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Person To Contact:
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Date:
May 11, 2017

Legend:

Taxpayer =

LLC =

Property =

City =

State =

State Agency =

Date 1 =

Year 1 =

Year 2 =

Year 3 =

Year 4 =

Amount 1 =

Amount 2 =

Amount 3 =

a =

b =

Dear :

This is in reply to a letter dated April 14, 2016, submitted on behalf of Taxpayer by its authorized representative. Taxpayer requests a ruling under section 856(c)(5)(J) with respect to the qualification under section 856(c)(3) of certain interest income received by Taxpayer.

FACTS

Taxpayer is a domestic limited liability company that elected to be treated as a corporation for Federal income tax purposes as of Date 1. Taxpayer elected on its Year 2 Federal Income tax return to be treated as a real estate investment trust ("REIT") under section 856(c) as of Date 1 ("First REIT Taxable Year"). Taxpayer is the sole owner of LLC, a domestic limited liability company that is disregarded as separate from Taxpayer for Federal income tax purposes.

LLC is the owner of Property located in City. On Property, LLC is constructing a large residential rental building (the "Building") with at least a percent of the units designated as affordable, or low income, housing. Taxpayer represents that, once completed, the Building will be real property within the meaning of section 856 and the rental income from units in the Building will be qualifying income under sections 856(c)(2) and (3). Taxpayer also represents that, based on the cost of constructing the Building and the market economics of real estate development in City, Taxpayer must utilize financing options offered by State Agency. To finance the construction of the Building, State Agency is offering bonds to the public from Year 1 through Year 4. State Agency will issue both tax-exempt bonds and taxable bonds. Each of the bonds issued by State Agency will have a term of b years.

LLC will receive the proceeds of the bonds issued by State Agency pursuant to a loan agreement between LLC and State Agency. State Agency's loan to LLC is secured by the land and improvements on Property. As part of State Agency's resolution authorizing the issuance of the bonds, State Agency can direct that a portion of the bond proceeds it receives from the public be held by a trustee in a special account (the "Account") and invested at State Agency's direction, until the funds are needed by LLC to finance construction of the Building. LLC must pay State Agency interest on all of the bond proceeds; however, the earnings on the bond proceeds held in the Account will be applied to reduce the debt service on the bonds.

State Agency has the sole ability to control how the money in the Account is invested, and treats the money in the Account as its own for purposes of State regulations that restrict the types of investments made by government agencies. For accounting purposes, LLC treats income from the Account as a reduction in interest expense on its loan from State Agency. Although neither LLC nor Taxpayer holds legal title to the Account and the EIN on file for the Account is not that of LLC or Taxpayer, LLC received a Form 1099 for Year 2 issued by State Agency for Amount 1 of interest earned from the Account. Of this amount, approximately Amount 2 represents interest earned after Date 1 and thus constitutes gross income to Taxpayer for its First REIT Taxable Year. LLC paid a total of Amount 3 to State Agency as interest on the bonds between Date 1 and the end of Year 2. Amount 3 is significantly more than Amount 2, the amount of interest earned on the Account after Date 1. Since Date 1, Taxpayer has also had a relatively minimal amount of qualifying income for purposes of the income test in section 856(c)(3) of the Code. Taxpayer does not expect to have a significant portion of the Building complete and producing rental income that qualifies under section 856(c)(3) prior to the end of Year 4.

Taxpayer requests a ruling that the income received by Taxpayer as interest earned from the Account in its First REIT Taxable Year, Year 3, and Year 4 constitutes qualifying income for purposes of the income test in section 856(c)(3) of the Code.

LAW AND ANALYSIS

Section 856(c)(2) provides that in order for a corporation to qualify as a REIT, at least 95 percent of the corporation's gross income (excluding gross income from prohibited transactions) must be derived from sources that include dividends; interest; rents from real property; gain from the sale or other disposition of stock, securities, and real property (other than section 1221(a)(1) property); abatements and refunds of taxes on real property; income and gain derived from foreclosure property; commitment fees; and gain from certain sales or other dispositions of real estate assets.

