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Date:
May 04, 2010

Legend:

Taxpayer =

State X =

Date 1 =

Date 2 =

Date 3 =

Resort =

a =

b =

c =

d =

e =

f =

g =

h =

Tenant =

Tenant Affiliate =

Year 1 =

Dear :

This is in reply to a letter dated November 13, 2009, in which Taxpayer requests a ruling concerning an election to treat certain property owned by Taxpayer as foreclosure property pursuant to § 856(e) of the Internal Revenue Code. In addition, Taxpayer requests a ruling that certain property owned by Taxpayer represents an interest in a "qualified lodging facility" as that term is defined in § 856(d)(9)(D).

Facts:

Taxpayer is a State X Corporation that elected to be taxed as a Real Estate Investment Trust (REIT) for its tax year ended Date 1. Taxpayer is engaged in the business of owning and investing in a diversified portfolio of real estate investments. Taxpayer primarily invests in properties located in the United States and abroad and generally leases the properties on a long term basis to tenants or operators who are significant industry leaders.

On Date 2, Taxpayer acquired the lodging and ski areas of Resort (the Resort Property). The Resort Property includes a four season hotel, an inn, and a lodge (collectively, the Lodging Facilities). The Lodging Facilities provide a rooms for lodging. Other facilities and amenities acquired as part of the Resort Property include a freestanding b square-foot restaurant, a c square-foot ski lodge and a d-acre ski area that includes e acres, f miles of groomed trails, and g chairlifts.

Upon acquisition of the Resort Property, Taxpayer entered into two long-term, triple-net leases with Tenant. Tenant engaged a resort management company to operate the Resort Property. At the time Taxpayer acquired the Resort Property, an entity affiliated with Tenant, Tenant Affiliate, acquired the remaining h acres of the Resort. These h acres included two golf courses, equestrian stables, a golf clubhouse/ski center, a sports club, utilities, and other undeveloped land (Tenant Affiliate Resort Property). Tenant Affiliate provided guests of the Lodging Facilities with access to all of the facilities and amenities included in the Tenant Affiliate Resort Property. The Resort Property and Tenant Affiliate Resort Property were operated and offered to the public as a single resort destination.

Tenant defaulted on its lease, and on Date 3, Taxpayer terminated Tenant's lease and took possession of the Resort Property. In order to continue to allow guests of the Lodging Facilities to use all of the Resort's amenities, Taxpayer intends to either acquire or lease the Tenant Affiliate Resort Property from Tenant Affiliate. As part of

the lease termination, Taxpayer also acquired from Tenant Affiliate the following assets, all of which have always been used in connection with the operation of the Resort (Tenant Affiliate Assets): 1) lease on overflow parking lot used in winter; 2) lease for golf course clubhouse used for ski operations during winter; 3) lease on office space used for overflow sales/marketing; 4) snowmaking ponds; 5) land and improvements; 6) equipment.

Taxpayer intends to make an election pursuant to Treas. Reg. § 1.856-6(c), on or before the due date of Taxpayer's Year 1 income tax return, to treat the Resort Property as "foreclosure property" under § 856(e). Taxpayer does not intend to consider any income derived from the Tenant Affiliate Resort Property or from the Tenant Affiliate Assets as income derived from foreclosure property for purposes of § 856(e).

Taxpayer further intends to form a new taxable REIT subsidiary ("TRS") and will lease the Resort Property and Tenant Affiliate Resort Property to the TRS. The TRS will engage an eligible independent contractor to operate and manage both the Resort Property and Tenant Affiliate Resort Property, so that the Resort can continue to operate as a single unified property.

Taxpayer represents that the amenities included in both the Resort Property and Tenant Affiliate Resort Property are customary amenities for other properties of a similar size and class.

Law and Analysis:

Issue 1:

Section 856(c)(2) provides that at least 95 percent of a REIT's gross income must be derived from, among other sources, rents from real property.

Section 856(c)(3) provides that at least 75 percent of a REIT's gross income must be derived from, among other sources, rents from real property.

Section 856(e) provides that the term "foreclosure property" means any real property (including interests in real property), and any personal property incident to such real property, acquired by the REIT as the result of such trust having bid on such property at foreclosure, or having otherwise reduced such property to ownership or possession by agreement or process of law, after there was a default (or default was imminent) on a lease of such property or on an indebtedness which such property secured.

Under section 856(e)(5), property is treated as foreclosure property only if a REIT makes an election to treat it as such prior to the due date for the REIT's tax return for

the taxable year in which it acquires such property upon default or as a result of the imminence of default.

Section 856(e)(4)(B) provides that any foreclosure property shall cease to be such on the first day (occurring on or after the day on which the REIT acquired the property) on which any construction takes place on such property (other than completion of a building, or completion of any other improvement, where more than 10 percent of the construction of such building or other improvement was completed before default became imminent).

Section 1.856-6(b)(1) provides that foreclosure property which a REIT owned and leased to another is acquired for purposes of § 856(e) on the date on which the REIT acquires possession of the property from its lessee.

Section 1.856-6(b)(2) provides that personal property (including personal property not subject to a mortgage or lease of the real property) will be considered incident to a particular item of real property if the personal property is used in a trade or business conducted on the property or the use of the personal property is otherwise an ordinary and necessary corollary of the use to which the real property is put.

