

Part III

Administrative, Procedural, and Miscellaneous

26 CFR 601.201: Rulings and determination letters.
(Also Part I, §§ 856; 1.856-3, 1.856-5, and 301.7701-3)

Rev. Proc. 2003-65

SECTION 1. PURPOSE

This revenue procedure sets forth a safe harbor under which a loan from a real estate investment trust (REIT) secured by an interest in a partnership or by the sole membership interest in a disregarded entity will be treated as a real estate asset for purposes of §§ 856(c)(4)(A) and 856(c)(5)(B) of the Internal Revenue Code and the interest on the loan will be treated as interest on an obligation secured by a mortgage on real property or on an interest in real property for purposes of § 856(c)(3)(B).

SECTION 2. BACKGROUND

.01 Many REITs invest in real estate by making loans that are secured by real property. In certain cases because of financing arrangements and restrictive loan covenants, REITs make loans to the owners of entities that hold real property instead of making loans that are secured directly by real property. These loans are secured by a pledge of the borrowers' ownership interests in the property-owning entities.

.02 Section 856(a) provides that an entity shall not be considered a REIT for any taxable year unless certain requirements are satisfied. One requirement is a test contained in § 856(c)(4)(A) that provides that at the close of each quarter of its taxable year, at least 75 percent of the value of a REIT's total assets must be represented by real estate assets, cash and cash items (including receivables), and government securities.

.03 Section 856(c)(5)(B) provides that the term "real estate assets" means real property (including interests in real property and interests in mortgages on real property) and shares (or transferable certificates of beneficial interest) in other REITs that meet the requirements of §§ 856 through 859. Section 1.856-3(d) of the Income Tax Regulations provides that the term "real property" means land or improvements thereon, such as buildings and that the term "real property" includes interests in real property. Section 1.856-3(d) further provides that local law definitions will not be controlling for purposes of determining the meaning of the term "real property" as used in § 856 and the regulations thereunder.

.04 Section 856(c)(3)(B) provides that at least 75 percent of a REIT's gross income must be derived from certain items, including interest on obligations secured by mortgages on real property or on interests in real property.

.05 Section 1.856-5(c)(1) provides that if a mortgage covers both real property and other property, an apportionment of the interest income must be made for purposes of the 75-percent requirement of § 856(c)(3). Section 1.856-5(c)(1)(i) provides that if the loan value of the real property is equal to or exceeds the amount of the loan, the entire interest income shall be apportioned to the real property. Section 1.856-5(c)(2) provides that the loan value of the real property is the fair market value of the property, determined on the date the commitment by the trust to make the loan becomes binding on the trust.

.06 Under § 301.7701-3(b)(1)(ii) of the Procedure and Administration Regulations, certain entities (including limited liability companies) with a single member that do not elect to be treated as corporations will be disregarded as entities separate from their owners for federal tax purposes.

.07 Section 1.856-3(g) provides that in the case of a REIT that is a partner in a partnership, the REIT will be deemed to own its proportionate share of each of the assets of the partnership and will be deemed to be entitled to the income of the partnership attributable to such share. For purposes of § 856, the interest of a partner in the partnership's assets will be determined in accordance with the partner's capital interest in the partnership. The character of the various assets in the hands of the partnership and items of gross income of the partnership retain the same character in the hands of the partners for all purposes of § 856. Thus, for example, if the REIT owns a 30-percent capital interest in a partnership that owns a shopping mall, the REIT will be treated as owning 30 percent of such property and as earning 30 percent of the rent derived from the property by the partnership.

.08 In Rev. Rul. 77-459, 1977-2 C.B. 239, a REIT makes a construction loan to a partnership, and as security for the loan the partnership assigns its interest in an Illinois land trust to the REIT. The partnership is the sole beneficiary of the land trust, and the sole asset of the land trust is real property. Although the beneficial interest in an Illinois land trust is personal property under Illinois law, so long as the real property remains the sole asset of the land trust, the beneficial interest has no value apart from the underlying real property. Accordingly, Rev. Rul. 77-459 concludes that the loan is a real estate asset for purposes of § 856(c) and that interest on the loan is interest on an obligation secured by a mortgage on real property or on an interest in real property for purposes of § 856(c)(3).

SECTION 3. SCOPE

This revenue procedure applies to a loan made by an entity that makes an election to be taxed as a REIT under § 856(c) if the loan meets the requirements of this section.

.01 The borrower is either a partner in a partnership or the sole member of an eligible entity that has not elected to be treated as a corporation for federal tax purposes and is therefore disregarded as an entity separate from its owner under §§ 7701 and 301.7701-3(b)(1).

.02 The loan is nonrecourse, secured only by the partner's interest in the partnership, or the member's interest in the disregarded entity; thus, in the event of default, the sole recourse is against the pledged ownership interest.

.03 The lender is granted a first priority security interest in the pledged ownership interest. This security interest will place the lender's claim as lender ahead of the claims of other creditors of the partner or LLC member. The pledged ownership interest cannot be further encumbered unless the security interest created is subordinate to the lender's security interest.

.04 Upon default and foreclosure on the secured loan, the lender will replace the borrower as a partner in the partnership or as the sole member of the disregarded entity. In the case of a loan secured by a partnership interest, the other partners in the partnership must have agreed that upon default and foreclosure they will not unreasonably oppose the admission of the lender as a partner.

.05 On the date the commitment by the lender to make the loan becomes binding on the lender, the partnership or disregarded entity holds real property within the meaning of § 1.856-3(d). If all or part of this real property is subsequently sold or otherwise transferred, the loan will become due and payable upon the sale or transfer of the real property.

.06 On each testing date, the value of the real property (within the meaning of § 1.856-3(d)) held by the partnership or disregarded entity is at least 85 percent of the value of all of the assets of the partnership or disregarded entity. For this purpose a testing date means the close of the first quarter of the lender's taxable year following the date on which the commitment by the lender to make the loan becomes binding on the lender, and the close of each subsequent quarter in which the partnership or disregarded entity acquires any assets other than real estate assets, cash and cash items (including receivables), or government securities (within the meaning of

§ 856(c)(4)(A)), or reasonable quantities of equipment and materials customarily used for the maintenance and repair of real property. For this purpose, asset acquisitions by a partnership or disregarded entity include additional partnership or member contributions.

.07 The loan value of the real property owned by the partnership or disregarded entity equals or exceeds the amount of the loan as determined under § 1.856-5(c)(2). For this purpose, the loan value is reduced by any liens encumbering the real property, as well as by any other liabilities of the partnership or disregarded entity on the date the commitment by the lender to make the loan becomes binding on the lender. If the real property is owned by a partnership, only the proportionate share of the loan value (determined using the principles of § 1.856-3(g)) attributable to the interest that secures the lender's loan is taken into account.

.08 Interest on the loan meets the requirements of §§ 1.856-5(a) and (b); thus, the interest includes only an amount that constitutes compensation for the use or forbearance of money, and, subject to the exception contained in § 1.856-5(d), the determination of the amount does not depend in whole or in part on the income or profits of any person.

SECTION 4. PROCEDURE

A loan made by a REIT that satisfies the requirements of Section 3 of this revenue procedure will be treated as a real estate asset for purposes of §§ 856(c)(4)(A) and 856(c)(5)(B), and the interest on the loan will be treated as interest on an obligation secured by a mortgage on real property or on an interest in real property for purposes of

§ 856(c)(3)(B).

SECTION 5. EFFECTIVE DATE

This revenue procedure is effective August 11, 2003.

DRAFTING INFORMATION

The principal author of this revenue procedure is Eric E. Boody of the Office of Associate Chief Counsel (Financial Institutions and Products). For further information regarding this revenue procedure, contact Mr. Boody on (202) 622-3960 (not a toll-free call).