

Tax Credit 2 =

Return =

Dear :

This is in reply to a letter dated September 27, 2013, and supplemental submission dated March 21, 2014, requesting the following rulings:

- (1) Taxpayer's right to receive a state franchise tax refund attributable to certain refundable state tax credits is a receivable for purposes of the asset test in section 856(c)(4)(A) of the Internal Revenue Code (the "Code"); and
- (2) Taxpayer's accrual of the income attributable to the refundable state tax credits constitutes qualifying income for purposes of the income tests in sections 856(c)(2) and (c)(3) of the Code.

FACTS

Taxpayer was formed on Date 1 and elected to be treated as a real estate investment trust ("REIT") under section 856 of the Code for its taxable year ending on Date 2. Taxpayer owns 100 percent of the stock in Subsidiary which was formed on Date 3. Subsidiary is a qualified REIT subsidiary as defined in section 856(i). Subsidiary owns, indirectly through entities taxable as partnerships for federal income tax purposes, a mixed-use real estate development in State (the "Project"). The Project includes the demolition of an existing building and construction of new retail buildings.

The Project will be constructed on contaminated land located at Site pursuant to the Statute enacted in Year 1 to promote the cleanup and redevelopment of blighted and contaminated properties. The Agency determines eligibility of sites for the remedial program under the Statute. Eligible sites which successfully complete remedial activities are issued a Certificate of Completion ("CoC") by the Agency.

In Year 2, Taxpayer received a CoC from the Agency relating to Taxpayer's remediation of contamination at the Site. Beginning with Year 2, Taxpayer will be eligible to claim State Tax Credit 1 and Tax Credit 2 (collectively, the "Credits") pertaining to Taxpayer's remediation of the Site and the construction and operation of the Project. Under State tax law, the Credits will be deemed to be an overpayment of State franchise tax and refundable to the Taxpayer to the extent the amount of the Credits exceeds the Taxpayer's liability for State franchise tax for the year in which the

Credits are claimed. Taxpayer records unpaid claims for Credits as receivables for generally accepted accounting principles (“GAAP”) purposes.

The amount of Tax Credit 1 available to an approved redevelopment site is equal to the sum of a percentage of the following three types of expenditures: (1) the cost of site preparation; (2) the cost (or other basis for federal tax purposes) of qualified tangible property placed in service on the site; and (3) the cost of on-site groundwater remediation.

The amount of Tax Credit 2 available to an approved redevelopment site is equal to the product of the following three factors: (1) the benefit period factor; (2) the employment number factor; and (3) the eligible real property taxes imposed on the site. To qualify for Tax Credit 2, the taxes must become a lien on the real property in the period during which the real property is a qualified site.

On its Return for Year 2, Taxpayer claimed Credits and anticipates claiming additional Credits for up to ten years as permitted by the Statute. Taxpayer is concerned that: (i) the value of its claim for refunds generated by the Credits, if considered to be an “asset” for purposes of section 856(c)(4)(A), could exceed 25 percent of the value of its total assets, thereby causing Taxpayer to fail to qualify as a REIT; and (ii) to the extent the Credits or any refunds based on the Credits will be includible in Taxpayer’s gross income, such income could constitute income other than that described in sections 856(c)(2) and (c)(3).

LAW AND ANALYSIS

Asset Test

Section 856(c)(4)(A) provides that at the close of each quarter of its tax year, at least 75 percent of the value of a REIT’s total assets must be represented by real estate assets, cash and cash items (including receivables), and Government securities.

Section 1.856-2(d)(1)(iii) of the Income Tax Regulations defines the term “receivables” for purposes of section 856(c)(4)(A) to mean only those receivables which arise in the ordinary course of a REIT’s operation and does not include receivables purchased from another person.

Section 1.856-2(d)(3) provides that in determining the investment status of a REIT, the term “total assets” means the gross assets of the REIT determined in accordance with GAAP.

Under section 1.856-3(g), 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 to be entitled to the income of the partnership attributable to that 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 retain the same character in the hands of the partners for all purposes of section 856.

Taxpayer's right to receive a State franchise tax refund attributable to the Credits arises from the redevelopment of real property on contaminated land in connection with Taxpayer's leasing business. Taxpayer will own and lease the redeveloped Site for the purpose of generating qualifying rents from real property under sections 856(c)(2) and (c)(3). Taxpayer's right to receive the State franchise tax refund attributable to the Credits constitutes a receivable that arises in the ordinary course of Taxpayer's operations within the meaning of section 1.856-2(d)(1)(iii); and therefore, qualifies as a receivable for purposes of section 856(c)(4)(A).

Income Tests

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, and gain from the sale or other disposition of stock, securities, and real property (other than property in which the corporation is a dealer), 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 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, 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."

Income attributable to the receipt of Tax Credit 2 constitutes gross income that is tied to the payment of real property taxes by Taxpayer since the basis for Tax Credit 2 is the actual payment of real property taxes imposed on the Site. Therefore, the income attributable to Tax Credit 2 is a refund of real property taxes under sections 856(c)(2)(E) and (c)(3)(E), and qualifies for purposes of sections 856(c)(2) and (c)(3).

Income attributable to the receipt of Tax Credit 1 constitutes gross income that is not listed as qualifying income under sections 856(c)(2) or (c)(3) because, unlike Tax Credit 2, Tax Credit 1 is not tied to the payment of real property taxes, and otherwise does not qualify under either section 856(c)(2) or (c)(3). Pursuant to section 856(c)(5)(J), the Secretary has the authority to determine that income either be considered as not constituting gross income under sections 856(c)(2) or (c)(3) or as qualifying gross income under those provisions. Taxpayer represents that the rental income generated by the Project will qualify for purposes of sections 856(c)(2) and (c)(3). Tax Credit 1 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), we rule that the income attributable to the receipt of Tax Credit 1 is considered qualifying income for purposes of sections 856(c)(2) and (c)(3).

CONCLUSIONS

Based on the facts and representations submitted by Taxpayer, we rule that:

- (1) Taxpayer's right to receive the State franchise tax refund attributable to the Credits constitutes a receivable that arises in the ordinary course of Taxpayer's operations as owner and lessor of real property within the meaning of section 1.856-2(d)(1)(iii); and therefore, is a receivable for purposes of section 856(c)(4)(A);
- (2) The income attributable to the receipt of Tax Credit 2 represents a refund of real property taxes under sections 856(c)(2)(E) and (c)(3)(E); and therefore, is qualifying income for purposes of sections 856(c)(2) and (c)(3); and
- (3) Pursuant to section 856(c)(5)(J)(ii), the income attributable to the receipt of Tax Credit 1 is considered qualifying income for purposes of sections 856(c)(2) and (c)(3).

Except as specifically ruled upon above, no opinion is expressed concerning any federal income tax consequences related to the facts herein under any other provisions 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 requesting it. Taxpayer should attach a copy of this ruling to each tax return to which it applies. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

The rulings contained in this letter are based upon information and representations submitted by the Taxpayer under a penalties 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 rulings, it is subject to verification on examination.

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

Sincerely,

K. Scott Brown
Branch Chief, Branch 3
Office of Associate Chief Counsel
(Financial Institutions & Products)

cc: