IT 10-0009-GIL 04/08/2010 ADDITION MODIFICATIONS – OTHER RULINGS

General Information Letter: The attribution rules in IRC Section 318 are used to determine ownership for purposes of determining whether a REIT is a captive REIT required to add back its dividends-paid deduction, not for determining control.

April 8, 2010

Dear:

This is in response to your letter dated January 22, 2010 in which you state the following:

I am the Executive Director–Tax for COMPANY1, LLC ("COMPANY1") based in CITY1, STATE1. The purpose of this letter is to seek advice from the Department of Revenue ("DOR") on whether the Illinois captive REIT statute imposed pursuant to 35 Ill. Comp. Stat. 5/1501(a)(1.5) would apply to the private REITs held in our institutional real estate fund that we formed in MONTH 200X. Illinois requires captive REITs to add to its federal taxable income the dividends paid deduction allowed under the Internal Revenue Code of 1986, as amended ("Code" or "IRC"). It is my belief that the statute does not apply since the REITs in the fund are not owned or controlled by a taxable corporate entity and are not used for tax-avoidance purposes. A detailed discussion of the facts and applicable law in support of this request is set forth below.

**FACTS**

COMPANY1 is the U.S. arm of COMPANY2. COMPANY1 manages, on behalf of institutional investors, over $XX billion of real estate assets in the U.S. and over $XX billion globally. COMPANY1, and its predecessor COMPANY3A, have been providing real estate asset management to institutional investors since 19XX. Since that time, our commingled real estate fund, FUND1 ("FUND1"), has grown its net asset value to over $X.X billion. FUND1 is focused on providing institutional investors with an actively managed portfolio of primarily equity real estate investments located throughout the U.S. The investors are tax-exempt entities, the majority of which are state and local governmental pension plans.

FUND1 formed the largest part of COMPANY3A's investment management business. As part of COMPANY3's strategy to leave the institutional asset management business in the mid-19XXs, it sold COMPANY3A in 19XX (subsequently acquired by COMPANY1 in 19XX) and required that the real estate assets in these separate accounts come off of COMPANY3's balance sheet within a XX-year period. As a result, FUND1 recently converted (MONTH 1, 200X) from an insurance separate account to a limited partnership and FUND1 has been renamed FUND2 ("FUND2" or the "Fund").

FUND2 owns, among other investments, membership interests in three separate REITs that are organized as limited liability companies, two of which derive a portion of their income from properties located in Illinois, COMPANY4 ("COMPANY4") and COMPANY5 ("COMPANY5").

COMPANY4 owns a 99.9% limited partnership interest in COMPANY6 ("COMPANY6"), with the remaining .1% general partnership interest owned by FUND2 REIT's wholly owned subsidiary, COMPANY7 ("COMPANY7"). COMPANY7 is taxed as a corporation for federal tax purposes. COMPANY6 owns single member limited liability companies ("SMLLCs") that are treated as disregarded entities for federal tax purposes and other joint venture interests. It is these SMLLCs and joint ventures that hold property and income that is sourced to Illinois for

COMPANY4.

Similarly, COMPANY5 owns a 99.9% limited partnership interest in COMPANY8 (“COMPANY8”), with the remaining .1% general partnership interest owned by COMPANY5’s wholly owned subsidiary, COMPANY9 (“COMPANY9”). COMPANY9 is taxed as a corporation for federal tax purposes. COMPANY8 owns SMLLCs that are treated as disregarded entities for federal tax purposes and other joint venture interests. One of these SMLLCs holds the property and income that is sourced to Illinois for COMPANY5.

[Chart illustrating the relationship between the Fund, its REITs, and the investors not transposed into this letter. Letter contains the following heading for the Chart: **FUND3 as constituted from the date of its conversion from an insurance separate account (X/X/08) to the current date.]**

Since its conversion from an insurance separate account, the general partner of the Fund has been FUND4 (“FUND4”), a wholly-owned subsidiary of COMPANY1 that holds no units in the Fund. All of the limited partners in the Fund are tax-exempt entities including:

1. State and local governmental pension plans which are tax exempt under IRC § 115;

2. Corporate and multi-employer (“COMPANY10”) pension plans, tax-exempt under IRC § 501; and

3. Foundations and endowments, also qualified as tax-exempt under IRC § 501.

**TECHNICAL DISCUSSION**

**I. REITS IN THIS INSTITUTIONAL FUND DO NOT MEET THE REQUIREMENTS TO BE “CAPTIVE REITS.”**

Pursuant to 35 Ill. Comp. Stat. 5/1501(a)(1.5), the REITs within the Fund should not qualify as captive REITs. Under the statute, a REIT is a captive REIT if:

> (i) [It] is considered a real estate investment trust for the taxable year under Section 856 of the Internal Revenue Code; (ii) the certificates of beneficial interest or shares of which are not regularly traded on an established securities market; (iii) and of which more than 50% of the voting power or value of the beneficial interest or shares, at any time during the last half of the taxable year, is owned or controlled, directly, indirectly, or constructively, by a single corporation.

Here, the REITs in the Fund are REITs for purposes of Code § 856 and are not regularly traded on an established securities market.

35 Ill. Comp. Stat. 5/1501(a)(1.5)(C) also states that “the constructive ownership rules prescribed under § 318(a) of the Internal Revenue Code, as modified by § 856(d)(5) of the Internal Revenue Code, apply in determining the ownership of stock, assets, or net profits of any person.” Under Code § 318(a)(2)(A), stock owned directly or indirectly by or for a partnership is considered as owned proportionately by the partners in the partnership. Code §

318(a)(5)(A) further tells us that stock constructively owned by a person by reason of paragraph (2) is for purposes of applying paragraph (2), considered as actually owned by such person. Therefore, under 35 Ill. Comp. Stat. 5/1501(a)(1.5)(C), which specifically refers to Code § 318 for purposes of defining ownership, the common units of the REITs owned by the Fund are considered to be owned proportionately by each partner in the Fund. Since the partnership is a pass-through entity, we must look at the partners to determine whether any corporate entities indirectly own more than 50% of the REITs. The Fund has more than XXX partners, none of whom own more than a 50% share in the Fund. Thus, it would not be possible for any single entity (C corporation or otherwise) to have more than 50% ownership over the REITs (in fact, the organizational documents prohibit ownership in the Fund of over 10% by any single investor). As such, based upon FUND2's facts, the captive REIT rules should not apply in the current situation.

In addition, the statute specifically exempts REITs more than 50% owned or controlled by tax-exempt entities from the "captive REIT" classification. Here, all of the investors in the Fund are tax-exempt entities. By specifically exempting entities tax-exempt under Code § 501, it is apparent that the intent of 35 Ill. Comp. Stat. 5/1501(a)(1.5)(A) was not to subject REITs held by tax-exempt entities to Illinois income taxation. Even though the state and local pension funds are not tax-exempt under Code § 501, but instead under Code § 115, the pension funds are still exempt from federal and Illinois taxation. These pension funds are similar to the types of entities the statute excludes. Thus, any REIT which is more than 50% owned by tax-exempt entities should not be treated as a captive REIT.

**II. THE CAPTIVE REIT LEGISLATION IS AIMED AT RETAIL CORPORATIONS TRYING TO SHIELD INCOME FROM STATE TAXATION, NOT REITS HELD BY AN INSTITUTIONAL FUND FOR TAX-EXEMPT INVESTORS.**

The REITs are not engaged in the tax avoidance activities that the captive REIT legislation was meant to address. The DOR sought enactment of 35 Ill. Comp. Stat. 5/105(a)(1.5) in response to the state tax minimization strategies employed by large retail companies as demonstrated in the state of STATE2's battle with COMPANY11. Under that strategy, retail corporations were creating abusive captive REITs to hold their own operating real estate properties, such as stores and office space. The retail company would have all of their stores pay rent to the REIT for use of the store space, then the REIT would issue dividends to another subsidiary of the retail company. The captive REIT would not be subject to tax on the rental income since it would take a deduction for the dividends paid to its shareholders and the corporation would not be subject to state taxes since it would deduct the rental expense paid to the REIT against the amount of the dividends received from the REIT. By disallowing the dividends paid deduction for captive REITs, STATE3, STATE2 and other states have sought to eliminate the ability of retail corporations to reduce or avoid paying state income taxes.

