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August 24, 2016

Legend:

Taxpayer =

State =

Dear :

This is in reply to a letter dated July 20, 2016, in which Taxpayer requests rulings in connection with certain income attributable to its investment in foreign subsidiaries under section 856 of the Internal Revenue Code of 1986, as amended (the "Code").

Facts:

Taxpayer is a corporation organized under the laws of State that will elect to be taxed as a real estate investment trust ("REIT") beginning with its first taxable year. Taxpayer was organized for the purpose of making direct and indirect investments in commercial timberland businesses.

Taxpayer operates in foreign countries through one or more foreign corporate subsidiaries and associated intermediate holding companies (each, a "Foreign Sub"). Taxpayer has jointly elected with certain Foreign Subs that are qualified REIT subsidiaries under section 856(i) to treat each of those Foreign Subs as a taxable REIT subsidiary ("TRS") for federal income tax purposes under section 856(l) (each, a "Foreign TRS").

Taxpayer expects that each Foreign TRS will be either (i) a controlled foreign corporation (a “CFC”) within the meaning of section 957(a), with respect to which Taxpayer will be a United States shareholder within the meaning of section 951(b) (a “United States Shareholder”), (ii) a passive foreign investment company (a “PFIC”) within the meaning of section 1297(a), for which Taxpayer has made or intends to make an election under section 1295(a) to treat as a qualified electing fund (a “QEF”) for all taxable years during which the corporation was a PFIC that is included in the Taxpayer’s holding period of the PFIC stock (“a pedigreed QEF”), or (iii) a PFIC for which Taxpayer has not made a mark-to-market election and which is not a pedigreed QEF with respect to Taxpayer.

As a United States Shareholder with respect to the CFCs, Taxpayer is required under section 951(a)(1)(A) to include in gross income its pro rata share of each CFC’s subpart F income, as defined in section 952(a). Taxpayer expects that the subpart F income of each CFC will consist of items that are foreign personal holding company income (“FPHCI”) within the meaning of section 954(c). Taxpayer’s inclusions under section 951(a)(1)(A) that are attributable to each CFC deriving (i) interest; (ii) dividends; (iii) gains from the sale or other disposition of stock, securities, or real property that is not property described in section 1221(a)(1); and (iv) items that also would constitute “rents from real property” under section 856(d) if received by a REIT are referred to hereinafter as the “Subpart F Inclusions.”

As a shareholder in PFICs for which Taxpayer has made a QEF election, Taxpayer is required under section 1293(a) to include in gross income its pro rata share of the ordinary earnings and net capital gain of each QEF. Taxpayer expects to include amounts in income under section 1293(a) with respect to a PFIC for which it has made a QEF election. Taxpayer’s inclusions under section 1293(a) that are attributable to the QEF deriving (i) interest; (ii) dividends; (iii) gains from the sale or other disposition of stock, securities, or real property that is not property described in section 1221(a)(1); and (iv) items that also would constitute “rents from real property” under section 856(d) if received by a REIT are referred to hereinafter as the “QEF Inclusions.”

As a shareholder in a PFIC for which Taxpayer has not made a mark-to-market election and which is not a pedigreed QEF with respect to Taxpayer, Taxpayer is required under section 1291(a)(1) to include certain amounts in gross income under section 61. Taxpayer expects to include amounts in income under section 1291(a)(1) with respect to such PFICs (the “Non-QEF Inclusions” and, together with QEF Inclusions, the “PFIC Inclusions”). Taxpayer represents that the majority of the gross income that each of these PFICs will derive while owned by Taxpayer will be comprised of one or more of the following items: (i) interest; (ii) dividends; (iii) gains from the sale or other disposition of stock, securities, or real property that is not property described in section 1221(a)(1); and (iv) items that also would constitute “rents from real property” under section 856(d) if received by a REIT.

