Internal Revenue Service

Number: **201129031**
Release Date: 7/22/2011

Index Number: 856.00-00

Department of the Treasury
Washington, DC 20224

Third Party Communication: None
Date of Communication: Not Applicable

Person To Contact:
, ID No.
Telephone Number:

Refer Reply To:
CC:FIP:B02
PLR-147655-10
Date:
April 19, 2011

Legend:

Taxpayer =

State A =

State B =

Date 1 =

Operating Partnership =

TRS A =

Type A =

Company A =

Company B =

Dear :

This is in reply to a letter dated November 19, 2010, and a subsequent submission, requesting rulings on behalf of Taxpayer. The requested rulings concern the treatment of a REIT and its taxable REIT subsidiary (TRS) under section 856 of the Internal Revenue Code in the circumstances described below.

Facts:

Taxpayer is a publicly held State A corporation that elected to be taxed as a real estate investment trust (REIT) for its tax year beginning Date 1. Taxpayer owns substantially all of its assets and conducts all of its operations through Operating Partnership and Operating Partnership's subsidiaries. Taxpayer is the sole general partner of Operating Partnership and owns approximately 98 percent of the outstanding partnership interests of Operating Partnership. TRS A is a State B corporation and a wholly-owned subsidiary of Operating Partnership that has jointly elected with Taxpayer to be treated as a TRS of Taxpayer pursuant to § 856(l).

Taxpayer is engaged primarily in the acquisition, ownership, and leasing of a portfolio of Type A properties (the Properties) through its interest in Operating Partnership and Operating Partnership's lower-tier subsidiaries. The Properties are leased to TRS A and other TRSs of Taxpayer. Taxpayer represents that each lease between Operating Partnership or one of its subsidiaries and a TRS was negotiated at arm's length and reflects market rates and commercially reasonable terms.

The Properties are operated by unrelated third-party Type A property operators (the Operators). Taxpayer represents that each Operator is in the business of operating and managing Type A properties for persons unrelated to Taxpayer and qualifies as an "eligible independent contractor" (EIK) within the meaning of § 856(d)(9)(A). Taxpayer further represents that each management agreement between Operating Partnership or one of its subsidiaries and one of the Operators was negotiated by the parties at arm's length and reflects market terms.

Sale of property to Operator

Although Taxpayer represents that it acquires and holds the Properties for investment and not primarily for sale in the ordinary course of its trade or business, Taxpayer may sell one of the Properties when it is economically advantageous. Taxpayer represents that it will not sell a property to any entity that directly operates or manages the Properties and that any potential buyer that is affiliated with the operator of a property would be a separate legal entity for state law purposes and federal income tax purposes from the entities directly operating or managing the Properties, would maintain its own bank accounts, books and records and would have its own employees under its separate control.

In certain cases, an Operator of one of the Properties has negotiated, as part of the management agreement, a right of first offer ("ROFO") and/or a right of first refusal ("ROFR") with respect to the property being sold by Taxpayer. Taxpayer represents that each management agreement providing a ROFO and/or ROFR was negotiated by

the parties at arm's length, and a sale pursuant to a ROFO or ROFR is intended to result in a market price being paid by an Operator to Taxpayer. Even if no ROFO or ROFR exists, an Operator may offer Taxpayer the most competitive bid for a property. Taxpayer represents that any agreement to sell to an Operator will be negotiated at arm's length.

Investment in Target Management Company

Taxpayer is considering acquiring, on an arm's length basis, part or all of the real estate assets of Company A and Company B (collectively referred to as "Targets") and, as part of that acquisition, making an investment, through Operating Partnership or TRS A, in Company A's Type A management company and Company B's Type A management company (collectively referred to as "Target Management Companies") or their subsidiaries.

Company A is a publicly-traded company that owns and operates all of its assets through its management company, a limited liability company in which it owns substantially all of the outstanding interests. Company B is a private company.

The investment in Target Management Companies or their subsidiaries may take various forms, including investments in secured and unsecured loans, and equity investments such as common stock, preferred stock, warrants or options to acquire stock, convertible debt, and loans with warrants. The loans will have market-based terms.

Taxpayer represents that it will not make a loan to, or an equity investment in, any of the entities that would operate or manage any of the Type A properties acquired by Taxpayer from Targets or already owned by Taxpayer or a TRS of Taxpayer. Each of the entities operating or managing one of the acquired or previously owned Type A properties would be a separate legal entity for state law purposes and federal income tax purposes, would maintain its own bank accounts, books and records and would have its own employees under its separate control.

Taxpayer further represents that any loan that is determined to be a security under § 856(c)(4)(B)(iii) will represent not more than 10 percent of the value of the total outstanding securities of the loan recipient, and any equity investment will represent not more than either 10 percent of the total voting power or value of the total outstanding securities of the issuer. And, both before and after the proposed transaction, neither Targets nor Target Management Companies will own more than 35 percent of the shares of Taxpayer, and no one or more persons owning more than 35 percent of the shares of Taxpayer will own more than 35 percent of the shares of Targets or Target Management Companies (measured in each case both by combined voting power and total number of shares).

TRS A may make a loan to, or an equity investment in, an entity that would operate or manage one of the Type A properties acquired by Taxpayer from Targets or already owned by Taxpayer or a TRS of Taxpayer. However, Taxpayer represents that any investment by TRS A in Target Management Companies or their subsidiaries will not cause TRS A to own directly or indirectly securities possessing more than 35 percent of the total voting power, or having a value of more than 35 percent of the total value, of the outstanding securities of Target Management Companies or any of their subsidiaries. For this purpose, TRS A will take into account any investment by Taxpayer or Operating Partnership other than through TRS A in applying these 35 percent undertakings.

Following the acquisition of a Type A property of Targets, Operating Partnership and its subsidiaries intend to lease the properties to TRS A pursuant to leases negotiated at arm's length and reflecting market rates and commercially reasonable terms. TRS A will enter into or assume a management agreement for each property with an entity, a subsidiary of Target Management Companies, that meets the definition of an EIK within the meaning of § 856(d)(9)(A). TRS A will bear all the expenses for the operation of the properties and will receive all of the revenues, net of operating expenses and fees payable to the Operator, from the operation of the properties pursuant to the management agreement. The management agreements will reflect terms negotiated at arm's length and the fees payable to the operator will be at market rates.

Law and Analysis:

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)(1) provides that rents from real property include (subject to exclusions provided in section 856(d)(2)): (A) rents from interests in real property; (B) charges for services customarily furnished or rendered in connection with the rental of real property, whether or not such charges are separately stated; and (C) rent attributable to personal property leased under, or in connection with, a lease of real property, but only if the rent attributable to the personal property for the taxable year does not exceed 15 percent of the total rent for the tax year attributable to both the real and personal property leased under, or in connection with, the lease.

Section 856(d)(2)(B) provides that rents from real property does not include any amount received or accrued directly or indirectly from any person if the REIT owns directly or indirectly: (1) in the case of a corporation, stock 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 the corporation; or (2) in the case of any person that is not a corporation, an interest of 10 percent or more in the assets or net profits of the person.

Section 856(d)(2)(C) provides that any impermissible tenant service income is excluded from the definition of rents from real property. Section 856(d)(7)(A) defines impermissible tenant service income to mean, with respect to any real or personal property, any amount received or accrued directly or indirectly by the REIT for services furnished or rendered by the REIT to tenants at the property, or for managing or operating the property.

Section 856(d)(7)(C) provides certain exclusions from impermissible tenant service income. Section 856(d)(7)(C) provides that for purposes of section 856(d)(7)(A), services furnished or rendered, or management or operation provided, through an independent contractor from whom the REIT does not derive or receive any income shall not be treated as furnished, rendered, or provided by the REIT, and there shall not be taken into account any amount which would be excluded from unrelated business taxable income under section 512(b)(3) if received by an organization described in section 511(a)(2).

Section 856(d)(8)(B) provides that amounts paid to a REIT by a TRS shall not be excluded from rents from real property by reason of section 856(d)(2)(B) when a REIT leases a qualified lodging facility or qualified health care facility to a TRS, and the facility or property is operated on behalf of the TRS by a person who is an eligible independent contractor.

Section 856(d)(3) defines an independent contractor as any person who does not own, directly or indirectly, more than 35 percent of the REIT's shares and, if such person is a corporation, not more than 35 percent of the total combined voting power of whose stock (or 35 percent of the total shares of all classes of whose stock) is owned directly or indirectly, by one or more persons owning 35 percent or more of the shares of the REIT.

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

Section 856(l) provides that a REIT and a corporation (other than a REIT) may jointly elect to treat such corporation as a TRS. To be eligible for treatment as a TRS,

section 856(l)(1) provides that the REIT must directly or indirectly own stock in the corporation, and the REIT and the corporation must jointly elect such treatment.

Section 856(l)(2) provides that any corporation in which a TRS owns directly or indirectly more than 35 percent of the total voting power or value of the outstanding securities shall be treated as a TRS. Section 856(l)(3)(A) provides that a TRS cannot directly or indirectly operate or manage a lodging facility or a health care facility.

Rev. Rul. 75-136, 1975-1 C.B. 195 concerns whether a wholly-owned subsidiary of a REIT's corporate investment adviser can serve as an independent contractor to manage the REIT's property, as required under section 856(d)(3). In determining that the subsidiary may qualify as an independent contractor, the ruling states that it is the relationship of the entity or individual (such as an employee or trustee) to the trust itself that precludes the entity from qualifying as an independent contractor for the management of the property. A relationship between the entity or individual and the trustee, or employee, or investment adviser of the REIT would not in itself disqualify the entity, assuming the other requirements for qualification as an independent contractor are met. Accordingly, the ruling holds that the wholly-owned subsidiary of the investment adviser is not precluded from qualifying as an independent contractor if it operates as a separate entity with its own separate officers and employees and keeps its own separate books and records that clearly reflect its activities in the management of the property.

