or business. Gain from the sale or other disposition of property described in section 1221(1) (other than foreclosure property) that is included in gross income for a taxable year of a qualified real estate investment trust constitutes income from a prohibited transaction, even though the sale or other disposition from which the gain is derived occurred in a prior taxable year. For example, if a corporation that is a qualified real estate

investment trust for the current taxable year elected to report the income from the sale of an item of section 1221(1) property (other than foreclosure property) on the installment method of reporting income, the gain from the sale that is taken into income by the real estate investment trust for the current taxable year is income from a prohibited transaction. This result follows even though the sale occurred in a prior taxable year for which the corporation did not qualify as a real estate investment trust. On the other hand, if the gain is taken into income in a taxable year for which the taxpayer is not a qualified real estate investment trust, the 100-percent tax does not apply.

(c) *Net income or loss from prohibited transactions.* Net income or net loss from prohibited transactions is determined by aggregating all gains from the sale or other disposition of property (other than foreclosure property) described in section 1221(1) with all losses from the sale or other disposition of such property. Thus, for example, if a real estate investment trust sells two items of property described in section 1221(1) (other than foreclosure property) and recognizes a gain of \$100 on the sale of one item and a loss of \$40 on the sale of the second item, the net income from prohibited transactions will be \$60.

Par. 35. Section 1.857-6, as redesignated by paragraph 34 of this document, is amended as follows:

1. The first sentence of paragraph (b) is amended by striking out "an investment trust for" and inserting in lieu thereof "a corporation, trust, or association for".

2. Paragraph (c)(1) is amended by striking out "857(b)(4)" and inserting in lieu thereof "857(b)(7)".

3. Paragraphs (c) (2) and (3) are amended by striking out "857(b)(4)" and inserting in lieu thereof "857(b)(7)".

(4) The first sentence of paragraph (e)(1) is amended by striking out "not later than 30 days after the close of its taxable year" and inserting in lieu thereof "within the period specified in section 857(b)(3)(C) and paragraph (f) of this section".

5. Paragraph (e)(1) is amended by striking out "excess of the net long-term capital gain over the net short-term capital loss" each place it appears and inserting in lieu thereof "net capital gain".

6. The fourth sentence of paragraph (e)(1) is amended by striking out "that such excess was" and inserting in lieu thereof "the net capital gain was".

7. A new sentence is added at the end of paragraph (e)(1) to read as set forth below.

8. A new paragraph (f) is added, to read as set forth below.

§ 1.857-6 Method of taxation of shareholders of real estate investment trusts.

(e) *Definition of capital gain dividend.* (1)(i) * * *

(ii) For purposes of section 857(b)(3)(C) and this paragraph, the net capital gain for a taxable year ending after October 4, 1976, is deemed not to exceed the real estate investment trust taxable income determined by taking into account the net operating loss deduction for the taxable year but not the deduction for dividends paid. See example (2) in § 1.172-5(a)(5).

(f) *Mailing of written notice to shareholders—(1) General rule.* Except as provided in paragraph (f)(2) of this section, the written notice designating a dividend or part thereof as a capital gain dividend must be mailed to the shareholders not later than 30 days after the close of the taxable year of the real estate investment trust.

(2) *Net capital gain resulting from a determination.* If, as a result of a determination (as defined in section 859(c)), occurring after October 4, 1976, there is an increase in the amount by which the net capital gain exceeds the deduction for dividends paid (determined with reference to capital gains dividends only) for the taxable year, then a real estate investment trust may designate a dividend (or part thereof) as a capital gain dividend in a written notice mailed to its shareholders at any time during the 120-day period immediately following the date of the determination. The designation may be made with respect to a dividend (or part thereof) paid during the taxable year to which the determination applies (including a dividend considered as paid during the taxable year pursuant to section 858). A deficiency dividend (as defined in section 859(d)), or a part thereof, that is paid with respect to the taxable year also may be designated as a capital gain dividend by the real estate investment trust (or by the acquiring corporation to which section 381(c)(25) applies) before the expiration of the 120-day period immediately following the determination. However, the aggregate amount of the dividends (or parts thereof) that may be designated as capital gain dividends after the date of the determination shall not exceed the amount of the increase in the excess of the net capital gain over the deduction for dividends paid (determined with reference to capital gains dividends only) that results from

the determination. The date of a determination shall be established in accordance with § 1.859-2(b)(1).

Par. 36. Section 1.857-7(b), as redesignated by paragraph 34 of this document, is amended by adding two new sentences at the end thereof, to read as follows:

§ 1.857-7 Earnings and profits of a real estate investment trust.

(b) * * * For purposes of section 857(d) and this section, if an amount equal to any net loss derived from prohibited transactions is included in real estate investment trust taxable income pursuant to section 857(b)(2)(F), that amount shall be considered to be an amount which is not allowable as a deduction in computing taxable income for the taxable year. The earnings and profits for the taxable year (but not the accumulated earnings and profits) shall not be considered to be less than (i) in the case of a taxable year ending before October 5, 1976, the amount (if any) of the net capital gain for the taxable year, or (ii) in the case of a taxable year ending after December 31, 1973, the amount (if any), of the excess of the net income from foreclosure property for the taxable year over the tax imposed thereon by section 857(b)(4)(A).

§ 1.857-8 [Amended]

Par. 37. Paragraph (e) of § 1.857-8 (as redesignated by paragraph 34 of this document) is amended by deleting "§ 1.857-7" from the second sentence and inserting in lieu thereof "§ 1.857-9".

§ 1.857-9 [Amended]

Par. 38. Paragraph (a) of § 1.857-9 (as redesignated by paragraph 34 of this document) is amended by deleting "§ 1.857-6" and inserting in lieu thereof "§ 1.857-8".

§ 1.857-10 [Amended]

Par. 39. Section 1.857-10 (as redesignated by paragraph 34 of this document) is amended by deleting "§§ 1.857-6 and 1.857-7" and inserting in lieu thereof "§§ 1.857-8 and 1.857-9".

§ 1.858 [Removed]

Par. 40. Section 1.858 is removed.

Par. 41. Section 1.858-1 is amended as follows:

1. Paragraphs (a) and (b) are revised to read as set forth below.

2. Paragraph (d) is amended by adding a new example (3) at the end thereof, to read as set forth below.

3. Paragraph (e) is amended by deleting "paragraph (e) of § 1.857-4" each place it appears and inserting in lieu thereof "paragraph (f) of § 1.857-6".

4. The next to the last sentence of paragraph (e) is amended to areas as set forth below.

§ 1.858-1 Dividends paid by a real estate investment trust after close of taxable year.

(a) *General rule.* Under section 858, a real estate investment trust may elect to treat certain dividends that are distributed within a specified period after the close of a taxable year as having been paid during the taxable year. The dividend is taken into account in determining the deduction for dividends paid for the taxable year in which it is treated as paid. The dividend may be an ordinary dividend or, subject to the requirements of sections 857(b)(3)(C) and 858(c), a capital gain dividend. The trust may make the dividend declaration required by section 858(a)(1) either before or after the close of the taxable year as long as the declaration is made before the time prescribed by law for filing its return for the taxable year (including the period of any extension of time granted for filing the return).

(b) *Election—(1) Method of making election.* The election must be made in the return filed by the trust for the taxable year. The election shall be made by treating the dividend (or portion thereof) to which the election applies as a dividend paid during the taxable year of the trust in computing its real estate investment trust taxable income and, if applicable, the alternative tax imposed by section 857(b)(3)(A). (In the case of an election with respect to a taxable year ending before October 5, 1976, if the dividend (or portion thereof) to which the election is to apply is a capital gain dividend, the trust shall treat the dividend as paid during such taxable year in computing the amount of capital gains dividends paid during the taxable year.) In the case of an election with respect to a taxable year beginning after October 4, 1976, the trust must also specify in its return (or in a statement attached to its return) the exact dollar amount that is to be treated as having been paid during the taxable year.

(2) *Limitation based on earnings and profits.* The election provided in section 858(a) may be made only to the extent that the earnings and profits of the taxable year (computed with the application of sections 857(d) and 1.857-7) exceed the total amount of distributions out of such earnings and profits actually made during the taxable year. For purposes of the preceding sentence, deficiency dividends and distributions with respect to which an election has been made for a prior year under section 858(a) are disregarded in determining the total amount of

distributions out of earnings and profits actually made during the taxable year. The dividend or portion thereof, with respect to which the real estate investment trust has made a valid election under section 858(a), shall be considered as paid out of the earnings and profits of the taxable year for which such election is made, and not out of the earnings and profits of the taxable year in which the distribution is actually made.

(3) *Additional limitation based on amount specified.* The amount treated under section 858(a) as having been paid in a taxable year beginning after October 4, 1976, cannot exceed the lesser of (i) the dollar amount specified by the trust in its return (or a statement attached thereto) in making the election or (ii) the amount allowable under the limitation prescribed in paragraph (b)(2) of this section.

