Internal Revenue Service

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Date:
January 09, 2009

Legend:

Taxpayer =

State =

Date 1 =

Date 2 =

Date 3 =

LLC1 =

City =

Project =

State tax credit =

Return =

Date 4 =

a =

Dear :

This is in reply to a letter dated July 29, 2008, and a supplemental letter dated October 2, 2008, requesting a ruling that the Taxpayer's right to receive a State franchise tax refund attributable to the State tax credits will not be considered in determining whether Taxpayer satisfies the asset test in section 856(c)(4)(A) of the Internal Revenue Code. The facts of a ruling issued to Taxpayer on Date 1 (PLR-149814-05), in which the Service held that the tax refund at issue would not be considered in determining whether Taxpayer satisfies the income tests under sections 856(c)(2) and (c)(3) of the Code, are incorporated by reference into the present ruling.

Facts:

Taxpayer was formed to invest in and develop real estate. Taxpayer elected to be classified as an association taxable as a corporation pursuant to section 301.7701-3 of the Procedure and Administration Regulations effective Date 2, and elected to be treated as a real estate investment trust (REIT) under subchapter M of Chapter 1 of the Code for its first taxable year ended Date 3.

Taxpayer's principal asset is an indirect interest, through a number of tiers of partnerships, in a large mixed-use real estate development in City known as "The Project." The Project includes two separate buildings that include rental apartments, retail, and entertainment space.

Taxpayer was organized to develop and operate The Project, which Taxpayer asserts will allow it to qualify as a REIT. The Project will be constructed on land contaminated by an oil spill. Pursuant to a 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 areas 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. The State tax credits are refundable to the extent that they exceed the State tax liabilities of the owners.

Taxpayer represents that the State tax credits are intended to promote the remediation and development of contaminated real estate, and Taxpayer's entitlement thereto and to the State tax refund arising therefrom are thus incidental to Taxpayer's investment in real estate.

On its Return for its tax year ended Date 3, filed on or about Date 4, Taxpayer claimed a State tax credit of a dollars and a refund, based on the credit, of the same amount. Taxpayer is concerned that the value of its claim for refund of State taxes based on the State tax credit, if considered to be an "asset" for purposes of section 856(c)(4)(A), could exceed 25 percent of the value of its total assets, thereby causing Taxpayer to fail to qualify as a REIT.

Law and Analysis:

Section 856(c)(4)(A) provides that at the close of each quarter of its tax year, at least 75 percent of the value of a REIT's total assets must be represented by real estate assets, cash and cash items (including receivables), and Government securities.

Section 856(c)(5)(B) defines the term "real estate assets," in part, to mean real property (including interests in real property and interests in mortgages on real property) and shares (or transferable certificates of beneficial interest) in other REITs. Section 856(c)(5)(C) provides that the term "interests in real property" includes fee ownership and co-ownership of land or improvements thereon, leaseholds of land or improvements thereon, options to acquire land or improvements thereon, and options to acquire leaseholds of land or improvements thereon, but does not include mineral, oil or gas royalty interests.

Section 1.856-2(d)(3) of the Income Tax Regulations 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 generally accepted accounting principles (GAAP).

Section 1.856-3(b) provides, in part, that the term "real estate assets" means real property. Section 1.856-3(c) provides that "interests in real property" includes fee ownership and co-ownership of land or improvements thereon, leaseholds of land or improvements thereon, options to acquire land or improvements thereon, and options to acquire leaseholds of land or improvements thereon.

Under section 1.856-3(g) of the 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 REIT asset test in section 856(c)(4) indicates that the test “is designed to give assurance that the bulk of the trust’s investments are in real estate.” H.R. Rep. No. 2020, 86th Cong., 2d Sess. 4 (1960) at 6, 1960-2 C.B. 819, 822. The legislative history also indicates that Congress intended to provide REITs with tax treatment similar to 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 the RIC’s gross income under section 61 of 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). However, the prior revenue rulings remain instructive in determining how certain payments may be treated for RIC or REIT qualification purposes when the payment is not specifically described by the governing statute or underlying regulations.

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 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 REIT qualification tests under sections 856(c). Accordingly, we rule that Taxpayer’s claim for a refund of State taxes based upon the

State tax credits will not be considered in determining whether Taxpayer satisfies the REIT asset test under sections 856(c)(4)(A).

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 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,

David B. Silber
David B. Silber
Chief, Branch 2
Office of Associate Chief Counsel
(Financial Institutions & Products)