

Internal Revenue Service

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Department of the Treasury
Washington, DC 20224

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Person To Contact:
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Date:
October 30, 2018

Legend:

Taxpayer =

Operating Partnership =

LLC =

Partnership =

Property =

City =

Agency =

Participation Agreement =

Subsidy Agreement =

Date 1 =

Date 2 =

Date 3 =

Date 4 =

Date 5 =

Taxable Year =

State 1 =

State 2 =

State 3 =

State 4 =

A =

B =

C =

D =

E =

F =

G =

H =

I =

J =

Dear _____ :

This letter is in reply to a letter dated May 1, 2018, in which Taxpayer requests a ruling in connection with its status as a real estate investment trust (“REIT”) under section 856 of the Internal Revenue Code. Specifically, Taxpayer has requested a ruling that pursuant to the authority of section 856(c)(5)(J), a cash payment received in

exchange for restricting certain apartment units to below market rental rates will be considered as qualifying income for purposes of section 856(c)(2) and (c)(3).

Facts:

Taxpayer is a State 1 corporation that elected to be treated as a REIT beginning with its taxable year ended Date 1. Taxpayer's annual accounting period is the calendar year, and its method of accounting is the accrual method.

Taxpayer owns a A% general partner interest directly in Operating Partnership, a State 2 limited partnership, and a B% interest indirectly through a wholly-owned subsidiary. Operating Partnership, through the C% ownership of several disregarded entities, owns C% of LLC, a State 3 limited liability company which is also disregarded for federal income tax purposes. LLC owns a D% partnership interest in Partnership, a State 4 limited partnership, as general partner. Partnership owns Property, a collection of more than E apartment homes in an apartment complex in City.

The original redevelopment of Property was financed through a series of bonds issued by Agency on Date 2 and Date 3. In connection with the bond issuances, the Agency and Partnership entered into certain regulatory agreements and a Participation Agreement that required Partnership to make available F% of the apartment units, equivalent to G units, to occupants of low or moderate income until Date 4. Upon that date, Partnership was no longer required to provide below market rate housing or affordability protections, but if Property continued to be operated on a rental basis, Agency had the right to rent up to G units from Partnership at market rents, thereby causing the units to remain at below market rents by providing a subsidy to Partnership in the amount of the difference between the below market rent and the market rent for each unit.

To ensure the long-term availability of affordable housing in the area and to prevent the displacement of low and moderate income residents residing at Property upon the expiration of the Participation Agreement, City and Partnership entered into Subsidy Agreement, dated Date 4, providing that Partnership would maintain the current affordability levels of all G units with respect to the tenants currently residing in those units and also create permanent restrictions on H of those units so that they remain affordable to any future tenants earning up to I% of City's average median income. As part of the Subsidy Agreement, City made a payment of \$J ("Payment"), to Partnership. The Subsidy Agreement references the right of the City under the Participation Agreement to cause the units to remain at below market rental rates by providing a subsidy to Partnership in the amount of the difference between the below market rental rate and the market rate rent for each selected unit. The amount of the Payment was agreed upon through a process of negotiation between City and Partnership that involved projections by both parties of future market level rents and a process of discounting such future rental stream to net present value. A private appraisal firm

retained by City reported that the value of permanently preserving the H units for households earning up to I% of area median income is \$J.

To assure Partnership's compliance with the terms of the Subsidy Agreement, Partnership provided City with a promissory note for \$J. No principal payment or interest is due under the promissory note and there is no maturity date. The promissory note only becomes payable if there is default under the Subsidy Agreement that is not cured.

Partnership received Payment on Date 5. Taxpayer intends to include its share of Payment in gross income in Taxable Year.

Law and Analysis:

Section 61(a) provides that except as otherwise provided by law, gross income means all income from whatever source derived. Under Section 61, Congress intends to tax all gains or undeniable accessions to wealth, clearly realized, over which taxpayers have complete dominion. Commissioner v. Glenshaw Glass Co., 348 U.S. 426, 431 (1955).

Section 856(c)(2) provides that 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; 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 to make loans secured by mortgages on real property or to purchase or lease real property; and gain from certain sales or other dispositions of real estate assets.

Section 856(c)(3) provides that 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 mortgages on real property or on interests in 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(d)(1) provides that rents from real property includes (subject to exclusions provided in section 856(d)(2)): (A) rents from interests in real property; (B) charges for services customarily furnished or rendered in connection with the rental of

real property, whether or not such charges are separately stated; and (C) rent attributable to personal property leased under, or in connection with, a lease of real property, but only if the rent attributable to the personal property for the taxable year does not exceed 15 percent of the total rent for the taxable year attributable to both the real and personal property leased under, or in connection with, such lease.

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, (i) whether any item of income or gain that 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) whether any item of income or gain that otherwise constitutes gross income not qualifying under section 856(c)(2) or (c)(3) may be considered as gross income that qualifies under section 856(c)(2) or (c)(3).

Section 1.856-3(g) 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 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.

Section 1.856-4(a)(1) provides that the term "rents from real property" means, generally, the gross amounts received for the use of, or the right to use, real property of the real estate investment trust.

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."

Under the Subsidy Agreement, the Payment is being provided by City to Partnership in exchange for preserving the affordability of certain units. Based on the language of the Subsidy Agreement, the extensive appraisal report provided, and the representations of Taxpayer regarding the negotiations between City and Partnership, the amount of the Payment was calculated specifically with the intent to compensate Partnership for the difference between the below market rental rate and the market rental rate for specific units throughout the remaining life of Property. The cash Payment, however, is not specifically enumerated as qualifying income in section 856(c)(2) or (c)(3). Provided in a lump-sum, the Payment approximates the net present value of the rent foregone by keeping certain units at below market rental rates. The Payment can therefore be considered as being in the nature of, or substitute for, actual

rent. If received by Partnership in the form of monthly payments from tenants paying market rent, Taxpayer's share of the payments would be qualifying income to Taxpayer under section 856(c)(2) and (c)(3). Therefore, treating Taxpayer's share of the lump-sum Payment as qualifying income for purposes of section 856(c)(2) and (c)(3) does not interfere with or impede the objectives of Congress in enacting section 856(c)(2) and (c)(3).

Conclusions:

Based on the facts and representations set forth above, we rule pursuant to the authority of section 856(c)(5)(J)(ii) that Taxpayer's proportionate share of income from Payment in Taxable Year will be considered as qualifying income under section 856(c)(2) and (c)(3).

This ruling's application is limited to the facts, representations, Code sections, and regulations cited herein. 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. In particular, no opinion is expressed with regard to whether Taxpayer or any other entity otherwise qualifies as a REIT under subchapter M of the Code.

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
Chief, Branch 2
Office of Associate Chief Counsel
(Financial Institutions & Products)