**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: December 04, 2018

**Legend:**

| | |
|---|---|
| Taxpayer | = |
| Partnership | = |
| DE1 | = |
| DE2 | = |
| State A | = |
| State B | = |
| County | = |
| Site | = |
| Date 1 | = |
| Month A | = |
| Month B | = |

Year A =

Year B =

Structure =

Facility =

A =

B =

C =

Dear :

This letter is in reply to a letter dated May 31, 2018, in which Taxpayer requests a ruling that pursuant to Section 856(c)(5)(J)(ii) Taxpayer's income attributable to the receipt or accrual of the County Payment (as defined below) is considered qualifying income for purposes of Sections 856(c)(2) and (3).

**Facts:**

Taxpayer is a domestic corporation that elected to be taxed as a real estate investment trust (REIT) under Sections 856 through 860 on Date 1. Taxpayer owns A percent of the interests in Partnership, a State A limited partnership treated as a partnership for U.S. federal income tax purposes. The remainder of Partnership is owned by unrelated third parties. Partnership owns 100% of DE1. DE1 owns 100% of DE2. DE1 and DE2 are disregarded as entities separate from Partnership for federal income tax purposes. DE2 owns Site.

The County, as part of its economic development plan, wished to facilitate the construction of Facility and Structure. A building existed on Site. It was determined that the most expeditious means for developing this project was for DE2 to demolish the existing building and construct a multi-use office, retail, and residential development on Site (the "Property"). Taxpayer represents that, upon completion, the Property will qualify as real property as defined in Section 1.856-10 and that Taxpayer will lease the Property to third party tenants for the purpose of generating qualifying rents from real property under Section 856(c)(2) and (3).

The Property will also include Structure (which will be a part of the Property's foundation), which DE2 will design and build. DE2 has granted a permanent easement to County for Structure and an easement to facilitate connecting Structure to other assets that qualify as real property under Section 1.856-10 and as real estate assets under Section 856(c)(5)(B). DE2 will also construct the shell of Facility on Site and pay for the construction of at least one elevator and stairs (and an escalator if possible) for Facility. DE2 will own and maintain Facility's shell (which will also be part of Property's foundation). DE2 will not own or maintain the improvements within Facility or provide services to County with respect to the easements.

A financial analysis submitted by Taxpayer in connection with this ruling request indicates that the proposed project will result in increased economic activity and tax revenue for the County and State B. To encourage the redevelopment of Site to include Facility and Structure, County considered incentives to the owner of Site, including an increase in zoning capacity. The building on Site had several tenants with leases that had to be bought out in order to proceed with the development. A study conducted by a real estate consulting firm for County determined that, taking into account the cost of buying out existing tenants, increasing the zoning capacity would likely be insufficient to induce the owner of Site to demolish the current building and develop the Property. The study estimated the value of additional inducements that may be needed. In Month A of Year A, County council passed a resolution with inducements to encourage the redevelopment of Site.

In Month B of Year B, DE2 entered into an agreement with County (the "Agreement") to develop Site. Under the Agreement, DE2 will, among other things, (i) design and build Structure, develop Site to support Structure, provide permanent easements to County for Structure, and cooperate with County in the event that County decides to connect Structure to other infrastructure (for which DE2 will bear no expense); and (ii) enter into an agreement with State B to construct the shell of Facility, provide access to Facility, and provide all easements to State B that are necessary to accommodate Facility.

The Agreement provides for an incentive payment by County of costs in excess of B dollars incurred by Partnership to terminate leases of tenants of the existing building that was at Site (the "County Payment"). The amount of the County Payment will be limited to C dollars. The County Payment will be paid in part upon the completion of a construction milestone with the remainder to be paid upon the earlier of another construction milestone or a date specified in the Agreement. Both of these payments are conditioned on Taxpayer providing satisfactory evidence of the buyout costs, conveyance of all required easements, and evidence of required improvements to Site.

Taxpayer represents that the rental income that will be generated by the Property will be qualifying income for purposes of Sections 856(c)(2) and (3). Taxpayer further represents that substantially all of the income generated by the Property (other than income arising from the County Payment) will be qualifying income for purposes of Section 856(c)(2) and (3).

**Law and Analysis:**

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 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, 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 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 such 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 assets and items of gross income of the partnership retain their character in the hands of the partners for purposes of Section 856.

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 Sections 856(c)(2) or (3) may be considered as not constituting gross income for purposes of Sections 856(c)(2) or (3), or (ii) whether any item of income or gain that otherwise constitutes gross income not qualifying under Sections 856(c)(2) or (3) may be considered as gross income that qualifies under Sections 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.”

Income attributable to the receipt or accrual of the County Payment, to the extent not attributable to the easements conveyed by DE2 to County, is not derived from any source listed in Section 856(c)(2) or (3). Pursuant to Section 856(c)(5)(J), the Secretary has the authority to determine that such income be considered as qualifying gross income for purposes of those provisions. On the basis of all of the facts and circumstances, including Taxpayer's representations that the Property will generate rents from real property and that substantially all of the income generated by the Property will be qualifying income for purposes of Section 856(c)(2) and (3), treating Taxpayer's income attributable to its receipt or accrual of its share of the portion of the County Payment that is not attributable to the easements conveyed by DE2 to County 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 that, pursuant to Section 856(c)(5)(J), Taxpayer's income attributable to the receipt and accrual of its share of the County Payment, to the extent that it is not attributable to the easements conveyed by DE2 to County, is considered qualifying income for purposes of 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 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, whether substantially all income from the Property is qualifying income, or whether any of the County Payment is attributable to the easements conveyed by DE2.

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)