Taxpayer expects to recognize foreign currency gains with respect to distributions of previously taxed earnings and profits (“PTI”) as described in section 986(c)(1) attributable to the Subpart F Inclusions and QEF Inclusions (the “Section 986(c) Gains”).

Taxpayer requests the following rulings:

- 1) The Subpart F Inclusions and the PFIC Inclusions will be treated as qualifying income under section 856(c)(2).
- 2) The Section 986(c) Gains will not be taken into account for purposes of section 856(c)(2).

Law and Analysis:

Ruling #1: Whether the Subpart F Inclusions and PFIC Inclusions will be treated as qualifying income under section 856(c)(2).

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 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 section 1221(a)(1) property), abatements and refunds of taxes on real property, income and gain derived from foreclosure property, and certain commitment fees.

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 which 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 [REIT] 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.”

Subpart F Inclusions

Section 957 defines a CFC as a foreign corporation in which more than 50 percent of the total combined voting power of all classes of stock entitled to vote, or the total value of the stock, is owned by United States Shareholders on any day during the corporation's taxable year. A United States Shareholder is defined in section 951(b) as a United States person who owns 10 percent or more of the total voting power of the foreign corporation.

Section 951(a)(1)(A)(i) generally provides that if a foreign corporation is a CFC for an uninterrupted period of 30 days or more during a taxable year, every person who is a United States Shareholder of the corporation and who owns stock in the corporation on the last day of the taxable year in which the corporation is a CFC shall include in income the shareholder's pro rata share of the CFC's subpart F income for the taxable year.

Under section 952, subpart F income includes foreign base company income. Under section 954(a)(1), foreign base company income includes FPHCI, which is defined under section 954(c)(1) to mean certain enumerated types of income. Subject to certain exceptions, FPHCI includes (i) dividends, interest, royalties, rents, and annuities under section 954(c)(1)(A); and (ii) the excess of gains over losses from the sale or exchange of certain property under section 954(c)(1)(B).

Taxpayer's Subpart F Inclusions will be attributable to subpart F income of CFCs that consists of: (i) interest; (ii) dividends; (iii) gains from the sale or other disposition of stock, securities, or real property that is not property described in section 1221(a)(1); and (iv) items that also would constitute "rents from real property" under section 856(d) if received by a REIT. Therefore, treatment of the Subpart F Inclusions attributable to such income as qualifying income for purposes of section 856(c)(2) does not interfere with or impede the policy objectives of Congress in enacting the income test under section 856(c)(2).

PFIC Inclusions

Section 1297(a) provides that a foreign corporation is a PFIC if either (1) 75 percent or more of the gross income of such corporation for the taxable year is passive income, or (2) the average percentage of assets (as determined in accordance with section 1297(e)) held by such corporation during the taxable year which produce passive income or which are held for the production of passive income is at least 50 percent. Section 1297(b) defines the term "passive income" as income of a kind that would be FPHCI under section 954(c), subject to certain exceptions.

Section 1295(a) provides that a PFIC will be treated as a QEF with respect to a shareholder if (1) an election by the shareholder under section 1295(b) applies to such

PFIC for the taxable year; and (2) the PFIC complies with such requirements as the Secretary may prescribe for purposes of determining the ordinary earnings and net capital gains of such company and otherwise carrying out the purposes of the PFIC provisions. Section 1293(a) provides that every United States person who owns (or is treated under section 1298(a) as owning) stock of a QEF at any time during the taxable year of such fund shall include in gross income (A) as ordinary income, such shareholder's pro rata share of the ordinary earnings of such fund for such year, and (B) as long-term capital gain, such shareholder's pro rata share of the net capital gain of such fund for such year.