In our situation, the REITs held by the Fund are not being used for tax avoidance purposes. First, the Fund invests in real estate and REITs were enacted specifically to be an efficient way to hold real estate investments. Furthermore, the REITs in the Fund are not in the business of renting space to COMPANY1 or its affiliates. In fact, COMPANY1, and its predecessor COMPANY3A, and their affiliates were prohibited (under ERISA's prohibited transaction rules) from renting space from the Fund in excess of 8,000 square feet. As of MONTH 1, 200X, the only lease in the entire Fund involving COMPANY2 or its affiliates is a CITY2 office totaling

7,000 square feet. Thus, the Fund is not engaged (and never will be) in rental activities to generate any meaningful rental expense (in comparison to the value of the Fund). Finally, the Fund itself is a pass-through entity not subject to Illinois income taxation, and the Fund is owned entirely by tax-exempt investors who are not subject to federal and state income taxes. Thus, the Fund and its investors have no motive to avoid state taxes through the use of captive REITs nor is there opportunity to distort taxable income among the entities involved.

**III. THE DEFINITION OF "CAPTIVE REIT" DOES NOT CLEARLY DEFINE "CONTROL."**

While it is my belief that, for the reasons stated above, the REITs in the Fund are not "captive REITs" as defined under 35 Ill. Comp. Stat. 5/1501(a)(1.5), my concern is with the portion of the statute that states that a captive REIT is a REIT that has more than 50% of its shares "owned or **controlled**, directly, indirectly, or constructively by a single corporation" that is a C corporation under the Code. Whereas 35 Ill. Comp. Stat. 5/1501(a)(1.5)(C) refers to "the constructive ownership rules prescribed under § 318(a) of the Internal Revenue Code . . . apply in determining the ownership . . .," the statute does not clearly indicate if "control" is to be similarly determined.

The general partner of the Fund is the FUND4, a single-member limited liability company, disregarded for federal and state income tax purposes, that is owned by an entity that is a C corporation. The FUND4, as the general partner of the Fund, makes certain decisions for the Fund that do not require votes from the rest of the owners. Thus, there are some matters with respect to the Fund and the REIT which are controlled indirectly by a C corporation.

Codification of attribution in Code § 318 was intended to define control, to provide "precise rules of attribution where this is appropriate . . . to prevent tax avoidance." The attribution rules of Code § 318 were enacted in the Internal Revenue Code of 1954, to clear up uncertainty with respect to corporate redemptions over the question of "control," the courts having commented that "before enactment, attribution rules were sometimes applied, and sometimes, not applied."

Using Code § 318 to determine "control," we would find that the voting power in the Fund would be proportionately allocated to the partners in the Fund. Again, there is no single entity which has a direct or indirect share of more than 50% of the Fund nor will there be under its organizational documents, thus no single entity could control the Fund through its share of votes.

Alternatively, prior to the passage of captive REIT legislation in Illinois, 35 Ill. Comp. Stat. 5/404 provides the DOR with the authority to adjust taxable income to properly reflect business done in Illinois. Under this provision, Code § 482 is applied to make necessary adjustments. Treasury Regulation § 1.482-1(i)(4) provides a broad definition of controlled:

> Controlled includes any kind of control, direct or indirect, whether legally enforceable or not, and however exercisable or exercised, including control resulting from the actions of two or more taxpayers acting in concert or with a common goal or purpose. It is the reality of the control that is decisive, not its form or the mode of its exercise. A presumption of control arises if income or deductions have been arbitrarily shifted

Thus, applying the broad definition of "control" found in Code § 482, the general partner of the

Fund may control the REITs although it does not own greater than a 50% interest in the REITs. Under the administration of Code § 482, however, common control is irrelevant if the transactions at issue were conducted at arm's length—balancing the control test against a showing of arm's length dealings. Here, the captive REIT control provision should be similarly viewed in light of its purpose to limit a company's ability to avoid Illinois income tax and should not deter the legitimate use of REITs by the Fund.

**CONCLUSIONS AND REQUEST FOR RULING**

Accordingly, I respectfully request that a letter ruling be provided under which the Fund's REITs are not considered captive REITs pursuant to 35 Ill. Comp. Stat. 5/1501(a)(1.5) nor are the REITs in the Fund abusive REITs that the statute is meant to apply to. Simply put, there is no opportunity for distortion of income among the entities which ultimately the legislation was designed to address. Thus, the REITs are entitled to take the dividends paid deduction for purposes of calculating Illinois state income taxes.