Section 1.856-6(e)(1) provides that under § 856(e)(4)(B), all real property (and any incidental personal property) for which a particular election has been made shall cease to be foreclosure property on the first day (occurring on or after the day on which the trust acquired the property) on which any construction takes place on the property, other than completion of a building (or completion of any other improvement) where more than 10 percent of the construction of the building (or other improvement) was completed before default became imminent.

Section 1.856-6(e)(2) notes that construction includes the renovation of a building, such as the remodeling of apartments, or the conversion of apartments into condominiums. Direct costs of construction include amounts paid for labor and for building materials and supplies consumed. Section 1.856-6(e)(5) provides that construction does not include repair and maintenance of a building or other improvement. Architect's fees, administrative costs of the developer or builder, lawyers' fees and expenses incurred in connection with obtaining zoning approval or building permits are not direct costs of construction.

The legislative history of § 856(e) reflects a concern to provide relief for situations where a REIT inadvertently acquires property on foreclosure and risks becoming disqualified involuntarily or taking action which is not economically sensible to remain qualified. S. Rep. No. 93-1357, at 11 (1974). Under the foreclosure rules, a REIT will be able to complete construction of a project where there has been so much construction that it would be difficult to dispose of the property unless the project is

completed. *Id*. at 14. This is necessary for a REIT to make a project economically viable and for the REIT to preserve its investment. *Id.*

Although the term "construction" is not expressly defined in either § 856(e) or the regulations thereunder, the terminology used in the regulations indicates that the term should be given its ordinary meaning. In the instant case, Taxpayer is not performing any construction within the ordinary meaning of the term. For example, Taxpayer has not incurred expenses for building materials or supplies, nor has Taxpayer engaged in building remodeling or renovations.

In this case, Taxpayer is merely acquiring or leasing additional real property or acquiring personal property incident to such real property previously used in connection with the Resort to protect its investment. Without these acquisitions, the value of the Resort would decrease because guests of the Lodging Facilities would be denied access to many of the amenities customary for a resort of this size and class. This result would be contrary to the legislative intent that led to the enactment of § 856(e). The acquisition or lease of the Tenant Affiliate Resort Property and the acquisition of the Tenant Affiliate Assets supplement the use of the Lodging Facilities and are necessary for the Lodging Facilities to be utilized in the manner intended. Therefore, Taxpayer's acquisition or lease of the Tenant Affiliate Resort Property and the acquisition of the Tenant Affiliate Assets do not fit within the definition of "construction" and do not affect the status of Taxpayer's foreclosure property election.

Issue 2:

Section 856(c)(2) provides that at least 95 percent of a REIT's gross income must be derived from, among other sources, rents from real property.

Section 856(c)(3) provides that at least 75 percent of a REIT's gross income must be derived from, among other sources, rents from real property.

Section 856(d)(2) excludes certain amounts from the definition of rents from real property. Specifically, except as provided in § 856(d)(8), § 856(d)(2)(B) provides that the term does not include any amount received or accrued directly or indirectly from a corporation if the REIT owns, directly or indirectly, stock of such corporation possessing 10 percent or more of the total combined voting power of all classes of stock entitled to vote, or 10 percent or more of the total value of shares of all classes of stock of such corporation.

Section 856(d)(8) provides that in certain situations, amounts paid to a REIT by a TRS shall not be excluded from the definition of rents from real property.

Section 856(d)(8)(B) provides that the requirements of § 856(d)(8) are met with respect to an interest in real property which is a qualified lodging facility (as defined in

§ 856(d)(9)(D)) leased by a REIT to a TRS of the REIT if the property is operated on behalf of such subsidiary by a person who is an eligible independent contractor.

Section 856(d)(9)(A) provides that the term "eligible independent contractor" means, with respect to any qualified lodging facility, any independent contractor if, at the time such contractor enters into a management agreement or similar service contract with the TRS to operate such qualified lodging facility, such contractor (or any related person) is actively engaged in the trade or business of operating qualified lodging facilities for any person who is not a related person with respect to the REIT or the TRS.

Section 856(d)(9)(D) defines the term "qualified lodging facility" to mean any lodging facility (unless wagering activities are conducted at or in connection with such facility), and the term "lodging facility" means a 1) hotel, 2) motel, or 3) other establishment more than one-half of the dwelling units in which are used on a transient basis.

Section 856(d)(9)(D)(iii) provides that the term "lodging facility" includes customary amenities and facilities operated as part of, or associated with, the lodging facility so long as such amenities and facilities are customary for other property of a comparable size and class owned by other owners unrelated to such REIT.

The Resort Property and the Tenant Affiliate Resort Property, comprising the entire Resort, include the Lodging Facilities as well as supplementary amenities and facilities that are customary for other properties of similar size and class. Therefore, both properties together meet the definition of a qualified lodging facility.

The Resort Property and the Tenant Affiliate Resort Property will together be operated as the Resort by a single eligible independent contractor. Consequently, rents paid by the TRS to Taxpayer with respect to the lease of the Resort Property and Tenant Affiliate Resort Property qualify as rents from real property under § 856(d)(8).

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 subchapter M of Chapter 1 of the Code. Nor do we rule on whether any party acting as an eligible independent contractor qualifies as such for purposes of § 856(d).

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,

Alice M. Bennett

Alice M. Bennett
Chief, Branch 3
Office of Associate Chief Counsel
(Financial Institutions and Products)