Section 1291(a)(1) provides that if a United States person receives an excess distribution (as defined in section 1291(b)) in respect of stock in a PFIC that is a section 1291 fund (as defined in §1.1291-1T(b)(2)(v)), then (A) the amount of the excess distribution shall be allocated ratably to each day in the shareholder's holding period for the stock, (B) with respect to such excess distribution, the shareholder's gross income for the current year shall include (as ordinary income) only the amounts allocated under section 1291(a)(1)(A) to (i) the current year, or (ii) any period in the shareholder's holding period before the 1st day of the 1st taxable year of the company which begins after December 31, 1986, and for which it was a PFIC, and (C) the tax imposed by chapter 1 of the Code for the current year shall be increased by the deferred tax amount (determined under section 1291(c)). Under section 1291(a)(2), the rules of section 1291(a)(1) apply to any gain recognized on the disposition of stock of a section 1291 fund as if the gain were an excess distribution.

Taxpayer's QEF Inclusions will be attributable to income of PFICs (with respect to which a QEF election has been made) that consists of: (i) interest; (ii) dividends; (iii) gains from the sale or other disposition of stock, securities, or real property that is not property described in section 1221(a)(1); and (iv) items that also would constitute "rents from real property" under section 856(d) if received by a REIT. Taxpayer's Non-QEF Inclusions are derived with respect to PFICs that will generate the same types of passive income. Therefore, treatment of the PFIC Inclusions as qualifying income for purposes of section 856(c)(2) does not interfere with or impede the policy objectives of Congress in enacting the income test under section 856(c)(2).

Ruling #2: Whether the Section 986(c) Gains will be taken into account for purposes of section 856(c)(2).

In general, sections 959(d) and 1293(c) provide that when a taxpayer includes in income a Subpart F Inclusion or QEF Inclusion, the subsequent distribution to the shareholder of the PTI attributable to the inclusion is not treated as a dividend for purposes of chapter 1 of the Code.

Section 986(c)(1) provides that foreign currency gain or loss with respect to distributions of PTI (as described in section 959 or section 1293(c)) attributable to

movements in exchange rates between the times of the deemed and actual distribution shall be recognized and treated as ordinary income or loss from the same source as the associated income inclusion.

Section 856(n)(1)(A) provides that “passive foreign exchange gain” for any taxable year shall not constitute gross income for purposes of section 856(c)(2).

Section 856(n)(3) defines passive foreign exchange gain as: (A) real estate foreign exchange gain (as defined in section 856(n)(2)); (B) foreign currency gains (as defined in section 988(b)(1)) which is not real estate foreign exchange gain and is attributable to (i) any item of income or gain described in section 856(c)(2), (ii) the acquisition or ownership of obligations (other than foreign currency gains attributable to any item of income or gain described in clause (i)), or (iii) becoming or being the obligor under obligations (other than foreign currency gain attributable to any item of income or gain described in clause (i)); and (C) any other foreign currency gains determined by the Secretary.

While the Section 986(c) Gains are not foreign currency gains defined in section 988(b)(1), such Section 986(c) Gains are attributable to the Subpart F Inclusions and QEF Inclusions, items of income that are qualifying income for purposes of section 856(c)(2). This Section 986(c) Gain is substantially similar to passive foreign exchange gain described in section 856(n)(3)(B)(i). Therefore, pursuant to section 856(n)(3)(C), the Section 986(c) Gains are excluded from gross income for purposes of section 856(c)(2) because these foreign currency gains are considered passive foreign exchange gain that is excluded from gross income for purposes of section 856(c)(2).

Conclusion:

Based on the facts and representations set forth above, we rule that (i) under section 856(c)(5)(J)(ii), the Subpart F Inclusions are considered gross income that qualifies for purposes of section 856(c)(2), (ii) under section 856(c)(5)(J)(ii), the PFIC Inclusions are considered gross income that qualifies for purposes of section 856(c)(2), and (iii) under section 856(n)(3)(C), the Section 986(c) Gains are excluded from gross income for purposes of section 856(c)(2).

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. In particular, no opinion is expressed concerning whether Taxpayer otherwise qualifies as a REIT under part II of subchapter M of the Code.

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
Branch Chief, Branch 2
Office of Associate Chief Counsel
(Financial Institutions and Products)