

# Client Alert

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## IRS Issues Guidance on Treatment of Money Market Funds Held by REITs

The Internal Revenue Service (“IRS”) issued Revenue Ruling 2012-17 (the “Revenue Ruling”), dated June 18, 2012, addressing the treatment of shares in money market funds for the purposes of the asset tests applicable to real estate investment trusts (“REITs”). The Revenue Ruling provides that a REIT’s investment in a money market fund will qualify as an investment in “cash or cash items” for the purposes of these tests. The Revenue Ruling resolves the uncertainty surrounding a REIT’s ability to invest excess cash in money market funds and maintain its REIT qualification.

### The Uncertainty Surrounding Money Market Funds

Money market funds have historically provided an attractive alternative to bank deposit accounts because they combine liquidity and competitive returns. Because of the treatment of money market funds under generally accepted accounting principles and established business practices, many financial managers view money market funds as a cash equivalent. However, for federal income tax purposes, investments in money market funds constitute shares of stock in a regulated investment company.

Section 856(c)(4) of the Internal Revenue Code (the “Code”) provides that a REIT must meet several asset tests at the close of each quarter of the taxable year:

- at least 75% of the value of the REIT’s total assets must be represented by real estate assets, cash and cash items (including receivables), and government securities (the “75% Asset Test”);
- not more than 25% of the value of the REIT’s total assets may be represented by securities (except those allowed under the 75% Asset Test) (the “25% Securities Test”); and
- with respect to assets which do not qualify under the 75% Asset Test:
  - not more than 5% of the REIT’s total assets may be represented by the securities of any one issuer (the “5% Securities Test”); and
  - the REIT may not hold securities representing more than 10% of the voting power or value of the outstanding securities of any one issuer (the “10% Vote or Value Test”).

The Code provides that all terms not defined in section 856(c)(5) shall have the same meaning as in the Investment Company Act of 1940 (the “1940 Act”). Neither section 856(c)(5) nor the 1940 Act defines the term “cash item.” Although a 2000 Securities and Exchange Commission (“SEC”) no-action letter (the “No-Action Letter”) concluded that money market fund shares may be treated as “cash items” for purposes of the 1940 Act, it was unclear whether this holding meant that money market funds were cash items under section 856 of the Code. Thus, there has been significant uncertainty surrounding the acceptable level of cash that a REIT could invest in money market funds and satisfy the asset tests described above.

## Money Market Fund Shares Qualify as “Cash Items” for REITs

The Revenue Ruling concludes that shares in money market funds qualify as “cash items” for purposes of the 75% Asset Test. This means that (1) shares in money market funds may be included along with real estate assets, cash and government securities as items that qualify under the 75% Asset Test and (2) such shares will no longer be potential sources of a violation of the 25% Securities Test, the 5% Securities Test or the 10% Vote or Value Test. In reaching its conclusion, the IRS relied on the No-Action Letter’s conclusion treating money market fund shares as “cash items.” The IRS found that the SEC’s interpretation was “not inconsistent” with the language of section 856(c)(4)(A), which sets forth the 75% Asset Test, or with the underlying legislative history. The Revenue Ruling provides greater flexibility for REITs with a need to invest excess cash prior to making long-term investments.

## Continuing Concerns with Investments in Money Market Funds

Although the Revenue Ruling provides REITs with helpful guidance for purposes of the asset tests, there are two continuing concerns associated with investments in money market funds.

First, in the Revenue Ruling, the IRS specifically noted that its conclusion was predicated on provisions of nontax law applicable to money market funds (i.e., the No-Action Letter). Consequently, if changes in the SEC’s ruling position with respect to money market funds, or other changes impacting the conclusion of the No-Action Letter were to occur, the conclusion of the Revenue Ruling may not continue to be valid.

Second, the Revenue Ruling may have altered the REIT gross income test treatment of new capital that is invested in money market funds. Section 856(c)(3)(I) of the Code provides that the income from certain investments of new capital may be treated as qualifying income for purposes of the REIT 75% gross income test (the “75% Gross Income Test”) under the rules for qualified temporary investment income (“QTI”). Section 865(c)(5)(D) defines QTI, in part, as income attributable to stock or debt instruments. Because the Revenue Ruling concludes that shares in money market funds constitute cash items for purposes of the asset tests, it appears that income from investments in money market funds will not be eligible for treatment as qualifying income under the 75% Gross Income Test as such shares cannot be considered both “cash items” and “stock.” Consequently, REITs investing new capital that require the income from such investments to qualify under the 75% Gross Income Test should work closely with their tax advisor before making such investments.

Click on the following link for a copy of the [Revenue Ruling](#).

## Hunton & Williams LLP REIT Tax Practice

Hunton & Williams LLP attorneys are available to provide more information about the Revenue Procedure. If you would like to receive more information, please contact **George C. Howell, III** at 804.788.8793 or ghowell@hunton.com, **Mark C. Van Deusen** at 804.788.8349 or mvandeusen@hunton.com, **Cameron N. Cosby** at 804.788.8604 or ccosby@hunton.com or **Christopher Mangin, Jr.** at 804.787.8188 or cmangin@hunton.com.

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