

Internal Revenue Service

Department of the Treasury
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Legend:

Taxpayer =

Partnership =

State A =

State B =

City =

Month A =

Year A =

A =

B =

C =

D =

E =

Dear _____ :

This letter is in reply to a letter dated February 25, 2015, in which Taxpayer requests certain rulings in connection with its status as a real estate investment trust ("REIT") under section 856 of the Internal Revenue Code. Specifically, Taxpayer has asked for the following rulings:

- (1) Taxpayer's right to receive its share of the Total Annual Payment (as defined below) 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) of the Income Tax Regulations, and therefore is a receivable for purposes of section 856(c)(4);
- (2) Taxpayer's income attributable to its share of the Annual Rebate Amount (as defined below) represents a refund of real property taxes under section 856(c)(2)(E) and (3)(E), and therefore is qualifying income under section 856(c)(2) and (3); and
- (3) Pursuant to section 856(c)(5)(J)(ii), Taxpayer's income attributable to the receipt of its share of the Annual Refund Amount (as defined below) is considered qualifying income for purposes of section 856(c)(2) and (3).

Facts:

Taxpayer is a State A limited liability company that has elected to be taxed as a REIT under sections 856 through 860. Taxpayer is in the business of owning and renting commercial real estate. Taxpayer owns A percent of the interests in Partnership, a State B limited liability company treated as a partnership for U.S. federal income tax purposes. Partnership owns, directly and through a disregarded entity, land upon which it is developing a new B square foot, mixed-use shopping center, that will include an anchor retailer, a fueling station, restaurants, a community center, and other retail and service businesses typically found in a mixed-use shopping center, along with associated common spaces, parking, and landscaping (the "Project"). The land on which the Project is being developed is a C net acre site located in City. Taxpayer represents that, upon completion, the Project will be real property within the meaning of section 856 that Taxpayer owns and leases to third party tenants, and personal property leased in connection with the real property, for the purpose of generating qualifying rents from real property under section 856(c)(2) and (3).

In Month A of Year A, Partnership entered into an agreement with City regarding the Project (the "Agreement"). City determined that the development of the Project on a long-vacant site in the community would be of public benefit and would contribute to the

general welfare of its citizens, eliminating a source of economic and physical blight and creating construction jobs and permanent operational jobs. In addition, City determined that the Project would increase City's tax base to better fund municipal facilities and services, and to provide other public benefits.

Given the anticipated benefits to City, Partnership and City sought to expedite the construction of the Project. In order to facilitate the Project's construction, City determined that it would provide up to D dollars to Partnership to partially offset the cost of the Project (the "Total Payment").

City's policy for reinvestment of site specific tax revenues provides that no more than E percent of the net new tax revenues collected by City as a result of a project may be reinvested for purposes of offsetting project costs. City considers net new tax revenues to be tax revenues, including property taxes and any sales or use taxes, actually paid to and received by City subsequent to the completion of a specific project that are directly attributable to the development and operation of such project and are in excess of certain specified revenues already received by City.

As a result, the Agreement provides that City will establish a special fund into which City will deposit from its general funds on a yearly basis, an amount equal to E percent of net new tax revenues generated by the development of the Project, and will remit to Partnership on a yearly basis, out of amounts so deposited into the special fund, annual payments, each comprising (i) a rebate of City's share of property taxes paid by Partnership (the "Annual Rebate Amount") and (ii) to the extent E percent of net new tax revenues is in excess of Annual Rebate Amount, an additional amount (the "Annual Refund Amount"). The total amount due to Partnership pursuant to the Agreement in a single year is referred to as the "Total Annual Payment." Partnership will be entitled to the Total Annual Payment each year until the earliest of (i) the twenty-fifth anniversary of the completion of the Project, (ii) the date on which Partnership has received the Total Payment, or (iii) the termination of the Agreement.

