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, ID No.

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Refer Reply To:
CC:FIP:B01
PLR-105209-22

Date: November 7, 2023

Legend

Taxpayer	=
Predecessor	=
Operating Partnership	=
General Partner	=
Holdings	=
Property 1 Owner	=
Property 2 Owner	=
Lessee	=
BondCo	=
Developer	=
Hotels	=
Property 1	=
Property 2	=
State A	=
State B	=
State C	=
County	=
Municipality	=
Agency	=
Prior PLR	=
Law 1	=
Law 2	=
Year 1	=
Year 2	=

Year 3	=
Year 4	=
Year 5	=
Year 6	=
Year 7	=
Year 8	=
Year 9	=
Date 1	=
a	=
b	=
c	=
d	=
e	=
f	=
g	=
h	=
k	=
m	=
n	=

Dear :

This letter is in reply to a letter dated March 8, 2022, in which Taxpayer requests certain rulings in connection with its status as a real estate investment trust ("REIT"). Specifically, Taxpayer requests rulings under section 856(c) of the Internal Revenue Code (the "Code") in respect of income attributable to incentives received from local governments and agencies in the form of tax abatements and tax increment financing.

Facts:

Taxpayer is a publicly traded State A corporation that has elected to be a REIT under part II of subchapter M of chapter 1 of the Code ("Part II of Subchapter M"), beginning with Year 1. Taxpayer's predecessor was Predecessor, a publicly traded State A corporation that merged with and into Taxpayer in connection with a REIT conversion in Year 1. Taxpayer and Predecessor together are referred to herein as the "Company." Taxpayer is engaged in the acquisition, ownership, redevelopment, and leasing of Hotels.

Taxpayer is a limited partner of, and owns an a% partnership interest in, Operating Partnership, a State A limited partnership. General Partner, a State A wholly owned limited liability company that Taxpayer represents is a taxable REIT subsidiary ("TRS") of Taxpayer, owns the sole general partnership interest in Operating Partnership. Unrelated third parties own small minority limited partnership interests in Operating Partnership.

Operating Partnership owns Hotels through entities that, for tax purposes, are disregarded as separate from Operating Partnership. Specifically, Operating Partnership owns Holdings, a disregarded State A limited liability company. Holdings owns several disregarded entities each of which holds one or more Hotels, including Property 1 Owner, which owns Property 1, and Property 2 Owner, which owns Property 2 through a disregarded entity. Operating Partnership also owns all of the interests in Lessee, a State A limited liability company that taxpayer represents is a TRS of Taxpayer.

Property 1 and Property 2 are leased to separate disregarded entities of Lessee. Each of those disregarded entities of Lessee has a management contract with a company that, with respect to Property 1 and Property 2, Taxpayer represents is an eligible independent contractor under section 856(d)(9) from which contractor Taxpayer does not derive or receive any income. Pursuant to these management contracts, the contractor performs all day-to-day activities of managing and operating the Hotels, such as taking reservations, booking conferences, and cleaning rooms.

Taxpayer represents that the property comprising each of Property 1 and Property 2 is primarily real property within the meaning of section 1.856-10(b) and related personal property with a value that allows the rents for such property to qualify as rents from real property under section 856(d)(1)(C). Taxpayer further represents that substantially all income that Taxpayer derives from Property 1 and Property 2 (other than income from the Bonds and Reimbursement Amounts, each discussed below) is rental income that constitutes qualifying income for purposes of section 856(c)(2) and (3).

Bonds

To induce the Company's construction of Property 1, County agreed to finance a portion of the construction costs of Property 1. County obtained authorization under legislative acts of State B and County to sell certain special obligation bonds (the "Bonds") and to use the proceeds to reimburse Taxpayer for a portion of the construction costs. The Bonds, however, were not marketable before Property 1 was operational. Accordingly, County issued the Bonds to the Company.

The Prior PLR is a private letter ruling issued to the Company on its receipt of the Bonds. The Prior PLR concludes, based on the representations made by the Company, that: (1) the transfer of the Bonds to the Company was a nonshareholder contribution of capital under section 118(a), and (2) the Company's initial basis in each of the Bonds was zero under section 362(c)(1). Taxpayer represents that all facts represented in the Prior PLR remain true.

