

Internal Revenue Service

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Date: September 24, 2012

Legend:

Taxpayer =

State =

Year 1 =

Dear _____ :

This is in response to your letter dated April 24, 2012, requesting rulings that, pursuant to section 856(c)(5)(J)(ii) of the Internal Revenue Code of 1986, as amended (the "Code"), (1) certain inclusions under sections 951(a)(1)(A), 1291(a), and 1293(a) of the Code will be considered gross income qualifying under section 856(c)(2), and (2) section 986(c) gains will not be taken into account for purposes of section 856(c)(2).

Facts:

Taxpayer, a self-administered and self-managed, publicly traded State corporation, has elected to be treated as a real estate investment trust ("REIT") for federal income tax purposes. Taxpayer owns, either directly or indirectly through disregarded entities or U.S. or foreign partnerships, stock of several foreign subsidiaries that are classified as associations pursuant to section 301.7701-3 of the Procedure and Administration Regulations, and for which elections have been made to be treated as taxable REIT subsidiaries ("TRS") pursuant to section 856(l)(1)(B). Such foreign subsidiaries are either controlled foreign corporations under section 957(a) ("CFCs") with respect to which Taxpayer is a United States shareholder under section 951(b) ("United States Shareholder"), or passive foreign investment companies under section

1297(a) (“PFICs”), with respect to some of which Taxpayer has made an election under section 1295(a) to treat as qualified electing funds (“QEFs”).

As a result of being a United States Shareholder with respect to CFCs, Taxpayer is required by section 951(a)(1)(A)(i) to include in its gross income its pro rata share of the subpart F income, as defined in section 952(a), of any such CFCs. For its Year 1 tax year and subsequent years, Taxpayer expects to report section 951(a)(1)(A) inclusions attributable to one or more CFC’s foreign personal holding company income (“FPHCI”), net of allocable expenses, which is passive rental income, interest, dividends and gain from the sale of property that gives rise to income such as dividends, interest and rental income (the “Subpart F Inclusions”).

Taxpayer represents that, to date, the income from the PFICs has been passive within the meaning of section 1297(b). Taxpayer expects that in the future a majority of the PFICs’ income will be passive income. As a result of being a shareholder in PFICs for which Taxpayer has made QEF elections, Taxpayer is required under section 1293(a) to include in its gross income its pro rata share of the ordinary earnings and net capital gain income of each such QEF. As a result of being a shareholder in PFICs for which Taxpayer has not made QEF elections, Taxpayer is required to include amounts in its gross income (as ordinary income) pursuant to section 1291(a)(1)(B). For its Year 1 tax and subsequent years, Taxpayer expects to report inclusions consisting of section 1293(a)(1) ordinary income inclusions attributable to passive income from numerous PFICs for which QEF elections have been made and section 1291(a) ordinary income inclusions attributable to passive income for PFICs for which QEF elections have not been made (the “PFIC Inclusions”).

Furthermore, under section 986(c)(1), Taxpayer is required to include in its gross income foreign currency gain or loss with respect to distributions of previously taxed earnings and profits (as described in section 959 or section 1293(c)) attributable to movements in exchange rates between the times of the deemed inclusions attributable to the Subpart F Inclusions and the PFIC Inclusions and the actual distributions of such amounts as ordinary income or loss from the same source as the associated income inclusion (“Section 986(c) Gains”). Any Section 986(c) Gains recognized by Taxpayer would be attributable to the Section 951 Inclusions and PFIC Inclusions as actual distributions of such income are made.

Law and Analysis:

Section 856(c)(2) requires that at least 95 percent of a REIT’s gross income (excluding gross income from prohibited transactions) be derived from dividends, interest, rents from real property, gain from the sale or other disposition of stock, securities, and real property (including interests in real property and interests in mortgages on real property) which is not property described in section 1221(a)(1), and certain other sources.

