PART XIV: MUTUAL FUNDS AND TRUSTS

Mutual Funds

7850. What are mutual funds?

A mutual fund is a company that offers investors an interest in a portfolio of professionally managed investment assets. Mutual funds are "open-ended" in the sense that they maintain a continuous market and a constantly changing number of outstanding shares. The term "mutual fund" is sometimes used (incorrectly) to refer to closed-end investment companies, which have a fixed number of outstanding shares and are actively traded on the secondary market (See Q 7865).

Mutual funds are managed, in the sense that the underlying portfolio is changing as assets are bought and sold. Funds are generally designed to accomplish some primary investment objective, such as growth, income, capital appreciation, tax-exempt interest, international investing, etc., and therefore emphasize investments they consider appropriate to this purpose. Many funds (e.g., asset allocation funds, balanced funds, equity-income funds, hybrid funds) combine two or more investment objectives in an effort to maintain a more diversified portfolio. "Tax-managed" funds (i.e., tax-sensitive, tax-efficient funds) employ investment strategies designed to minimize current income taxes by keeping taxable gains and income as low as possible and emphasizing long-term growth. Although the specific methods vary from one fund to another, they generally include: (1) keeping turnover low; (2) offsetting capital gains with capital losses; and (3) keeping dividends and interest at a minimum. "Life cycle" funds (or "target date" funds) invest in stocks, bonds, and cash in a ratio considered appropriate for investors with a particular age and risk tolerance.[1]

The Securities and Exchange Commission (SEC) requires mutual fund companies to disclose standardized after-tax returns for 1-, 5-, and 10-year periods to help investors understand the magnitude of tax costs and compare the impact of taxes on the performance of different funds. After-tax returns must accompany before-tax returns in a fund's prospectus and must be presented in two ways: (1) returns after taxes on fund distributions only; and (2) returns after taxes on fund distributions and redemption of fund shares. The SEC also requires that funds include standardized after-tax returns in certain advertisements and other sales material.[2]

Portfolio investment programs provide investors with the opportunity to use a sponsoring broker-dealer's web site to "create and manage portfolios of securities ('baskets') based on each investor's individual needs and objectives." (Portfolio investment programs are frequently referred to as "folios," the name of the initial sponsor's product). However, unlike a mutual fund, "the investor does not hold an undivided interest in a pool of securities; rather the investor is the direct beneficial owner of each of the securities included in the portfolio. Each investor has

1. See United States Securities and Exchange Commission, Frequently Asked Questions about Rule 35d-1 (Investment Company Names), at www.sec.gov/divisions/investment/guidance/rule35d-1faq.htm.
2. See 17 CFR Parts 230, 239, and 270.

BK-SBM-15TFInvest-140469-Part 14.indd 355 10/9/2014 9:38:40 PM

all of the rights of ownership with respect to such securities."[1] The SEC denied a request from the Investment Company Institute (ICI) to adopt a rule that would deem portfolio investment programs to be regulated as mutual funds.[2]

Because investors in investment portfolio programs own the stocks directly, they are taxed on distributions and the sale of their shares in the same manner as stockholders. For the treatment of cash dividends, see Q 7502. For the treatment of capital gain on the sale or exchange of stock, see Q 7517. For the treatment of capital gains and losses, see Q 608.

7851. How are dividends received from a mutual fund taxed?

Mutual funds may pay three kinds of dividends to their shareholders; generally, taxable dividends will be reported to the shareholder on Form 1099-DIV.

(1) *Ordinary income dividends*. Ordinary income dividends are derived from the mutual fund's net investment income (i.e., interest and dividends on its holdings) and short-term capital gains. A shareholder generally includes ordinary income dividends in income for the year in which they are received by reporting them as "dividend income" on his or her income tax return.[3]

However, under JGTRRA 2003, *qualified dividend income* (see Q 608) is treated in some respects like *net capital gain* and is, therefore, eligible for what are now the 20/15/0 percent tax rates instead of the higher ordinary income tax rates. (ATRA 2012 made the special treatment of "qualified dividends" permanent—or as permanent as anything in the IRC). As a result of JGTRRA 2003, mutual funds are required to report on Form 1099-DIV the nature of the ordinary dividend being distributed to shareholders—that is, whether the ordinary dividend is a "qualified dividend" subject to the 20/15/0 percent rates (Box 1b), or a nonqualifying dividend subject to ordinary income tax rates (Box 1a). Unless otherwise designated by the mutual fund, all distributions to shareholders are to be treated as ordinary income dividends.

Ordinary income dividends paid by mutual funds are eligible for the 20/15/0 percent rate *if* the income being passed from the fund to shareholders is qualified dividend income in the hands of the fund and *not* short-term capital gains or interest from bonds (both of which continue to be taxed at ordinary income tax rates).[4]

The Service has stated that mutual funds that pass through dividend income to their shareholders must meet the holding period test (see Q 608) for the dividend-paying stocks that they pay out to be reported as qualified dividends on Form 1099-DIV. Investors must also meet the holding period test relative to the shares they hold directly, from which they received the qualified dividends that were reported to them.[5] In summary, the holding period

1. U.S. Securities and Exchange Commission, Letter in Response to Petition for Rulemaking from Investment Company Institute, (August 23, 2001); Speech by Paul F. Roye (Director of Investment Management, U.S. Securities and Exchange Commission) to the American Law Institute - American Bar Association Conference on Investment Management Regulation, (October 11, 2001).
2. See Letter in Response to Petition for Rulemaking from Investment Company Institute, above.
3. Treas. Reg. §1.852-4(a).
4. See IRC Secs. 854(b)(1), 854(b)(2), 854(b)(5).
5. IRS News Release IR-2004-22 (2-19-2004).

BK-SBM-15TFInvest-140469-Part 14.indd 356 10/9/2014 9:38:40 PM

test (see Q 608) must be satisfied by both the mutual fund and the shareholder in order for the dividend to be eligible for the 20/15/0 percent rate.[1]

The Service has ruled that in making dividend designations (under IRC Sections 852(b)(3)(C), 852(b)(5)(A), 854(b)(1), 854(b)(2), 871(k)(1)(C), and 871(k)(2)(C)), a mutual fund may designate the maximum amount permitted under each provision even if the aggregate of all the amounts so designated exceeds the total amount of the mutual fund's dividend distributions. (IRC Section 852(b)(3) provides rules for determining the amount distributed by a mutual fund to its shareholders that may be treated by the shareholders as a capital gain dividend (see below). IRC Section 854 provides rules for determining the amount distributed that may be treated as qualified dividend income. IRC Section 871(k) provides rules for determining the amount distributed that may be treated as interest-related dividends or short-term capital gain dividends). The Service further ruled that individual U.S. shareholders may apply designations to the dividends they receive from the mutual fund that differ from designations applied by shareholders who are nonresident alien individuals.[2]

Varying distributions paid by a mutual fund to shareholders in different "qualified groups" (shares in the same portfolio of securities that have different arrangements for shareholder services or the distribution of shares, or based on investment performance) constitute deductible dividends for the mutual fund.[3]

An award of points to a shareholder under an airline awards program, in which one point is awarded for each new dollar invested in the mutual fund, will not result in the payment of a preferential dividend by the fund; instead, the investor will be informed of the fair market value of the points and informed that the basis in the shares giving rise to the award of points should be adjusted downward by the fair market value of the points as a purchase price adjustment.[4]

Certain pass-through entities are required to report as part of a shareholder's ordinary income dividends the shareholder's allocated share of certain investment expenses (i.e., those which would be classified as *miscellaneous itemized deductions* if incurred by an individual), in addition to ordinary income dividends actually paid to a shareholder. The shareholder then must include such additional amount in income and treat the amount as a miscellaneous itemized deduction (subject to the 2 percent floor) in the same year. However, publicly offered regulated investment companies (generally mutual funds) are excluded from the application of this provision.[5]

See Q 7855 regarding dividends declared for a year prior to the year of receipt. See Q 7885 for the treatment of certain stock distributions by mutual funds.

(2) *Exempt interest dividends*. Some mutual funds invest in securities that pay interest exempt from federal income tax. This interest may be passed through to the fund's shareholders, retaining its tax-exempt status, provided at least 50 percent of the fund's assets consist of

1. See also IRS Pub. 550 (2013), p.20 (formerly IRS Pub. 564, p. 3 (2008)).
2. Rev. Rul. 2005-31, 2005-1 CB 1084.
3. Rev. Proc. 99-40, 1999-2 CB 565.
4. Let. Rul. 199920031.
5. IRC Sec. 67(c).

BK-SBM-15TFInvest-140469-Part 14.indd 357 10/9/2014 9:38:41 PM

such tax-exempt securities. Thus, a shareholder does not include exempt-interest dividends in income. The mutual fund will send written notice to its shareholders advising them of the amount of any exempt-interest dividends.[1] Any person required to file a tax return must report the amount of tax-exempt interest received or accrued during the taxable year on that return.[2] Under JGTRRA 2003, exempt-interest dividends do *not* count as *qualified dividend income* (see Q 608) for purposes of the 20/15/0 percent tax rates.[3]

(3) *Capital gain dividends*. Capital gain dividends result from sales by the mutual fund of stocks and securities that result in long-term capital gains. The mutual fund will notify shareholders in writing of the amount of any capital gain dividend. The shareholder reports a capital gain dividend on the federal income tax return for the year in which it is received as a long-term capital gain regardless of how long the shareholder has owned shares in the mutual fund.[4] As such, a capital gain dividend may be partially or totally offset by the shareholder's capital losses (if any); if not totally offset by capital losses, the excess (i.e., *net capital gain*) will be taxed at the applicable capital gains rate.[5] For additional guidance on designations of capital gain dividends, see Revenue Ruling 2005-31, above.

The Service issued guidance clarifying that capital gain dividends received from a mutual fund in 2004 would be taxed at the lower capital gain rates enacted under JGTRRA 2003. Concern had been expressed that the prior rules for dividend designation and the transition to the new, lower capital gain rates might cause some 2004 capital gain dividends to be taxed to mutual fund shareholders at the old, higher rates. However, the guidance clarified that this would not occur.[6]

See Q 608 for the treatment of capital gains and losses, including the lower rates (20/15/0 percent) for long-term capital gain. (These rates were made as permanent as anything in the IRC is for tax years beginning after 2012). See Q 7854 for the taxation of undistributed capital gains. See Q 7854 for the taxation of undistributed capital gains.

Generally, a shareholder may elect to treat all or a portion of *net capital gain* (i.e., the excess of long-term capital gain over short-term capital loss) as investment income.[7] If the election is made, the amount of any gain so included is taxed as investment income. This election may be advantageous if the shareholder's investment interest expense would otherwise exceed his investment income for the year. If the shareholder makes the election, the shareholder must also reduce net capital gain by the amount treated as investment income (See Q 608).

Detailed instructions for reporting mutual fund distributions on Form 1040 or Form 1040A are set forth in IRS Publication 550, Investment Income and Expenses (2013) (formerly, Publication 564, Mutual Fund Distributions (2011)).

1. IRC Sec. 852(b)(5).
2. IRC Sec. 6012(d).
3. See IRC Sec. 1(h)(11)(B).
4. IRC Sec. 852(b)(3)(B); Treas. Reg. §1.852-4(b)(1).
5. IRC Sec. 1(h).
6. See Notice 2004-39, 2004-1 CB 982.
7. IRC Sec. 163(d)(4); Treas. Reg. §1.163(d)-1.

BK-SBM-15TFInvest-140469-Part 14.indd 358 10/9/2014 9:38:41 PM

7852. How is the shareholder taxed if the mutual fund pays a dividend in its portfolio stocks or securities rather than in cash?

The taxability of a dividend distribution is the same whether the distribution is in cash or portfolio stock or securities; thus, the distribution will be treated as an ordinary income dividend, exempt-interest dividend, or capital gains dividend, as the case may be (see Q 7851). The amount (if any) that the shareholder reports on his or her income tax return is the fair market value of the stocks or securities received as of the date of distribution.[1]

For temporary guidance regarding certain distributions declared on or after January 1, 2008, and on or before December 31, 2012, by publicly traded mutual funds when shareholders have the ability to elect to receive stock instead of cash, see the discussion of Revenue Procedure 2010-12 in Q 7885.

7853. How are dividends that are automatically reinvested taxed?

Some mutual funds automatically reinvest shareholder dividends under a plan that credits the shareholder with additional shares, but gives the shareholder the right to withdraw the dividends at any time. Even though the dividend is not distributed directly to the shareholder, it is credited to his or her account. Such dividends are considered "constructively" received by the shareholder and are included in the shareholder's income for the year in which they are credited to the shareholder's account.[2] The basis of the new shares is the net asset value used to determine the dividend (i.e., the amount of the dividend used to purchase the new shares).[3]

7854. How is a mutual fund shareholder taxed on undistributed capital gains?

A mutual fund may declare but retain a capital gain dividend. If it does so, the mutual fund will notify its shareholders of the amount of the undistributed dividend and will pay federal income tax on the undistributed amount at the corporate alternative capital gain rate, which is currently 35 percent.[4]

A shareholder who is notified of an undistributed capital gain dividend includes the amount of the dividend in income in the same manner as a normal capital gain dividend (See Q 7851). However, the shareholder is also credited with having paid his or her share of the tax paid by the mutual fund on the undistributed amount; thus, on the shareholder's income tax return, the shareholder is treated as though he or she has made an advance payment of tax equal to 35 percent of the amount of the undistributed dividend reported. The shareholder reports the undistributed dividend and is credited with the payment of tax for the calendar year that includes the last day of the mutual fund's taxable year during which the dividend was declared.[5]

1. IRC Sec. 301(b); see Rev. Rul. 57-421, 1957-2 CB 367.
2. Rev. Rul. 72-410, 1972-2 CB 412.
3. See IRS Pub. 550; Treas. Reg. §1.305-2.
4. See IRC Sec. 1201(a); IRC Sec. 852(b)(3)(A).
5. IRC Sec. 852(b)(3)(D).

BK-SBM-15TFInvest-140469-Part 14.indd 359 10/9/2014 9:38:41 PM

Generally, a shareholder who reports an undistributed capital gain dividend increases the tax basis in his or her shares of the mutual fund by the difference between the amount of the undistributed capital gain dividend and the tax deemed paid by the shareholder in respect of such shares.[1]

See Q 608 for the treatment of capital gains and losses.

7855. How is a mutual fund dividend taxed if it is declared for a prior year?

In some cases, a mutual fund may declare a dividend after the close of its taxable year and treat the dividend as having been paid in the prior year. This is often done in order for the fund to retain its status as a regulated investment company (because it must distribute a certain percentage of its income).

As a general rule, ordinary income dividends and capital gain dividends declared for a prior mutual fund tax year are treated as received and included in income (as discussed in Q 7851) by the shareholder in the year in which the distribution is made. Similarly, exempt-interest dividends for a prior mutual fund tax year are treated as received in the year when the distribution is made, but are not included in the shareholder's income (see Q 7851).[2]

However, if a mutual fund declares a dividend in October, November, or December of a calendar year, which is payable to the shareholders on a specified date in such a month, the dividend is treated as having been received by the shareholders on December 31 of that year (so long as the dividend is actually paid during January of the subsequent calendar year).[3] This rule applies to ordinary income dividends, capital gain dividends, and exempt-interest dividends.

7856. How is a return of capital taxed?

A distribution from a mutual fund that does not come from its earnings is a return of capital distribution (sometimes incorrectly referred to as a "nontaxable dividend" or "tax-free dividend"). These often occur when the fund is liquidating. The shareholder treats the return of capital as nontaxable to the extent of tax basis in the shares. Any excess over the shareholder's basis is treated as a capital gain, which will be long-term or short-term depending on how long the shareholder held the mutual fund shares with respect to which the distribution was made. The shareholder must also reduce tax basis (but not below zero) in those shares by the amount of the return of capital distribution.[4] See Q 608 for the treatment of capital gain.

7857. How is a shareholder taxed when a mutual fund passes through a foreign tax credit?

Mutual funds with more than 50 percent of the value of their total assets invested in stocks or securities of foreign corporations may elect to give the benefit of the foreign tax credit to their shareholders.[5]

1. IRC Sec. 852(b)(3)(D)(iii); Treas. Reg. §1.852-4(b)(2).
2. IRC Sec. 855; Treas. Reg. §1.855-1.
3. IRC Sec. 852(b)(7).
4. IRC Sec. 301(c); See Rev. Rul. 57-421, 1957-2 CB 367; IRS Pub. 550.
5. IRC Sec. 853.

BK-SBM-15TFInvest-140469-Part 14.indd 360 10/9/2014 9:38:41 PM

When a mutual fund makes this election, each shareholder, in addition to reporting any ordinary income and capital gains dividends, includes in income his or her proportionate share of foreign taxes paid by the fund. Each shareholder then treats the proportionate share of foreign taxes paid by the mutual fund as if paid by the shareholder for which he or she may take a tax credit or an itemized deduction. (In calculating the credit or deduction, each shareholder treats his or her share of the foreign taxes and the amount of any dividends paid with respect to the foreign income of the fund as foreign income).[1] The shareholder may take the deduction or the credit, but not both.[2]

A mutual fund that makes this election must notify each shareholder of his or her share of the foreign taxes paid by the fund and the portion of the dividend that represents foreign income.[3] The Service released regulations in 2007 that generally eliminate country-by-country reporting by a mutual fund to its shareholders of foreign source income that the mutual fund takes into account and foreign taxes that it pays. Accordingly, the regulations require that a mutual fund provide aggregate per-country information on a statement filed with its tax return, and require that only summary foreign income and foreign tax amounts be reported to the fund's shareholders.[4]

7858. Do mutual fund dividends give rise to tax preference items for purposes of the alternative minimum tax?

The receipt of an exempt-interest dividend creates a tax preference to the extent that the dividend is derived from interest paid on certain private activity bonds issued after August 7, 1986 (See Q 653).[5] (The receipt of capital gain and ordinary income mutual fund dividends generally does not create tax preferences). Also, mutual funds do pass through, and each shareholder must report a proportionate share of, the fund's own tax preference items.[6]

For an explanation of the alternative minimum tax, see Q 653.

7859. Can a shareholder deduct the interest paid on a loan used to purchase mutual fund shares?

Yes, subject to the general limitation applicable to the deduction for investment interest (see Q 7941) and subject to total or partial disallowance if the company pays an exempt-interest dividend.[7]

Under the American Taxpayer Relief Act of 2012, for tax years beginning after 2012, the top rate for capital gain and qualified dividends is 20 percent (rather than 15 percent) for taxpayers with incomes over $400,000 ($450,000 for married filing jointly). This base threshold level is adjusted annually for inflation. Those taxpayers will be subject to the 20 percent rate for

1. IRC Sec. 853(b); Treas. Reg. §1.853-2(b).
2. IRC Sec. 275.
3. IRC Sec. 853(c); Treas. Reg. §1.853-3(a).
4. Treas. Regs. §§1.853-3, 1.853-4; TD 9357, 72 Fed. Reg. 48551 (8-24-2007).
5. IRC Sec. 57(a)(5)(B).
6. IRC Sec. 59(d).
7. IRC Secs. 163(d), 265(a)(4).

BK-SBM-15TFInvest-140469-Part 14.indd 361 10/9/2014 9:38:41 PM

any net capital gain and qualified dividends that would, without the preferential treatment, be taxed at a 39.6 percent rate.

For taxpayers with income taxed at rates below 25 percent, net capital gain and qualified dividends will permanently be subject to a 0 percent rate. Taxpayers who are subject to a 25 percent-or-greater rate on ordinary income, but with income levels below the $400,000/$450,000 thresholds, are subject to a maximum 15 percent rate on net capital gain and qualified dividends (See Q 608). (The 15 percent rate would also apply to any net capital gain or qualified dividends of taxpayers above those thresholds to the extent the gain or dividends would, without the preferential treatment, be taxed at the 35 percent rate, rather than the 39.6 percent rate).[1] However, qualified dividend income does not include any amount that the taxpayer takes into account as investment income under IRC Section 163(d)(4)(B).[2]

A shareholder may not deduct interest on indebtedness incurred or continued to purchase or carry shares of a mutual fund to the extent that the company distributed exempt-interest dividends to the shareholder during the year.[3] The amount of interest disallowed is the amount that bears the same ratio to total interest paid on the indebtedness for the year as the exempt-interest dividends bear to exempt interest and taxable dividends received by the shareholder (excluding capital gains dividends).[4]

In determining whether the indebtedness was "incurred or continued to purchase or carry" shares, one should be able to look to interpretations of comparable language with respect to deductions for interest on "indebtedness incurred or continued to purchase or carry" certain other property (See, for example, Q 7943).[5] For purposes of determining whether interest is investment interest, temporary regulations provide complex rules under which interest expense is allocated on the basis of the use of the proceeds of the underlying debt (See Q 7942).

7860. How is a shareholder taxed when selling, exchanging, or redeeming mutual fund shares?

When a shareholder sells, exchanges, or redeems mutual fund shares, the shareholder will generally have a capital gain or loss. Whether such gain or loss is short-term or long-term usually depends on how long the shareholder held the shares before selling (or exchanging) them.[6] If the shares were held for one year or less, the capital gain or loss will generally be short-term; the capital gain will generally be long-term if the shares were held for more than one year. See Q 605 for an explanation of the holding period calculation, and Q 608 for the treatment of capital gains and losses.

The gain or loss is the difference between the shareholder's adjusted tax basis in the shares (see below) and the amount realized from the sale, exchange, or redemption (which includes

1. For example, if an unmarried taxpayer who is not a head of household has taxable income of $425,000, including $30,000 of net capital gain, $25,000 of the gain will be taxed at a 20 percent rate, and $5,000 will be taxed at a 35 percent rate.
2. IRC 1(h)(11)(D)(i).
3. IRC Sec. 265(a)(4); Treas. Reg. §1.265-3.
4. Treas. Reg. §1.265-3(b)(2).
5. Rev. Rul. 95-53, 1995-2 CB 30; Rev. Rul. 82-163, 1982-2 CB 57.
6. See IRC Secs. 1222, 1223.

BK-SBM-15TFInvest-140469-Part 14.indd 362 10/9/2014 9:38:41 PM

money plus the fair market value of any property received).[1] For the taxation of a wash sale of mutual fund shares, see Q 7862. For the treatment of mutual fund shares that were held as part of a conversion transaction, see Q 7604 and Q 7605.

In some cases, a company that manages mutual funds will allow shareholders in one mutual fund to exchange their shares for shares in another mutual fund managed by the same company without payment of an additional sales charge. Nevertheless, the exchange is treated as a taxable transaction; any gain or loss on the original shares must be reported as a capital gain or loss in the year the exchange occurs. The exchange does not qualify as a "like-kind" exchange, nor as a tax-free exchange of common stock for common stock, or preferred for preferred, in the same corporation. Because stock in each fund is "backed" by a different set of assets (i.e., the portfolio securities held by each fund), shares in the funds are neither common nor preferred stock in the managing company.[2] Furthermore, such an exchange may be subject to special rules delaying an adjustment to basis for load charges if the exchanged shares were held for less than 90 days (see below).

In *Paradiso v. Commissioner*,[3] the Tax Court stated that IRC Section 1031(a)(1), which provides for nonrecognition of gain or loss from like-kind exchanges, expressly does not apply to the sale of stock or other securities (citing IRC Sections 1031(a)(2)(B) and 1031(a)(2)(C)). Accordingly, the court held that the taxpayer realized taxable income from sales of mutual fund shares at a gain.

The Service has privately ruled that a mutual fund's redemption of stock pursuant to a tender offer would constitute a single and isolated transaction that was not part of a periodic redemption plan; thus, the transaction would not result in an IRC Section 305 deemed distribution to any of the fund's shareholders.[4] The Service has also stated that no gain or loss was required to be recognized by shareholders on the conversion of institutional class shares to Class A shares of the same mutual fund. Each shareholder's basis in the Class A shares would equal the shareholder's basis in the converted institutional class shares immediately before the conversion, and each shareholder's holding period for the Class A shares would include the shareholder's holding period for the converted institutional class shares, provided that the shareholder held those converted shares as capital assets immediately before the conversion.[5] In addition, the Service privately ruled that the conversion of two classes of mutual fund shares into a single class of shares, based on the relative net asset value of the respective shares, did not result in gain or loss to the shareholders.[6]

If a shareholder purchases mutual fund shares, receives a capital gain dividend (or is credited with an undistributed capital gain), and then sells the shares *at a loss* within six months after purchasing the shares, the loss is treated as a *long-term* capital loss to the extent of the capital

1. IRC Sec. 1001.
2. Rev. Rul. 54-65, 1954-1 CB 101. See IRS Pub. 550 (formerly IRS Pub. 564).
3. TC Memo 2005-187.
4. Let. Rul. 200025046.
5. Let. Rul. 199941016.
6. Let. Rul. 9807026.

gain dividend (or undistributed capital gain).[1] Similarly, if a shareholder purchases mutual fund shares, receives an exempt-interest dividend, and then sells the shares at a loss within six months after purchasing the shares, the loss (to the extent of the amount of the dividend) will be *disallowed*.[2] In the case of a fund that regularly distributes at least 90 percent of its net tax-exempt interest, the regulations may prescribe that the holding period for application of the loss disallowance rule is less than six months (but not less than the longer of 31 days or the period between the regular distributions of exempt-interest dividends).[3] For purposes of calculating the 6-month period, periods during which the shareholder's risk of loss is diminished as a result of holding other positions in substantially similar or related property, or through certain options or short sales, are not counted.[4] Regulations will provide a limited exception to these rules for shares sold pursuant to a periodic redemption plan.[5]

7861. How does a shareholder determine the basis of mutual fund shares?

Generally a shareholder's tax basis in mutual fund shares is the cost of acquiring them, including any load charges (i.e., sales or similar charges incurred to acquire mutual fund shares). (See Q 598 regarding the determination of basis). However, a shareholder who exercises a *reinvestment right*, which was acquired as a result of the load charge, is subject to a 90-day holding period during which the load charge will not be fully included in basis. ("Reinvestment right" is defined to mean the right to acquire stock of one or more regulated investment companies without a load charge or at a reduced load charge). If such a shareholder (1) disposes of the shares before the 91st day after the date of acquisition, and (2) subsequently acquires other shares (in the same or another mutual fund) and the otherwise applicable load charge is reduced as a result of the reinvestment right, then the initial load charge will not be included in basis for purposes of determining the gain or loss on the disposition (except to the extent that the initial load charge exceeds the reduction applicable to the second load charge). Instead, it will be includable in the basis in the newly acquired shares. If the original shares are transferred by gift, the donee succeeds to the treatment of the donor.[6]

If all of a shareholder's shares in a mutual fund were acquired on the same day and for the same price (or, if by gift or inheritance, at the same tax basis), the shareholder will have little difficulty in establishing tax basis and holding period of the shares sold or redeemed. However, if the shares were acquired at different times or prices (or bases), the process is more difficult. Unless the shareholder can "adequately identify" (see Q 606) the lot from which the shares being sold or redeemed originated, the shareholder must either treat the sale or redemption as disposing of shares from the earliest acquired lots (i.e., by a first-in, first-out (FIFO) method) or, if he or she qualifies, elect to use one of two *average basis* methods for determining his adjusted basis and holding period of shares sold or redeemed.[7]

1. IRC Sec. 852(b)(4).
2. IRC Sec. 852(b)(4)(B).
3. IRC Sec. 852(b)(4)(E).
4. IRC Secs. 852(b)(4)(C), 246(c).
5. IRC Sec. 852(b)(4)(D).
6. IRC Sec. 852(f).
7. Treas. Regs. §§1.1012-1(c), 1.1012-1(e). See IRS Pub. 550 (formerly IRS Pub. 564).