The Bonds include $b of Bonds issued in Year 2, bearing stated interest at c% annually ("Series A Bonds") and an additional $d of Bonds issued in Year 3, bearing stated interest at e% annually ("Series B Bonds"). Each Bond provides for one or more partial principal payments and for payment of the remaining stated principal amount at

maturity. All of the Bonds have maturities of approximately f years. The construction costs of Property 1 exceeded the original stated principal amount of the Bonds.

Stated interest and principal on the Bonds are payable solely from an account funded by incremental property taxes imposed on Property 1 (property taxes in excess of those imposed on the raw land underlying Property 1) and occupancy taxes paid by Property 1 guests (such account, the "Tax Increment Fund"). To the extent that a scheduled payment on the Bonds cannot be made because of insufficient cash in the Tax Increment Fund, the unpaid amount is deferred until the next payment date. Any interest that is so deferred does not compound.

The Company completed construction of Property 1 in Year 4. At the time it received the Bonds, the Company expected to receive all stated principal and interest due under the Bonds. Presently, the Bonds are held by BondCo, a State A limited liability company that is disregarded as separate from Operating Partnership. There are contractual limits on sale of the Bonds, and Taxpayer intends to hold the Bonds to maturity.

Taxpayer represents that: (1) the Bonds are securities within the meaning of section 856 and the Investment Company Act of 1940; (2) the Bonds are debt instruments as described in section 1.1275-1(d); (3) the Bonds are not market discount bonds because Operating Partnership's adjusted basis in each Bond is determined by reference to the adjusted basis of the Bond in the hands of the person who acquired the Bond at its original issue and such basis was not determined under section 1012; and (4) payments of stated interest on the Bonds constitute compensation for the use or forbearance of money.

Reimbursement Amounts

As an incentive to develop Property 2, Municipality and Agency entered into an agreement (the "Incentive Agreement") with Company on Date 1. Under the Incentive Agreement, Agency would make payments directly to the Company as reimbursement for eligible costs of construction of Property 2 ("Permitted Costs"), but solely from specified taxes ("Available Taxes," and such payments, "Reimbursement Amounts").

In Year 1, the Company sold the rights to develop Property 2, including the right to acquire the site of Property 2, to Developer (an unrelated party). The Company assigned the Incentive Agreement to Developer in connection with that sale. Delays arising from lawsuits and other challenges to the development plan led Developer, Municipality, and Agency to enter into a new agreement in Year 6 (the "Advance Agreement"), which reiterated the right of Developer (or its assigns) to the Reimbursement Amounts.

Operating Partnership has now reacquired all rights to the Reimbursement Amounts. In Year 7, Developer assigned Property 2 (the site of which Developer acquired in Year 1) and all rights under the Incentive Agreement and Advance

Agreement to a disregarded entity of Property 2 Owner. In Year 8, approximately two years before Property 2 opened to the public, Operating Partnership began acquiring ownership interests in Property 2 Owner, initially through an equity contribution to Property 2 Owner, causing Property 2 Owner to be treated as a partnership for tax purposes. In Year 9, Operating Partnership acquired from Developer the remaining g percent of the ownership interests in Property 2 Owner, which then became a disregarded entity for tax purposes. Taxpayer represents that, as a result of the deemed liquidation of Property 2 Owner, Operating Partnership is deemed to have purchased g% of the assets of Property 2 Owner and acquired the remainder of the assets of Property 2 Owner in a liquidating distribution from Property 2 Owner.

Taxpayer represents that it reports its allocable share of the gross income attributable to the Reimbursement Amounts for the taxable year in which such income is recognizable.

I. Permitted Costs

Reimbursement Amounts are limited to Permitted Costs that Taxpayer submits for certification to Agency and which Agency approves. Permitted Costs generally include expenditures related to the construction of Property 2 that are permitted under Law 1 and Law 2. For this purpose, the "Project" is defined as Property 2 "and all related amenities as may be expanded or enhanced from time to time."

The amount of Permitted Costs that have been certified to date is $h. More than k% of that amount was for hard construction costs, with the remainder including amounts for fixtures, furniture, equipment, insurance, interest, permits, and other various fees and costs related to the development of Property 2.

Most of the Permitted Costs that have been certified to date were incurred by the Property 2 Owner (through a disregarded entity) when Taxpayer owned (through Operating Partnership) approximately g% of the Property 2 Owner.

Neither the Incentive Agreement nor the Advance Agreement prohibits Taxpayer from submitting additional Permitted Costs for certification and reimbursement (to the extent of Available Taxes) in the future. Taxpayer expects to receive Reimbursement Amounts for all certified Permitted Costs. The Advance Agreement does not contemplate Taxpayer's sale of the Reimbursement Amounts (to anyone other than an affiliate of Taxpayer) without Agency's consent.

