Internal Revenue Service

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Department of the Treasury
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Person To Contact:
, ID No.

Telephone Number:

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CC:FIP:B02
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Date:
April 04, 2019

Legend

Taxpayer =

Parent =

LP 1 =

LP 2 =

LLC 1 =

LLC 2 =

Bank =

State A =

State B =

Date 1 =

Date 2 =

Date 3 =

a =

b =

c =

d =

e =

Dear :

This letter responds to a letter dated October 22, 2018, requesting a ruling on behalf of Taxpayer. Taxpayer requests a ruling under section 856(c)(5)(J)(i) of the Internal Revenue Code (Code) that the patronage dividends described below do not constitute gross income to Taxpayer for purposes of sections 856(c)(2) and (3).

FACTS

Taxpayer is a State A limited liability company that has elected to be classified as an association taxable as a corporation. Taxpayer will elect to be taxed as a real estate investment trust (REIT) under sections 856 through 859 of the Code beginning with its first taxable year that ended on Date 3.

Parent is a publicly traded REIT whose primary business is the ownership and management of timberland properties. On Date 1, Parent, through various disregarded subsidiaries, formed LP 1 and Taxpayer. LP 1, a limited partnership classified as a partnership for federal tax purposes, owns all of the common interests in Taxpayer. Parent formed LP 1 and Taxpayer to acquire all of the interests in LP 2, a limited partnership that is an entity disregarded as separate from its owner for federal tax purposes. LP 2 owns e gross acres of timberlands located in State B. LP 2 also owns LLC 1, a limited liability company classified as a corporation for federal tax purposes, and LLC 2, a limited liability company that is an entity disregarded as separate from its owner for federal tax purposes. Following the acquisition of LP 2, described below, Taxpayer and LLC 1 made a taxable REIT subsidiary (TRS) election for LLC 1 under section 856(l)(1) effective Date 2.

On Date 2, a disregarded subsidiary of Taxpayer acquired all of the outstanding partnership interests in LP 2 in exchange for approximately $a in cash. The acquisition consisted of four steps. First, Parent, through various disregarded subsidiaries, contributed $b in cash to LP 1 in exchange for a common equity interest in LP 1. Second, unrelated parties contributed $c in cash to LP 1 in exchange for a preferred equity interest in LP 1. Third, LP 1 contributed these funds to Taxpayer. Fourth, Taxpayer received $d in cash from a seven-year term loan pursuant to a credit agreement (the Credit Agreement) that Taxpayer and certain of its subsidiaries entered into with Bank and a consortium of lenders. The Credit Agreement indicates that the

purpose of the loan was to enable the purchase of LP 2, and the loan is secured by the acquired timberlands. Taxpayer used its contributed and borrowed funds to complete the acquisition of LP 2.

Bank is a farm cooperative subject to taxation under subchapter T of chapter 1 of subtitle A of the Code (sections 1381 through 1388) and is subject to regulation by the Farm Credit Administration. Taxpayer is an equity holder in Bank, and is qualified to receive patronage dividends from Bank. Patronage dividends are generally paid either solely in cash or in both cash and equity. The Credit Agreement entitles Taxpayer to receive annual patronage dividends based on the amount of interest Taxpayer paid in the preceding year. Taxpayer represents that the patronage dividends it receives from Bank under the Credit Agreement will be patronage dividends within the meaning of the term provided in section 1388(a).

For federal income tax purposes, Taxpayer will include the patronage dividends in gross income in the year of receipt pursuant to section 1385. However, for financial reporting purposes, Taxpayer represents that it will reduce its interest expense for the prior year by the amount of patronage dividends it anticipates it will receive.

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 dividends, interest, rents from real property, and gain from the sale or other disposition of stock, securities, and real property (other than property described in section 1221(a)), 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 on interests in real property or to purchase or lease real property, gain from certain sales or other dispositions of real estate assets, and certain mineral royalty income.

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 on interests in real property, gain from the sale or other disposition of real property (other than property described in section 1221(a)), certain dividends or distributions on, and gains from the sale or disposition of, shares in other REITs, 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 on interests in 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 (3) may be considered as not constituting gross income for purposes of sections 856(c)(2) or (3), or (ii) otherwise constitutes gross income not qualifying under sections 856(c)(2) or (3) may be considered as gross income which qualifies under sections 856(c)(2) or (3).

