

# I.R.S. RULES SUBPART F & P.F.I.C. INCOME INCLUSIONS ARE R.E.I.T. QUALIFYING INCOME

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## Tags

95% Gross Income Test  
C.F.C. Inclusion  
P.F.I.C. Inclusion  
R.E.I.T.

A real estate investment trust (“R.E.I.T.”) is a tax-favorable investment entity used for investment in real estate and real estate mortgages. R.E.I.T.’s that invest in non-U.S. real estate often make such investments through foreign corporate entities that may be classified as controlled foreign corporations (“C.F.C.’s”)<sup>1</sup> or passive foreign investment companies (“P.F.I.C.’s”).<sup>2</sup> Qualification as a R.E.I.T. requires that the entity meet certain income and asset tests designed to ensure that a R.E.I.T.’s gross income is largely composed of passive income related to real estate or real estate mortgage investments. In a recent private letter ruling (“P.L.R.”),<sup>3</sup> the I.R.S. ruled that certain income from a R.E.I.T.’s ownership of C.F.C.’s and P.F.I.C.’s was income that qualified as passive investment income, which is required under the 95% gross income test of Internal Revenue Code (“Code”) §856(c)(2).

## R.E.I.T. TAXATION

A R.E.I.T. is a corporate entity, with some of the features of a “pass-thru” entity, used to pool capital to invest in a professionally managed portfolio of real estate assets. Unlike a typical corporation, a R.E.I.T. generally is not subject to entity-level taxation if it distributes its earnings and profits as dividends to its shareholders, since a R.E.I.T. can claim a deduction for dividends paid to its shareholders.<sup>4</sup> As a result, a R.E.I.T. generally may avoid the double taxation that applies to corporations.

## R.E.I.T. INCOME AND ASSET TESTS

In addition to several requirements regarding a R.E.I.T.’s form, management, and ownership,<sup>5</sup> a R.E.I.T. must meet a two-part income test and an asset test,<sup>6</sup> as follows:

<sup>1</sup> A C.F.C. is a foreign corporation in which more than 50% of the total combined voting power of all classes of stock entitled to vote, or the total value of the stock, is owned by U.S. shareholders on any day during the corporation’s tax year. A U.S. shareholder is a U.S. person (e.g., a domestic corporation, including a domestic R.E.I.T.) who owns 10% or more of the total voting power of the foreign corporation (Code §§951, 957).

<sup>2</sup> A foreign corporation is a P.F.I.C. if either (i) 75% or more of its gross income for the tax year is passive income, or (ii) the average percentage of its assets during the tax year which produce or are held for the production of passive income is at least 50%. “Passive income” includes interest, dividends, royalties, and rents (Code §1297).

<sup>3</sup> P.L.R. 201649013, 12/02/2016.

<sup>4</sup> Code §857(b)(2)(B).

<sup>5</sup> Code §856(a).

<sup>6</sup> Code §856(c).

- 75% of its gross income must be derived from specified passive real property-related income sources, such as rents from real property and gain from the sale of real property.
- 95% of its gross income must be from such sources, plus certain additional passive investment income items (discussed below).<sup>7</sup>
- 75% of its assets must be comprised of real property assets, and investments in cash, cash items, and government securities.<sup>8</sup>

Code §856(c)(2) specifies passive investment income that meets the 95% gross income test, as follows:

- Dividends
- Interest
- Rents from real property
- Gain from the sale or other disposition of stock, securities, and real property (including interests in real property and interests in mortgages on real property)
- Abatements and refunds of taxes on real property
- Income and gain derived from foreclosure property
- Amounts (but not amounts the determination of which depends on the income or profits of any person) received or accrued as consideration for entering into agreements to make mortgage-secured loans on real property or interests in real property, or to purchase or lease real property
- Gain from the sale or other disposition of a real estate asset which is not a prohibited transaction<sup>9</sup>
- Qualified temporary investment income

For the purposes of the 95% gross income test, “rents from real property” are defined in Code §856(d) and generally include rents from interests in real property, charges for services usually provided in connection with the rental of real property, and, under certain circumstances, rent attributable to personal property leased in connection with a lease of real property.<sup>10</sup>

The I.R.S. is authorized to determine whether any item of income or gain not specified in the Code may otherwise constitute qualifying income for purposes of the 95% and 75% gross income tests.<sup>11</sup>

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<sup>7</sup> Code §856(c)(2).

<sup>8</sup> Code §856(c)(4).

<sup>9</sup> A prohibited transaction means the sale or disposition of property held primarily for sale to customers in the ordinary course of a trade or business (Code §857(b)(6)).

<sup>10</sup> Code §856(d)(1).

<sup>11</sup> Code §856(c)(5)(J).

## SUBPART F AND P.F.I.C. INCOME INCLUSIONS ARE QUALIFYING INCOME FOR THE PURPOSE OF THE 95% GROSS INCOME TEST

In the P.L.R, the I.R.S. stated that, for purpose of the 95% gross income test, income inclusions attributable to a R.E.I.T.'s ownership in foreign subsidiaries that are C.F.C.'s or P.F.I.C.'s constituted qualifying income.

The taxpayer, a domestic R.E.I.T. organized for the purpose of making investments in commercial timberland businesses, operated in foreign countries through one or more foreign corporate subsidiaries (each, a "Foreign Sub"). Each Foreign Sub was treated as a taxable R.E.I.T. subsidiary ("T.R.S.") for U.S. Federal income tax purposes and was either a C.F.C. or a P.F.I.C.

For each Foreign Sub that was a C.F.C., the taxpayer was required to include in gross income its *pro rata* share of the C.F.C.'s "Subpart F income,"<sup>12</sup> which consisted of interest; dividends; gains from the sale or other disposition of stock, securities, or real property that was not property held as inventory; and items that also would constitute rents from real property, under Code §856(d), if received by a R.E.I.T. This income was the taxpayer's "Subpart F inclusions."

The taxpayer made an election to treat some of the Foreign Subs that were P.F.I.C.'s as qualified electing funds ("Q.E.F.'s"). As a shareholder in P.F.I.C.'s with Q.E.F. elections, the taxpayer was required to include in gross income its *pro rata* share of the ordinary earnings and net capital gain of each Q.E.F.<sup>13</sup> The taxpayer's income inclusions with respect to the Q.E.F.'s were attributable to: (i) interest; (ii) dividends; (iii) gains from the sale or other disposition of stock, securities, or real property that is not property held as inventory; and (iv) items that also would constitute rents from real property, under Code §856(d), if received by a R.E.I.T. This income was the taxpayer's "Q.E.F. inclusions."

As a shareholder in P.F.I.C.'s for which the taxpayer had not made a Q.E.F. election (or a mark-to-market election), the taxpayer was required to include certain amounts in gross income. The taxpayer represented that the gross income attributable to these "non-Q.E.F." P.F.I.C.'s, mostly consisted of the same type of income that was attributable to Q.E.F.'s. This income was the taxpayer's "non-Q.E.F. inclusions."

Subpart F inclusions<sup>14</sup> and P.F.I.C. income inclusions, attributable to Q.E.F.'s<sup>15</sup> or non-Q.E.F.s,<sup>16</sup> are included in a taxpayer's gross income for the tax year, whether or not the income is actually distributed to the taxpayer. These income inclusion rules serve the purpose of preventing a taxpayer from deferring U.S. Federal income tax on foreign passive investment income.



<sup>12</sup> Subpart F income includes foreign base company income, which includes foreign personal holding company income ("F.P.H.C.I."). F.P.H.C.I. generally includes passive investment income such as dividends, interest, rents, royalties, and net gains from the sale of certain specified property (Code §§952, 954).

<sup>13</sup> Code §1293.

<sup>14</sup> Code §951.

<sup>15</sup> Code §1293.

<sup>16</sup> Code §1291.

In addition to the issue of deemed income from the C.F.C.'s and P.F.I.C.'s, the taxpayer raised a concern regarding the foreign currency gains that likely would arise upon the actual distribution of income from the Foreign Subs. Such distributions would be previously taxed earnings and profits ("P.T.I."). The C.F.C.<sup>17</sup> and P.F.I.C.<sup>18</sup> rules provide that when a taxpayer includes in income Subpart F inclusions or Q.E.F. inclusions, the subsequent distribution to the shareholder of the P.T.I. attributable to the inclusion is not treated as a dividend and, therefore, is not subject to taxation for a second time. However, foreign currency gain (or loss) with respect to P.T.I. must be recognized as ordinary income (or loss) from the same source as the associated income inclusion.<sup>19</sup>