II. Available Taxes

For purposes of the Incentive Agreement and the Advance Agreement, Available Taxes include, for specified periods, (i) incremental real and personal property taxes imposed on Property 2 by Municipality and certain other local governments and agencies and certain other properties, (ii) all real and personal property taxes imposed by a new district created in connection with the development of Property 2, and (iii)

certain sales, use, and lodger's taxes collected by Municipality and State C. The foregoing taxes are included in Available Taxes for periods that range from m to n years.

Agency issues to Taxpayer a monthly accounting of the Reimbursement Amounts disbursed to Taxpayer and the type of Available Taxes to which Agency attributes such Reimbursement Amounts. This accounting identifies, among other things, the amount of monthly Reimbursement Amounts that Agency attributes to property taxes on real property owned by Operating Partnership.

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 specified sources, which include: dividends; interest; rents from real property; gain from the sale or other disposition of stock, securities, and real property not described in section 1221(a)(1); abatements and refunds of taxes on real property; income and gain derived from foreclosure property; certain 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 specified sources, which include: 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 not described in section 1221(a)(1); certain dividends or distributions on, and gains from the sale or disposition of, shares in other REITs; abatements and refunds of taxes on real property; income and gain derived from foreclosure property; certain commitment fees; gain from certain sales or other dispositions of real estate assets; and, qualified temporary investment income.

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.

Section 856(c)(5)(J) provides that to the extent necessary to carry out the purposes of Part II of Subchapter M, 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 (3) may be considered as not constituting gross income for purposes of section 856(c)(2) or (3), or (ii) whether any item of income or

gain 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).

Legislative history indicates that Congress intended Part II of Subchapter M to apply to certain "organizations specializing in investments in real estate and real estate mortgages." H.R. Rep. No. 2020, 86th Cong., 2d Sess. 4 (1960), 1960-2 C.B. 819, 820. Congress intended to restrict the beneficial tax treatment of Part II of Subchapter M to "what is clearly passive income from real estate investments, as contrasted to income from the active operation of businesses involving real estate." Id.

Requested Ruling 1: Taxpayer's allocable share of income on the Bonds that is treated as interest for federal income tax purposes is "interest" within the meaning of section 856(c)(2)(B).

Section 1.856-5(a) provides that the term "interest" as used in section 856(c)(2) and (3) includes only amounts which constitute compensation for the use or forbearance of money.

Section 1.856-5(a) provides that "interest" does not generally include any amount received or accrued, directly or indirectly, if, under the principles set forth in section 1.856-4(b)(3) and (6)(i), the determination of such amount depends in whole or in part on the income or profits of any person.

Section 1.856-4(b)(3) provides, in part, as follows:

> [A]ny amount accrued or received shall not be excluded from the term "rents from real property" solely by reason of being based on a fixed percentage or percentages of receipts or sales (whether or not receipts or sales are adjusted for returned merchandise, or Federal, State, or local sales taxes). * * * . An amount received or accrued as rent for the taxable year which consists, in whole or in part, of one or more percentages of the lessee's receipts or sales in excess of determinable dollar amounts may qualify as "rents from real property", but only if two conditions exist. First, the determinable amounts must not depend in whole or in part on the income or profits of the lessee. Second, the percentages and * * * determinable amounts, must be fixed at the time the lease is entered into and a change in percentages and determinable amounts is not renegotiated during the term of the lease (including any renewal periods of the lease) in a manner which has the effect of basing rent on income or profits. In any event, an amount will not qualify as "rents from real property" if, considering the lease and all the surrounding circumstances, the arrangement does not conform with normal business practice but is in reality used as a means of basing the rent on income or profits.

Section 301.7701-6(a) of the Procedure and Administrative regulations provides that the term person includes (among others) an individual, a corporation, a partnership,

a trust or estate, a joint-stock company, an association, or a syndicate, group, pool, joint venture, or other unincorporated organization or group.

The Bonds bear stated interest at fixed rates. Payments on the Bonds are payable except in the case of a deficit in the Tax Increment Fund—a fund that is not reducible by any expenditure other than Bond payments and that is funded by 100% of the specified taxes on real property in excess of a determinable amount and 100% of the revenues from specified occupancy taxes. Accordingly, even if County is a person for purposes of section 1.856-5(a), payments on the Bonds do not depend in whole or in part on the income or profits of County.