Section 856(c)(5)(J) provides, in relevant part, 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 otherwise constitutes gross income not qualifying under section 856(c)(2) or (3) may be considered as gross income which qualifies under section 856(c)(2) or (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."

Subpart F Inclusions

Section 957 defines a CFC as a foreign corporation in which more than 50 percent of the total combined voting power of all classes of stock entitled to vote, or the total value of the stock is owned by United States Shareholders on any day during the corporation's taxable year. A United States Shareholder is defined in section 951(a) as a United States person who owns 10 percent or more of the total voting power of the foreign corporation. Taxpayer represents that it is a United States shareholder within the meaning of section 951(b) with respect to certain subsidiaries that are CFCs.

Section 951(a)(1)(A)(i) generally provides that, if a foreign corporation is a CFC for an uninterrupted period of 30 days or more during a taxable year, every person who is a United States Shareholder of the corporation and who owns stock in the corporation on the last day of the taxable year in which the corporation is a CFC shall include in income the shareholder's pro rata share of the CFC's subpart F income for the taxable year.

Section 952 defines subpart F income to include foreign base company income, as determined under section 954. Under section 954(a)(1), foreign base company income includes FPHCI, as determined under section 954(c). Section 954(c)(1)(A) defines FPHCI income to include (among other things) dividends, interest, royalties, rents, and annuities. Section 954(c)(1)(B) also includes gain from the sale or exchange of property which (among other things) gives rise to income described in section 954(c)(1)(A) (after application of paragraph (2)(A)) other than property which gives rise to income not treated as FPHCI by reason of section 954(h) or (i) for the taxable year.

Taxpayer has represented that it is a United States Shareholder within the meaning of section 951(b) with respect to certain of its subsidiaries that are CFCs. As Taxpayer's CFCs earn subpart F income attributable to foreign base company income

that is FPHCI and such income is generally passive income, treatment of the section 951(a)(1)(A)(i) inclusion attributable to such passive income as qualifying income for purposes of section 856(b)(2) does not interfere with or impede the policy objectives of Congress in enacting the income test under section 856(c)(2). Accordingly, we rule that Subpart F Inclusions attributable to the FPHCI earned by Taxpayer's CFCs are qualifying income for purposes of section 856(c)(2), as provided in section 856(c)(5)(J)(ii).

PFIC Inclusions

Section 1297(a) of the Code defines a PFIC as a foreign corporation where either (1) 75 percent or more of the gross income of such corporation for the taxable year is passive income, or (2) the average percentage of assets (as determined in accordance with section 1297(e)) held by such corporation during the taxable year which produce passive income or which are held for the production of passive income is at least 50 percent. Section 1297(b) defines the term "passive income" as income of a kind that would be FPHCI under section 954(c), subject to certain exceptions.

Section 1291(a)(1) provides that if a United States person receives an excess distribution (as defined in section 1291(b)) in respect of stock in a PFIC, then – (A) the amount of the excess distribution shall be allocated ratably to each day in the shareholder's holding period for the stock, (B) with respect to such excess distribution, the shareholder's gross income for the current year shall include (as ordinary income) only the amounts allocated under section 1291(a)(1)(A) to – (i) the current year, or (ii) any period in the shareholder's holding period before the 1st day of the 1st taxable year of the company which begins after December 31, 1986, and for which it was a PFIC, and (C) the tax imposed by this chapter for the current year shall be increased by the deferred tax amount (determined under section 1291(c)).

Section 1295(a) provides that a PFIC will be treated as a QEF with respect to a shareholder if (1) an election by the shareholder under section 1295(b) applies to such PFIC for the taxable year; and (2) the PFIC complies with such requirements as the Secretary may prescribe for purposes of determining the ordinary earnings and net capital gains of such company. Section 1293(a) provides that every United States person who owns (or is treated under section 1298(a) as owning) stock of a QEF at any time during the taxable year of such fund shall include in gross income – (A) as ordinary income, such shareholder's pro rata share of the ordinary earnings of such fund for such year, and (B) as long-term capital gain, such shareholder's pro rata share of the net capital gain of such fund for such year.

Taxpayer has represented that it is a shareholder of certain subsidiaries that are PFICs and that it has made QEF elections with respect to certain of these PFICs. As Taxpayer's PFICs earn income that is FPHCI and such income is generally passive income, treatment of such PFIC Inclusions as qualifying income for purposes of section

856(c)(2) does not interfere with or impede the policy objectives of Congress in enacting the income test under section 856(c)(2). Accordingly, we rule Taxpayer's PFIC Inclusions are qualifying income for purposes of section 856(c)(2), as provided in section 856(c)(5)(J)(ii).

Section 986(c) Gains

Sections 959(a), 1291(b)(3)(F) and 1293(c) provide that, when a United States shareholder is taxed on undistributed corporate earnings under the subpart F or QEF inclusion rules, subsequent distributions of the previously taxed earnings are tax-free to the shareholder.

Section 986(c)(1) provides that foreign currency gain or loss with respect to distributions of previously taxed earnings and profits (as described in section 959 or section 1293(c)) attributable to movements in exchange rates between the times of the deemed inclusion and the actual distributions will be recognized and treated as ordinary income or loss from the same source as the associated income inclusion.

Section 856(n)(1)(A) provides that "passive foreign exchange gain" for any taxable year will not constitute gross income for purposes of section 856(c)(2).

Section 856(n)(3) defines passive foreign exchange gain as: (A) real estate foreign exchange gain (as defined in section 856(n)(2)); (B) foreign currency gains (as defined in section 988(b)(1) which is not described in subparagraph A and is attributable to (i) any item of income or gain described in section 856(c)(2), (ii) the acquisition or ownership of obligations (other than foreign currency gains attributable to any item described in clause (i), or (iii) becoming or being the obligor under obligations (other than foreign currency gain attributable to any item of income or gain described in clause (i)); and (C) any other foreign currency gains determined by the Secretary.

While Section 986(c) Gain is not a foreign currency gain defined in section 988(b)(1), such Section 986(c) Gain is attributable to the Subpart F Inclusions and PFIC Inclusions, items of income that are qualifying income for purposes of section 856(c)(2). This is substantially similar to passive foreign exchange gain described in section 856(n)(3)(B)(i). Therefore, pursuant to section 856(n)(3)(C), the Section 986(c) Gains are excluded from gross income for purposes of section 856(c)(2) because these currency gains are considered passive foreign exchange gain that is excluded from gross income for purposes of section 856(c)(2).

Conclusion:

Based on the facts as represented, we rule that, pursuant to section 856(c)(5)(J)(ii), Taxpayer's Subpart F Inclusions and PFIC Inclusions constitute

qualifying income under section 856(c)(2). In addition, pursuant to section 856(n)(3)(C), Taxpayer's Section 986(c) Gains are excluded from gross income for purposes of section 856(c)(2).

No opinion is expressed about the tax treatment of the proposed transaction under other provisions of the Code and Regulations or about the tax treatment of conditions existing at the time of, or effects resulting from, the proposed transactions that are not specifically covered by the above rulings. Additionally, we express no opinion as to whether any of Taxpayer's assets qualify as real estate assets under section 856(c)(5)(B) of the Code. In particular, no opinion is expressed concerning whether Taxpayer otherwise qualifies as a REIT under part II of subchapter M of Chapter 1 of the Code.

This ruling is directed only to the taxpayer who requested it, and is limited to the facts as represented by the taxpayer. Section 6110(k)(3) provides that this letter may not be used or cited as precedent. A copy of this letter ruling must be attached to any federal income tax return to which it is relevant.

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

Sincerely,

Diana Imholtz
Diana Imholtz
Branch Chief, Branch 1
Office of Associate Chief Counsel
(Financial Institutions & Products)