BK-SBM-15TFInvest-140469-Part 14.indd 364 10/9/2014 9:38:41 PM

Effective January 1, 2012, in connection with their obligation to report sales of securities to the IRS, brokers are generally required to provide each customer's bases in, and holding periods for, stock for which the average–basis method is available. A broker's obligations generally track the description above—i.e., to use the FIFO method unless adequate identification of the shares disposed of is possible.[1]

A shareholder may elect to use an "average basis" for the shares if (1) the shares are held in a custodial account maintained for the acquisition or redemption of shares in the fund, and (2) the shareholder purchased or acquired the shares at different prices or bases.[2]

Under the *double-category method* of determining average basis, all shares in the mutual fund account are divided into two categories: (1) those with a holding period of more than one year; and (2) those with a holding period of one year or less. The basis for each share in either category is the total cost (or other basis) of all the shares in that category, divided by the number of shares in that category. The shareholder can then elect to have the shares being sold come from either the "more than one year" category (thus recognizing long-term gain or loss), or the "one year or less" category (thus recognizing short-term gain or loss). If the shareholder does not designate the category from which the shares are to be sold, the shares are deemed to come from the "more than one year" category first.[3]

When shares in the "one year or less" category have been held for more than one year, they are transferred to the "more than one year" category. If some of the shares in the "one year or less" category have been sold or transferred, they are deemed to have been the earliest acquired shares (i.e., by a FIFO method). The basis of unsold shares transferred to the "more than one year" category is the average basis of the shares in the "one year or less" category at the time of the most recent sale, determined as discussed above. If no shares have been sold from the "one year or less" category, the basis of the shares transferred to the "more than one year" category is their cost or other basis (not the average basis).[4]

Under the *single category method* of determining average basis, all shares in the mutual fund account are added together. The basis of each share in the account is the total cost or other basis of all the shares in the account, divided by the total number of shares. Any shares sold or redeemed are deemed to be those acquired first. The single category method may not be used for the purpose of converting short-term gain or loss to long-term gain or loss, or vice versa.[5]

The election to use either of the "average basis" methods is made on the shareholder's tax return for the first year for which he or she wishes the election to apply and will apply to all shares in the same mutual fund held by the shareholder, even if in different accounts. In reporting gain or loss, the taxpayer reports on the return for each year to which the election applies

1. See IRC Sec. 6045(g).
2. Treas. Reg. §1.1012-1(e).
3. Treas. Reg. §1.1012-1(e)(3).
4. Treas. Reg. §1.1012-1(e)(3)(iii).
5. Treas. Reg. §1.1012-1(e)(4).

BK-SBM-15TFInvest-140469-Part 14.indd 365 10/9/2014 9:38:41 PM

that an average basis is being used, and which method has been selected. An election may not be revoked without the consent of the IRS.[1]

In the case of shares acquired by gift, the basis in the hands of a donee is generally the same as it was in the hands of the donor; however, this rule applies only for purposes of determining gain. In the event that the shares' adjusted basis exceeds their fair market value at the time of the gift, the basis in the hands of the donee for purposes of determining loss is their fair market value at the time the gift was made. Ordinarily, an average basis method may not be used on such shares; however, a donee shareholder can elect to apply an average basis method to accounts containing shares acquired by gift if the donee includes a statement with the tax return indicating that the donee will use the fair market value of the shares at the time of the gift in computing the average bases. The statement applies to all shares acquired either before or after the statement is filed, for as long as the election to use average basis remains in effect.[2]

A unit trust unit holder (See Q 7881) may not use either of the average basis methods discussed above unless the unit trust invests primarily in the securities of one management company, or one other corporation, and unless the trust has no power to invest in any other securities except those issued by a single other management company.[3]

7862. How is a wash sale of mutual fund shares taxed?

A wash sale of mutual fund shares is taxed in the same manner as a wash sale of regular corporation stock or other securities (see Q 7534 to Q 7536).

However, when the double category method is used for determining basis and holding period, a wash sale of mutual fund shares from the "one year or less" category *after* acquisition of the replacement shares will result in the aggregate basis of the shares remaining in the "one year or less" category being increased by the amount of the loss that is disallowed.[4] When the single category method is used for determining basis, or when an average basis method is not used, the general wash sale tax basis rules apply.[5]

7863. What is a "money market fund"?

A money market fund is a mutual fund generally seeking maximum current income and liquidity through investment in short-term money market instruments, such as Treasury bills, certificates of deposit, or commercial paper. Dividends are customarily declared daily, and automatically reinvested in additional shares, unless a distribution option is elected. Shares may be redeemed at any time.

7864. How is a money market fund shareholder taxed?

Because a money market fund is a mutual fund, its shareholders are taxed in the manner discussed in Q 7851 through Q 7862. Money market funds ordinarily do not have capital gain

1. Treas. Reg. §1.1012-1(e)(6).
2. Treas. Reg. §1.1012-1(e)(1)(ii).
3. Treas. Reg. §1.1012-1(e)(5)(ii).
4. Treas. Reg. §1.1012-1(e)(3)(iii)(d); IRC Sec. 1091(d).
5. See Treas. Reg. §1.1012-1(e)(4)(iv).

BK-SBM-15TFInvest-140469-Part 14.indd 366 10/9/2014 9:38:41 PM

dividends because of the policy to invest in short-term securities. Note that money market fund dividends are not qualified dividends and, thus, do not qualify for the lower tax rates (20%/15%/0%) (See Q 608).

7865. What is a closed-end fund? How are shareholders in a closed-end fund taxed?

A closed-end fund holds a portfolio of investment assets, but does not ordinarily redeem shares at net asset value or sell new shares. Shares of the fund itself are actively traded on the secondary market.

Although a closed-end fund is not actually a mutual fund, if the fund qualifies and makes the necessary election to be taxed as a regulated investment company, its shareholders will be taxed like shareholders of a mutual fund. See Q 7851 through Q 7862 for details. If, on the other hand, the closed-end fund is established as a regular corporation, its shareholders will be taxed accordingly (see Q 7501 to Q 7537).

Because closed-end fund shares are traded in the open market or on an exchange and are not redeemed by the company, capital gain or loss on sale is based on the sale price and not on redemption price.

Exchange-Traded Funds (ETFs)

7866. What is an exchange-traded fund (ETF)?

In promulgating a proposed rule under the Investment Company Act of 1940, the SEC described exchange-traded funds (ETFs) as "offer[ing] public investors an undivided interest in a pool of securities and other assets." They "are similar in many ways to traditional mutual funds, except that shares in an ETF can be bought and sold throughout the day like stocks on an exchange through a broker-dealer. ETFs therefore possess characteristics of traditional mutual funds, which issue redeemable shares, and of closed-end investment companies, which generally issue shares that trade at negotiated market prices on a national securities exchange and are not redeemable."[1]

The first ETFs in the early 1990s generally held baskets of securities that mirrored broad-based stock market indexes, such as the S&P 500. That has changed, however. According to the SEC, "Many of the newer ETFs are based on more specialized indexes, including indexes that are designed specifically for a particular ETF, bond indexes, and international indexes.… ETFs are held today in increasing amounts by institutional investors (including mutual funds) and other investors as part of sophisticated trading and hedging strategies. Shares of ETFs can be bought and held (sometimes as a core component of a portfolio), or they can be traded frequently as part of an active trading strategy."[2]

1. *Exchange-Traded Funds, Proposed Rule*, RIN 3235-AJ60, 73 Fed. Reg. 14618, 14619 (3-18-2008).
2. *Exchange-Traded Funds, Proposed Rule*, 73 Fed. Reg. 14618, 14619 (3-18-2008).

BK-SBM-15TFInvest-140469-Part 14.indd 367 10/9/2014 9:38:41 PM

ETFs are thought to have certain benefits compared to traditional mutual funds, including "lower expense ratios and certain tax efficiencies" and "allow[ing] investors to buy and sell shares at intra-day market prices." Investors can also "sell ETF shares short, write options on them, and set market, limit, and stop-loss orders on them."[1] ETF shares can be purchased on margin.

ETFs are promoted as being more tax-efficient than mutual funds, in large part because the turnover in portfolio securities is likely to be lower. In addition, as the SEC noted, "[b] ecause an exchange-traded fund typically redeems creation units of exchange-traded shares by delivering securities in the 'redemption basket,' an exchange-traded fund generally does not have to sell securities (and thus possibly realize capital gains) in order to pay redemptions in cash."[2] As a result, although ETFs may produce fewer, and smaller, capital gain distributions than some mutual funds, that does not mean that such funds never make capital gain distributions, or that the amount of a distribution will always be smaller than a capital gain distribution from a mutual fund.

7867. How do ETFs operate?

The SEC described the operation of ETFs as follows:

> Unlike traditional mutual funds, ETFs do not sell or redeem their individual shares ('ETF shares') at net asset value ('NAV'). Instead, financial institutions purchase and redeem ETF shares directly from the ETF, but only in large blocks called "creation units." A financial institution that purchases a creation unit of ETF shares first deposits with the ETF a "purchase basket" of certain securities and other assets identified by the ETF that day, and then receives the creation unit in return for those assets. The basket generally reflects the contents of the ETF's portfolio and is equal in value to the aggregate NAV of the ETF shares in the creation unit. After purchasing a creation unit, the financial institution may hold the ETF shares, or sell some or all in secondary market transactions.[3]

ETFs must register offerings and sales of shares under the securities laws, and, "as with any listed security, investors may trade ETF shares at market prices. ETF shares purchased in secondary market transactions are not redeemable from the ETF except in creation units."[4]

Redemption of ETF shares mirrors the purchase process:

> The financial institution acquires (through purchases … the number of ETF shares that comprise a creation unit, and redeems the creation unit from the ETF in exchange for a "redemption basket" of securities and other assets. An investor holding fewer ETF shares than the amount needed to constitute a creation unit (most retail investors) may dispose of those ETF shares by selling them on the

1. *Exchange-Traded Funds, Proposed Rule*, 73 Fed. Reg. 14618, 14620 (3-18-2008).
2. *Concept Release: Actively Managed Exchange-Traded Funds*, 66 Fed. Reg. 57514 (11-15-2001).
3. Exchange-Traded Funds, Proposed Rule, 73 Fed. Reg. 14618, 14620 (3-18-2008).
4. Exchange-Traded Funds, Proposed Rule, 73 Fed. Reg. 14618, 14620 (3-18-2008).

BK-SBM-15TFInvest-140469-Part 14.indd 368 10/9/2014 9:38:41 PM

secondary market. The investor receives market price for the ETF shares, which may be higher or lower than the NAV of the shares, and pays customary brokerage commissions on the sale.[1]

7868. How are ETFs taxed?

ETF shares represent undivided interests in the assets held by the fund. ETFs are "organized either as open-end investment companies or unit investment trusts."[2] ETFs organized as unit investment trusts (see Q 7881) generally qualify for tax treatment as regulated investment companies for tax purposes. For the treatment of dividends, see Q 7851. For the treatment of capital gain on the sale or exchange of exchange-traded shares, see Q 7860. For the treatment of capital gains and losses, see Q 608.

Exchange-Traded Funds Invested in Metals. In a memorandum prepared by the Office of Chief Counsel of the IRS, which was made public only as the result of a court order, the IRS advised that the sale of an interest in an ETF that directly invests in metal ("physically-backed metal ETF") is treated as the sale of a "collectible" (see Q 608), such that any gain from the sale of the interest is subject to the maximum capital gains rate of 28 percent (i.e., instead of the 20/15/0 percent capital gains rate (see Q 608)).[3] The Service reasoned that in the case of a physically-backed metal ETF that is treated as a trust, the investor is treated as owning an undivided beneficial interest in the collectible held by the trust. Accordingly, if the investor sells an interest in the ETF or the trust sells a portion of the collectible, the investor is treated as having sold all or a portion of his or her share of the collectible held by the trust, and any gain from the sale of the trust interest or sale of the collectible by the trust is treated as collectible gain and, therefore, is subject to the maximum capital gains rate of 28 percent. However, if a physically-backed metal ETF is not structured as a trust, or if the ETF does not directly invest in the metal, then the above rule does not apply. The Service cautions that the structure of each physically backed metal ETF should be considered to determine the tax consequences of an investment in that ETF.

7869. What are the tax advantages of owning ETFs?

One of the advantages of owning ETFs is their tax efficiency.

ETFs enjoy a more favorable tax treatment than mutual funds due to their unique structure. Mutual funds create and redeem shares with in-kind transactions that are not considered sales. As a result, they do not create taxable events. However, when you sell an ETF, the trade triggers a taxable event. Whether it is a long-term or short-term capital gain or loss depends on how long the ETF was held. In the United States, a taxpayer must hold an ETF for more than one year to receive long-term capital gains treatment. If the security is held for one year or less, then it will receive short-term capital gains treatment.

1. Exchange-Traded Funds, Proposed Rule, 73 Fed. Reg. 14618, 14620 (3-18-2008).
2. *Exchange-Traded Funds, Proposed Rule*, 73 Fed. Reg. 14618, 14619 (3-18-2008), Footnote 8.
3. Office of Chief Counsel IRS Memorandum by TaJuana Nelson Hyde, Assistant Branch Chief (May 2, 2008), "Exchange-Traded Funds Invested in Metal (*Wall Street Journal* Article)."