Therefore, the payments on the Bonds that are interest for federal income tax purposes will not be treated as other than interest for purposes of section 856(c) by application of the principles of section 1.856-4(b)(3) pursuant to section 1.856-5(a).

Requested Ruling 2: Taxpayer's allocable share of gain on the Bonds, including gain from the receipt of partial principal payments, will be treated as gain from "the sale or other disposition" of securities for purposes of section 856(c)(2)(D).

Section 1271(a)(1) provides that amounts received upon retirement of a debt instrument shall be considered as amounts received in exchange for the debt instrument.

Section 1.1275-1(d) provides that, except as provided in section 1275(a)(1)(B), "debt instrument" means any instrument or contractual arrangement that constitutes indebtedness under general principles of federal income tax law and that nothing in the regulations under sections 163(e), 483, and 1271 through 1275, however, shall influence whether an instrument constitutes indebtedness for federal income tax purposes.

Section 1.1273-1(d)(5) provides that any amount of de minimis OID includible in income under paragraph (d)(5), i.e., OID that is not treated as OID or qualified stated interest, is treated as gain recognized on retirement of the debt instrument.

In Timken v. Commissioner, 6 T.C. 483 (1946), and Avery v. Commissioner, 13 T.C. 351 (1949), the Tax Court considered whether partial payments on corporate notes were entitled to capital gain treatment under a predecessor of section 1271(a). Noting that the statute does not require a particular time period for retirement of the note, the court held in those cases that each partial payment on the note constituted a partial retirement of the note and hence was considered as amounts received in exchange therefore.

Rev. Rul. 60-284, 1960-2 C.B. 464, concerns interest-bearing bonds that a taxpayer purchased flat, meaning without any additional amount paid for accrued interest, which was in default. The taxpayer subsequently received payments of defaulted interest accrued on the bonds before the purchase. The ruling held that the

payments—which were not treated as interest under then prevailing law—constituted amounts received upon the retirement of bonds within the meaning of a predecessor to section 1271(a), and hence were considered as amounts received in exchange therefore, regardless of any expectancy that the principal or face amount of the bonds ultimately would be collected.

Rev. Rul. 64-162, 1964-1 (Pt.1) C.B. 304, provides that, where a shareholder-creditor of an S corporation previously has reduced her basis in the corporation's note by an amount by which her share of the corporation's net operating loss sustained in a prior year exceeded her basis in the corporation's stock, the repayment of the note (exclusive of interest) is considered to be an amount received in exchange for a capital asset, where the note is a capital asset in the shareholder's hands.

Rev. Rul. 56-299, 1956-1 C.B. 603, provides that retirement treatment under a predecessor of section 1271(a) "does not apply to the amount of interest (whether paid in the form of discount or not) which is received by reason of holding the bond."

The reference in section 856(c)(2)(D) to a "sale or other disposition" is broad enough to include an "exchange" as used in section 1271(a). See also Helvering v. Roth, 115 F.2d 239, 241 (2d Cir. 1940) (finding no intended difference between "sale or exchange" as used in section 111(c) of the Revenue Act of 1934 and "sale or other disposition" as used in section 111(a) of that Act).

Taxpayer represents that the Bonds are securities within the meaning of section 856 and the Investment Company Act of 1940, and debt instruments as described in section 1.1275-1(d). Taxpayer further represents that the Bonds are not market discount bonds because the holder's adjusted basis in each Bond is determined by reference to the adjusted basis of the Bond in the hands of the person who acquired the Bond at its original issue and such basis was not determined under section 1012. See section 1278(a)(1)(D). Accordingly, income from payments on the Bonds that is not interest (or required to be treated as interest) represents gain from the disposition of a security.

Requested Ruling 3: Taxpayer's allocable share of gain from the Bonds, including gain from the receipt of partial principal payments, not including any amounts properly treated as interest for tax purposes, will be treated as qualifying income for purposes of section 856(c)(3).

The Bonds were issued in connection with County's agreement to finance a portion of the construction costs of Property 1. Because the Bonds were ultimately issued to the Company and determined to have a zero basis, Taxpayer will have gain as it receives principal payments (or upon a sale if, contrary to Taxpayer's current intentions, Taxpayer sells the Bonds). Taxpayer's allocable share of such gain is not derived from any source enumerated in section 856(c)(3). Under section 856(c)(5)(J), the Secretary is authorized to determine that gross income attributable to Taxpayer's

share of gain from the Bonds be considered as qualifying gross income under section 856(c)(3).

