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Date:
February 09, 2016

Legend

Taxpayer =

Operating Partnership =

Company X =

Company Y =

Manager =

LLC =

State A =

State B =

Date 1 =

Date 2 =

Date 3 =

Date 4 =

Date 5 =

a =

b =

c =

d =

e =

f =

Dear :

This is in response to your letter dated January 13, 2015, and supplemental submissions, regarding the treatment of the Taxpayer's allocable share of management fees for purposes of the gross income tests under section 856(c)(2) and (c)(3) of the Internal Revenue Code ("Code").

FACTS

Taxpayer is a State A corporation. Taxpayer was formed during Date 1, and will elect to be taxed as a real estate investment trust ("REIT") beginning with the taxable year ended Date 2.

Taxpayer conducts substantially all of its investment activities through Operating Partnership, a State B limited partnership, which is treated as a partnership for federal income tax purposes.

Taxpayer owns the sole general partnership interest in Operating Partnership through its wholly owned subsidiary Company X, a State B limited liability company. Company X is disregarded for federal income tax purposes. Taxpayer also directly owns a limited partnership interest in Operating Partnership. Taxpayer completed an initial public offering ("IPO") of its stock on Date 3. As of Date 5, Taxpayer's collective ownership percentage in Operating Partnership is a%.

Operating Partnership is the sole owner of Company Y, a State B limited liability company, which elected to be treated as a corporation for federal income tax purposes. Company Y and Taxpayer jointly elected to treat Company Y as a taxable REIT subsidiary. Company Y owns b% of Manager, a State B limited liability company treated as a partnership for federal income tax purposes. Manager owns c% of Taxpayer.

Operating Partnership's primary business is to acquire, invest in, and manage a portfolio of re-performing and non-performing mortgage loans secured by single-family residences, and, to a lesser extent, loans secured by multi-family residential and commercial mixed use retail/residential properties (collectively, the "Mortgages"). Taxpayer represents that Operating Partnership owns 100% of the investments. Operating Partnership's portfolio predominantly consists of re-performing loans. With respect to the non-performing loans, Operating Partnership will often acquire the underlying properties securing the Mortgages through foreclosure (such properties referred to as "real estate owned" or "REOs") (collectively, the Mortgages and REOs are the "Investments"). REOs acquired by Operating Partnership will be either rented or sold to third parties soon after they are acquired.

On Date 4, Manager entered into a management agreement with Taxpayer and Operating Partnership ("Management Agreement"). Pursuant to the Management Agreement, Manager implements Operating Partnership's business strategy and manages Operating Partnership's business and investment activities and day-to-day operations. Manager also provides Operating Partnership and Taxpayer with management, corporate governance, administrative and other services related to finance and accounting, human resources, legal, investment company exemption, risk management, corporate services, vendor management operations, operations support, and REIT qualification (collectively, the "Services"), including a management team and necessary administrative and support personnel to run the daily operations of Operating Partnership and Taxpayer.[1] Taxpayer represents that the Services provided by Manager will be usual and customary asset management of investments in mortgages and REOs. Manager does not currently provide Services to any persons (as defined in section 7701(a)(1)) other than Operating Partnership. The Management Agreement provides that Manager may provide Services in the future to third parties under the condition that its Services provided to Taxpayer are not impaired. Neither Taxpayer nor Manager, however, anticipates that Manager will provide Services to or invest on behalf of third parties.

Manager will not be the servicer of the Mortgages or provide any services to the tenants of any REOs. LLC will service the mortgages and provide any necessary property management, lease management, and renovation management required for the REOs. Taxpayer represents that LLC is an independent contractor within the meaning of section 856(d)(3) with respect to Taxpayer.

Manager is compensated through fees paid by Operating Partnership. Operating Partnership pays a base management fee and an incentive fee to Manager (collectively,

[1] Taxpayer anticipates the rental of real property to constitute a small part of its business. If Taxpayer provides any services to its tenants, Taxpayer will use an independent contractor or taxable REIT subsidiary as described under section 856(d)(7)(C) to ensure that any impermissible tenant service income does not exceed the de minimis amount in section 856(d)(7)(B).

the “Management Fees”). The base management fee is d% of Taxpayer’s consolidated stockholders’ equity per annum. Taxpayer’s consolidated stockholders’ equity is the sum of the net proceeds from any issuances of equity by Taxpayer or Operating Partnership since inception, plus Taxpayer’s and Operating Partnership’s retained earnings less (i) any amount Taxpayer or Operating Partnership has paid to repurchase its common stock or units since inception, (ii) any unrealized gains and losses and other non-cash items that have affected consolidated stockholder’s equity, (iii) any amount related to one-time events caused by changes in GAAP, and (iv) certain non-cash items not otherwise discussed above. The base management fee will be paid in a combination of cash and shares of Taxpayer’s common stock.

The incentive fee will be payable quarterly in an amount equal to e% of the dollar amount by which the sum of (A) aggregate cash dividends declared out of the REIT taxable income of Taxpayer and (B) distributions declared out of the taxable income of Operating Partnership (without duplication) exceeds the product of f% and the book value per share of Taxpayer’s common stock as of the end of each quarter. The incentive fee is payable in cash.

