

Internal Revenue Service

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Department of the Treasury
Washington, DC 20224

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August 27, 2019

Legend:

- Taxpayer =

- Operating Partnership =
- Holding =
- Company A =
- Company B =
- State A =
- State B =
- State C =
- Project =
- Act =
- Authority =

- Area =

- Qualified Venture =

- u =
- v =
- w =

x =
y =
z =

Dear :

This is in response to your letter dated March 2, 2015, and subsequent correspondence, requesting a ruling that the Tax Credits (described below) will be treated as qualifying income for purposes of section 856(c)(2) and (c)(3) of the Internal Revenue Code ("Code") pursuant to section 856(c)(5)(J)(ii).

FACTS

Taxpayer, a State A corporation, is engaged in the business of owning and operating rental real estate. Taxpayer elected to be taxed as a real estate investment trust ("REIT") under sections 856 through 859. Taxpayer uses the calendar year and an accrual method as its overall method of accounting.

Taxpayer has over a y% general partnership interest in Operating Partnership, and Taxpayer is the sole general partner in Operating Partnership. Operating Partnership, a State B limited partnership, is engaged in the ownership, operation, leasing, acquisition and management of rental property.

Operating Partnership is the sole member of Company A. Company A is a State C limited liability company that is treated as a disregarded entity for U.S. tax purposes. Company A is a w% member of Holding. The remaining x% membership interests of Holding are held by Company B, an unrelated third-party. Holding is treated as a partnership for all tax purposes.

Holding was organized for the purpose of financing, developing, constructing, owning, operating, managing, leasing and maintaining Project, a Qualified Venture. Project is the first phase of a possible three-phase larger project at the same location.

Under State C law, Act authorizes the issuance of state tax credits when a developer makes a capital investment¹ in a Qualified Venture within an Area (the "Tax Credits"). The purpose of the program creating the Tax Credits is to encourage economic development of Areas through capital investment and the creation of employment opportunities. The Tax Credits issued for a Qualified Venture are based

¹ Act defines "capital investment" as expenses incurred for the development of real property including site preparation and construction, repair, renovation, improvement, equipping, or furnishing of a building, structure, facility or improvement to real property.

exclusively on the developer's capital investment in the Qualified Venture, but are limited to no more than $y\%$ of the capital investment. The Tax Credits are nonrefundable credits that may be used against specified State C taxes. The Tax Credits may be transferred (by sale or assignment) if the developer that receives the Tax Credits under Act applies for and receives a Tax Credit transfer certificate from Authority.

Holding submitted an application for a grant of Tax Credits relating to Project to Authority. Authority approved the issuance of Tax Credits in an amount up to a maximum of \$ z to be received over a period of u years. Taxpayer represents that it will include the income from the Tax Credits when required under section 451. Because Taxpayer has no State C tax liability, Holding has opted to sell its Tax Credits. Taxpayer further represents that the Tax Credits are sold or disposed of by the unextended due date of the federal tax return for the taxable year in which the Tax Credits are included in income in accordance with section 451.

Taxpayer further represents that the income from the Tax Credits will be used to offset the actual cost of developing Project and upon completion of Project, substantially all of Taxpayer's income from Project will be qualifying income for purposes of sections 856(c)(2) and (c)(3). Taxpayer further represents that upon completion, Project will be a qualified real estate asset under section 856(c)(5)(B).

LAW

Section 856(c)(2) provides that at least 95 percent of a REIT's gross income must be derived from dividends, interest, rents from real property, gain from the sale or other disposition of stock, securities, and real property (other than property in which the corporation is a dealer), abatement and refunds of taxes on real property, income and gain derived from foreclosure property, certain commitment fees, and gain from certain sales or other dispositions of real estate assets.

Section 856(c)(3) provides that at least 75 percent of a REIT's gross income must be derived from rents from real property, interest on obligations secured by real property, gain from the sale or other disposition of real property (other than property in which the corporation is a dealer), 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, certain commitment fees, gain from certain sales or other disposition 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 section 856(c)(2) or (c)(3) may be considered as not constituting gross income for purposes of section 856(c)(2) or (c)(3), or (ii) otherwise

constitutes gross income not qualifying under section 856(c)(2) or (c)(3) may be considered as gross income which qualifies under section 856(c)(2) or (c)(3).

Section 1.856-3(g) of the Income Tax Regulations provides that a REIT that is a partner in a partnership is deemed to own its proportionate share of each of the assets of the partnership and is deemed to be entitled to the income of the partnership attributable to such share. For purposes of section 856, the interest of a partner in the partnership's assets is determined in accordance with the partner's capital interest in the partnership. The character of the various assets in the hands of the partnership and items of gross income of the partnership shall retain the same character in the hands of the partners as in the hands of the partnership for all purposes of section 856.

Section 61(a) provides that, except as otherwise provided, gross income includes all income from whatever source derived.

Section 451(a) provides that the amount of any item of gross income shall be included in the gross income for the taxable year in which received by the taxpayer, unless, under the method of accounting used in computing taxable income, such amount is to be properly accounted for as of a different period.

Under an accrual method of accounting, unless section 451(b)(1)(A) requires earlier inclusion, an item of gross income is includible when all the events have occurred which fix the right to receive such income and the amount thereof can be determined with reasonable accuracy. See section 451(b) and section 1.451-1(a). All the events that fix the right to receive income generally occur upon the earliest of the following: (1) the required performance takes place, (2) payment is due, or (3) payment is made. See Schlude v. Commissioner, 372 U.S. 128 (1963); Rev. Rul. 2003-10, 2003-1 C.B. 288.

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 822-823 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."

ANALYSIS

Income attributable to the receipt of the Tax Credits constitutes gross income that is not listed as qualifying income under section 856(c)(2) or (c)(3). Taxpayer represents that Project will be a qualified real estate asset for purposes of section 856 and that substantially all of the income Taxpayer derives from Project will be qualifying income for purposes of sections 856(c)(2) and (c)(3). Furthermore, Taxpayer represents that it

will include the Tax Credits in income when required under section 451. The Act provides the Tax Credits as a government incentive to redevelop property that may not otherwise be a profitable venture for the REIT and, therefore, the Tax Credits are received in connection with the development of real property, an activity that is permissible for REITs. Treating income from the receipt of the Tax Credits as qualifying income does not interfere with or impede the objectives of Congress in enacting sections 856(c)(2) and (c)(3). Accordingly, pursuant to section 856(c)(5)(J)(ii), it is appropriate for the Secretary to determine that amounts included in income with respect to the Tax Credits in accordance with section 451 shall be treated as qualifying income for purposes of section 856(c)(2) and (c)(3).

CONCLUSION

Based on the facts and representations submitted by Taxpayer, we conclude that amounts included in income with respect to the Tax Credits in accordance with section 451 will be qualifying income for purposes of section 856(c)(2) and (c)(3) pursuant to section 856(c)(5)(J)(ii).

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. Specifically, no opinion is expressed whether taxpayer otherwise qualifies as a REIT under part II of subchapter M of Chapter 1 of the Code. Nor is any opinion expressed with respect to the tax consequences of any dispositions of the Tax Credits, including whether a sale of the Tax Credits constitutes a prohibited transaction as described in section 857(b)(6)(B)(iii).

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

In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to your authorized representatives.

Sincerely,

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