§ 1.857–3

Net income from foreclosure property.

(a) In general. For purposes of section 857(b)(40(B), net income from foreclosure property means the aggregate of—

(1) All gains and losses from sales or other dispositions of foreclosure property described in section 1221(1), and,

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

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

(b) Net capital gain in taxable years ending October 5, 1976. The rules relating to the taxation of capital gains in 26 CFR 1.857–2(b) (revised as of April 1, 1977) apply to taxable years ending before October 5, 1976.
(b) **Directly connected deductions.** A deduction which is otherwise allowed by chapter 1 of the Code is “directly connected” with the production of gross income from the foreclosure property if it has a proximate and primary relationship to the earning of the income. Thus, in the case of gross income from real property that is foreclosure property, “directly connected” deductions would include depreciation on the property, interest paid or accrued on the indebtedness of the trust (whether or not secured by the property) to the extent attributable to the carrying of the property, real estate taxes, and fees paid to an independent contractor hired to manage the property. On the other hand, general overhead and administrative expenses of the trust are not “directly connected” deductions. Thus, salaries of officers and other administrative employees of the trust are not “directly connected” deductions. The net operating loss deduction provided by section 172 is not allowed in computing net income from foreclosure property.

(c) **Net loss from foreclosure property.** The tax imposed by section 857(b)(4) applies only if there is net income from foreclosure property. If there is a net loss from foreclosure property (that is, if the aggregate computed under paragraph (a) of this section results in a negative amount) the loss is taken into account in computing real estate investment trust taxable income under section 857(b)(2).

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

1. Gross income which is taken into account in computing net income from foreclosure property and
2. Other income (such as income described in subparagraph (A), (B), (C), (D), or (G) of section 856(c)(3)).

The apportionment may be made on any reasonable basis.

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

1. **Deductible interest.** Interest is taken into account under this paragraph (e) only if it is otherwise deductible under chapter 1 of the Code.
2. **Interest specifically allocated to property.** Interest that is specifically allocated to an item of property is attributable only to the carrying of that property. Interest is specifically allocated to an item of property if (i) the indebtedness on which the interest is paid or accrued is secured by that property, (ii) such indebtedness was specifically incurred for the purpose of purchasing, constructing, maintaining, or improving that property, and (iii) the proceeds of the borrowing were applied for that purpose.
3. **Other interest.** Interest which is not specifically allocated to property is apportioned between foreclosure property and other property under the principles of §1.861-8(e)(2)(v).

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


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

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