### **Treating the Subpart F and P.F.I.C. Inclusions as Qualifying Income Is Consistent with the Purpose of the 95% Gross Income Test**

As noted above, in order for an entity to qualify as a R.E.I.T., at least 95% its gross income must be derived from specified sources set forth in Code §856(c)(2), including dividends, interest, rents from real property, and gain from the sale or other disposition of stock, securities, and real property (other than inventory-type property). The treatment of C.F.C. and P.F.I.C. income inclusions is not addressed in the Code or the Treasury Regulations. However, to the extent necessary to carry out the purpose of the Code's R.E.I.T. provisions, the I.R.S. is authorized to determine whether an item of income or gain that does not constitute gross income under Code §856(c)(2) may be considered gross income for the purposes of the 95% gross income test.<sup>20</sup>

The I.R.S. looked to the legislative history underlying the tax treatment of R.E.I.T.'s and determined that it indicates that a central concern behind the gross income restrictions is that a R.E.I.T.'s gross income should largely be composed of passive income.<sup>21</sup>

The I.R.S. determined that the taxpayer's Subpart F inclusions would be qualifying income since they consisted of (i) interest; (ii) dividends; (iii) gains from the sale or other disposition of stock, securities, or real property that is not property described not held as inventory property; and (iv) items that also would constitute rents from real property, under Code §856(d), if received by a R.E.I.T. The I.R.S. concluded that treating the Subpart F inclusions attributable to such income as qualifying income under Code §856(c)(2) would not interfere with or impede the policy objectives of the 95% gross income test.

The I.R.S. determined that the taxpayer's Q.E.F. inclusions and non-Q.E.F. inclusions would be qualifying income since they consisted of (i) interest; (ii) dividends; (iii) gains from the sale or other disposition of stock, securities, or real property that

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<sup>17</sup> Code §959(d).

<sup>18</sup> Code §1293(c).

<sup>19</sup> Code §986(c)(1).

<sup>20</sup> Code §856(c)(5)(J).

<sup>21</sup> *E.g.*, H.R. Rep. No. 2020, 86th Cong., 2d Sess. 4 (1960) at 6, 1960-2 C.B. 819, at 822-23 states, "[o]ne of the principal purposes of your committee in imposing restrictions on types of income of a qualifying [REIT] is to be sure the bulk of its income is from passive income sources and not from the active conduct of a trade or business."

is not property held for inventory, and (iv) items that also would constitute rents from real property, under Code §856(d), if received by a R.E.I.T. The I.R.S. concluded that treatment of the Q.E.F. inclusions and non-Q.E.F. inclusions as qualifying income under Code §856(c)(2) would not interfere with or impede the policy objectives of the 95% gross income test.

### **Foreign Currency Gains Will Not Be Taken into Account for the Purposes of the 95% Gross Income Test**

Code §986(c)(1) states that foreign currency gain (or loss) with respect to distributions of P.T.I. attributable to movements in exchange rates between the times of the deemed and actual distributions generally must be recognized and treated as ordinary income or loss from the same source as the associated income inclusion. Ordinary income is not income that would meet the 95% gross income test.

Code §856(n)(1)(A) states that “passive foreign exchange gain,” as defined in Code §856(n)(3), does not constitute gross income for purposes of Code §856(c)(2).

The I.R.S. determined that the Code §986(c) foreign currency gain attributable to the Subpart F inclusions and the Q.E.F. inclusions is substantially similar to passive foreign exchange gain, as defined in Code §856(n)(3). Therefore, the foreign currency gains would be excluded from gross income for purposes of the 95% income test.

## **CONCLUSION**

Subpart F, Q.E.F., and non-Q.E.F. inclusions are qualifying income for the purpose of the 95% gross income test. Accordingly, a R.E.I.T. will not jeopardize its R.E.I.T. status under the 95% gross income test by virtue of receiving deemed income from a C.F.C. or P.F.I.C. Further, foreign currency gains attributable to a distribution of P.T.I. from a C.F.C. or P.F.I.C. will not be counted for the purposes of the 95% gross income test.

*“A R.E.I.T. will not jeopardize its R.E.I.T. status under the 95% gross income test by virtue of receiving deemed income from a C.F.C. or P.F.I.C.”*