(4) *Irrevocability of the election.* After the expiration of the time for filing the return for the taxable year for which an election is made under section 858(a), such election shall be irrevocable with respect to the dividend or portion thereof to which it applies.

(d) Illustrations. * * *

Example (3). Assume the facts are the same as in example (2), except that the taxable years involved are calendar years 1977 and 1978, and Y Trust specified in its Federal income tax return for 1977 that the dollar amount of \$40,000 of the \$65,000 distribution payable to shareholders on March 31, 1978, is to be treated as having been paid in 1977. The result will be the same as in example (2), since the amount of the undistributed earnings and profits for 1977 is less than the \$40,000 amount specified by Y Trust in making its election. Accordingly, the election is valid only to the extent of \$15,000. Y Trust will treat the amount of \$15,000 as a distribution, in 1977, of earnings and profits of the trust for the taxable year 1977 and the remaining \$50,000 as a distribution, in 1978, of the earnings and profits for 1978.

(e) *Notice to shareholders. * * ** If the notice under section 858(c) relates to an election with respect to any capital gains dividends, such capital gains dividends shall be aggregated by the real estate investment trust with the designated capital gains dividends actually paid during the taxable year to which the election applies (not including deficiency dividends or dividends with respect to which an election has been made for a prior taxable year under section 858) to determine whether the aggregate of the designated capital gains dividends with respect to such taxable year exceeds the net capital gain of the trust. * * *

Par. 42. New sections 1.859-1, 1.859-2, 1.859-3, 1.859-4, and 1.860-1 are added after section 1.858-1, to read as follows:

§ 1.859-1 Deficiency dividends.

Section 859 provides a method by which a real estate investment trust may be relieved from the payment of a deficiency in (or be allowed a credit or refund with respect to) the tax imposed by section 857(b)(1) or (3), the minimum tax on tax preferences imposed by section 56, or, in the case of a real estate investment trust that fails the distribution requirements of section 857(a)(1), the corporate income tax imposed by section 11(a) or 1201(a). The method provided by section 859 is to allow an additional deduction for a dividend distribution (which meets the requirements of sections 859 and 1.859-2) in computing the deduction for dividends paid for the taxable year for which the deficiency is determined. A deficiency dividend may be an ordinary dividend, or, subject to the limitations of sections 857(b)(3)(C) and 859(d)(2)(B), may be a capital gain dividend.

§ 1.859-2 Requirements for deficiency dividends.

(a) *In general.* A real estate investment trust is allowed a deduction for a deficiency dividend only if there is a determination (as defined in section 859(c) and paragraph (b)(1) of this section) occurring after October 4, 1976, that results in an adjustment (as defined in section 859(b)(1)) for the taxable year with respect to which the deficiency dividend is paid. The deficiency dividend must be paid on, or within 90 days after, the date of the determination and before the filing of a claim under section 859(e) and paragraph (b)(2) of this section. This claim must be filed within 120 days after the date of the determination. The deficiency dividend must be a distribution of property (including money) that would have been properly taken into account in the computation of the deduction for dividends paid under section 561 for the taxable year with respect to which the liability for tax resulting from the determination exists; if the money or other property had been distributed during that taxable year. Thus, for purposes of section 859(d), where the distribution would have been a dividend within the meaning of sections 316(a) and 1.316-1, if it had been made during the taxable year with respect to which the determination applies, the distribution will meet the requirements of section 562(a) (relating to rules applicable in determining dividends eligible for the deduction for dividends paid), even though the distributing

corporation, trust, or association has no current or accumulated earnings and profits for the taxable year in which the distribution is actually made. The amount of the distribution shall be determined under section 301 as of the date of the distribution. The amount of the deduction is subject to the limitations set forth in sections 562 and 859(d)(2) and the regulations thereunder. Thus, in the case of a distribution to an individual shareholder of property (other than money) which has a fair market value in excess of the adjusted basis of the property in the hands of the distributing corporation, trust, or association at the time of the distribution, the amount of the deficiency dividend, for purposes of section 316(b)(3), shall be the amount which would have been a dividend if the property (taking into account its fair market value as of the date of the distribution) had been distributed during the taxable year with respect to which the determination applies, even though the deduction for dividends paid is limited, under § 1.562-1(a), to the adjusted basis of the property. The corporation, trust, or association that pays the deficiency dividends does not have to be a qualified real estate investment trust at the time of payment.

(b) *Determination and claim for deduction.*—(1) *Determination.* For purposes of applying section 859(c) and this section, the following rules shall apply:

(i) The date of determination by a decision of the United States Tax Court is the date upon which the decision becomes final, as prescribed in section 7481.

