Internal Revenue Service

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Person To Contact:
, ID No.
Telephone Number:

Refer Reply To:
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Date:
April 5, 2005

Legend:

Taxpayer =

State =

Month =

LLC1 =

City =

Project =

State tax credits =

a =

Dear :

This is in reply to a letter dated January 13, 2005, requesting a ruling on behalf of Taxpayer. You have requested a ruling that taxable income earned by Taxpayer from State tax credits will either be treated as qualifying income or disregarded for purposes of sections 856(c)(2) and (c) (3) of the Internal Revenue Code.

Facts:

Taxpayer is a domestic limited liability company that is currently classified as a partnership for federal tax purposes. It was formed to invest in and develop real estate. When Taxpayer begins its real estate development activities in Month, Taxpayer will

elect to be taxable as a corporation pursuant to section 301.7701-3 of the Procedure and Administration Regulations, and thereafter intends to elect and qualify to be treated as a real estate investment trust (REIT) under subchapter M of Chapter 1 of the Code.

Taxpayer's principal REIT asset will be its interest in LLC1, a limited liability company, which will construct, own and operate a large mixed-use real estate development in City known as "The Project". The Project will include two separate buildings that will include rental apartments, retail, and entertainment space.

Taxpayer was organized to develop and operate The Project. The Project will be constructed on land contaminated by an oil spill. Pursuant to a recently enacted State statute, the site will be eligible for a substantial amount of State tax credits. The State legislature enacted the State tax credits statute to promote the cleanup and development of properties in designated area that have hazardous waste contamination. Sites eligible for the State Tax credits are designated by the State Commissioner of Environmental Conservation.

The total amount of State tax credits available to an approved development is equal to the sum of a percentage of up to three types of expenditures for the site: (1) the cost of site preparation; (2) the cost (or other basis for Federal tax purposes) of tangible property principally used for commercial, industrial, recreational, or environmental conservation purposes; and (3) the cost of on-site groundwater remediation. In each case, the applicable percentage of the costs to be applied in calculating the amount of the credits is 10 percent or 12 percent, and may be increased if certain factors are evident. Taxpayer currently anticipates that The Project will generate up to approximately a dollars of State tax credits over a ten year period. Most of the credits will likely be generated in the first two years. The State tax credits are refundable to the extent that they exceed the State tax liabilities of the owners.

Because Taxpayer (as a REIT) does not expect to incur a material amount of State tax liability, it expects to receive significant cash payments from State, which will cause Taxpayer to realize a significant amount of taxable income for Federal tax purposes. During the first two years of The Project's development, Taxpayer expects that such amounts will exceed five percent of its gross revenues. Taxpayer expects that substantially all of its other income will be qualifying income for purposes of section 856(c).

Law and Analysis:

Section 856(c)(2) of the Code provides that in order for a corporation to be considered a REIT, at least 95 percent of the corporation's gross income (excluding gross income from prohibited transactions) must be derived from 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, and gain from certain sales or other dispositions of real estate assets (the "95 percent gross income test").

Under section 856(c)(3) of the Code, 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, gain from certain sales or other dispositions of real estate assets, and qualified temporary investment income (the "75 percent gross income test").

Section 61(a) of the Code provides that, except as otherwise provided, gross income includes all income from whatever source derived.

Under section 1.856-3(g) of the Income Tax Regulations, 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 legislative history underlying the tax treatment of REITs indicates that the 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 822-823 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 legislative history also indicates that Congress intended to equate the tax treatment of REITs with the treatment accorded regulated investment companies (RICs).

In Rev. Rul. 64-247, 1964-2 C.B. 179, a RIC recovered excess management fees from its investment manager. The recovery was made as a result of legal action brought against the company's former officers and directors who had owned the investment manager. In Rev. Rul. 74-248, 1974-1 C.B. 167, a RIC's former investment advisor paid the company an amount the advisor had improperly received for assigning its advisory contract. The payment was made pursuant to a settlement agreement that was reached after the company's shareholders filed a derivative action against the

investment advisor. In both rulings, the amounts in question were includible in gross income under section 61of the Code. Those amounts were not, however, income from sources that, at the time the rulings were published, were described in section 851(b)(2) of the Code. The rulings hold, nevertheless, that the companies' inclusion of the amounts in gross income did not cause the companies to fail to meet the definition of a RIC contained in section 851, provided the companies in all other respects qualified for RIC status for the tax year in question.

Rev. Rul. 64-247 and Rev. Rul. 74-248 were rendered obsolete, in part, for purposes of section 851 by Rev. Rul. 92-56, 1992-2 C.B. 153, which holds that if, in the normal course of its business, a RIC receives a reimbursement from its investment advisor and the reimbursement is included in the RIC's gross income, the reimbursement is qualifying income under section 851(b)(2). Although Rev. Rul. 92-56 provides that the prior revenue rulings are, in part, obsolete, those revenue rulings remain instructive in determining how certain payments should be treated for purposes of section 856(c).

In this case, Taxpayer intends that the development and operation of The Project through its interests in LLC1 will allow it to qualify as a REIT. The State tax credits derived from the development of The Project should not cause The Project to be other than a qualifying asset, and the rental income generated by The Project should satisfy the REIT income tests under sections 856(c)(2) and (c)(3). The State tax credits are intended to promote the remediation and development of contaminated real estate and the furtherance of this public policy does not interfere with or impede the policy objectives of Congress in enacting the income tests under sections 856(c)(2) and (c)(3). Accordingly, we rule that taxable income associated with the receipt of the State tax credits will not be considered in determining whether Taxpayer satisfies the REIT income tests under sections 856(c)(2) and (c)(3).

OTHER INFORMATION

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 will qualify 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 this ruling may not be used or cited as precedent.

In accordance with a Power of Attorney on file with this office, a copy of this letter is being sent to your authorized representative.

Sincerely yours,

William E. Coppersmith
William E. Coppersmith
Chief, Branch 2
Office of Associate Chief Counsel
(Financial Institutions & Products)

Enclosures:
Copy of this letter
Copy for section 6110 purposes