BK-SBM-15TFInvest-140469-Part 14.indd 369 10/9/2014 9:38:41 PM

Planning Point: Long-term capital gains are normally taxed at a favorable rate of 20 percent, 15 percent or 0 percent, depending on the taxpayer's income tax bracket. These favorable rates were made permanent for tax years beginning after 2012.

As with stocks, taxpayers are subject to the wash-sale rules if an ETF is sold for a loss and then repurchased within 30 days. A wash sale occurs when a taxpayer sells or trades a security at a loss and, within 30 days after the sale, the taxpayer:

- Buys a substantially identical ETF,
- Acquires a substantially identical ETF in a fully taxable trade, or
- Acquires a contract or option to buy a substantially identical ETF.

Planning Point: If a loss was disallowed because of the wash-sale rules, the taxpayer should add the disallowed loss to the cost of the new ETF. This increases the basis in the new ETF. This adjustment postpones the loss deduction until the disposition of the new ETF. The holding period for the new ETF begins on the same day as the holding period of the ETF that was sold.

Many ETFs generate dividends from the stocks they hold. Ordinary (taxable) dividends are the most common type of distribution from a corporation. According to the IRS, a taxpayer can assume that any dividend received on common or preferred stock is an ordinary dividend unless the paying corporation specifies otherwise. These dividends are taxed when paid by the ETF as ordinary income.

Qualified dividends are subject to the same maximum tax rate that applies to net capital gains. In order to qualify:

1. An American company or a qualifying foreign company must have paid the dividend.
2. The dividends must not be listed with the IRS as dividends that do not qualify.
3. The required dividend holding period must be met.

The ETF provider should specify whether the dividends that have been paid are ordinary or qualified.

7870. What are the exceptions to the general rules for how ETFs are taxed?

There are exceptions to the general tax rules for ETFs (discussed in Q 7868 and Q 7869). Understanding the particular tax rules that apply to sector in which the ETF belongs can help in understanding these exceptions, because if the ETF fits into certain market sectors, it must follow the tax rules that apply to that sector rather than the general tax rules. Currencies, futures, and metals are the sectors that receive special tax treatment.

Currencies

Most currency ETFs are formed as grantor trusts. This means the profit from the trust creates ordinary income tax liability for the individual ETF shareholder based on the rules

BK-SBM-15TFInvest-140469-Part 14.indd 370 10/9/2014 9:38:42 PM

that apply to grantor trusts. As a result, currency ETFs are not eligible for favorable long-term capital gains treatment, even if the ETF is held for several years. Since currency ETFs trade in currency pairs, the taxing authorities assume that these trades take place over short periods of time.

Futures ETFs

Futures ETFs trade in commodities, stocks, Treasury bonds, and currencies. For example, PowerShares DB Agriculture (AMEX:DBA) invests in futures contracts of agricultural commodities - corn, wheat, soybeans, and sugar - not the underlying commodities. Gains and losses on the futures within the ETF are treated for as 60 percent long-term capital gain (or loss) and 40 percent short-term capital gain (or loss) regardless of how long the contracts were held by the ETF. Further, ETFs that trade futures follow mark-to-market rules at year-end. This means that any unrealized gains at the end of the year are taxed as though they were sold.

Metals ETFs

Individual taxpayers who trade or invest in gold, silver, or platinum bullion are subject to the IRS' rules that govern "collectibles" for tax purposes. The same rules apply to ETFs that trade or hold gold, silver, or platinum. Under the rules that apply to collectibles, if gain is short-term, it is taxed as ordinary income. If gain is earned over a period that spans more than one year, then it is taxed at either of three capital gains rates, depending on the taxpayer's income tax bracket. This means that taxpayers cannot take advantage of the normal capital gains tax rates on investments in ETFs that invest in gold, silver, or platinum. The ETF provider will specify what is considered short-term and what is considered long-term gain or loss.

7871. What are the differences between mutual funds and ETFs?

ETFs track indexes which are, in turn, managed professionally and have teams of analysts and economists choosing the securities included in the index and the methodology for measuring the percentage of gain against base. Mutual funds pool investors' funds and their professional managers select the securities, which the fund buys. The fund charges the investors a percentage of an investment pool for their services. This charge is called the "load." Typically, the cost of the load for ETFs is lower than that of mutual funds. In theory, this should produce a higher yield for the individual or non-institutional investor over time. There are, however, some no-load mutual funds available.

ETFs are a much newer investment vehicle and have been available only for the last twenty years. Mutual funds have existed since the 1930s and, as a result, many have a long history with their institutional investors. For a less sophisticated investor, the process of purchasing and redeeming a mutual fund and the longer history of return that is available may be less intimidating.

ETFs appeal to sophisticated investors because they are more nimble. They can be traded throughout the day, purchased on margin, and sold short, while mutual funds cannot. ETFs also afford the individual investor access to myriad markets and asset classes.

7872. What are the advantages of ETFs over mutual funds?

ETFs have several advantages over mutual funds, including the following:

- They are easy to trade: they can be bought and sold anytime through any broker, just like a stock.
- They are tax efficient: ETFs typically have lower portfolio turnover and strive to minimize capital gains distributions so that investors are only taxed when they initiate a trade. Note: There are special rules for currency, commodity, and metals ETFs that cause them to be taxed in the same way as the underlying class of investment (see Q 7870).
- Greater Transparency: ETFs disclose the exact holdings of their funds on a daily basis so the investor always understands precisely what he or she owns and is paying for.
- Flexibility: Any action that an investor can take with respect to stock can be accomplished with an ETF. This includes shorting them, holding them in margin accounts and placing limit orders.

7873. What is the advantage of owning an ETF rather than individual stocks?

Because ETFs track particular indexes, they mirror the underlying index's diversification. Diversification is the term used in the financial world for a risk management technique that mixes a wide variety of investments within a portfolio. The rationale behind the technique is the theory that a portfolio of diverse investments will both yield a higher return over time and pose a lower risk of loss than any individual investment found within the portfolio.

Studies and mathematical models have shown that, over time, maintaining a well-diversified portfolio will yield a higher return and provide the most cost effective level of risk reduction. Most individual or non-institutional investors have limited investment budgets and may find it very difficult to independently create an adequately diversified portfolio.

Because ETFs are traded as securities on the public stock exchanges, individual and non-institutional investors can purchase shares in an ETF and obtain the benefit of its diversification together with the expertise of the analysts and economists who select the stocks and bonds in the index which the ETF tracks.

As an example, it would be very difficult for most individual investors to purchase shares in each of the companies listed in the Standard & Poor's 500. ETFs can provide a method for individual investors to accomplish this level of diversification.

7874. What is the advantage of being able to sell an ETF short?

A short sale is a market transaction in which an investor sells borrowed securities in anticipation of a price decline and is required to return an equal number of shares to the lender at some point in the future. This is known as "selling short."

BK-SBM-15TFInvest-140469-Part 14.indd 372 10/9/2014 9:38:42 PM

The payoff to selling short is the opposite of a long position. A short seller will profit if the value of the stock declines, while the holder of a long position profits when the stock value increases. The profit that the investor receives is equal to the value of the sold borrowed shares less the cost of repurchasing the borrowed shares for repayment to the lender at a later date.

Planning Point: Like purchasing on margin, this is a higher risk investment strategy that, if executed properly, can produce a high profit, thus making ETFs a more attractive strategy for sophisticated investors. Mutual funds cannot be sold short.

7875. What is the advantage of being able to purchase ETFs on margin?

Investors who hold securities in brokerage accounts can use their portfolios as collateral for loans from the brokerage for purchasing additional securities. These loans and cash for the purchase of securities are held in accounts known as "margin accounts." Using margin accounts effectively allows investors to use their brokerage's cash to buy securities and leverage their gains.

The dollar amount that is currently available in a margin account for the purchase of securities or for withdrawal from the account using the portfolio as collateral is the "margin loan availability."

The margin loan availability will change daily as the value of margin debt (which includes purchased securities) changes.

If the margin loan availability amount in an investor's account becomes negative, the investor may be due for a margin call, which is a formal request that the investor sell some of the marginable securities in order to repay the brokerage.

Purchasing on margin is a higher risk strategy that if executed properly can produce large profits. The fact that ETFs can be purchased on margin makes them more attractive to investors using this strategy. Mutual funds cannot be purchased on margin.

7876. What is a leveraged ETF?

A leveraged ETF uses financial derivatives and debt to amplify the returns of an underlying index. Leveraged ETFs are available for most indexes, such as the Nasdaq-100 and the Dow Jones Industrial Average. These funds aim to keep a constant amount of leverage during the investment time frame, such as a 2:1 or 3:1 ratio.

A leveraged ETF does not amplify the annual returns of an index; instead it follows the daily changes. For example, let's examine a leveraged fund with a 2:1 ratio. This means that each dollar of investor capital used is matched with an additional dollar of invested debt. On a day in which the underlying index returns 1 percent, the fund will theoretically return 2 percent. The 2 percent return is theoretical, as management fees and transaction costs diminish the full effects of leverage.

The 2:1 ratio works in the opposite direction as well. If the index drops 1 percent, the fund's loss would then be 2 percent.

BK-SBM-15TFInvest-140469-Part 14.indd 373 10/9/2014 9:38:42 PM

Leveraged funds have been available since the early 1990s. The first leveraged ETFs were introduced in the summer of 2006, after being reviewed for almost three years by the Securities and Exchange Commission. The goal of a leveraged ETF is for future appreciation of the investments made with the borrowed capital to exceed the cost of the capital itself.

The typical holdings of a leveraged index fund would include a large amount of cash invested in short-term securities, and a smaller, but highly volatile, portfolio of derivatives. The cash is used to meet any financial obligations that arise from losses on the derivatives.

A derivative is a security whose price is dependent upon or derived from one or more underlying assets. The derivative itself is merely a contract between two or more parties. Its value is determined by fluctuations in the underlying asset. The most common underlying assets include stocks, bonds, commodities, currencies, interest rates, and market indexes. Most derivatives are characterized by high leverage.

There are also inverse-leveraged ETFs that sell the same derivatives short. These funds profit when the index declines and take losses when the index rises.

7877. What are currency ETFs?

Currency ETFs allow investors to invest in foreign currencies in the same manner as with stocks or any other ETF.

Currency ETFs replicate the movements of the currency in the exchange market by either holding currency cash deposits in the currency being tracked, or using futures contracts on the underlying currency.

Either way, these methods should provide a highly correlated return to the actual movements of the currency over time.

Planning Point: These funds typically have low management fees, as there is little management involved in the funds, but investors should be advised to examine the fees before purchasing.

There are several choices of currency ETFs in the marketplace, including ETFs that track individual currencies. For example, the Swiss franc is tracked by the CurrencyShares Swiss Franc Trust (NYSE:FXF). If an investor believes that the Swiss franc is set to rise against the U.S. dollar, he or she may want to purchase this ETF, while a short sell on the ETF can be placed if an investor believes that the Swiss currency is set to fall.

ETFs that track a basket of different currencies are also available. For example, the PowerShares DB U.S. Dollar Bullish (NYSE:UUP) and Bearish (NYSE:UDN) funds track the U.S. dollar up or down against the euro, Japanese yen, British pound, Canadian dollar, Swedish krona, and Swiss franc. If an investor believes that the U.S. dollar is going to fall broadly, it may be advisable to purchase the Powershares DB U.S. Dollar Bearish ETF.

There are even more active currency strategies used in certain currency ETFs.

BK-SBM-15TFInvest-140469-Part 14.indd 374 10/9/2014 9:38:42 PM

In general, much like other ETFs, when a currency ETF is sold, if the foreign currency has appreciated against the dollar, the sale will produce a profit. On the other hand, if the ETF's currency or underlying index has declined relative to the dollar, a loss is generated.

There is, however, a difference in how these profits are taxed. Most currency ETFs are in the form of grantor trusts. This means that the profit from the trust creates an ordinary income tax liability for the underlying ETF shareholder (as a result of the general tax rules that apply to grantor trusts). ETFs that are organized as grantor trusts are not eligible for the typically favorable long-term capital gains rates, even if the ETF is held for a period of several years. Since currency ETFs trade in currency pairs, the taxing authorities assume that these trades take place over short periods.

7878. What is a "Double Gold" ETF? How is its yield taxed?

A Double Gold ETF is an exchange-traded fund that tracks the value of gold and responds to movements in the same manner as an otherwise similar double leveraged ETF. A double gold ETF is one in which the spot value of gold or a basket of gold companies acts as the underlying asset for the fund. The ETF attempts to deliver price movements that are twice the value of the movements of the underlying gold.

It is important to note that even though there is a potential for huge profits with this strategy, the risk of loss is also significant because the price could fall dramatically. Double gold ETFs are by no means a unique fund product. There are numerous leveraged ETFs that aim to deliver movements equal to two or more times the movements of their underlying assets. Some examples include leveraged ETFs on natural gas and crude oil. These ETFs can also aim to mimic an inverse movement relative to the underlying; such ETFs are known as inverse or bear ETFs.

It is also important to remember that trades or investments in gold are treated "collectibles" for tax purposes. The same applies to ETFs that trade or hold gold. As a collectible, if gain is short-term, then it is taxed as ordinary income. If gain is earned over a period spanning more than one year, then it is taxed at either of three capital gains rates, depending on the investor's income tax bracket. This means that investors cannot take advantage of normal capital gains tax rates on investments in ETFs that invest in gold for shorter-term investment.

Hedge Funds

7879. What is a hedge fund?

There is no statutory or regulatory definition of *hedge fund*, a type of pooled investment vehicle, but such funds have several characteristics in common. As described by the SEC, "hedge funds are organized by professional investment managers who frequently have a significant stake in the funds they manage and receive a management fee that includes a substantial share of the performance of the fund."[1]

1. SEC Final Rule Release No. IA-2333, Registration Under the Act of Certain Hedge Fund Advisers, at www.sec.gov/rules/final/ia-2333.htm.

BK-SBM-15TFInvest-140469-Part 14.indd 375 10/9/2014 9:38:42 PM

"Hedge funds were originally designed to invest in equity securities and short selling to 'hedge' the portfolio's exposure to movements of the equity markets. Today, however, advisors to hedge funds utilize a wide variety of investment strategies and techniques designed to maximize the returns for investors in the hedge funds they sponsor."[1]

Hedge funds are varied in investment style, strategies, and objects of investment. A 2004 SEC staff report noted that they "invest in equity and fixed income securities, currencies, over-the-counter derivatives, futures contracts, and other assets. Some hedge funds may take on leverage, sell securities short, or use hedging and arbitrage strategies. … Hedge funds offer investors an important risk management tool by providing valuable portfolio diversification because hedge fund returns in many cases are not correlated to the broader debt and equity markets."[2] A *fund of funds* is a fund that invests in several hedge funds.

Traditionally, hedge fund investors were limited to the very wealthy. Beginning in the mid-to-late 1990s, the SEC was increasingly faced with a number of important policy concerns, including: (1) the growing number of hedge funds; (2) the accompanying growth of hedge fund fraud; and (3) the growing exposure of smaller investors, pensioners, and other market participants to hedge funds (due, in part, to the lowering of minimum investment requirements by some hedge funds).[3] To address these concerns, in 2004 the SEC adopted a rule requiring certain hedge funds to register with the SEC and be subject to that agency's oversight.[4] But a federal court rejected the rule and it was subsequently removed.

7880. How are shareholders in a hedge fund taxed?

Domestic hedge funds are generally set up as limited partnerships. Thus, holders of interests in hedge funds are taxed on their distributions as limited partners. For the treatment of cash distributions, see Q 7719. For the treatment of capital gain on the sale or exchange of interests, see Q 7722 and Q 7723.

Unit Funds

7881. What is a unit trust?

A unit trust (unit investment trust) holds a fixed portfolio of specified assets, such as tax-exempt bonds, Ginnie Maes, corporate bonds, or certificates of deposit. The trust issues redeemable securities, each of which represents an undivided interest in the assets held by the trust.[5] The assets in the trust are not traded, but are monitored instead. When the assets mature, the trust ends. A contractual or periodic payment plan mutual fund is a type of unit trust.

1. SEC Final Rule Release No. IA-2333, Registration Under the Act of Certain Hedge Fund Advisers, at www.sec.gov/rules/final/ia-2333.htm.
2. United States Securities and Exchange Commission, *Implications of the Growth of Hedge Funds, Staff Report to the United States Securities and Exchange Commission* (September 2003), at www.sec.gov/spotlight/hedgefunds.htm.
3. SEC Final Rule Release No. IA-2333, Registration Under the Act of Certain Hedge Fund Advisers, at www.sec.gov/rules/final/ia-2333.htm.
4. See SEC Rule 203(b)(3)-2, 17 CFR 275.203(b)(3)-2.
5. 15 USC §80a-4.

BK-SBM-15TFInvest-140469-Part 14.indd 376 10/9/2014 9:38:42 PM

7882. How are unit holders taxed?

If the trust is established as a "grantor" trust (that is, a trust under subpart E, subchapter J of Chapter 1 of the Internal Revenue Code, as the prospectus may say), the unit holder is treated as the owner of a part of the trust assets in proportion to his or her investment. In a grantor trust, income, deductions, and credits against tax of the trust are attributed to the investor as if the investor directly owned a share of the securities themselves.[1] (Expenses of the trust that would have been "miscellaneous itemized deductions" had they been incurred by an individual are included with the investor's miscellaneous itemized deductions for purposes of calculating the investor's taxation. See Q 631). Thus, gain on any sale of trust assets by the trust is taxable to the unit holders. What is passed through by the trust depends on the character of its assets. For example, the unit holder may have to reduce basis in the unit to reflect amortization of bond premium, especially in exempt-interest trusts. See Q 7646. The unit holder may also have to reduce basis for accrued interest received, if any, on bonds delivered after payment is made for the unit.

Gain on the sale of a unit by the unit holder is capital gain, to the extent it does not include accrued interest or earned original issue discount. See Q 7635 to Q 7638. For the treatment of capital gain, see Q 608.

If the trust qualifies and makes the election to be taxed as a regulated investment company, unit holders will be taxed like shareholders in a mutual fund. See Q 7851 to Q 7862.

Interest on indebtedness incurred or continued to purchase or carry exempt-interest units is not deductible. See Q 7859, Q 7943.[2]

The IRS released regulations clarifying the reporting obligations for trustees and middlemen of widely-held fixed investment trusts (WHFITs).[3]

Real Estate Investment Trust (REITs)

7883. What is a real estate investment trust (REIT)?

A real estate investment trust (REIT) is a corporate entity that owns, operates, acquires, develops and manages real estate. The investment objective of most REITs is to produce current income through rents or interest on mortgage lending.

REITs are required to distribute at least 90 percent of their annual earnings to shareholders. Thus, REITs are popular with investors seeking higher levels of current income and real estate as part of their portfolios. While current yields tend to be higher than those of stocks and investment grade bonds, the total return of REIT shares can fluctuate substantially because of their sensitivity to the real estate market. REIT market values and distributable cash flow will

1. IRC Sec. 671.
2. IRC Sec. 265(a)(2).
3. See TD 9308, 71 Fed. Reg. 78351 (12-29-2006). See also TD 9241, 71 Fed. Reg. 4002 (1-24-2006); Notice 2006-30, 2006-1 CB 1044, Notice 2006-29, 2006-1 CB 644.

both be affected by fluctuations in the real estate market, and REITs tend to run in and out of favor as the real estate market experiences booms and declines.

REITs are often compared to mutual funds because they allow smaller investors to pool capital to invest in larger and more diversified real estate portfolios than might otherwise be available. Both REITs and mutual funds are pass-through vehicles, as income earned is passed through for taxation at the investor level, bypassing taxation at the corporate level.

REITs must meet a detailed set of qualification tests in order to qualify for the favorable tax treatment afforded by the IRC. For a discussion of the tax treatment of a REIT, see Q 7884 (entity taxation) and Q 7885 and Q 7888 (shareholder taxation). For the qualification requirements applicable to REITs, see Q 7891.

7884. How is income earned by a REIT taxed?

An important aspect of REITs is their pass-through income tax treatment. Like partnerships, REITs are not taxed at the entity level, but at the shareholder level. Thus, annual taxable income is allocated pro-rata to all shareholders, and these amounts are included in the shareholders' individual returns and will be taxed at their level.

The amount of income determined at the entity level and passed through to REIT shareholders is usually less than the actual cash distributions received for the same year. In most instances this is due to the fact that taxable income is reduced by depreciation, a deductible expense that does not reduce distributable cash flow. Since REIT distributions differ from REIT income allocations, and the information reported to shareholders on a Form 1099, this can cause confusion that, in some cases, may cause investors to avoid investing in REITs. See Q 7885 and Q 7888 for a discussion of how REIT shareholders are taxed.

Planning Point: Shareholders use Form 1120-REIT (*U.S. Income Tax Return for Real Estate Investment Trusts*) to report the income, gains, losses, deductions, credits and to figure the income tax liability of real estate investment trusts.

7885. How is a shareholder (or beneficiary) in a real estate investment trust taxed?

A real estate investment trust (REIT) invests principally in real estate and mortgages. Shareholders (or holders of beneficial interests) in real estate investment trusts are taxed like shareholders in regular corporations (Q 7501 to Q 7537) unless the REIT distributes at least 90 percent of its real estate investment trust taxable income.[1] If the required distribution is made, the taxation is similar to that of mutual fund shareholders.

Ordinary income dividends. Under JGTRRA 2003, *qualified dividend income* is treated like *net capital gain* for most purposes (see Q 608) and is, therefore, eligible for the 20%/15%/0% tax rates instead of the higher ordinary income tax rates. ATRA made these tax rates permanent for tax years beginning after 2012. Because REITs generally do not pay corporate income taxes,

1. IRC Sec. 857(a).

BK-SBM-15TFInvest-140469-Part 14.indd 378 10/9/2014 9:38:42 PM

most ordinary income dividends paid by REITs do *not* constitute qualified dividend income, and, consequently, are not eligible for the 20%/15%/0% rates.[1] However, a small portion of dividends paid by REITs may constitute qualified dividend income—for example, if the: (1) dividend is attributable to dividends received by the REIT from non-REIT corporations, such as taxable REIT subsidiaries; or (2) income was subject to tax by the REIT at the corporate level, such as built-in gains, or when a REIT distributes less than 100 percent of its taxable income. Earnings and profits, which were accumulated prior to becoming a REIT, and distributed by a REIT in order to qualify as such, may also count as qualified dividend income.[2]

REITs that pass through dividend income to their shareholders must meet the holding period test (see Q 608) in order for the dividend-paying stocks that they pay out to be reported as qualified dividends on Form 1099-DIV. Investors must *also* meet the holding period test relative to the shares they hold directly, from which they received the qualified dividends that were reported to them.[3]

Unless designated by the REIT as qualified dividend income, all distributions are ordinary income dividends.[4] Ordinary income dividends are included in the shareholder's (or beneficiary's) income for the taxable year in which they are received. Shareholders do not include a share of a REIT's investment expenses in income, nor with the shareholder's miscellaneous itemized deductions, as is the case with certain other pass-through entities. See Q 631.

Capital gain dividends. Capital gain dividends are designated as such by the REIT in a written notice to the shareholder (beneficiary).[5] The shareholder (beneficiary) reports capital gain dividends as long-term capital gain in the year received, regardless of how long the shareholder has owned an interest in the REIT.[6] See Q 608 for the treatment of capital gains and losses, including the lower rates under JGTRRA 2003 (20%/15%/0%) for long-term capital gains incurred on or after May 6, 2003—now made permanent by ATRA—and the availability of the election to include *net capital gain* in investment income.

If the total amount designated as a capital gain dividend for the taxable year exceeds the net capital gain for the year, the portion of each distribution that will be a capital gain dividend will be only that proportion of the amount so designated that such excess of the net long-term capital gain over the net short-term capital loss bears to the total amount designated as a capital gain dividend. For example, a REIT making its return on the calendar year basis advised its shareholders by written notice mailed December 30 that $200,000 of a distribution of $500,000 made December 15 constituted a capital gain dividend, amounting to $2 per share. It was later discovered that an error had been made in determining the net capital gain of the taxable year, which turned out to be $100,000 instead of $200,000. In such case, each shareholder would have received a capital gain dividend of $1 per share instead of $2 per share.[7]

1. See IRC Sec. 857(c); see also National Association of Real Estate Investment Trusts, *Policy Bulletin*, (5-28-2003).
2. See IRC Sec. 857(c). See also IRS News Release IR-2004-22 (2-19-2004).
3. IRS News Release IR-2004-22 (2-19-2004).
4. Treas. Reg. §1.857-6(a).
5. IRC Sec. 857(b)(3)(C).
6. IRC Sec. 857(b)(3)(B); Treas. Reg. §1.857-6(b).
7. Treas. Reg. 1.857-6(e)(1)(i).

Generally, ordinary income dividends and capital gain dividends declared for the prior REIT tax year are included in income by the shareholder in the year they are received.[1] However, any dividend declared by a REIT in October, November, or December of any calendar year and payable to shareholders on a specified date in such a month is treated as received by the shareholder on December 31 of that calendar year so long as the dividend is actually paid during January of the following calendar year.[2]

A REIT may declare but retain a capital gain dividend. If it does so, the REIT must notify its shareholders of the amount of the undistributed dividend and pay federal income tax on the undistributed amount at the corporate alternative capital gains rate, which is currently 35 percent.[3]

A shareholder who is notified of an undistributed capital gain dividend is required to include the dividend in computing his or her long-term capital gains for the taxable year that includes the last day of the REIT's taxable year. However, the shareholder is credited or allowed a refund for the share of the tax paid by the REIT on the undistributed amount; thus, on the shareholder's income tax return he or she is treated as though the shareholder made an advance payment of tax equal to 35 percent of the amount of the undistributed dividend reported.[4] The adjusted basis of a shareholder's shares in a REIT is increased by the difference between the amount of the undistributed capital gain dividend and the tax deemed paid by the shareholder in respect of such shares.[5]

7886. How are REIT stock dividends taxed?

In a private letter ruling, the IRS concluded that shareholders who received all or part of a REIT's special stock dividend would be treated as having received a distribution to which IRC Section 301 applies through the application of IRC Section 305(b)(1). The amount of the stock distribution would be equal to the value of the stock on the valuation date rather than on the date of the distribution. The special dividend qualifies for the dividends paid deduction under IRC Sections 561, 562 and 857 provided the REIT has sufficient earnings and profits.[6]

The Service determined in a private letter ruling that a distribution of earnings and profits from a newly established REIT (arising from earnings and profits accumulated during the pre-REIT years), in which shareholders could elect to receive cash, stock, or a combination of both, should be treated as a distribution of property to which IRC Section 301 applies.[7]

Temporary Guidance Regarding Certain Stock Distributions After 2009 and before 2013. Recognizing the difficulty faced by publicly traded REITs and mutual funds in preserving liquidity in a

1. IRC Sec. 858(b); Treas. Reg. §1.858-1(c).
2. IRC Sec. 857(b)(9).
3. IRC Sec. 857(b)(3)(A). See IRC Sec. 1201(a).
4. IRC Sec. 857(b)(3)(D).
5. IRC Sec. 857(b)(3)(D)(iii).
6. Let. Rul. 200122001.
7. Let. Rul. 200348020.

capital-constrained environment,[1] the Service issued a revenue procedure providing temporary guidance concerning the tax treatment of REIT and mutual fund distributions when shareholders have the ability to elect to receive either cash or stock.[2] (The guidance formalizes the conclusion reached by the Service in several earlier private letter rulings.)[3] The Service states that it will treat a distribution of stock by either a publicly traded REIT or mutual fund as a distribution of property to which IRC Section 301 applies by reason of IRC Section 305(b). The amount of the stock distribution will be considered to equal the amount of the money that could have been received instead *if*:

(1) the distribution is made by the corporation to its shareholders with respect to its stock;

(2) stock of the corporation is publicly traded on an established securities market in the United States;

(3) the distribution is declared on or before December 31, 2012, with respect to a taxable year ending on or before December 31, 2011, whether declared and distributed prior to the close of the taxable year, or whether declared and distributed pursuant to provisions of IRC Sections 855, 852(b)(7), 868, 857(b)(9), or 860;

(4) pursuant to such declaration, each shareholder may elect to receive his or her entire entitlement under the declaration in either money or stock of the distributing corporation of equivalent value subject to a limitation on the amount of money to be distributed in the aggregate to all shareholders (the "cash limitation"), provided that:

   (a) such cash limitation is not less than 10 percent of the aggregate declared distribution, and

   (b) if too many shareholders elect to receive money, each shareholder electing to receive money will receive a pro rata amount of money corresponding to his respective entitlement under the declaration, but in no event will any shareholder electing to receive money receive less than 10 percent of his entire entitlement under the declaration in money;

(5) The calculation of the number of shares to be received by any shareholder will be determined, over a period of up to two weeks ending as close as practicable to the payment date, based upon a formula utilizing market prices that is designed to equate in value the number of shares to be received with the amount of money that could be received instead. For purposes of applying item (4), the value of the shares to be distributed must be determined by using the formula described in the preceding sentence; and

1. See National Association of Real Estate Investment Trusts (NAREIT), Letter to Eric Solomon, Assistant Secretary of Tax Policy, Department of the Treasury, October 31, 2008, at: http://www.reit.com.
2. Rev. Proc. 2009-15, 2009-4 IRB 356.
3. Let. Ruls. 200832009, 200817031, 200618009, 200615024, 200406031, and 200348020.

BK-SBM-15TFInvest-140469-Part 14.indd 381 10/9/2014 9:38:42 PM

(6) With respect to any shareholder participating in a dividend reinvestment plan ("DRIP"), the DRIP applies only to the extent that, in the absence of the DRIP, the shareholder would have received the distribution in money under item (4).[1]

Revenue Procedure 2010-12 is effective with respect to distributions declared on or after January 1, 2008.

7887. Do REIT dividends give rise to tax preference items for purposes of the alternative minimum tax?

REIT dividends ordinarily do not create tax preferences. However, real estate investment trusts do pass through, and each shareholder must report a proportionate share of, the REIT's own tax preference items.[2]

For an explanation of the alternative minimum tax, see Q 653.

7888. How is a REIT shareholder taxed when the shareholder sells, exchanges, or redeems shares?

When a shareholder (or owner of a beneficial interest) sells, exchanges, or redeems shares, the shareholder will generally have a capital gain or loss. The capital gain or loss will be short-term if the shares were held for one year or less; it will be long-term if the shares were held for more than one year. See Q 605 and Q 608 for the treatment of capital gains and losses, including the lower rates for capital gains incurred on or after May 6, 2003—now permanent under ATRA for tax years beginning after 2012. However, if a loss is realized on the sale of shares held less than six months, such loss must be treated as long-term loss to the extent of any capital gains dividend received on those shares during such period. (This 6-month period is tolled during any time that the shareholder's risk of loss with respect to the shares is reduced through certain option contracts, short sales, or offsetting positions in substantially similar property.) A limited exception will, however, be provided by regulation for sales pursuant to a periodic liquidation plan.[3]

The gain or loss is the difference between the shareholder's adjusted tax basis in the shares and the amount realized from the sale, exchange, or redemption (which includes money plus the fair market value of any property received. See Q 598.[4]

If a shareholder's shares in the REIT were acquired on the same day and for the same price, the shareholder will have little difficulty in establishing tax basis and holding period of the shares sold, exchanged, or redeemed. However, if the shares were acquired at different times or prices, the process is more difficult; unless the shareholder can "adequately identify" the lot from which the shares being sold or exchanged originated, the shareholder must treat the sale or exchange as disposing of the shares from the earliest acquired lots (i.e., by a first-in, first-out (FIFO) method). If the earliest lot purchased or acquired is held in a stock certificate that

1. Rev. Proc. 2010-12, 2010-1 CB 302, *amplifying and superseding* Rev. Proc. 2009-15, 2009-1 CB 356, *amplifying* and *superseding* Rev. Proc. 2008-68, 2008-52 IRB 1373.
2. IRC Sec. 59(d).
3. IRC Sec. 857(b)(7).
4. IRC Sec. 1001.

BK-SBM-15TFInvest-140469-Part 14.indd 382 10/9/2014 9:38:42 PM

represents multiple lots of stock, and the taxpayer does not adequately identify the lot from which the stock is sold or transferred, the stock sold or transferred is charged against the earliest lot included in the certificate.[1] In connection with reporting sales of securities to the IRS, brokers will be obligated to provide the customer's basis in, and holding period for, shares sold, and brokers must use the principles just described to determine which shares were sold (i.e., FIFO if the shares cannot be adequately identified).[2] The "average basis" methods discussed in Q 7860 for mutual fund shares are not available to REIT shareholders. For an explanation of how shares may be "adequately identified," see Q 606.

See Q 7604 and Q 7605 for the income tax consequences upon the disposition of a position that is held as part of a conversion transaction.

7889. What types of REITs are commonly formed?

REITs can be broken down into three basic classes: equity, mortgage and hybrid.

An equity REIT will actually acquire and take ownership of real property. Most equity REITs buy and hold properties for their net rental income. Others seek profits through appreciation in property values. These often try to add value through increasing occupancy levels or by making physical improvements to the property. Equity REITs can be sub-classified by the type of real estate in which they invest. For example, investments may be confined to (or predominantly focused on) office buildings, apartments, shopping centers, warehouses, or medical care facilities, etc. Some equity REITs may diversify their holdings among several different types of real estate.

Mortgage REITs do not actually own real estate, but rather, they hold mortgages on income-producing commercial properties. Mortgage REITs generally provide a higher current yield than equity REITS, but they lack the opportunity for capital appreciation through increases in property values. Instead, their market valuations will be affected by fluctuations in the prevailing market interest rates.

Hybrid REITs are simply REITs that invest in both direct property ownership and in mortgages.

7890. What rules exist to restrict the ability of REITs to actively conduct a trade or business?

Originally, REITs were developed to serve as passive vehicles through which investors could invest in real estate assets. The IRS has recognized that Congress intended to restrict pass-through treatment of a REIT's income to the passive income earned by the REIT through its real estate investments, rather than through the active conduct of a business.[3]

However, in the intervening years, the code has been amended to permit a REIT to participate more actively in the conduct of its real estate business activities. In 2001, the IRS found

1. Treas. Reg. §1.1012-1(c).
2. IRC Sec. 6045(g).
3. Rev. Rul. 73-236, 1973-1 CB 183 (finding that a REIT did not impermissibly engage in the active conduct of a trade or business because its property was managed and operated by independent contractors, rather than direct employees of the REIT itself).

that a REIT was permitted to engage in the active conduct of the trade or business of producing rental income from real estate property that qualified as such under IRC Section 856(d).[1] This has significantly expanded a REIT's ability to engage in the management and operation of the real estate assets from which it derives income.

Even though a REIT's ability to actively produce rental income has been expanded, there are still many activities related to the production of rental income in which a REIT is not permitted to directly engage. As a result, many REITs use independent contractors and taxable REIT subsidiaries (see Q 7907) in order to provide the necessary services. For example, a REIT is permitted to own an apartment building and derive its income from the rents received through that investment. In order to generate this rental income, however, the tenants will require certain basic services, such as landscaping of the premises, elevator maintenance, trash collection, etc. The REIT itself can engage independent contractors to perform these services without jeopardizing the status of rental income as income derived from real property. Taxable REIT subsidiaries are treated in the same manner as independent contractors under the regulations.[2]

See Q 7899 for a discussion of the types of property that qualify as real estate assets for REIT purposes.

7891. What are the general requirements that must be met in order for a REIT to qualify for pass-through tax treatment?

As the name suggests, a real estate investment trust (REIT) is required to invest primarily in assets that are closely connected to real estate. Permissible investments include ownership interests in real property, interest derived from loans where the underlying asset is real property and investments in other REITs.[3]

Importantly, a REIT is required to distribute 90 percent of its annual earnings to shareholders. A company that meets the requirements described below will qualify as a REIT, and therefore be allowed to deduct from its corporate taxable income all of the dividends that it pays out to its shareholders. Because of this special tax treatment, most REITs pay out 100 percent of their taxable income (rather than simply meeting the 90 percent requirement) to shareholders and, therefore, owe no tax at the corporate level.

In addition to paying out at least 90 percent of its taxable income in the form of shareholder dividends, a REIT must meet several tests relating to its management, assets, income and diversification. Specifically, a REIT must:

- be an entity that would be taxable as a domestic corporation "but for" its REIT status;
- be managed by a board of directors or trustees;
- have shares that are fully transferable;

1. Rev. Rul. 2001-29, 2001-26 IRB 1348.
2. Treas. Reg. §1.856-4(b).
3. See IRC Sec. 856(c).

BK-SBM-15TFInvest-140469-Part 14.indd 384 10/9/2014 9:38:42 PM

- gave a minimum of 100 shareholders after its first year as a REIT[1];
- have no more than 50 percent of its shares held by five or fewer individuals during the last half of any taxable year[2];
- at the close of each quarter, have investments comprising at least 75 percent of its total assets that consist of real estate, cash (including receivables) and government securities.[3] See Q 7898 to Q 7900;
- derive at least 75 percent of its gross income from real estate related sources (real estate related sources include gain on the sale of real property, gain from the sale of, or dividends derived from, interests in other REITs, rents derived from real property and interest on mortgages financing real property).[4] See Q 7903 and Q 7904;
- derive at least 95 percent of its gross income from a combination of real estate related sources and dividends or interest (from any source)[5]; and
- have no more than 25 percent of its assets consist of non-government securities or stock in taxable REIT subsidiaries (Q 7907)[6].

7892. What is the 90 percent distribution requirement applicable to REITs?

In order to qualify for REIT tax treatment, a REIT is required to distribute 90 percent of its income each tax year.[7] The calculation of the amount actually distributed is made by taking the sum of (a) 90 percent of the REIT taxable income (REITTI), determined without regard to the deduction for dividends paid and excluding capital gains and (b) 90 percent of the excess of net income from foreclosure property over the tax imposed on such income. Any excess noncash income is then subtracted.[8]

Dividends paid within the tax year are taken into account in determining whether the distribution requirement is met, but there are two exceptions to this rule. First, if a REIT declares a dividend in October, November or December of one tax year, those dividends will be deemed to have been paid to the shareholders as of December 31 of that tax year, even if the REIT doesn't actually pay them until January of the following year.[9]

Second, if a REIT declares a dividend before its tax return is due (including extensions) and actually pays the dividend within the 12 month period following the close of its tax year (and not later than the date of the first regular dividend payment made after the declaration), then the REIT can elect to treat the dividend (or a portion thereof) as though it was paid in the prior

1. IRC Sec. 856(a).
2. IRC Secs. 856(a)(6), (h), 542(a)(2).
3. IRC Sec. 856(c)(4)(A).
4. IRC Sec. 856(c)(3).
5. IRC Sec. 856(c)(2).
6. IRC Sec. 856(c)(4)(B).
7. IRC Sec. 857(a).
8. IRC Sec. 857(a)(1).
9. IRC Sec. 857(b)(9).

tax year.[1] The REIT must make the election in the tax return it files for the taxable year and it is irrevocable once made.[2] If the REIT elects this treatment, the shareholder is not required to include the dividend in income until the year in which it is actually paid.[3]

7893. What is a deficiency dividend? How can a REIT use deficiency dividends to avoid disqualification based on the 90 percent distribution requirement?

A deficiency dividend is a dividend paid by a REIT in a later year with respect to an earlier tax year. Deficiency dividends are typically used when it is determined that an adjustment to a REIT's taxable income for a prior year, and thus to the corresponding amount required to be distributed to shareholders, was required. Any deficiency dividends are required to be paid within 90 days after it is determined that the adjustment was necessary.[4]

Determination of whether an adjustment is necessary may be made by a formal court order or may be made by the REIT itself in a statement attached to an amended or supplemental tax return.[5] As shown in the following example, the REIT can eliminate its tax liability by distributing the entire amount of the adjustment as a deficiency dividend, but cannot eliminate liability for any interest or penalties that result from the adjustment.[6]

Example: For 2012, a REIT reports real estate investment trust taxable income (REITTI) of $100, a dividends paid deduction of $100 and thus incurs no tax liability at the corporate level. In 2014, the Tax Court issues a determination that the REIT's RETTI for 2012 was actually $120. The REIT pays a $20 dividend and files a claim for a dividend deficiency deduction within the required period, and is allowed that deduction for 2012. The REIT therefore has no undistributed REITTI for 2012 and meets its dividend distribution requirement. However, the REIT is still considered to have underreported by $20 and the time for paying its 2012 taxes (including extensions) has expired. The REIT is liable for interest on the $20 under IRC Sec. 6601 despite the fact that it was granted the dividend deficiency deduction.[7]

The REIT shareholder is taxed on the deficiency dividend in the year that the shareholder actually receives the dividend payment (even though the deficiency dividend will, by definition, relate to an earlier tax year).[8]

7894. What asset tests apply in determining whether a trust qualifies as a REIT?

A REIT must satisfy several asset-based tests in order to qualify for pass-through tax treatment as a REIT. The following asset-based tests are applied at the close of each quarter of the taxable year of a REIT's existence:

1. *The 75 Percent Test*: At least 75 percent of a REIT's assets must consist of cash, cash items (including receivables), real estate assets and government securities.[9]

1. IRC Sec. 858(a).
2. Treas. Reg. §1.858-1(b).
3. IRC Sec. 858(b),
4. IRC Sec. 860(f).
5. IRC Sec. 860(e).
6. Treas. Reg. §1.860-3.
7. See Treas. Reg. §1.860-3, Ex. 1.
8. IRC Sec. 858(b).
9. IRC Sec. 856(c)(4)(A), Treas. Reg. §1.856-2.

BK-SBM-15TFInvest-140469-Part 14.indd 386 10/9/2014 9:38:43 PM

2. *The 25 Percent Test*: No more than 25 percent of a REIT's assets may consist of securities (other than securities permitted under the 75 percent test).[1]

3. *The Taxable REIT Subsidiary Test*: No more than 25 percent of the total value of a REIT's assets may consist of securities of one or more taxable REIT subsidiary.[2]

The purpose of these asset-based tests is to ensure that REITs continue to concentrate their investments in the real estate assets for which they were created. See Q 7898 to Q 7900 for a detailed discussion of the types of assets that qualify as permissible REIT assets for purposes of the 75 percent asset test. See Q 7907 for information on taxable REIT subsidiaries.

7895. What is the definition of "land" for determining whether an asset qualifies as a real estate asset for purposes of the REIT asset tests?

In order to qualify as a REIT, at least 75 percent of the REIT's assets must consist of certain defined assets, including real estate assets (see Q 7894). "Land" is a type of real property asset that qualifies as a real estate asset for this purpose.[3] The IRS has recently clarified what types of property constitute "land" in the context of REITs.

Land includes any water or air space that is adjacent to the physical land itself, and also includes any natural products (such as crops growing on the land) and deposits that remain physically attached to the land. However, once a product is severed from the land (such as when crops are harvested or minerals are extracted) it no longer qualifies as land and is no longer treated as a real estate asset.[4]

The new IRS proposed regulations clarify that if crops, minerals or other products that were previously physically attached to the land are stored upon the land after they are severed, such storage does not serve to recharacterize the stored property as "land" for REIT asset testing purposes.

7896. When is an asset considered to be an "inherently permanent structure" so that it qualifies as a real estate asset? Are there any safe harbor provisions?

Buildings and other "inherently permanent structures" qualify as real estate assets for purposes of the REIT asset tests (see Q 7899). Generally, an inherently permanent structure is a building or other structure that is reasonably expected to last indefinitely based on all of the surrounding facts and circumstances. However, the new proposed regulations provide that if the asset serves an active function (such as a piece of machinery or equipment) it is *not* a building or other inherently permanent structure.[5] Inherently permanent structures are those that serve a *passive* function, as described in the regulations as a function that is designed to contain,

1. IRC Sec. 856(c)(4)(B)(i).
2. IRC Sec. 856(c)(4)(B)(ii).
3. IRC Sec. 856(c).
4. Prop. Treas. Reg. §1.856-10(c).
5. Prop. Treas. Reg. §1.856-10(d)(2).

support, shelter, cover, or protect—rather than an active function, such as one that is designed to manufacture, create, produce, convert or transport.

The regulations provide a safe harbor listing of the types of assets that will qualify as buildings or other inherently permanent structures without the need for a facts and circumstances analysis. "Buildings" are defined to include houses, apartments, hotels, factory and office buildings, warehouses, barns, enclosed garages, enclosed transportation stations and terminals, and stores.[1]

The safe harbor for "inherently permanent structures" includes the following specifically enumerated structures:

(1) microwave transmission, cell, broadcast and electrical towers,

(2) telephone poles,

(3) parking facilities,

(4) bridges and tunnels,

(5) roadbeds,

(6) railroad tracks,

(7) transmission lines,

(8) pipelines,

(9) fences,

(10) in-ground swimming pools,

(11) offshore drilling platforms,

(12) storage structures such as silos and oil and gas storage tanks,

(13) stationary wharves and docks,

(14) outdoor advertising displays for which an election has been properly made under IRC Section 1033(g)(3).[2]

If a structure is not specifically enumerated within the safe harbor provision of the proposed regulations, a facts and circumstances analysis is necessary to determine whether it qualifies as a building or inherently permanent structure for purposes of meeting the REIT asset tests. Q 7899 outlines the analysis that is undertaken if the asset does not qualify for the safe harbor protection.

1. Prop. Treas. Reg. §1.856-10(d)(2)(ii)(B).
2. Prop. Treas. Reg. §1.856-10(2)(iii)(B).

BK-SBM-15TFInvest-140469-Part 14.indd 388 10/9/2014 9:38:43 PM

7897. What is a structural component? When will a structural component qualify as a real estate asset for purposes of the REIT asset tests?

Structural components of inherently permanent structures also qualify as real estate assets for purposes of the REIT asset tests.[1] Structural components are, generally, those assets that are integrated into an inherently permanent structure and serve the inherently permanent structure in its passive function. The proposed regulations provide a safe harbor listing of structural components that qualify as real estate assets as follows:

(1) wiring,

(2) plumbing systems,

(3) central heating and air conditioning systems,

(4) elevators or escalators,

(5) walls, floors and ceilings,

(6) permanent coverings of walls, floors and ceilings,

(7) windows and doors,

(8) insulation,

(9) chimneys,

(10) fire suppression systems (such as sprinkler systems and fire alarms),

(11) fire escapes,

(12) central refrigeration systems,

(13) integrated security systems, and

(14) humidity control systems.[2]

An asset that is not listed in the safe harbor regulation may still qualify as a structural component that is a real estate asset based on a facts and circumstances analysis that considers several factors, including the following specifically enumerated factors:

(1) The manner, time, and expense of installing and removing the asset;

(2) Whether the asset is designed to be moved;

(3) The damage that removal of the asset would cause to the item itself or to the inherently permanent structure of which it is a part;

1. Prop. Treas. Reg. §1.856-10(a).
2. Prop. Treas. Reg. §1.856-10(d)(3)(iii).

BK-SBM-15TFInvest-140469-Part 14.indd 389 10/9/2014 9:38:43 PM

(4) Whether the asset serves a utility-like function with respect to the inherently permanent structure;

(5) Whether the asset serves the inherently permanent structure in its passive function;

(6) Whether the asset produces income from consideration for the use or occupancy of space in or upon the inherently permanent structure;

(7) Whether the asset is installed during construction of the inherently permanent structure;

(8) Whether the asset will remain if the tenant vacates the premises; and

(9) Whether the owner of the real property is also the legal owner of the asset.[1]

7898. When will an asset be characterized as "cash items, receivables or government securities" for purposes of the 75 percent asset test?

In order to qualify as a REIT, at least 75 percent of a REIT's assets must consist of cash, cash items (including receivables), real estate assets and government securities at the end of each quarter of a REIT's tax year.[2]

For purposes of the 75 percent asset test, the IRS has found that money market fund shares are considered "cash items," rather than securities, because they have the essential characteristics of cash items—namely, a high degree of liquidity and relative safety of principal.[3] Certificates of deposit also qualify as cash items because, based on the IRS' reasoning, the certificates held by REITs are issued in large denominations, mature within one year and are readily tradable on a secondary market.[4] Their short-term nature, coupled with an active secondary market, renders these investments sufficiently liquid and low-risk so as to qualify as cash items.

The term "receivables" has been interpreted to include only receivables that arise in the REIT's ordinary course of business (rather than receivables that are purchased from another person).[5]

"Government securities" include only securities issued by the federal government—state and local securities do not qualify.[6] The IRS has issued guidance providing that securities issued by the Federal Housing Administration,[7] Federal National Mortgage Administration[8] and United States Postal Service,[9] among others, qualify as government securities.

For a discussion of what constitutes a real estate asset for purposes of the 75 percent asset test, see Q 7899 and Q 7900.

1. Prop. Treas. Reg. §1.856-10(d)(3)(iii).
2. IRC Sec. 856(c)(4)(A), Treas. Reg. §1.856-2.
3. Rev. Rul. 2012-17, 2012-25 IRB 1018.
4. Rev. Rul. 77-199, 1977-1 CB 195.
5. Treas. Reg. §1.856-2.
6. 15 USC 80(a)-2(a)(16).
7. Rev. Rul. 64-85, 1964-1 C.B. 230.
8. Rev. Rul. 64-85, above, GCM 39626, Rev. Rul. 92-89, 1992-2 C.B. 154.
9. Rev. Rul. 71-537, 1971-2 C.B. 262, GCM 34648.

BK-SBM-15TFInvest-140469-Part 14.indd 390 10/9/2014 9:38:43 PM

7899. When will an asset be characterized as a real estate asset for purposes of the 75 percent asset test?

In order to qualify as a REIT, at least 75 percent of a REIT's assets must consist of cash, cash items (including receivables), real estate assets and government securities at the end of each quarter of a REIT's tax year.[1]

"Real estate assets" include real property (and interests therein), interests in other REITs (as long as the REIT issuing the interest was properly qualified as a REIT), and mortgage interests in real property. For a discussion of mortgage interests in real property, see Q 7900.

Congress acknowledged that a REIT that receives new equity capital may have a difficult time quickly finding satisfactory investments that meet the asset-based tests. Because of this, the term "real estate assets" has been defined in the statute to include property attributable to temporary investment in new capital (even if not otherwise a real estate asset) if the property is stock or a debt instrument. This treatment of temporary investments is permitted for only a one year period.[2] "New capital" for this purpose means an amount the REIT receives either (1) in exchange for stock (or certificates of beneficial interest) in the REIT or (2) in a public offering of debt instruments issued by the REIT which have maturities of at least five years.[3]

Real property includes not only the actual land investment, but also any improvements (including buildings) that are made upon that land.[4] "Interests in real property" include (whether with regard to the actual land or the improvements on the land):

- ownership interests,
- co-ownership interests,
- leasehold interests,
- options to acquire the property, and
- options to lease the property.[5]

The definition of real property interests also encompasses timeshare interests (interests that grant the REIT the right to use real property only for a specified portion of each year) and stock in cooperative housing corporations. Mineral, oil and gas royalty interests are specifically excluded from the statutory definition of "interests in real property."[6]

The IRS has applied a "permanence" standard in determining whether improvements upon real property are considered real property for purposes of the REIT asset tests. In one private

1. IRC Sec. 856(c)(4)(A), Treas. Reg. 1.856-2.
2. IRC Sec. 856(c)(6)(D)(ii). See also Let. Rul. 9342021.
3. IRC Sec. 856(c)(6)(D)(ii).
4. Treas. Reg. §1.856-3(d).
5. Treas. Reg. §1.856-3(c).
6. Treas. Reg. §1.856-3(c).

BK-SBM-15TFInvest-140469-Part 14.indd 391 10/9/2014 9:38:43 PM

letter ruling, the IRS found that manufactured homes are "inherently permanent structures" based on examination of the property in light of the following questions:

1. Is the property capable of being moved, and has it in fact been moved?

2. Is the property designed to remain permanently in place?

3. Are there circumstances that tend to show the intended length of affixation to the underlying real property?

4. How substantial and time-consuming is the job of moving the property?

5. How much damage will the property sustain if it is moved?

6. What is the manner of affixation of the property to the land?[1]

The IRS has also ruled privately that so-called "real estate intangibles" can constitute real estate assets to the extent that the value of the intangibles is inextricably linked to the underlying real estate.[2] In that ruling, a REIT purchased several well-known hotels, the value of which was significantly increased by the goodwill associated with the brand name. The increase in value associated with this goodwill was characterized as "real estate intangibles" for GAAP purposes. The IRS found that the value of the brand names was created by the underlying real estate assets that made the hotels unique—meaning that the names themselves would have no value but for the quality of the physical real estate to which they were attached. As such, these real estate intangibles were treated as real estate assets for purposes of the REIT asset tests.

For a discussion of the definitions of cash items, receivables and government securities for purposes of the 75 percent asset test, see Q 7898. Classification of assets owned through a REIT's interest in a partnership is discussed in Q 7901.

7900. When will a loan qualify as a real estate asset?

In order to qualify as a REIT, at least 75 percent of a REIT's assets must consist of cash, cash items (including receivables), real estate assets and government securities at the end of each quarter of a REIT's tax year.[3] Interests derived from mortgage loans typically qualify as real estate assets because the mortgage interest is really an interest in the underlying real property that secures the loan.

If a mortgage loan covers both interests in real property and other non-real estate assets, the regulations require that the interest income on the loan must be apportioned between the two types of property. If the loan value of the property equals or exceeds the amount of the loan, all of the interest can be attributed to real property. If the amount of the loan is greater than the loan value of the property, the interest income apportioned to the real property portion is

1. Let. Rul. 8931039.
2. Let. Rul. 200813009.
3. IRC Sec. 856(c)(4)(A), Treas. Reg. 1.856-2.

BK-SBM-15TFInvest-140469-Part 14.indd 392 10/9/2014 9:38:43 PM

determined by multiplying the interest income by a fraction, the numerator of which is the loan value of the real property and the dominator of which is the amount of the loan.[1]

The loan value of the real property is equal to the fair market value of the property on the date the loan is made.[2]

The IRS has set forth a safe harbor in Revenue Procedure 2003-65 that allows a REIT to make a loan to a partnership or other disregarded entity where the loan is secured by interests in the entity that owns the real property, rather than directly by the real property, and still count the loan as a real estate asset.[3] In order to qualify for the safe harbor, the loan transaction must satisfy all of the following criteria:

- The borrower must be a partner in a partnership or sole member of another type of disregarded entity for tax purposes (e.g., the entity cannot have elected to be taxed as a corporation).
- The loan must be nonrecourse.
- The REIT must be granted a first priority security interest in the pledged property (meaning that the REIT's interest must be superior to that of all other creditors).
- The terms of the transaction must provide that if the borrower defaults, the REIT will replace the borrower as partner in the partnership or sole member of the disregarded entity.
- The borrower must own real property and the terms of the transaction must provide that if the real property is subsequently sold, the loan will immediately become due and payable.
- The value of the real property owned by the borrower must constitute 85 percent or more of the total value of the entity's assets at each testing date.
- The loan value of the real property owned by the borrower must equal or exceed the amount of the loan made by the REIT (the loan value of the property is reduced by any encumbrances on the real property and any other liabilities of the borrower).
- The interest on the loan must only constitute compensation for the use of money and the determination of interest cannot depend upon the income or profits of any person.

7901. How are the assets and income of a REIT classified if the REIT owns interests in a partnership?

A REIT may own interests in a partnership and participate in that partnership as a partner much in the same way as any other taxpayer-entity. For purposes of the asset and income tests

1. Treas. Reg. §1.856-5(c)(1).
2. Treas. Reg. §1.856-5(c)(2).
3. Rev. Proc. 2003-65, 2003-32 IRB 336.

BK-SBM-15TFInvest-140469-Part 14.indd 393 10/9/2014 9:38:43 PM

applicable to REITs, the REIT will be deemed to own its proportionate share of each of the underlying partnership assets. The characterization given to any partnership asset for partnership purposes is controlling in determining the character of the asset for purposes of applying the REIT asset tests (see Q 7898 to Q 7900).[1]

Under the regulations, the REIT's proportionate interest in a partnership is determined based upon its capital interest in the partnership. The IRS has found that, because a partner's capital account typically reflects its net investment in the partnership, a REIT's capital interest in a partnership is determined by dividing the REIT's capital account balance by the sum of all of the partners' capital account balances.[2]

For purposes of the income tests applicable to REITs, any income realized when a REIT-partner sells its interest in the partnership will be attributable to real property to the extent that the underlying assets of the partnership constitute real property.[3]

7902. What diversification requirements apply in determining whether a trust qualifies as a REIT?

In addition to meeting the asset-based tests described in Q 7894, a REIT must satisfy several diversification tests with respect to its assets in order to qualify for pass-through tax treatment as a REIT. The following diversification tests are applied at the close of each quarter of each taxable year of a REIT's existence:

1. No more than five percent of the value of a REIT's total assets may consist of securities of any one issuer (except with respect to taxable REIT subsidiaries (TRS) and securities permitted under the 75 percent test).

2. A REIT may not hold securities that represent more than ten percent of the voting power of the outstanding securities of any one issuer.

3. A REIT may not hold securities that represent more than ten percent of the total value of the outstanding securities of any one issuer.[4]

The IRC recognizes that the value of securities may fluctuate between quarters. As such, Section 856 provides that if a REIT meets the diversification requirements at the close of any given quarter, it will not fail to meet the requirements in the subsequent quarter unless the failure is due to the acquisition of securities or property and is wholly or partially the result of that acquisition. If a REIT fails to meet the diversification tests at the close of a quarter as a result of an acquisition of securities made during that quarter, it has a thirty day period in which to correct the discrepancy. If the discrepancy is corrected within that thirty day period, the REIT will be treated as having satisfied the diversification test for the quarter.[5]

1. Treas. Reg. §1.856-3(g).
2. See Let. Rul. 200310014.
3. Treas. Reg. §1.856-3(g).
4. IRC Sec. 856(c)(4)(B)(iii).
5. IRC Sec. 856(c)(4).

BK-SBM-15TFInvest-140469-Part 14.indd 394 10/9/2014 9:38:43 PM

7903. What are the income-related qualification requirements that a REIT must satisfy?

In order to ensure that REITs continue to further the legislative intent that their income should primarily be derived passively from real estate activities, a REIT must satisfy both of the following income tests in order to qualify as a REIT[1]:

- *75 Percent Income Test*: At least 75 percent of the REIT's gross income each tax year must be derived from rents, mortgage interest, gain from the sale of real property, dividends received from other qualified REITs and certain other income derived from real estate sources.
- *The 95 Percent Income Test*: At least 95 percent of the REIT's gross income must be derived from (a) items that qualify for the 75 percent income test and (b) income from interest, dividends, gain from the sale of stocks or other securities and certain mineral royalty income.

Unlike in the case of the asset-based qualification tests, the income-related qualification tests must only be satisfied at the close of each tax year (rather than on a quarterly basis).

7904. What is gross income of a REIT for purposes of the income qualification tests?

Gross income, for purposes of the REIT income qualification tests, is determined in the same manner as for any other entity under IRC Section 61.[2] Therefore, losses from the sale of stock, securities, real property, etc. do not impact the REIT's gross income. However, the gross income from a REIT does not include amounts realized in a prohibited transaction, which, for REIT purposes, means income from the sale of property that has been held primarily for sale to customers in the ordinary course of business.[3]

Income earned by qualified REIT subsidiaries that are wholly-owned by the REIT must be included in the REIT's gross income.[4]

A REIT who owns interests in a partnership is also required to include in its gross income the share of partnership income that corresponds to its proportionate ownership share of the partnership's assets.[5] See Q 7901 for more information on the treatment of partnership interests in the REIT context.

7905. What is the penalty if a REIT fails to satisfy the income tests?

If a REIT fails to meet either of the two income tests for any given tax year, and the failure is due to reasonable cause (rather than willful neglect)[6], the REIT will continue to qualify as a

1. IRC Sec. 856(c)(2) and (c)(3).
2. Treas. Reg. §1.856-2(c)(1).
3. IRC Secs. 857(b)(2), 857(b)(6), 1221(a)(1).
4. IRC Sec. 856(i).
5. See, for example, Let. Rul. 9428018.
6. IRC Sec. 856(c)(6).

BK-SBM-15TFInvest-140469-Part 14.indd 395 10/9/2014 9:38:43 PM

REIT for that year, but will be subject to an excise tax equal to 100 percent of the unqualified income. The tax is calculated by dividing 95 percent or 75 percent of the total gross income of the REIT (depending upon which test is failed) by the amount of REIT income that would qualify for the particular test.[1]

Once the REIT has determined that it has failed one or both of the income tests for the year, it is required to file a schedule describing each item of its gross income that would qualify for the failed test (or tests) in order to avoid disqualification.[2]

If the failure is due to willful neglect, the REIT will be disqualified and will be taxed as a regular corporation the tax year, and for four years following the year of disqualification.[3]

7906. What are the differences between publicly traded, public unlisted REITs and private REITs?

REITs, like any other corporate entity, can be listed or unlisted, publicly traded or private. Both publicly traded listed REITs and public unlisted REITs are required to file reports with the SEC, though, as the name suggests, only the shares of publicly traded listed REITs are actually traded on public stock exchanges. A publicly traded listed REIT may choose to list its shares on any national stock exchange, though most are listed on the NYSE.[4]

Both publicly traded listed and public unlisted REITs are subject to traditional corporate governance rules, including rules regarding the independence of directors. A publicly traded listed REIT must abide by the rules prescribed by the stock exchange on which it chooses to list shares, while public unlisted REITs are subject to the rules adopted by the North American Securities Administrators Association (NASAA), as well as any applicable state laws. Private REITs are not subject to any external corporate governance rules.

Some smaller investors may find investing in publicly traded listed REITs more beneficial than investments in unlisted or private REITs. Because both public unlisted REITs and private REITs are not available for purchase on a stock exchange, their shares are typically much less liquid than those of a publicly traded REIT. Shares in REITs that are not publicly listed are typically subject to redemption rules that are set by the individual REIT, and often cannot be redeemed at the will of the investor.

Further, information about the value of a publicly traded REIT's shares is widely available, so smaller investors can make knowledgeable investment decisions based on historical performance and the investments underlying the individual REIT.[5]

1. IRC Sec. 857(b)(5).
2. IRC Sec. 856(c)(6)(A).
3. IRC Sec. 856(g)
4. See SEC Investor Bulletin: Real Estate Investment Trusts (REITs), available at http://www.sec.gov/investor/alerts/reits.pdf (last accessed May 7, 2014).
5. For a comparison of the characteristics of publicly traded listed REITs, public unlisted REITs and private REITs, see the chart provided on REIT.com at http://www.reit.com/portals/0/PDF/REITTypes-Chart.pdf (last accessed May 7, 2014).

BK-SBM-15TFInvest-140469-Part 14.indd 396 10/9/2014 9:38:43 PM

7907. What is a taxable REIT subsidiary (TRS)?

A taxable REIT subsidiary (TRS) is a corporation in which the REIT owns interests, whether directly or indirectly, if both the REIT and the corporation agree to elect that the corporation will be treated as a TRS.[1] A corporation will automatically become a TRS if another TRS owns either (a) securities representing 35 percent or more of the voting power of the corporation or (b) securities representing 35 percent or more of the total value of the corporation.[2]

Corporations that own or manage lodging or health care facilities cannot qualify as a TRS.[3] Other than this limitation, a TRS is permitted to provide many of the services that a REIT might otherwise be restricted from providing because of the asset and income tests required to maintain REIT qualification.

For example, a REIT that owned residential apartment buildings was permitted to use a TRS in order to provide housekeeping services to its tenants without risking disqualification. The services provided by the TRS did not cause the rental income received by the REIT to fail to qualify as income derived from real property even though the REIT itself would have been unable to provide the housekeeping services in question.[4]

7908. What is a qualified REIT subsidiary?

A qualified REIT subsidiary is a corporation in which the REIT owns 100 percent of the interests—e.g., it is a wholly owned subsidiary of a REIT. A qualified REIT subsidiary is not treated as an entity separate from the parent-REIT, so that all of the income and assets of the subsidiary are considered along with the REIT's for purposes of the REIT income and asset tests.[5]

A subsidiary that has elected to be treated as a taxable REIT subsidiary (see Q 7907) cannot qualify as a qualified REIT subsidiary.[6]

If a qualified REIT subsidiary ceases to be 100 percent wholly-owned by the parent-REIT, its status as a qualified REIT subsidiary is terminated and it is treated as a new corporation that acquired all of its assets from the parent-REIT in exchange for its stock.[7]

7909. Does the Foreign Investment in Real Property Tax Act (FIRPTA) impose any special rules upon foreign individuals who invest in U.S. REITs?

Yes. In general, the Foreign Investment in Real Property Tax Act (FIRPTA) imposes a 10 percent tax upon gains or losses stemming from the disposition of a foreign investor's

1. IRC Sec. 856(l)(1).
2. IRC Sec. 856(l)(2).
3. IRC Sec. 856(l)(3).
4. Rev. Rul. 2002-38, 2002-26 IRB 4.
5. IRC Sec. 856(i)(1).
6. IRC Sec. 856(i)(2).
7. IRC Sec. 856(i)(3).

BK-SBM-15TFInvest-140469-Part 14.indd 397 10/9/2014 9:38:43 PM

holdings in any United States real property interest.[1] However, special rules apply in the case of REIT distributions of "United States real property interests" involving foreign individuals or corporations. If such a REIT distribution to a nonresident alien or foreign corporation is treated as a gain from the sale or exchange of U.S. real property, the REIT must deduct and withhold a 35 percent tax on the amount distributed.[2]

The amount subject to this 35 percent tax is the foreign individual's proportionate share of the amount of any distribution that is designated by the REIT to be a capital gain distribution.[3]

See Q[5] for a discussion of the exceptions to the general treatment of foreign investments in REITs that can allow foreign individuals and corporations to avoid the 35 percent FIRPTA tax.

7910. Are there any exceptions to the 35 percent tax that is imposed upon certain REIT distributions to foreign individuals under FIRPTA?

Yes. While the Foreign Investment in Real Property Tax Act (FIRPTA) imposes a 35 percent tax upon certain REIT distributions to foreign individuals and corporations (see Q[4]), this withholding requirement applies only to gains and losses resulting from a sale or exchange of a United States real property interest. Several exclusions apply to this general rule.

First, a foreign investor may avoid the 35 percent FIRPTA tax if he or she invests in certain publicly-traded REITs. If the shares of the REIT are regularly traded in a U.S. securities market, a distribution to a foreign individual will not be treated as gain recognized from the sale or exchange of a United States real property interest if the foreign individual (or foreign corporation) does not own more than 5 percent of the REIT shares at any time during the one-year period ending on the date of the distribution.[4]

Further, if the REIT qualifies as a domestically controlled qualified investment entity, distributions to foreign individuals or corporations will not be subject to the 35 percent tax because the IRC defines the term "United States real property interest" to exclude interests in a domestically controlled qualified investment entity.[5] A domestically controlled qualified investment entity includes a REIT (whether publicly or non-publicly held) in which foreign individuals and corporations own less than 50 percent of the value at all times during the shortest of the following periods:

(1) The period beginning June 19, 1980 and ending on the date of the distribution;

1. IRC Sec. 1445(a).
2. IRC Sec. 1445(e)(6).
3. Treas. Reg. §1.1445-8(c)(2)(ii).
4. IRC Sec. 897(h)(1).
5. IRC Sec. 897(h)(2).

BK-SBM-15TFInvest-140469-Part 14.indd 398 10/9/2014 9:38:43 PM

(2) The 5-year period ending on the date of the distribution; or

(3) The period that the REIT has been in existence.[1]

These rules effectively allow a foreign individual or corporation to avoid the 35 percent tax imposed upon REIT distributions under FIRPTA if the foreign ownership is limited to 5 percent of a publicly-traded REIT or less than 50 percent of any other REIT.

1. IRC Sec. 897(h)(4).

BK-SBM-15TFInvest-140469-Part 14.indd 399 10/9/2014 9:38:43 PM