

(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).

(Sec. 856(d)(4) (90 Stat. 1750; 26 U.S.C. 856(d)(4)); sec. 856(e)(5) (88 Stat. 2113; 26 U.S.C. 856(e)(5)); sec. 856(f)(2) (90 Stat. 1751; 26 U.S.C. 856(f)(2)); sec. 856(g)(2) (90 Stat. 1753; 26 U.S.C. 856(g)(2)); sec. 858(a) (74 Stat. 1008; 26 U.S.C. 858(a)); sec. 859(c) (90 Stat. 1743; 26 U.S.C. 859(c)); sec. 859(e) (90 Stat. 1744; 26 U.S.C. 859(e)); sec. 6001 (68A Stat. 731; 26 U.S.C. 6001); sec. 6011 (68A Stat. 732; 26 U.S.C. 6011); sec. 6071 (68A Stat. 749; 26 U.S.C. 6071); sec. 6091 (68A Stat. 752; 26 U.S.C. 6091); sec. 7805 (68A Stat. 917; 26 U.S.C. 7805), Internal Revenue Code of 1954))

[T.D. 7767, 46 FR 11278, Feb. 2, 1981]

§ 1.857-5 Net income and loss from prohibited transactions.

(a) *In general.* Section 857(b)(6) imposes, for each taxable year, a tax equal to 100 percent of the net income derived from prohibited transactions. A prohibited transaction is a sale or other disposition of property described in section 1221(1) that is not foreclosure property. The 100-percent tax is imposed to preclude a real estate investment trust from retaining any profit from ordinary retailing activities such as sales to customers of condominium units or subdivided lots in a development tract. In order to prevent a trust from receiving any tax benefit from such activities, a net loss from prohibited transactions effectively is disallowed in computing real estate investment trust taxable income. See § 1.857-2(a)(8). Such loss, however, does reduce the amount which a trust is required to distribute as dividends. For purposes of applying the provisions of the Code, other than those provisions of part II of subchapter M which relate to prohibited transactions, no inference is to be drawn from the fact that a type of transaction does not constitute a prohibited transaction.

(b) *Special rules.* In determining whether a particular transaction constitutes a prohibited transaction, the activities of a real estate investment trust with respect to foreclosure property and its sales of such property are disregarded. Also, if a real estate investment trust enters into a purchase and leaseback of real property with an option in the seller-lessee to repur-

chase the property at the end of the lease period, and the seller exercises the option pursuant to its terms, income from the sale generally will not be considered to be income from a prohibited transaction solely because the purchase and leaseback was entered into with an option in the seller to repurchase and because the option was exercised pursuant to its terms. Other facts and circumstances, however, may require a conclusion that the property is held primarily for sale to customers in the ordinary course of a trade or business. Gain from the sale or other disposition of property described in section 1221(1) (other than foreclosure property) that is included in gross income for a taxable year of a qualified real estate investment trust constitutes income from a prohibited transaction, even though the sale or other disposition from which the gain is derived occurred in a prior taxable year. For example, if a corporation that is a qualified real estate investment trust for the current taxable year elected to report the income from the sale of an item of section 1221(1) property (other than foreclosure property) on the installment method of reporting income, the gain from the sale that is taken into income by the real estate investment trust for the current taxable year is income from a prohibited transaction. This result follows even though the sale occurred in a prior taxable year for which the corporation did not qualify as a real estate investment trust. On the other hand, if the gain is taken into income in a taxable year for which the taxpayer is not a qualified real estate investment trust, the 100-percent tax does not apply.

(c) *Net income or loss from prohibited transactions.* Net income or net loss from prohibited transactions is determined by aggregating all gains from the sale or other disposition of property (other than foreclosure property) described in section 1221(1) with all losses from the sale or other disposition of such property. Thus, for example, if a real estate investment trust sells two items of property described in section 1221(1) (other than foreclosure property) and recognizes a gain of \$100 on the sale of one item and a loss of \$40 on the sale of the second item, the net

income from prohibited transactions will be \$60.

