

Internal Revenue Service

Department of the Treasury
Washington, DC 20224

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Person To Contact: _____, ID No. _____
Telephone Number: _____

Refer Reply To:
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Date:
May 28, 2009

Legend:

Taxpayer =

State A =

LP =

a =

Corporation A =

LLC 1 =

b =

LLC 2 =

c =

d =

Dear _____ :

This is in reply to a letter dated March 5, 2009, requesting a ruling on behalf of Taxpayer. You have requested a ruling that for purposes of determining whether Taxpayer holds Corporation A securities having a value of more than 10 percent of the outstanding securities of Corporation A under section 856(c)(4)(B)(iii)(III) of the Internal

Revenue Code, the outstanding securities of Corporation A include the mortgage loans described below.

Facts:

Taxpayer is a State A real estate investment trust (REIT) that has elected under section 856(c) to be treated as a REIT for federal income tax purposes. Taxpayer is the managing general partner of LP and owns approximately a percent of the outstanding common units of LP. LP, through business entities classified as taxable REIT subsidiaries (TRSs), partnerships, or disregarded entities, owns and operates a diversified portfolio of real properties and makes loans to third parties.

Corporation A owns and operates numerous properties throughout the world, directly and indirectly through various business entities including disregarded entities. Corporation A directly owns all of the membership interests in LLC 1, a limited liability company. Corporation A also indirectly owns all of the membership interests in d other LLCs in a chain of ownership with LLC 1 (together “the LLCs”). Pursuant to section 301.7701-3(b)(1)(ii) of the Income Tax Regulations, each of the LLCs is disregarded as a separate entity. The sole liability of each of the LLCs except LLC 2 is a loan (a “Mezz Loan”) due to an unrelated third party lender (a “Mezzanine Lender”) that is secured only by a pledge of the membership interests it owns in the next lower LLC in the chain of ownership. These loans are not convertible into equity of the issuer and do not have so-called “equity kickers” associated with them.

The sole asset of each of the LLCs is its interest in the membership interests in the next LLC in the chain of ownership except LLC 2, the last in the chain of LLCs owned by Corporation A. LLC 2 owns, directly or through other disregarded entities, all of the membership interests in b disregarded entities that own and operate properties (collectively, “the Property Owner LLCs”). The Property Owner LLCs have borrowed funds from unrelated lenders and secured those loans with mortgages on the real property interests that they own (“the Mortgage Loans”).

Neither Taxpayer nor LP is related to the equity owners of Corporation A or any of the lenders making the loans described above. Taxpayer will have no interest in the Property Owner LLCs and will not be involved in the management or operation of the properties owned by the Property Owner LLCs.

Taxpayer, through LP, proposes to acquire one or more of the Mezz Loans (or portions thereof) from the Mezzanine Lenders. The aggregate value of Taxpayer’s investment in these loans will not exceed c percent of Taxpayer’s gross assets. Also, Taxpayer has represented that it will not hold interests in the Mezz Loans that have a value of more than d percent of the total value of the outstanding securities of Corporation A, assuming that the “outstanding securities of Corporation A” includes the Mezz Loans and the Mortgage Loans.

Law and Analysis:

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

Section 856(c)(4)(B)(i) provides that not more than 25 percent of the value of a REIT's total assets may be represented by securities, other than those includible under section 856(c)(4)(A). Section 856(c)(4)(B)(iii)(I) provides that not more than 5 percent of the value of a REIT's total assets may be represented by securities of any one issuer, except with respect to the securities of the REIT's taxable REIT subsidiary (TRS) and securities includible under section 856(c)(4)(A). Section 856(c)(4)(B)(iii)(II) provides that a REIT may not hold securities possessing more than 10 percent of the total voting power of the outstanding securities of any one issuer. Under section 856(c)(4)(B)(iii)(III), a REIT may not hold securities having a value of more than 10 percent of the total value of the outstanding securities of any one issuer, except with respect to a TRS and securities includible under section 856(c)(4)(A) ("the "10 percent value test").

Section 856(c)(5)(B) provides that the term "real estate assets" means, in part, real property (including interests in real property and interests in mortgages on real property).

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.

Section 856(c)(5)(F) provides that all terms not defined in section 856 shall have the same meaning as when used in the Investment Company Act of 1940, as amended (15 U.S.C. 80a-1 et seq.) ("the 1940 Act"). Under section 1.856-3(e), the term "securities" does not include "interests in real property" or "real estate assets" as those terms are defined in section 856(c)(5). It must be determined, therefore, whether the mortgages of Corporation A are real estate assets or rather securities for purposes of the 10 percent value test.

Section 856(c)(4) is concerned with assets held by the REIT. The legislative history underlying this section, which predates the addition of the 10 percent value test, states that:

... [t]he first test is designed to give assurance that the bulk of the trusts' investments are in real estate: this requires that 75 percent of the value of its assets be in real estate assets, cash and cash items, and Government securities. The second test is to provide diversification in any of the trust investments other than real estate assets (or cash, cash items, or Government securities); this test requires that not more than 25 percent of the value of the trust's assets be represented by securities (other than those described above) of any one issuer in an amount greater in value than 5 percent of the trusts' total assets and not more than 10 percent of the voting securities of the issuer.

H.R. Rep. No. 2020, 86th Cong., 2d Sess. (1960), 1960-2 C.B. 820, 822.

The 10 percent value test was added to the Code by the Tax Relief Extension Act of 1999, P.L. 106-170. In discussing the addition of the 10 percent value test to the 10 percent voting securities test, the Senate Finance Committee Report describes the committee's concern that "disqualified income of a REIT may be avoided through transactions with entities that are engaged in activities that produce disqualified income but are effectively owned by the REIT." S. Rep. No. 106-201, at 57 (1999).

Although section 856(c)(5)(B) provides that loans secured by real property are real estate assets, that rule is only applicable to loans that are held directly or indirectly by a REIT. In the present case, the Mortgage Loans are issued by Corporation A through the Property Owner LLCs, and are held by the unrelated third party mortgage lenders, not by Taxpayer. Taxpayer has no interest in those loans, and has no recourse against the real estate securing the loans. In addition, the acquisition by Taxpayer of interests in the Mezz Loans does not give it any interests in the Mortgage Loans. Therefore, the Mortgage Loans issued by Corporation A through the Property Owner LLCs are treated as securities of Corporation A rather than as real estate assets for purposes of determining whether Taxpayer satisfies the 10 percent value test under section 856(c)(5)(B).

Accordingly, we rule that for purposes of determining whether Taxpayer holds securities in Corporation A having a value of more than 10 percent of the total value of the outstanding securities of Corporation A under section 856(c)(4)(B)(iii)(III), the outstanding securities of Corporation A will include the Mortgage Loans.

Except as specifically ruled upon above, no opinion is expressed concerning any federal income tax consequences relating to the facts herein under any other provision of the Code. Specifically, we do not rule whether Taxpayer otherwise 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.

Sincerely,

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