Section 856(c)(3) provides that in order for a corporation to qualify as a REIT, at least 75 percent of the corporation's gross income (excluding gross income from prohibited transactions) must be derived from rents from real property, interest on obligations secured by mortgages on real property or interests in real property, gain from the sale or other disposition of real property (other than section 1221(a)(1) property), dividends from REIT stock and gain from the sale of REIT stock, abatements and refunds of taxes on real property, income and gain derived from foreclosure property, commitment fees to make loans secured by mortgages on real property or to purchase or lease real property, gain from certain sales or other dispositions of real estate assets, and qualified temporary investment income.

Section 856(c)(5)(J) provides that to the extent necessary to carry out the purposes of Part II of Subchapter M of the Code, the Secretary is authorized to determine, solely for purposes of such part, whether any item of income or gain which (i) does not otherwise qualify under sections 856(c)(2) or (c)(3) may be considered as not constituting gross income for purposes of sections 856(c)(2) or (c)(3), or (ii) otherwise constitutes gross income not qualifying under sections 856(c)(2) or (c)(3) may be considered as gross income which qualifies under sections 856(c)(2) or (c)(3).

The legislative history underlying the tax treatment of REITs indicates that a central concern behind the gross income restrictions is that a REIT's gross income should largely be composed of passive income. For example, H.R. Rep. No. 2020, 86th Cong., 2d Sess. 4 (1960) at 6, 1960-2 C.B. 819, at 822-23 states, “[o]ne of the principal purposes of your committee in imposing restrictions on types of income of a qualifying real estate investment trust is to be sure the bulk of its income is from passive income sources and not from the active conduct of a trade or business.”

Although the interest earned from the Account, as gross income that is derived from interest, is qualifying income for purposes of section 856(c)(2), it is not qualifying income for purposes of section 856(c)(3). Pursuant to section 856(c)(5)(J), the Secretary has the authority to determine whether income that does not otherwise qualify under section 856(c)(2) or (c)(3) may be considered as either not constituting gross income under sections 856(c)(2) or (c)(3) or as qualifying gross income under those provisions.

Taxpayer represents that the Building being constructed on Property will be real property within the meaning of section 856 when completed. Additionally, Taxpayer represents that after completion of construction the rental income from the Building will be qualifying income for purposes of sections 856(c)(2) and (3). Furthermore, Taxpayer represents that the economics of the type of large-scale residential construction project being undertaken by Taxpayer in City generally requires the use of State Agency bond financing.

The terms of the financing transaction with State Agency require that the bond proceeds be placed in the Account, which is held by a trustee. The proceeds of the Account must be used by Taxpayer to construct the Building, and interest income earned on the Account must be used by Taxpayer to pay debt service on the bonds issued by State Agency. The interest income that Taxpayer receives from the Account is therefore inextricably linked to the development of the Building, which is real property that will generate qualifying rental income. Under these circumstances, treating the interest income from the Account as qualifying income in its First REIT Taxable Year, Year 3, and Year 4 does not interfere with or impede the objectives of Congress in enacting section 856(c)(3).

CONCLUSION

Based on the facts and representations submitted, we rule that, pursuant to section 856(c)(5)(J)(ii), interest income received by Taxpayer from the Account in its First REIT Taxable Year, Year 3, and Year 4 will be treated as qualifying income for purposes of section 856(c)(3).

Except as specifically ruled upon above, no opinion is expressed concerning any federal income tax consequences relating to the facts herein under any other provision of the Code. Specifically, we do not rule whether Taxpayer qualifies as a REIT under Part II of subchapter M of Chapter 1 of the Code.

This ruling is directed only to the taxpayer that requested it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

Sincerely,

Andrea M. Hoffenson
Andrea M. Hoffenson
Branch Chief, Branch 2
Office of the Associate Chief Counsel
(Financial Institutions and Products)