(Sec. 856(d)(4) (90 Stat. 1750; 26 U.S.C. 856(d)(4)); sec. 856(e)(5) (88 Stat. 2113; 26 U.S.C. 856(e)(5)); sec. 856(f)(2) (90 Stat. 1751; 26 U.S.C. 856(f)(2)); sec. 856(g)(2) (90 Stat. 1753; 26 U.S.C. 856(g)(2)); sec. 858(a) (74 Stat. 1008; 26 U.S.C. 858(a)); sec. 859(c) (90 Stat. 1743; 26 U.S.C. 859(c)); sec. 859(e) (90 Stat. 1744; 26 U.S.C. 859(e)); sec. 6001 (68A Stat. 731; 26 U.S.C. 6001); sec. 6011 (68A Stat. 732; 26 U.S.C. 6011); sec. 6071 (68A Stat. 749; 26 U.S.C. 6071); sec. 6091 (68A Stat. 752; 26 U.S.C. 6091); sec. 7805 (68A Stat. 917; 26 U.S.C. 7805), Internal Revenue Code of 1954))

[T.D. 7767, 46 FR 11278, Feb. 6, 1981]

§ 1.857-6 Method of taxation of shareholders of real estate investment trusts.

(a) *Ordinary income.* Except as otherwise provided in paragraph (b) of this section (relating to capital gains), a shareholder receiving dividends from a real estate investment trust shall include such dividends in gross income for the taxable year in which they are received. See section 858(b) and paragraph (c) of § 1.858-1 for treatment by shareholders of dividends paid by a real estate investment trust after the close of its taxable year in the case of an election under section 858(a).

(b) *Capital gains.* Under section 857(b)(3)(B), shareholders of a real estate investment trust who receive capital gain dividends (as defined in paragraph (e) of this section), in respect of the capital gains of a corporation, trust, or association for a taxable year for which it is taxable under part II of subchapter M as a real estate investment trust, shall treat such capital gain dividends as gains from the sale or exchange of capital assets held for more than 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977) and realized in the taxable year of the shareholder in which the dividend was received. In the case of dividends with respect to any taxable year of a real estate investment trust ending after December 31, 1969, and beginning before January 1, 1975, the portion of a shareholder's capital gain dividend which in his hands is gain to which section 1201(d) (1) or (2) applies is the portion so designated by the real estate invest-

ment trust pursuant to paragraph (e)(2) of this section.

(c) *Special treatment of loss on the sale or exchange of real estate investment trust stock held less than 31 days—(1) In general.* Under section 857(b)(7), if any person with respect to a share of real estate investment trust stock held for a period of less than 31 days, is required by section 857(b)(3)(B) to include in gross income as a gain from the sale or exchange of a capital asset held for more than 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977) the amount of a capital gains dividend, then such person shall, to the extent of such amount, treat any loss on the sale or exchange of such share as a loss from the sale or exchange of a capital asset held for more than 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977).

(2) *Determination of holding period.* The rules contained in section 246(c)(3) (relating to the determination of holding periods for purposes of the deduction for dividends received) shall be applied in determining whether, for purposes of section 857(b)(7)(B) and this paragraph, a share of real estate investment trust stock has been held for a period of less than 31 days. In applying those rules, however, "30 days" shall be substituted for the number of days specified in subparagraph (B) of such section.

(3) *Illustration.* The application of section 857(b)(7) and this paragraph may be illustrated by the following example:

Example. On December 15, 1961, A purchased a share of stock in the S Real Estate Investment Trust for \$20. The S trust declared a capital gains dividend of \$2 per share to shareholders of record on December 31, 1961. A, therefore, received a capital gain dividend of \$2 which, pursuant to section 857(b)(3)(B), he must treat as a gain from the sale or exchange of a capital asset held for more than six months. On January 5, 1962, A sold his share of stock in the S trust for \$17.50, which sale resulted in a loss of \$2.50. Under section 857(b)(4) and this paragraph, A must treat \$2 of such loss (an amount equal to the capital gain dividend received with respect to such share of stock) as a loss from the sale or exchange of a capital asset held for more than six months.