Partnership will record each year unpaid claims for the year's Total Annual Payment as a receivable for generally accepted accounting principles ("GAAP") purposes. Taxpayer represents that the rental income that the Project will generate will be qualifying income for purposes of section 856(c)(2) and (3). Taxpayer expects that substantially all of the income derived from the Project (other than amounts received under the Agreement) will be qualifying income for purposes of section 856(c)(2) and (3).

Law and Analysis:Asset Test

Section 856(c)(4)(A) provides that, in order for a corporation to qualify as a REIT for a taxable year, at the close of each quarter of a taxable year, at least 75 percent of the value of the corporation'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) of the Income Tax Regulations defines the term "receivables" for purposes of section 856(c)(4)(A) to mean only those receivables that arise in the ordinary course of a REIT's operation, excluding 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.

The right of Taxpayer to receive Taxpayer's share of the Total Annual Payment through its interest in Partnership arises from the development of real property on land in connection with the leasing business of Partnership and Taxpayer. To the extent that Taxpayer's right to receive Taxpayer's share of the Total Annual Payment is an asset under GAAP, such right is 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 for a taxable year, at least 95 percent of the corporation's gross income (excluding gross income from prohibited transactions) must be derived from certain enumerated sources, which include 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), abatements and refunds of taxes on real property, income and gain derived from foreclosure property, and certain commitment fees.

Section 856(c)(3) provides that, in order for a corporation to qualify as a REIT for a taxable year, at least 75 percent of the corporation's gross income (excluding gross income from prohibited transactions) must be derived from certain enumerated sources, which include 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), distributions on 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, 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 (i) that does not otherwise qualify under section 856(c)(2) or (3) may be considered as not constituting gross income for purposes of section 856(c)(2) or (3), or (ii) that otherwise constitutes gross income not qualifying under section 856(c)(2) or (3) may be considered as gross income that 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."

The Annual Rebate Amount is tied to the payment of real property taxes by Taxpayer because the basis for the Annual Rebate Amount is the actual payment of real property taxes previously paid by Partnership. Therefore, Taxpayer's gross income attributable to the receipt or accrual of Taxpayer's share of the Annual Rebate Amount is gross income derived from a refund of taxes on real property under section 856(c)(2)(E) and (3)(E).

Taxpayer's gross income attributable to the receipt or accrual of Taxpayer's share of the Annual Refund Amount is not tied to the payment of taxes on real property and is not derived from any other source enumerated in section 856(c)(2) or (3). Under section 856(c)(5)(J), the Secretary is authorized to determine that gross income attributable to Taxpayer's share of the Annual Refund Amount be considered as qualifying gross income under section 856(c)(2) and (3). On the basis of all of the facts and circumstances, including Taxpayer's representation that the rental income generated by the Project will be qualifying income under section 856(c)(2) and (3), treating Taxpayer's share of the Annual Refund Amount as qualifying income does not interfere with or impede the objectives of Congress in enacting section 856(c)(2) and (3).

Conclusion

We hereby rule as follows:

- (1) Taxpayer's right to receive Taxpayer's share of the Total Annual Payment, to the extent such right is an asset under GAAP, is 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) and is therefore a receivable for purposes of section 856(c)(4);
- (2) The Annual Rebate Amount represents a refund of real property taxes described in section 856(c)(2)(E) and (3)(E), and therefore Taxpayer's gross income from the receipt or accrual of Taxpayer's share of the Annual Rebate Amount is qualifying income under section 856(c)(2) and (3); and
- (3) Pursuant to section 856(c)(5)(J)(ii), Taxpayer's gross income from the receipt or accrual of Taxpayer's share of the Annual Refund Amount is considered qualifying income for purposes of section 856(c)(2) and (3).

This ruling's application is limited to the facts, representations, Code sections, and regulations cited herein. 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 that requested it. Section 6110(k)(3) provides that it may not be used or cited as precedent. In accordance with the provisions of a power of attorney on file, we are sending a copy of this ruling letter to your authorized representatives.

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

Sincerely,

Steven Harrison
Chief, Branch 1
Office of Associate Chief Counsel
(Financial Institutions & Products)