

Agreement =
Percentage =
Return =

Dear :

This is in reply to a letter dated August 7, 2014 requesting the following rulings:

- (1) The right of the Parent REIT and each Subsidiary REIT to receive a state franchise tax refund attributable to Tax Credit is a receivable for purposes of the asset test in § 856(c)(4)(A) of the Internal Revenue Code (the “Code”); and
- (2) The accrual by the Parent REIT and each Subsidiary REIT of the income attributable to Tax Credit constitutes qualifying income for purposes of the income tests in §§ 856(c)(2) and (c)(3) of the Code.

FACTS

Parent REIT was formed on Date 1 and will elect to be treated as a real estate investment trust (“REIT”) under § 856 of the Code for its taxable year ending on Date 2. Parent REIT is wholly owned by Taxpayer. Parent REIT organized the Subsidiary REITs. Each Subsidiary REIT was formed on Date 3 and will elect to be treated as a REIT under § 856 of the Code for its taxable year ending on Date 2 or Date 4. Parent REIT and each Subsidiary REIT will use the accrual method and have a calendar tax year.

The Subsidiary REITs were organized to own, develop, and operate a real estate development project (the “Project”) in State. The Project will include the development and construction of three separate buildings that will be residential rental apartments, which will be developed in three phases. Parent REIT was organized to develop and operate the Project directly or indirectly through the Subsidiary REITs. While it is currently contemplated that each building of the Project will be developed by one of the Subsidiary REITs, it is possible that a portion of the Project will be developed by Parent REIT or another subsidiary of Parent REIT. As such, Parent REIT (or such subsidiary) may benefit from Tax Credit.

The Project will be constructed on land that is eligible for Tax Credit associated with Statute enacted in Year 1 to enhance private-sector cleanups of brownfields and

reduce development pressure on “greenfields.” For tax years beginning on or after Date 5, a State taxpayer participating in the program created by the Statute who has entered into an Agreement with Agency may be eligible for Tax Credit.

The amount of Tax Credit is equal to Percentage of: (1) costs incurred for site preparation, (2) cost of qualified tangible property that is used by the taxpayer for industrial, commercial, recreational, or environmental purposes (including the commercial development of residential housing), and (3) the cost of on-site groundwater remediation. A greater percentage is allowed for sites that are cleaned up to a level that requires no restrictions on use, sites located in designated environmental zones, and sites located in brownfield opportunity areas. Generally, any Tax Credits that do not reduce the tax liability of a taxpayer are refundable to the taxpayer without interest.

It is anticipated that the Project site will be subdivided into three separate tax lots for each of the three expected phases of construction. However, subdivision will require governmental approvals. Such approval process cannot begin until demolition of the old buildings standing on the Project site is completed. The tax lots attributable to each phase will be contributed to a separate Subsidiary REIT. The Subsidiary REIT to which the tax lot is attributable will then claim the Tax Credit for that lot.

Each Subsidiary REIT will make a REIT election; thus, the Subsidiary REITs are not expected to incur a material amount of state tax liabilities because of each Subsidiary REIT’s ability to claim a dividends paid deduction for State tax purposes. Since the Tax Credits are refundable to the extent that they exceed a taxpayer’s tax liability, the Subsidiary REITs are expected to seek a refund in an amount substantially equal to the Tax Credits to which they are entitled. These refund amounts will cause the Subsidiary REITs to realize a significant amount of taxable income for federal tax purposes. For the years in which the Subsidiary REITs receive refunds attributable to the refundable Tax Credit, it is expected that such refunds will exceed five percent of each Subsidiary REIT’s gross revenues. Taxpayer expects that substantially all of the other income of the Subsidiary REITs (including other income derived from the Project) will be qualifying income for purposes of § 856(c).

It is anticipated that under the Project, the Tax Credit claims will be considered assets that are receivables under generally accepted accounting principles (GAAP) and that the value of the refund claims, if considered to be assets for purposes of § 856(c)(4)(A), could exceed 25% of the value of a Subsidiary REIT’s total assets.

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 § 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.

The right of the Parent REIT and each Subsidiary REIT to receive a State franchise tax refund attributable to the Tax Credits arises from the redevelopment of real property in connection with the leasing business of the Parent REIT and the Subsidiary REITs. Parent REIT and the Subsidiary REITs will own and lease the Project for the purpose of generating qualifying rents from real property under §§ 856(c)(2) and (c)(3). The right of the Parent REIT and each Subsidiary REIT to receive the State franchise tax refund attributable to the Tax Credits constitutes a receivable that arises in the ordinary course of their operations within the meaning of § 1.856-2(d)(1)(iii); therefore, the right to receive the State franchise tax refund attributable to the Tax Credits qualifies as a receivable for purposes of § 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 §§ 856(c)(2) or (c)(3) may be considered as not constituting gross income for purposes of §§ 856(c)(2) or (c)(3), or (ii) otherwise constitutes gross income not qualifying under §§ 856(c)(2) or (c)(3) may be considered as gross income which qualifies under §§ 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 constitutes gross income that is not listed as derived from a qualifying income source under §§ 856(c)(2) or (c)(3). Pursuant to § 856(c)(5)(J), the Secretary has the authority to determine that income either be considered as not constituting gross income under §§ 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 §§ 856(c)(2) and (c)(3). Tax Credit does not interfere with or impede the objectives of Congress in enacting §§ 856(c)(2) and (c)(3). Accordingly, pursuant to § 856(c)(5)(J)(ii), we rule that the income attributable to the receipt of Tax Credit is considered qualifying income for purposes of §§ 856(c)(2) and (c)(3).

CONCLUSIONS

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

- (1) The right of the Parent REIT and each Subsidiary REIT to receive the State franchise tax refund attributable to the Tax Credits constitutes a receivable that arises in the ordinary course of their operations as owner and lessor of real property within the meaning of § 1.856-2(d)(1)(iii); therefore, the right to receive the State franchise tax refund attributable to the Tax Credits is a receivable for purposes of § 856(c)(4)(A);
- (2) Pursuant to § 856(c)(5)(J)(ii), the income attributable to the receipt of Tax Credit is considered qualifying income for purposes of §§ 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,

Robert Martin
Senior Technician Reviewer, Branch 1
Office of Associate Chief Counsel
(Financial Institutions & Products)