Section 301(a) provides that in general, except as otherwise provided in this chapter (chapter 1 of subtitle A of the Code, which chapter includes sections 301, 316, 317, 856, and 1388), a distribution of property (as defined in section 317(a)) made by a corporation to a shareholder with respect to its stock shall be treated in the manner provided in section 301(c).

Section 301(c) provides, in part, that in the case of a distribution to which section 301(a) applies, that portion of the distribution which is a dividend (as defined in section 316) shall be included in gross income.

Section 316(a) provides that for purposes of this subtitle (subtitle A of the Code, which subtitle includes sections 856 and 1388), the term “dividend” means any distribution of property made by a corporation to its shareholders – (1) out of its earnings and profits accumulated after February 28, 1913, or (2) out of its earnings and profits of the taxable year (computed as of the close of the taxable year without diminution by reason of any distributions made during the taxable year), without regard to the amount of the earnings and profits at the time the distribution was made.

Section 316(a) provides in the flush language that, except as otherwise provided in this subtitle, every distribution is made out of earnings and profits to the extent thereof, and from the most recently accumulated earnings and profits. The flush language provides further that to the extent that any distribution is, under any provision of this subchapter (subchapter C of chapter 1 of subtitle A of the Code), treated as a distribution of property to which section 301 applies, such distribution shall be treated as a distribution of property for purposes of this subsection.

Section 1388(a) provides that, for purposes of subchapter T of the Code, the term “patronage dividend” means an amount paid to a patron by an organization to which part I of subchapter T applies – (1) on the basis of quantity or value of business done with or for such patron, (2) under an obligation of such organization to pay such amount, which obligation existed before the organization received the amount so paid, and (3) which is determined by reference to the net earnings of the organization from business done with or for its patrons. The flush language provides that the term patronage dividend does not include any amount paid to a patron to the extent that (A) such amount is out of earnings other than from business done with or for patrons, or (B) such amount is out of earnings from business done with or for other patrons to whom no

amounts are paid, or to whom smaller amounts are paid, with respect to substantially identical transactions. For purposes of section 1388(a)(3), the flush language provides that net earnings shall not be reduced by amounts paid during the year as dividends on capital stock or other proprietary capital interests of the organization to the extent that the articles of incorporation or bylaws of such organization or other contract with patrons provide that such dividends are in addition to amounts otherwise payable to patrons which are derived from business done with or for patrons during the taxable year.

Section 1385(a)(1) provides that, except as otherwise provided in section 1385(b), each person shall include in gross income the amount of any patronage dividend which is paid in money, a qualified written notice of allocation, or other property (except a nonqualified written notice of allocation), and which is received by him during the taxable year from an organization described in section 1381(a).

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.”

Patronage dividends paid by a subchapter T cooperative are a return of earnings to its cooperative patrons based on the amount of business that the patron transacts with the cooperative. The patronage dividends paid by a subchapter T financing cooperative effectively reduce the costs that its patrons incur to borrow funds from the cooperative. The amounts paid by Bank as patronage dividends represent earnings that the cooperative is able to refund to Taxpayer based on the average amounts that Taxpayer borrowed from Bank during the prior year. Thus, while Taxpayer must include the patronage dividends in its gross income under section 1385(a)(1), the patronage dividends Taxpayer receives effectively reduce Taxpayer's interest expense paid during the prior year. Under the facts of the instant case, exclusion of these patronage dividends from gross income for purposes of sections 856(c)(2) and (3) does not interfere with Congressional policy objectives in enacting the income tests under those provisions.

CONCLUSION

Accordingly, pursuant to section 856(c)(5)(J)(i), we conclude that the patronage dividends received from Bank under the Credit Agreement and included in Taxpayer's gross income under section 1385 are excluded from Taxpayer’s gross income for purposes of sections 856(c)(2) and (3).

Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter. In particular, we express no opinion regarding whether Taxpayer qualifies as a REIT under part II of subchapter M of chapter 1 of the Code. Additionally, we are not ruling on the tax treatment of the Credit Agreement and whether the agreement is a loan for federal income tax purposes.

The ruling contained in this letter is based upon information and representations submitted by Taxpayer and accompanied by a penalty of perjury statement executed by an appropriate party. While this office has not verified any of the material submitted in support of the request for a ruling, it is subject to verification on examination.

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

In accordance with the power of attorney on file with this office, copies of this letter are being sent to your authorized representatives.

Sincerely,

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