

SEC Regulations Committee
July 10, 2007 - Joint Meeting with SEC Staff
SEC Offices – Washington DC

Discussion Document C

Topic: Applying Rule 3-09 of Regulation S-X to an Equity Method Investee in the Real Estate Industry

Issue: Should the gain on partial sale of real estate property as described below be included in the numerator of the income test when evaluating the significance of the retained investment?

Background:

Under Rule 3-09 of Regulation S-X, the significance of a registrant's equity investee is determined by reference to the significance tests in Rule 1-02(w) of Regulation S-X. The income test of significance under Rule 1-02(w) of Regulation S-X requires the comparison of income from continuing operations before income taxes, extraordinary items, and cumulative effect of a change in accounting principle of the equity method investee with such income of the registrant.

The SEC staff previously expressed its view (SEC Regulations Committee Minutes of June 14, 2005, Discussion Document H) that in the year in which a consolidated subsidiary becomes an equity method investee, the numerator in the income test of significance should include the investee's pretax earnings for the period of the fiscal year in which it was accounted for by the equity method and any gain or loss arising from the transaction that caused the subsidiary to become an equity method investee.

A question has been raised as to whether the SEC staff's view of inclusion of any gain or loss arising from the transaction in the numerator of the income test applies to real estate transactions described below.

Real estate investment trusts (REITs) sometimes enter into transactions whereby a REIT contributes 100% owned (either outright ownership or through wholly-owned entities) operating real estate to a newly formed entity (Newco). Simultaneously, an investor contributes cash to Newco. The intent of the transaction is for the REIT to ultimately own an economic interest in Newco from, say 10% to 30% after the transaction. Thus, cash is distributed from the Newco to the REIT for the difference between the fair value of the real estate and the REITs retained economic interest.

By way of example, assume a REIT owns an operating real estate property with a cost basis of \$5,000 and a fair value of \$10,000. The REIT contributes the property to a newly formed LLC and an investor contributes \$9,000 of cash. The \$9,000 is distributed by the LLC to the REIT. As a result, the REIT and the investor own 10% and 90%, respectively, of the LLC.

Assuming the requirements of SFAS No. 66 are met, the transaction would be treated as a partial sale by the REIT with the gain on sale of \$4,500 (\$10,000 fair value less \$5,000 cost basis multiplied by 90% reduction in ownership of the property) recognized in the income statement. This gain and the operations of the real estate would not qualify for discontinued operations classification due to continuing involvement with the property under SFAS 144. The REIT would follow the guidance in EITF Topic No. D-46 and account for its 10% investment in the LLC using the equity method of accounting.

AICPA Statement of Position 78-9, "Accounting for Investments in Real Estate Ventures", and EITF Topic No. D-46 require investors to account for investments in limited partnerships (and in practice, limited liability corporations) using the equity method unless the investor's interest is "so

minor that the limited partner may have virtually no influence over partnership operating and financial policies” (generally considered to be 3% - 5%). As a result of the lower ownership level at which equity accounting applies to real estate companies, Rule 3-09 applies more frequently to investments in the real estate industry than in other industries where equity accounting is applied following the 20% ownership guidance in APB 18. As a result, situations frequently arise in the real estate industry where the ownership percentage and resulting equity in income of an investee is not significant under Rule 1-02(w), unless the gain on partial sale of the property is included in the income test. Many registrants and accounting practitioners in the real estate industry believe that the registrant's gain on partial sale of real estate property should be excluded from the income test because it is not indicative of the significance of the retained investment to the registrant.

Issue / Question: Should registrants in the real estate industry include any gain on partial sale of property in the numerator for computing significance of equity method investees under Rules 3-09 and 1-02(w) of Regulation S-X?

View A

No. Rule 3-15 of Regulation S-X, “special provisions as to real estate investment trusts”, requires REITs to include a separate income statement caption titled “gain or loss on sale of properties, net of applicable income tax”. This caption is to be presented on the income statement after discontinued operations and before extraordinary items and changes in accounting principle. As stated above, the income test required by Rule 1-02(w) is based on a comparison of income from continuing operations before income taxes, extraordinary items and cumulative effect of change in accounting principle of the investee and the registrant. Rule 3-15 specifically excludes the gain on sale of real estate from continuing operations for REITs. Therefore, the partial gain on sale of a property as discussed above should be excluded from the numerator and the denominator in performing the income test for entities that apply Rule 3-15.

In situations where the property is sold at a loss, application of SFAS 144, which was issued subsequent to Rule 3-15, generally results in an impairment charge prior to the sale of a real estate property. The asset impairment is recorded before the sale and, as a result, the loss on sale of real estate properties is generally nil.

View B

No. The views previously expressed by the Staff apply to situations where a formerly consolidated wholly-owned subsidiary or majority-owned subsidiary became an equity investee. In the type of transaction discussed above, REITs typically contribute an asset - a real estate property - not a subsidiary to the investee. The gain is therefore related to the partial sale of an asset, not a change in the level of ownership of a subsidiary. The previous interpretations of Rule 3-09 did not intend for the gain on the sale of an asset to be included in the numerator of the significance test.

View C

Yes. The SEC Staff's previous interpretation that any gain or loss related to changes in ownership of a subsidiary / investee should be included in the significance test also applies to the gain on partial sale of a real estate property as described above.

Committee Recommendation: The Committee supports View A. In reaching this conclusion, the Committee recognizes that the gain on the sale would be included in income from continuing operations for EPS purposes, but the Committee does not believe Rule 3-09 is driven by that guidance. The Committee believes the income test of significance should be based on the income statement classification rather than the EPS treatment.

SEC Staff Position: The staff supports View C. The staff also indicated that registrants with unusual situations may consult with the staff regarding the application of the test.