In Rev. Rul. 73-194, a REIT entered into a partnership with X corporation to construct and hold apartment buildings for investment. The partnership agreement provided that the partners would engage a management company to manage an apartment building. The management company was employed in an arm's length transaction and was paid a market rate for its services. X corporation was a wholly-owned subsidiary of Y corporation, which owned a substantial percentage of the stock of the management company. In concluding that the income received by the REIT from the partnership will not be disqualified as rents from real property due to the relationship between X, Y, and the management company, the ruling cites the legislative history underlying section 856(d), which states that the restrictions imposed by that section were intended to prevent income from active business operations from being included in a REIT's income. The legislative history indicates that for this requirement to be satisfied, the REIT and the independent contractor must have an arm's length relationship. See H.R. No. 2020, 86th Cong., 2d Sess.6, 1960-2 C.B. 819, 825.

In Rev. Rul. 2003-86, 2003 C.B. 290, a REIT owned all of the stock of a TRS that owned an interest in a partnership. The partnership was an independent contractor under section 856(d). The partnership provided certain noncustomary services to the REIT's tenants. Although the REIT did not directly receive payments from the independent contractor, the REIT indirectly held an equity interest in the independent contractor through its ownership of the TRS. The revenue ruling states that section

856(d)(7)(C)(i) provides an exception for services furnished or rendered through a TRS. Noting that the REIT's only interest in the independent contractor is through the TRS, the ruling states that the services provided by the independent contractor are provided by the TRS to the extent of the TRS's interest in the independent contractor. Accordingly, the ruling concludes that the REIT will not be treated as providing impermissible tenant services.

In the present case, Taxpayer may receive income from an entity affiliated with an Operator arising from the sale of one of the Properties. Taxpayer may provide loans to an entity affiliated with a manager or operator of the Properties. Taxpayer may also receive income from an equity investment in an entity affiliated with a company operating or managing one or more of the Properties. TRS A may provide loans or receive income from an equity investment in a company operating or managing one or more of the Properties, or an entity affiliated with the company. In each situation, the income received by Taxpayer or TRS A is not derived from or dependent upon Taxpayer's relationship with the company operating or managing any of the Properties. All of the agreements entered into by Taxpayer or TRS A for the management or operation of the Properties are represented to be arm's length and to reflect market terms.

Accordingly, based on the information received and representations made, we conclude that:

1) Income received by Taxpayer from the sale of a Type A property to an entity affiliated with an EIK that directly operates or manages a Type A property leased to or owned by a TRS of Taxpayer will not cause (1) that EIK to not be considered an EIK within the meaning of § 856(d)(9)(A) with respect to the properties operated or managed on behalf of the TRS of Taxpayer; (2) a TRS of Taxpayer to be considered to be directly or indirectly operating or managing any properties managed by that EIK within the meaning of § 856(l)(3)(A), or (3) rents received by Taxpayer with respect to any of the Type A properties leased to its TRS and operated or managed by that EIK to be treated as other than rents from real property under § 856(d).

2) A loan to, or an equity investment in Target Management Companies or any of their subsidiaries (other than the entities that directly operate or manage Type A properties leased to or owned by a TRS of Taxpayer, as described herein), by Taxpayer, through Operating Partnership, will not cause (1) any affiliated entity of Target Management Companies that directly operate or manage such properties not to be considered an EIK within the meaning of § 856(d)(9)(A) with respect to the properties operated or managed on behalf of the TRS of Taxpayer, (2) a TRS of Taxpayer that leases or owns Type A properties to be considered to be directly or indirectly operating or managing such properties within the meaning of § 856(l)(3)(A), or (3) rents received by

Taxpayer with respect to any of the Type A properties leased to its TRS and operated or managed by that EIK to be treated as other than rents from real property under § 856(d), provided that the loan or equity investment represents not more than 10 percent of the vote or value of the total outstanding securities of the issuer.

3) A loan by TRS A to, or an equity investment by TRS A in, Target Management Companies or any of their subsidiaries as described herein, will not cause (1) a TRS of Taxpayer that leases or owns the Properties to be considered to be directly or indirectly operating or managing such properties within the meaning of § 856(l)(3)(A), or (2) rents received by Taxpayer with respect to any of the Type A properties to be treated as other than rents from real property under § 856(d), provided that any such investment will not cause TRS A to own directly or indirectly securities possessing more than 35 percent of the total value of the outstanding securities of Target Management Companies or any of their subsidiaries (determined by taking into account any other securities owned by Taxpayer, Operating Partnership or any other TRS of Taxpayer).

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. Also, no opinion is expressed concerning the treatment of payments between Taxpayer's TRS and Taxpayer for purposes of section 857(b)(7).

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)