

Internal Revenue Service Issues Private Ruling That Entity With Zero Gross Income or Assets Can Qualify as a Real Estate Investment Trust

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In this article, the authors discuss a private letter ruling issued recently by the Internal Revenue Service concluding that a real estate investment trust having no income or assets during the year of its formation did not fail the gross income or asset tests for that year.

In Priv. Ltr. Rul.202440007, the taxpayer (Taxpayer REIT) elected to be treated as a real estate investment trust (REIT) for its initial tax year. The Taxpayer REIT was formed as a vehicle to invest indirectly through various partnerships in multifamily properties.

The parent company of the Taxpayer REIT raised the capital needed for the Taxpayer REIT to make its acquisition but was unable to contribute that capital to the Taxpayer REIT during its first year of existence for lack of investor and regulatory approvals. Consequently, the Taxpayer REIT had no income or assets during its first year and was unable to make its planned acquisition until after the conclusion of its first year of existence.

OVERVIEW OF REIT INCOME AND ASSET TESTS

At the close of each quarter of its taxable year, a REIT must satisfy a number of tests

relating to the nature of its assets and gross income. Among other restrictions, at least 75 percent of the value of total assets must be represented by interests in real property, interests in mortgages on real property, shares in other REITs, cash, cash items, government securities and qualified temporary investments. A certain percentage of a REIT's gross income must also be qualifying income.

A lingering question among practitioners has been whether a REIT with no income and no assets can technically satisfy the income and asset tests. The consequences of failing to meet either test are severe. In addition to suffering penalties, a REIT that fails to properly navigate the REIT rules may have its REIT election terminated and is restricted from making a subsequent REIT election for a five-year period. Though relief for noncompliance may be available in limited circumstances, REIT

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compliance is a delicate and ever-present concern.

THE RULING

The IRS ruled that having \$0 in assets and \$0 of income technically satisfied the gross income and asset tests applicable to REITs.

With respect to the gross income test, the IRS observed that Congress and the U.S. Department of the Treasury were concerned with the source of REIT income, not “whether the REIT has gross income in the first instance.” The IRS looked to Treas. Reg. § 1.856-2(c)(1), noting that it did not prevent qualification as a REIT on account of having \$0 of gross income.

Turning to the asset test next, the IRS similarly relied on legislative history in its claim that “Congress was concerned with the nature of a REIT’s assets and not whether the REIT had assets in the first instance.” The IRS reasoned that treating the asset test as met in the absence of any assets is consistent with this history.

Ultimately, the IRS concluded that the Taxpayer REIT’s election in its initial year was

unaffected by having no income or assets during such year. Given its potential for providing much-needed comfort to taxpayers involved in the formation and initial operations stages of REIT structures, the release of Priv. Ltr. Rul. 202440007 should be a welcome addition to existing REIT guidance.

IN SUMMARY

- The IRS recently issued a private letter ruling concluding that a REIT having no income or assets during the year of its formation did not fail the gross income or asset tests for that year.
- The taxpayer, a REIT, was unable to complete an acquisition of real property assets during its first tax year, which gave rise to concerns that it would not satisfy the REIT gross income and asset tests.
- The IRS used legislative history to support a technical application of Section 856(c) in concluding that the taxpayer satisfied the gross income and asset tests for its first year despite having no gross income or assets.