Taxpayer intends to restructure its operations. Company Y will distribute its b% interest in Manager to Operating Partnership. Thus, Operating Partnership will directly own the b% interest in Manager. Manager will continue to manage the Investments and be compensated as provided in the Management Agreement (as described above). Because Operating Partnership will be a partner in Manager and Taxpayer is a partner in Operating Partnership, Taxpayer will be allocated a portion of the fees that Manager receives from Operating Partnership. Therefore, Taxpayer, through its partnership interest in Operating Partnership, will have gross income that includes Taxpayer’s proportionate share of both the Investment Income from Operating Partnership’s assets and Operating Partnership’s b% share of the Management Fees.

LAW

Section 856(c)(2) of the Code provides that at least 95 percent of a REIT’s gross income 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), abatement 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.

Section 856(c)(3) of the Code provides that at least 75 percent of a REIT’s gross income 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 disposition of real estate assets, and qualified temporary investment income.

Section 856(c)(5)(J) of the Code provides, in relevant part, 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, whether any item of income or gain which—(i) 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) otherwise constitutes gross income not qualifying under section 856(c)(2) or (c)(3) may be considered as gross income which qualifies under section 856(c)(2) or (c)(3).

Section 1.856-3(g) of the Income Tax Regulations 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 is deemed 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 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 as in the hands of the partnership for all purposes of section 856.

Section 1.856-4(b)(5)(ii) of the Income Tax Regulations provides that the directors or trustees of a REIT are not required to delegate or contract out their fiduciary duty to manage the REIT itself, as distinguished from rendering or furnishing services to the tenants of the REIT's property or managing or operating the property. Thus, the trustees or directors may do all things necessary, in their fiduciary capacities, to manage and conduct the affairs of the trust itself. For example, the trustees or directors may establish rental terms, choose tenants, enter into and renew leases, and deal with taxes, interest, and insurance, relating to the REIT's property.

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

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. 86-2020, 2d Sess. 4, at 6 (1960), 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. Id.

The staff of the Joint Committee on Taxation in its General Explanation of the Tax Legislation Enacted in the 110th Congress describes section 856(c)(5)(J) as follows: "The provision authorizes the Treasury Department to issue guidance that would allow other items of income to be excluded for purposes of the computation of qualifying gross income under either the 75 percent or the 95 percent test, respectively, or to be included as qualifying income for either of such tests, respectively, in appropriate cases consistent with the purposes of the REIT provisions." Footnote 309 of the General Explanation provides that income that is statutorily excluded from a REIT's gross income computations is not intended to be within the authority granted to the Treasury Department to include amounts as qualifying income. Staff of the Joint Committee on Taxation, 111th Cong., General Explanation of the Tax Legislation Enacted in the 110th Congress, 1st Sess., at 239 (2009).

ANALYSIS

In the instant case, Manager will be providing Services to Operating Partnership that promote Operating Partnership's investment strategy through the management of investment activities as well as Operating Partnership's day-to-day operations. Manager is managing the Operating Partnership's investments in mortgages and REOs. Taxpayer represents that the activities that Manager performs are activities that a REIT may, under the Code and Regulations, perform in managing the assets of the REIT as well as the trust itself without adverse tax consequences. All mortgage servicing and all services provided in connection with the REOs are done by LLC, an independent contractor.

In the instant case, in the ordinary course of Operating Partnership's investment activities, Operating Partnership will receive interest income and income from the sale or rental of REO foreclosure property (collectively, "Investment Income"), and Operating Partnership will pay Management Fees to Manager. At the same time, Operating Partnership will be allocated b% of the Management Fees it pays to Manager because it is a b% partner in Manager. Thus, Operating Partnership's gross income will include both the Investment Income from its assets and its b% share of the Management Fees. Furthermore, Taxpayer, as a partner of Operating Partnership and, through its partnership interest in Operating Partnership, an interest holder in Manager, will include as income both its proportionate share of the Investment Income from its direct interest in Operating Partnership and the Management Fee income from its indirect interest in Manager. Because the Management Fees are derived from the same Investments that generate the Investment Income, including the Management Fees in Taxpayer's gross income would cause the amounts to be counted twice for purposes of the gross income tests under section 856(c). Accordingly, under the authority of section 856(c)(5)(J)(i), to the extent that Manager earns Management Fees from managing Operating Partnership's wholly owned Investments, we conclude that Taxpayer may exclude from its gross income (for purposes of section 856(c)(2) and (c)(3)) Taxpayer's allocable pro rata share (a%) of Operating Partnership's allocable pro rata share (b%) of

Management Fees that Manager receives from Operating Partnership. Under the facts of the instant case, excluding the Management Fees (as described above) from Taxpayer's gross income for purposes of section 856(c)(2) and (c)(3) does not interfere with Congressional policy objectives in enacting the income tests under those provisions.

CONCLUSION

Based on the facts and representations submitted by Taxpayer, we rule that to the extent that Manager earns Management Fees from managing Operating Partnership's wholly owned Investments, Taxpayer may exclude from its gross income (for purposes of section 856(c)(2) and (c)(3)) Taxpayer's allocable pro rata share of Operating Partnership's allocable pro rata share of Management Fees that Manager receives from Operating Partnership.

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. Specifically, no opinion is expressed or implied as to whether Taxpayer otherwise qualifies as a REIT under part II of subchapter M of Chapter 1 of the Code. No opinion is expressed or implied regarding whether Taxpayer's pro rata allocable share of the Investment Income is qualifying REIT income under either section 856(c)(2) or (3). Additionally, no opinion is expressed or implied regarding whether the REOs qualify as foreclosure property or whether the sale of an REO is a prohibited transaction under section 857(b)(6).

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
Andrea M. Hoffenson
Chief, Branch 2
Office of Associate Chief Counsel
(Financial Institutions & Products)