(ii) The date upon which a judgment of a court becomes final, which is the date of the determination in such cases, must be determined upon the basis of the facts in the particular case. Ordinarily, a judgment of a United States district court becomes final upon the expiration of the time allowed for taking an appeal, if no appeal is duly taken within that time. A judgment of the United States Court of Claims becomes final upon the expiration of the time allowed for filing a petition for certiorari if no petition is duly filed within that time.

(iii) The date of determination by a closing agreement, made under section 7121, is the date the agreement is approved by the Commissioner.

(iv) A determination under section 859(c)(3) may be made by an agreement signed by the district director or another official to whom authority to sign the agreement is delegated, and by or on behalf of the taxpayer. The agreement shall set forth the amount, if any, of

each adjustment described in subparagraphs (A), (B), and (C) of section 859(b)(1) for the taxable year, the amount of the liability for any tax imposed by section 11(a), 56(a), 857(b)(1), 857(b)(3)(A) or 1201(a) for the taxable year, and the amount of the limitation (determined under section 859(d)(2)) on the amount of deficiency dividends that can qualify as capital gain dividends and ordinary dividends, respectively, for the taxable year. An agreement under this subdivision which is signed by the district director (or other delegate) shall be sent to the taxpayer at its last known address by either registered or certified mail. If registered mail is used, the date of registration shall be treated as the date of determination. If certified mail is used, the date of the postmark on the sender's receipt shall be treated as the date of determination. However, if a dividend is paid by the taxpayer before the registration or postmark date, but on or after the date the agreement is signed by the district director (or other delegate), the date of determination shall be the date of signing.

(2) *Claim for deduction.* A claim for deduction for a deficiency dividend shall be made, with the requisite declaration, on Form 976 and shall contain the following information:

(i) The name, address, and taxpayer identification number of the corporation, trust, or association;

(ii) The amount of the deficiency and the taxable year or years involved;

(iii) The amount of the unpaid deficiency or, if the deficiency has been paid in whole or in part, the date of payment and the amount thereof;

(iv) A statement as to how the deficiency was established (i.e., by an agreement under section 859(c)(3), by a closing agreement under section 7121, or by a decision of the Tax Court or court judgment);

(v) Any date or other information with respect to the determination that is required by Form 976;

(vi) The amount and date of payment of the dividend with respect to which the claim for the deduction for deficiency dividends is filed;

(vii) The amount claimed as a deduction for deficiency dividends;

(viii) If the amount claimed as a deduction for deficiency dividends includes any amount designated (or to be designated) as capital gain dividends, the amount of capital gain dividends for which a deficiency dividend deduction is claimed; and

(ix) Any other information required by the claim form.

A certified copy of the resolution of the trustees, directors, or other authority,

authorizing the payment of the dividend with respect to which the claim is filed must accompany the claim. Also, any copy of a court decision, judgment, agreement, or other document required by Form 976 must accompany the claim. The claim, together with the accompanying documents, shall be filed with the district director, or director of the internal revenue service center, with whom the income tax return for the taxable year with respect to which the determination applies was filed. In the event that the determination is an agreement with the district director (or his delegate) described in section 859(c)(3) and paragraph (b)(1)(iv) of this section, the claim may be filed with the district director with whom (or pursuant to whose delegation) the agreement was made.

§ 1.859-3 Interest and additions to tax.

(a) *In general.* If a real estate investment trust is allowed a deduction for deficiency dividends, under section 859(b)(2) the tax imposed on the trust by chapter 1 of the Code (computed by taking into account the deduction) for the taxable year with respect to which the deduction is allowed is deemed to be increased by an amount equal to the amount of the deduction. This deemed increase in tax, however, applies solely for purposes of determining the liability of the trust for interest under subchapter A of chapter 67 of the Code and for additions to tax and additional amounts under chapter 68 of the Code. For purposes of applying subchapter A of chapter 67 and chapter 68, the last date prescribed for payment of the deemed increase in tax shall be considered to be the last date prescribed for the payment of tax (determined in the manner provided in section 6601(b)) for the taxable year for which the deduction for deficiency dividends is allowed. The deemed increase in tax shall be considered to be paid as of the date that the claim for the deficiency dividend deduction described in section 859(e) and § 1.850-2(b)(2) is filed.

(b) *Overpayments of tax.* If a real estate investment trust is entitled to a credit or refund of an overpayment of the tax imposed by chapter 1 of the Code for the taxable year for which the deficiency dividend deduction is allowed, then, for purposes of computing interest, additions to tax, and additional amounts, the payment (or payments) that result in the overpayment and that precede the filing of the claim described in section 859(e) will be applied against and reduce the increase in tax that is deemed to occur under section 859(b)(2).

(c) *Example.* This section may be illustrated by the following examples:

Example (1). Corporation X is a real estate investment trust that files its income tax return on a calendar year basis. For its taxable year 1977, corporation X receives an extension of time until June 15, 1978, to file its income tax return. Corporation X does not elect to pay any tax due in installments. On its 1977 income tax return, filed on May 15, 1978, corporation X reports real estate investment trust taxable income (computed without regard to the dividends paid deduction) of \$100, a dividends paid deduction of \$100, and no tax liability. Following an examination of corporation X's 1977 return, the district director and corporation X enter into an agreement which constitutes a determination under section 859(c)(3). Under the determination (which is dated November 1, 1979), the real estate investment trust taxable income of corporation X (computed without the dividends paid deduction) is increased by \$20 to \$120. Thus, taking into account the \$100 of dividends paid in 1977, corporation X has undistributed real estate investment trust taxable income of \$20 as a result of the determination. Corporation X pays a dividend of \$20 on November 10, 1979, files a claim for a deficiency dividend deduction of \$20 pursuant to section 859(e) with respect to such dividend on November 15, 1979, and is allowed a deficiency dividend deduction of \$20 with respect to its taxable year 1977. Corporation X, after taking into account the deduction for deficiency dividends, has no real estate investment trust taxable income and has met the distribution requirements of section 857(a)(1). However, for purposes of section 6601 (relating to interest on underpayment of tax) the tax imposed by chapter 1 of the Code on corporation X for the taxable year 1977 is deemed to be increased by \$20 (the amount of the deficiency dividend deduction allowed with respect to the taxable year 1977), and the last date prescribed for payment of the tax is March 15, 1978 (the due date of the return determined without regard to any extension of time). The tax of \$20 is deemed to be paid on November 15, 1979, the date the claim for the deficiency dividend deduction is filed pursuant to section 859(e). Thus, corporation X is liable for interest on \$20, at the rate established under section 6621, for the period from March 15, 1978, to November 15, 1979. Also for purposes of determining whether corporation X is liable for any addition to tax or additional amount imposed by chapter 68 of the Code (including the penalty prescribed by section 6697) the amount of tax imposed on corporation X by chapter 1 of the Code is deemed to be increased by \$20 (the amount of the deficiency dividend deduction allowed), the last date prescribed for payment of such tax is March 15, 1978, and the tax of \$20 is deemed to be paid on November 15, 1979. Corporation X, however, is not subject to interest and penalties with respect to the amount of any tax for which it would have been liable under section 11(a), 56(a), 1201(a), or 857(b) had it not been allowed the \$20 deduction for deficiency dividends.

Example (2). Assume the facts are the same as in example (1) except that the district director, upon examination of corporation X's income tax return, asserts a deficiency in

income tax of \$4, based on an asserted increase of \$10 in real estate investment trust taxable income, and no agreement is entered into between the parties. Corporation X pays the \$4 on June 1, 1979, and files suit for refund in the United States District Court. The District Court in a decision which becomes final on November 1, 1980, holds that corporation X did fail to report \$10 of real estate investment trust taxable income and is not entitled to any refund. (No other items of income or deduction is in issue.) Corporation X pays a dividend of \$10 on November 10, 1980, files a claim for a deficiency dividend deduction of \$10 with respect to such dividend on November 15, 1980, and is allowed a deficiency dividend deduction of \$10 for 1977. Assume further that \$4 is refunded to corporation X on December 31, 1980, as the result of the \$10 deficiency dividend deduction being allowed. Also assume that any assessable penalties, additional amounts, and additions to tax (including the penalty imposed by section 6697) for which corporation X is liable are paid within 10 days of notice and demand, so that no interest is imposed on such penalties, etc. The liability of corporation X for interest for the period March 15, 1978, to June 1, 1979, will be determined with respect to \$10 (the amount of the deficiency dividend deduction allowed). The liability of corporation X for interest for the period June 1, 1979 to November 15, 1980, will be determined with respect to \$6 (\$10 minus the \$4 payment). Corporation X will be entitled to interest on the \$4 overpayment for the period described in section 6611(b)(2), beginning on November 15, 1980.

§ 1.859-4 Claim for credit or refund.

In a case where the allowance of a deduction for a deficiency dividend results in an overpayment of tax, the taxpayer, in order to secure credit or refund of the overpayment, must file a claim on Form 1120X in addition to the claim for the deduction required under section 859(e). The credit or refund will be allowed as if on the date of the determination two years remained before the expiration of the period of limitations on the filing of claim for refund for the taxable year to which the overpayment relates.

§ 1.860-1 Adoption of or change in annual accounting period.

Under section 860, a real estate investment trust may not change to or adopt any taxable year beginning after October 4, 1976, other than the calendar year.

PART 55—EXCISE TAX ON CERTAIN REAL ESTATE INVESTMENT TRUSTS

Par. 43. Subparts A and B are added to part 55, to read as follows:

Subpart A—Tax on Certain Real Estate Investment Trust Taxable Income Not Distributed During the Taxable Year

§ 55.4981-1 Imposition of excise tax on certain real estate investment trust taxable income not distributed during the taxable year.

Section 4981 imposes an excise tax on a real estate investment trust if the deduction for dividends paid for the taxable year does not equal at least 75 percent of its real estate investment trust taxable income (computed as provided in section 4981) for the taxable year. For purposes of section 4981, the deduction for dividends paid is computed without regard to capital gains dividends (as defined in section 857(b)(3)(C)) and without regard to any dividends actually paid after the close of the taxable year. Thus, dividends considered as paid during the taxable year under section 858 are disregarded. Deficiency dividends (as defined in section 859(d)) paid with respect to the taxable year are also disregarded. The return referred to in the last sentence of section 4981 in the income tax return. Section 4981 applies only to taxable years beginning after December 31, 1979, for which the taxpayer is taxable under Part II of subchapter M of chapter 1 of subtitle A as a real estate investment trust.

Subpart B—Procedure and Administration

§ 55.6001-1 Notice or regulations requiring records, statements, and special returns.

(a) *In general.* Any person subject to tax under chapter 44 of the Code shall keep such complete and detailed records as are sufficient to enable the district director to determine accurately the amount of liability under chapter 44.

(b) *Notice by district director requiring returns, statements, or the keeping of records.* The district director may require any person, by notice served upon him, to make such returns, render such statements, or keep such specific records as will enable the district director to determine whether or not such person is liable for tax under chapter 44.

(c) *Retention of records.* The records required by this section shall be kept at all times available for inspection by authorized internal revenue officers or employees, and shall be retained so long as the contents thereof may become material in the administration of any internal revenue law.

§ 55.6011-1 General requirement of return, statement, or list

Every person liable for tax under section 4961 shall file an annual return with respect to the tax on the form prescribed by the Internal Revenue Service for such purpose and shall include therein the information required by the form and the instructions issued with respect thereto.

§ 55.6061-1 Signing of returns and other documents.

Any return required to be made by a real estate investment trust with respect to the tax imposed by chapter 44 shall be signed by a person authorized by section 6062 of the Code to sign the income tax return of the real estate investment trust. Any statement or other document required to be made with respect to the tax imposed by chapter 44 shall be signed by the person required or duly authorized to sign in accordance with the regulations, forms, or instructions prescribed with respect to such statement or document. An individual's signature on a return, statement, or other document made by or for the real estate investment trust shall be prima facie evidence that the individual is authorized to sign the return, statement, or other document.

§ 55.6065-1 Verification of returns.

If a return, statement, or other document made under the provisions of chapter 44 or subtitle F or the Code or the regulations thereunder with respect to any tax imposed by chapter 44 of the Code, or the form and instructions issued with respect to such return, statement, or other document, requires that it shall contain or be verified by a written declaration that it is made under the penalties of perjury, it must be so verified by the person or persons required to sign such return, statement, or other document. In addition, any other statement or document submitted under any provision of chapter 44 or subtitle F of the Code or regulations thereunder with respect to any tax imposed by chapter 44 of the Code may be required to contain or be verified by a written declaration that it is made under the penalties of perjury.

§ 55.6071-1 Time for filing returns.

A return required by § 55.6011-1 shall be filed at the time (including any extension of time granted or allowed under section 6081) that the real estate investment trust is required to file its income tax return under section 6012 for the taxable year for which the tax under section 4961 is imposed.

§ 55.6081-1 Extension of time for filing the return.

District directors and directors of service centers are authorized to grant a reasonable extension of time for filing any return, statement, or other document which relates to any tax imposed by chapter 44 and which is required under the provisions of chapter 44 or the regulations thereunder. Extensions of time shall not be granted for more than 6 months. An extension of time for filing a return shall not operate to extend the time for the payment of the tax or any part thereof unless specified to the contrary in the extension. The rules relating to an application for extension in § 53.6081-1(b) of this chapter (relating to foundation excise taxes) shall apply to an application for an extension of time for filing the return of tax imposed by chapter 44. If an extension of time for filing the return is granted, a return shall be filed before the expiration of the period of extension.

§ 55.6091-1 Place for filing chapter 44 tax returns.

Except as provided in § 55.6091-2 (relating to exceptional cases)—

(a) *In general.* Chapter 44 tax returns shall be filed with the district director for the internal revenue district in which is located the principal place of business or principal office or agency of the real estate investment trust.

(b) *Returns filed with service centers or by hand carrying.* Notwithstanding paragraph (a) of this section, unless a return is filed by hand carrying, whenever instructions applicable to chapter 44 tax returns provide that the returns be filed with a service center, the returns must be so filed in accordance with the instructions. Returns which are filed by hand carrying shall be filed with the district director (or with any person assigned the administrative supervision of an area, zone, or local office constituting a permanent post of duty within an internal revenue district of such director) in accordance with paragraph (a) of this section.

§ 55.6091-2 Exceptional cases.

Notwithstanding the provisions of § 55.6091-1, the Commissioner may permit the filing of any chapter 44 tax return in any internal revenue district.

§ 55.6161-1 Extension of time for paying tax or deficiency.

(a) *In general.*—(1) *Tax shown or required to be shown on return.* A reasonable extension of the time for payment of the amount of any tax imposed by chapter 44 and shown or required to be shown on any return, may

be granted by the district directors at the request of the taxpayer. The period of such extension shall not be in excess of 6 months from the date fixed for payment of such tax.

(2) *Deficiency.* The time for payment of any amount determined as a deficiency in respect of tax imposed by chapter 44 may, at the request of the taxpayer, be extended by the internal revenue officer to whom the tax is required to be paid. The extension may be for a period not to exceed 18 months from the date fixed for payment of the deficiency, as shown on the notice and demand. In exceptional cases, a further extension for a period not in excess of 12 months may be granted. No extension of time for payment of a deficiency shall be granted if the deficiency is due to negligence, to intentional disregard of rules and regulations, or to fraud with intent to evade tax.

(3) *Extension of time for filing distinguished.* The granting of an extension of time for filing a return does not operate to extend the time for the payment of the tax or any part thereof unless so specified in the extension.

(b) *Certain rules relating to extension of time for paying income tax to apply.* The provisions of § 1.6161-1 (b), and (c), and (d) of this chapter (relating to a requirement for undue hardship, the application for extension, and payment pursuant to an extension) shall apply to extensions of time for payment of the tax imposed by chapter 44.

§ 55.6165-1 Bonds where time to pay tax or deficiency has been extended.

If an extension of time for payment of tax or deficiency is granted under section 6161, the district director or the director of the service center may, if he deems it necessary, require a bond for the payment of the amount in respect of which the extension is granted in accordance with the terms of the extension. However, the bond shall not exceed double the amount with respect to which the extension is granted. For provisions relating to form of bonds, see the regulations under section 7101 contained in Part 301 of this chapter (Regulations on Procedure and Administration).

§ 1.857-6(c)(3) [Amended]

Par. 44. In redesignated § 1.857-6(c)(3) in the Example, second sentence delete "December 1, 1961" and insert "December 31, 1961".

PART 5—TEMPORARY INCOME TAX REGULATIONS UNDER THE REVENUE ACT OF 1978

Par. 45. Part 5 is amended by adding new § 5.856-1 to read as follows:

§ 5.856-1 Extensions of the grace period for foreclosure property by a real estate investment trust.

(a) *In general.* Under section 856(e), a real estate investment trust ("REIT") may elect to treat as foreclosure property certain real property (including interests in real property), and any personal property incident to such real property, that the REIT acquires after December 31, 1973. In general, the REIT must acquire the property as the result of having bid in the property at foreclosure, or having otherwise reduced the property to ownership or possession by agreement or process of law, after there was default (or default was imminent) on a lease of such property (where the REIT was the lessor) or on an indebtedness owed to the REIT which such property secured. Property that a REIT elects to treat as foreclosure property ceases to be foreclosure property with respect to such REIT at the end of a grace period. The grace period ends on the date which is 2 years after the date on which the REIT acquired the property, unless the REIT has been granted an extension or extensions of the grace period. If the grace period is extended, the property ceases to be foreclosure property on the day immediately following the last day of the grace period, as extended.

(b) *Rules for extensions of the grace period.* In general, § 1.856-6(g) prescribes rules regarding extensions of the grace period. However, in order to reflect the amendment of section 856(e)(3) of the Code by section 363(c) of the Revenue Act of 1978, the following rules also apply:

(1) In the case of extensions granted after November 6, 1978, with respect to extension periods beginning after December 31, 1977, the district director may grant one or more extensions of the grace period for the property, subject to the limitation that no extension shall extend the grace period beyond the date which is 6 years after the date the REIT acquired the property. In any other case, an extension shall be for a period of not more than 1 year, and not more than two extensions can be granted with respect to the property.

(2) In the case of an extension period beginning after December 31, 1977, a request for an extension filed on or before March 28, 1980, will be considered to be timely if the limitation on the number and length of extensions in section 856(e)(3), as in effect before the amendment made by section 363(c) of the Revenue Act of 1978, would have barred the extension.

PART 10—TEMPORARY INCOME TAX REGULATIONS UNDER PUBLIC LAW 93-625**§§ 10.1, 10.3 [Removed]**

Par. 46. In Part 10 §§ 10.1 and 10.3 are removed.

PART 7—TEMPORARY INCOME TAX REGULATIONS UNDER THE TAX REFORM ACT OF 1976**§ 7.856(g)-1 [Removed]**

Par. 47. In Part 7, § 7.856(g)-1 is removed.

[FR Doc. 81-4343 Filed 2-3-81; 2:23 pm]
BILLING CODE 4830-01-M

26 CFR Part 150

[LR-4-81]

Windfall Profit Tax; Correction

AGENCY: Internal Revenue Service, Treasury.

ACTION: Temporary regulation; correction.

SUMMARY: This document corrects an error in the publication of Treasury Decision 7755, a temporary regulation relating to windfall profit tax administrative provisions published at 46 FR 4873, January 19, 1981.

EFFECTIVE DATE: This correction is effective as of the same date as Treasury Decision 7755.

FOR FURTHER INFORMATION CONTACT: David B. Cubeta of the legislation and Regulations Division, Office of Chief Counsel, Internal Revenue Service, 1111 Constitution Avenue, N.W., Washington, DC 20224, Attention: CC:LR:T 202-566-3297.

SUPPLEMENTARY INFORMATION:**Background**

On January 19, 1981, the Federal Register published Treasury Decision 7755 (46 FR 4873) which amended the temporary regulations under the Crude Oil Windfall Profit Tax Act of 1980 (26 CFR Part 150). The new temporary regulations related primarily to administrative aspects of the tax. The text of the temporary regulations also served as the text of proposed regulations under 26 CFR Part 51 (46 FR 4950).

Need for Correction

The need for correction arises from the erroneous deletion of a sentence in paragraph (a) of § 150.4997-1. This document corrects the error by adding the deleted sentence.

Drafting Information

The principal author of this correction is David B. Cubeta of the Legislation and Regulations Division, Office of Chief Counsel, Internal Revenue Service.

Correction of Treasury Decision

Accordingly, FR Doc. 81-1850 (46 FR 4873) is amended as follows:

In Par. 8 on page 4884, § 150.4997-1 is amended by revising the portion of paragraph (a) that follows subparagraph (2) to read as follows:

§ 150.4997-1 Returns and recordkeeping.**(a) Returns. * * ***

Every producer taking the net income limitation provided by section 4988(b) into account in making windfall profit tax deposits shall file quarterly and annual statements in accordance with forms and instructions provided for that purpose. See § 150.6078-1 for the rules relating to the time for filing the returns required by this section.

David E. Dickinson,
Acting Director, Legislation and Regulations Division.

[FR Doc. 81-4054 Filed 2-5-81; 8:45 am]
BILLING CODE 4830-01-M

26 CFR Part 150

[T.D. 7755]

Temporary Excise Tax Regulations Under the Crude Oil Windfall Profit Tax Act of 1980; Windfall Profit Tax Administrative Provisions**Corrections**

In FR Doc. 81-1850 appearing on page 4873 in the issue of Monday, January 19, 1981, on page 4879, in the second column, the last twenty-six lines (including the stars) should be deleted; in the third column, delete the first nine lines from the top.

BILLING CODE 1505-01-M

DEPARTMENT OF LABOR**Wage and Hour Division, Employment Standards Administration****29 CFR Part 4****Service Contract Act; Labor Standards for Federal Service Contracts****Correction**

In FR Doc. 81-1362 appearing on page 4320 in the issue of Friday, January 16, 1981, make the following corrections:

(1) Within paragraph (g) of § 4.4, in the line that is fourth from the top of the