Please confirm that you agree with this analysis of the statute and my understanding of the legislature's intent. In the event that your office is unable to confirm my conclusions, I would like to reserve the right to meet with DOR to discuss this matter in further detail before a final ruling is issued. Your attention is much appreciated.

According to the Department of Revenue ("Department") regulations, the Department may issue only two types of letter rulings: Private Letter Rulings ("PLR") and General Information Letters ("GIL"). The regulations explaining these two types of rulings issued by the Department can be found in 2 Ill.Adm.Code §1200, or on the website http://www.tax.illinois.gov/LegalInformation/regs/part1200.

Due to the nature of your inquiry and the information presented in your letter, we are required to respond with a GIL. GILs are designed to provide background information on specific topics. GILs, however, are not binding on the Department.

Illinois defines a captive real estate investment trust in Section 1501(a)(1.5)(A) of the Illinois Income Tax Act ("IITA"; 35 ILCS 5/101 et seq.):

(1.5) Captive real estate investment trust:

(A) The term "captive real estate investment trust" means a corporation, trust, or association:

(i) that is considered a real estate investment trust for the taxable year under Section 856 of the Internal Revenue Code;

(ii) the certificates of beneficial interest or shares of which are not regularly traded on an established securities market; and

(iii) of which more than 50% of the voting power or value of the beneficial interest or shares, at any time during the last half of the taxable year, is owned or controlled, directly, indirectly, or constructively, by a single corporation.

The facts in your letter indicate that the FUND2 Fund is a limited partnership that owns three REITs,

two of which receive Illinois income: COMPANY4 and COMPANY5. The Illinois income is derived from property held by single member limited liability companies (“SMLLCs”) for the benefit of both the COMAPNY4 and the COMPANY5. The SMLLCs are ultimately owned by FUND2 based on the chain of ownership described in your letter: 99.9% of the SMLLCs are owned by COMPANY7/COMPANY8 (owned by FUND2 REITs) with the other .1% ownership going to COMPANY7/COMPANY9s - the FUND4s being wholly owned subsidiaries to the FUND2 REITs who are owned by the FUND2 Fund.

Your letter acknowledges that the REITs in the FUND2 Fund are considered REITs for purposes of IRC Section 856 and that the beneficial interest or shares of the REITs are not traded on an established securities market. The issue is therefore whether more than 50% of the voting power or value of the beneficial interest or shares of the REITs are owned or controlled by a single corporation. The fact that FUND2 Fund is a *partnership* (not a corporation) and owns membership interests in the REITs is an indication that the REITs at issue are not “captive” within the meaning of IITA Section 1501(a)(1.5).

Your reliance on Section 318(a)(5)(A) is appropriate given the fact that the FUND2 Fund is a partnership and IITA Section 1501(a)(1.5)(C) states “[f]or purposes of this subsection 1.5, the constructive ownership rules prescribed under Section 318(a) of the IRC, apply in determining the ownership of stock, assets, or net profits of any person”. The specific language in IRC Section 318(a) relating to partnerships states “stock owned, directly or indirectly, by or for a partnership or estate shall be considered as owned proportionately by its partners or beneficiaries.”

The facts in your letter state that not only does the FUND2 Fund partnership consist of more than XXX partners (making it unlikely that any one of XXX partners would own more than a 50% share given the aforementioned IRC language), but that the organizational documents for FUND2 prohibit ownership in the Fund of more than 10% by any single investor. These facts are enough to show that the REITs in FUND2 Fund do not meet the requirements of “captive REITs” as defined in IITA Section 1501(a)(1.5). Accordingly, FUND2 Fund REITs will not be required to add to its federal taxable income the dividends paid deduction for purposes of calculating Illinois state income taxes.

As stated above, this is a general information letter which does not constitute a statement of policy that either applies, interprets or prescribes tax law. It is not binding on the Department. Should you have additional questions, please do not hesitate to contact our office.

Sincerely,

Heidi Scott
Staff Attorney -- Income Tax