ending after October 4, 1976, then for purposes of determining the partial tax described in section 857(b)(3)(A)(i), the amount of the deduction for dividends paid is computed pursuant to paragraph (a)(3)(ii) of this section, except that capital gains dividends are excluded from the dividends paid or considered as paid during the taxable year, and the net capital gain is excluded in computing real estate investment trust taxable income.

(4) Section 443(b) disregarded. The taxable income is computed without regard to section 443(b). Thus, the taxable income for a period of less than 12 months is not placed on an annual basis even though the short taxable year results from a change of accounting period.

(5) Net operating loss deduction. In the case of a taxable year ending before October 5, 1976, the net operating loss deduction provided in section 172 is not allowed.

(6) Net income from foreclosure property. An amount equal to the net income from foreclosure property (as defined in section 857(b)(4)(B) and paragraph (a) of §1.857–3), if any, is excluded.

(7) Tax imposed by section 857(b)(5). An amount equal to the tax (if any) imposed on the trust by section 857(b)(5) for the taxable year is excluded.

(8) Net income or loss from prohibited transactions. An amount equal to the amount of any net income derived from prohibited transactions (as defined in section 857(b)(6)(B)(i)) is excluded. On the other hand, an amount equal to the amount of any net loss derived from prohibited transactions (as defined in section 857(b)(6)(B)(ii)) is included. Because the amount of the net loss derived from prohibited transactions is taken into account in computing taxable income before the adjustments required by section 857(b)(2) and this section are made, the effect of including an amount equal to the amount of the loss is to disallow a deduction for the loss.

(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.
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(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.


[T.D. 7767, 46 FR 11277, Feb. 6, 1981]

§ 1.857–4 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).