Taxpayer's gain on the Bonds is not attributable to investment experience but is in substance deferred recognition of County's financial assistance. On the basis of these circumstances, and Taxpayer's representation that substantially all income that Taxpayer derives from Property 1 (other than the income from the Bonds) is rents from real property and qualifying income for purposes of section 856(c)(2) and (3), treating Taxpayer's share of gain from the Bonds (not including any amounts properly treated as interest for tax purposes) as qualifying income is consistent with the purposes of Part II of Subchapter M.

Requested Ruling 4: Taxpayer's allocable share of income from the Reimbursement Amounts, to the extent attributable to property taxes imposed on real property owned by Operating Partnership, is an abatement or refund of taxes on real property under section 856(c)(2)(E) and (3)(E).

Some portion of the Reimbursement Amounts is a return of Taxpayer's capital, based on a proper allocation of basis to the right to receive the Reimbursement Amounts in connection with the deemed liquidation of Property 2 Owner and on a method of recovering that basis that clearly reflects income. That portion is not gross income for purposes of section 856(c)(2) or (3). The treatment of the remaining portion (the "RA gross income") depends on the extent to which that portion is attributable to a refund or abatement of real property taxes.

Reimbursement Amounts are tied to the real property taxes on Operating Partnership's property to the extent Agency attributes Reimbursement Amounts (in its monthly accountings issued to Taxpayer) to a return of Operating Partnership's real property taxes. For each month, therefore, it is possible to compute the fraction of the Reimbursement Amount disbursements that represents a return of Operating Partnership's real property taxes (the "real property tax fraction") and the fraction that does not (the "remaining fraction"). The product of the real property tax fraction and the amount of RA gross income is properly treated as income derived from a refund of taxes on real property under section 856(c)(2)(E) and (3)(E).

Requested Ruling 5: Taxpayer's allocable share of income from the Reimbursement Amounts, to the extent not attributable to property taxes imposed on real property owned by Operating Partnership, will be treated as qualifying income for purposes of section 856(c)(2).

Under section 856(c)(5)(J), the Secretary is authorized to determine that RA gross income not treated as a refund or abatement of real property taxes is qualifying gross income under section 856(c)(2). On the basis of all of the facts and circumstances, including Taxpayer's representation that substantially all income that Taxpayer derives from Property 2 (other than the income from the Reimbursement Amounts) is rents from real property and qualifying income for purposes of section

856(c)(2) and (3), treating the product of the remaining fraction and the amount of RA gross income as qualifying income for purposes of section 856(c)(2) is consistent with the purposes of Part II of Subchapter M.

Conclusion:

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

(1) Taxpayer's allocable share of income attributable to payments on the Bonds that are otherwise treated as interest, under the Code, constitutes "interest" within the meaning of section 856(c)(2)(B);

(2) Taxpayer's allocable share of income from payments on the Bonds that are not treated as interest, under the Code, will be treated as gain from the sale or other disposition of securities for purposes of section 856(c)(2)(D);

(3) Taxpayer's allocable share of gain (not including any amounts properly treated as interest for tax purposes) from the Bonds, including gain from the receipt of partial principal payments, will be treated as qualifying income for purposes of section 856(c)(3);

(4) The product of the real property tax fraction and the amount of RA gross income is an abatement or refund of taxes on real property under section 856(c)(2)(E) and (3)(E); and

(5) The product of the remaining fraction and the amount of RA gross income will be treated as qualifying income for purposes of section 856(c)(2).

This ruling's application is limited to the facts, representations, Code sections, and regulations cited herein. Except as expressly provided in this Conclusion, 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: (1) whether Taxpayer otherwise qualifies as a REIT under Part II of Subchapter M, (2) whether the Bonds are market discount bonds, (3) the extent to which payments on the Bonds are allocable to qualified stated interest, original issue discount, or any other item properly treated as interest, (4) the extent to which gain on principal payments on the Bonds constitutes capital gain, (5) whether or to what extent either the Bonds or the Reimbursement Amounts are debt instruments, or (6) the amount of basis allocated to the right to receive the Reimbursement Amounts or the method of recovering that basis.

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 Taxpayer and accompanied by a penalty 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.

Sincerely,

_____

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

cc: