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Date:
January 16, 2013

Legend:

Taxpayer =

State A =

Year 1 =

Dear :

This is in reply to a letter dated July 18, 2012, and further submissions, in which Taxpayer requests rulings in connection with its intent to elect to be taxed as a real estate investment trust ("REIT") under section 856 of the Internal Revenue Code.

Taxpayer is a publicly traded State A corporation that intends to elect to be taxed as a REIT. Taxpayer presently owns, leases, and operates correctional, detention, and re-entry facilities. Taxpayer also presently provides community based services to supervise and assist parolees and probationers. Taxpayer's facilities include residential facilities and non-residential facilities. Taxpayer's residential facilities include correctional and detention facilities, community-based services ("CBS") halfway houses, and youth services residential facilities (collectively the "Residential Facilities"). Taxpayer's non-residential facilities include CBS day reporting centers and youth services non-residential facilities ("Non-Residential Facilities").

Following its election to be taxed as a REIT, Taxpayer intends to create one or more TRSs to operate and provide services that it presently provides in connection with its Residential Facilities and Non-Residential Facilities. Taxpayer also intends to create one or more TRSs to which it will contribute certain contracts and facilities, as described below.

Taxpayer is seeking rulings that (1) the Residential Facilities and Non-Residential Facilities are not "health care facilities" in whole or in part under section 856(l)(4)(B); (2) the amounts received under Taxpayer's contracts with government tenants for the Residential Facilities will be treated as "rents from real property" for purposes of section 856(d)(1); and (3) the payments Taxpayer collects on behalf of its TRSs for the Services (as later defined) the TRSs provide at a Financed Facility (as later defined) will not be disqualified income for purposes of the REIT income tests.

Taxpayer's Current Business

Residential Facilities

Correction and Detention Facilities

Taxpayer contracts with federal, state, and foreign government entities ("government tenants") to provide facilities to house offenders or detainees on their behalf. The contracts are generally awarded through a competitive bid process.

Taxpayer owns or leases correctional and detention facilities that are currently under contract with government tenants. Taxpayer also has manage-only contracts under which it operates correctional and detention facilities that government tenants either own directly or lease from a third party. Taxpayer represents that the fair market value of the personal property that will be owned by the REIT in the owned and leased Residential Facilities will not exceed fifteen percent of the total fair market value of the owned and leased Residential Facilities.

Under a majority of the contracts for the correctional and detention facilities that Taxpayer owns or leases, Taxpayer receives a monthly lump sum amount from a government tenant for the use of the facility. Taxpayer agrees to house a certain number of occupants (the "guaranteed minimum") and provide related services. The monthly lump sum amount is calculated pursuant to the terms of the contract by multiplying the guaranteed minimum by a daily rate per occupant. If a government tenant needs space for more occupants than are included in the guaranteed minimum, it will pay an additional amount for each day that an extra occupant spends in the facility. The rate for extra occupants is generally lower than the rate for the occupants covered by the guaranteed minimum. Some of Taxpayer's contracts do not have a guaranteed minimum, and a government tenant's monthly payment will be based on a daily rate per occupant.

The contracts typically have terms from three to five years with multiple renewal options, ranging from one to five years, with a total contract period ranging from ten to fifteen years. At the end of the contract period, Taxpayer must competitively bid to receive the contract for another term.

Although Taxpayer's contracts vary by customer, Taxpayer is generally required to provide the following services (the "Services"):

- Facility security, including guard supervision
- Food service
- Counseling and substance abuse treatment
- Basic medical and dental care
- Academic and vocational programming
- Administrative and management services, including recordkeeping and reporting
- Facility maintenance and utilities
- Secure transportation of occupants
- Intake and screening

As mentioned above, the Services required by the contracts include some level of medical, dental, and mental health services. To avoid the security risk and expense of taking an occupant offsite to receive medical services, Taxpayer employees perform routine medical, dental, and mental health services in a segregated area of the facility. These employees also do an intake screening when a resident arrives at the facility to ascertain the health status of the inmate. The screenings are necessary to shield the other occupants and the staff from exposure to contagious illness. Medical employees may include doctors, nurses, and/or technicians but Taxpayer only provides basic medical services. None of the facilities are licensed as medical or dental facilities. A few of the facilities have a license from a state agency to provide substance abuse counseling. None of the facilities are licensed as medical facilities that are operated by a provider that is eligible for participation in the Medicare program.

CBS Facilities: Halfway Houses

Taxpayer also owns, leases, and manages CBS facilities. There are two types of CBS facilities: halfway houses and youth services residential facilities, which are Residential Facilities, and day reporting centers and youth services non-residential facilities, which are Non-Residential Facilities and are described below.

Residential Facilities

The halfway houses provide a home to federal or state offenders who are reentering society after incarceration. Taxpayer's halfway house contracts are awarded by government tenants in a competitive bid process and generally have a term of one to two years with three to four annual renewal periods. Taxpayer bills government tenants monthly pursuant to the contract terms, based on a formula price. The monthly payment is calculated based on the number of occupants residing at the facility at a daily rate per occupant.

Pursuant to the contracts with government tenants to house these newly released individuals, Taxpayer is required to provide drug testing, recordkeeping and reporting, food services, vocational and educational programming, employment assistance, and substance abuse and family counseling.

A few of the halfway houses employ a psychologist, but generally no other medical care is available onsite. One halfway house employs a nurse who provides basic medical services. None of the halfway houses are licensed as medical facilities that are operated by a provider that is eligible for participation in the Medicare program.

Residential Youth Services Facilities

Taxpayer owns, leases, and manages residential and non-residential youth services facilities. Government tenants use Taxpayer's residential youth services facilities to provide housing for juvenile offenders.

Taxpayer contracts with multiple government tenants to house youths in its residential youth services facilities. Taxpayer bills government tenants monthly pursuant to the contract terms, based on a formula price. The monthly payment is calculated based on the number of youths residing at the facility at a daily rate per youth. Each facility houses residents for several government tenants. The contracts do not have guaranteed minimums and government tenants do not have any specific amount of space reserved.

Taxpayer's residential youth services facilities provide multiple, residential, education programs specifically designed to address the needs of individuals within the juvenile justice system with programs tailored to the specific needs of youthful offenders. The programs typically vary in length from one to fourteen months. Taxpayer expects youths to stay at the facility for the entire length of the relevant programs, as approximately 90% of youths complete their programs.

As part of its contracts with government tenants for the use of facilities to shelter youths, Taxpayer is required to provide food service, counseling, supervision, vocational and culinary training, and transportation to the occupants.

Employees at the residential youth services facilities provide therapy and substance abuse counseling to the occupants. Nurses provide some basic medical care, but most medical needs are met offsite. Six of the youth services residential facilities are licensed by the state to treat alcoholism and substance abuse. Additionally, three of the youth services residential facilities are licensed by the state to provide mental health services. None of the residential youth services facilities are licensed as medical facilities that are operated by a provider that is eligible for participation in the Medicare program.

Non-Residential Facilities

Community-Based Services: Day Reporting Centers

Taxpayer operates CBS day reporting centers where it is required to provide drug testing, supervision, vocational and educational programming, and some counseling to offenders who are reentering society after incarceration. Offenders report to the day reporting centers a few days a week and spend at most a few hours at the facility per day. These contracts typically require Taxpayer to lease specific storefronts in a shopping center in which to provide the services. For a few CBS day reporting centers, a government tenant leases the space and Taxpayer only operates the center. Several of the CBS day reporting centers employ therapists, but generally no other medical care is available. Furthermore, the day reporting centers are not licensed as medical facilities that are operated by a provider that is eligible for participation in the Medicare program.

Non-Residential Youth Services Facilities

The non-residential youth services facilities are similar to the day reporting centers discussed above. They are operated in storefronts. Taxpayer provides programming, counseling, and mental health case management, but it does not house the youths on behalf of government tenants. No medical care is provided. They are not licensed as medical facilities operated by a provider that is eligible for participation in the Medicare program.

Financed Facility

In some cases, Taxpayer leases land from a state agency, builds a facility on the leased land, and then operates the facility for a government tenant for the duration of the contract. At the end of the contract, title to the facility shifts to the government tenant ("Financed Facilities").[1]

Taxpayer's Proposed Restructuring

Taxpayer intends to operate as a REIT beginning with an election to be taxed as a REIT for its Year 1 taxable year. Taxpayer also intends to create one or more wholly-owned subsidiaries, which will elect to be treated as TRSs (Taxpayer's TRSs). Taxpayer's TRSs will provide the Services described above to government tenants and will be compensated by Taxpayer at an arm's length rate. Taxpayer will contribute the

[1] In certain cases, similar arrangements have been treated as loans rather than lease arrangements. See e.g., Frank Lyon Co. v. United States, 435 U.S. 561 (1978).

manage-only Residential Facilities contracts and the Non-Residential Facilities to TRSs or make TRS elections for the existing entities that hold these assets.

Law and Analysis:

Section 856(c)(2) provides that at least 95 percent of a REIT's gross income must be derived from specified sources that include rents from real property, and section 856(c)(3) provides that at least 75 percent must be derived from sources, that likewise include, 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. With respect to each lease of real property, rent attributable to personal property for the taxable year is that amount which bears the same ratio to total rent for the taxable year as the average of the fair market values of the personal property at the end of the taxable year bears to the average of the aggregated fair market values of both the real property and the personal property at the beginning and at the end of such taxable year.

Section 1.856-4(b) provides that subject to the exceptions in sections 856(d) and section 1.856-4(b), the term, "rents from real property" means, generally, the gross amounts received for the use of, or the right to use, real property of the REIT. Section 1.856-4(b) provides that the term rents from real property includes charges for services customarily furnished or rendered in connection with the rental of real property, whether or not the charges are separately stated. Services furnished to tenants of a particular building will be considered as customary if, in the geographic market in which the building is located, tenants in buildings of similar class are customarily provided with the service. Where it is customary, in a particular geographic marketing area, to furnish electricity or other utilities to tenants in buildings of a particular class, the submetering of utilities to tenants in such buildings will be considered a customary service.

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 or through a TRS of such trust shall not be treated as furnished, rendered, or provided by the REIT, and 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) shall not be taken into account.

Section 512(b)(3) provides, in part, that there shall be excluded from the computation of unrelated business taxable income all rents from real property and all rents from personal property leased with such real property, if the rents attributable to such personal property are an incidental amount of the total rents received or accrued under the lease, determined at the time the personal property is placed in service.

Section 1.512(b)-1(c)(5) provides that payments for the use or occupancy of rooms and other space where services are also rendered to the occupant, such as for the use or occupancy of rooms or other quarters in hotels, boarding houses, or apartment houses furnishing hotel services, or in tourist camps or tourist homes, motor courts or motels, or for the use or occupancy of space in parking lots, warehouses, or storage garages, do not constitute rents from real property. Generally, services are considered rendered to the occupant if they are primarily for his convenience and are other than those usually or customarily rendered in connection with the rental of rooms or other space for occupancy only. The supplying of maid service, for example, constitutes such service; whereas the furnishing of heat and light, the cleaning of public entrances, exits, stairways and lobbies, and the collection of trash are not considered as services rendered to the occupant.

Section 856(d)(7)(B) provides that if the amount of impermissible tenant service income exceeds one percent of all amounts received or accrued during the tax year directly or indirectly by the REIT with respect to the property, the impermissible tenant service income of the REIT will include all of the amounts received or accrued with respect to the property.

In Rev. Rul. 2002-38, 2002-2 C.B. 4, a REIT pays its TRS to provide noncustomary services to tenants. The REIT does not separately state charges to tenants for the services. Thus, a portion of the amounts received by the REIT from tenants represents an amount received for services provided by the TRS. TRS employees perform all of the services and TRS pays all of the costs of providing the services. The TRS also rents space from the REIT for carrying out its services to tenants. The revenue ruling concludes that the services provided to the REIT's tenants are considered to be rendered by the TRS, rather than the REIT, for purposes of § 856(d)(7)(C)(i). Accordingly, the services do not give rise to impermissible tenant

service income and do not cause any portion of the rents received by the REIT to fail to qualify as rents from real property under § 856(d).

Section 856(l) provides that a REIT and a corporation (other than a REIT) may treat such corporation as a TRS if the REIT directly or indirectly owns stock in the corporation, and the REIT and the corporation jointly elect such treatment.

Section 856(l)(3)(A) provides that a TRS cannot directly or indirectly operate or manage a lodging facility or a health care facility. Section 856(l)(4)(B) provides that the term "health care facility" has the meaning given such term in section 856(e)(6)(D)(ii).

A "health care facility" is defined in section 856(e)(6)(D)(ii) as a hospital, nursing facility, assisted living facility, congregate care facility, qualified continuing care facility (as defined in section 7872(g)(4)), or other licensed facility which extends medical or nursing or ancillary services to patients and which was operated by a provider of such services that is eligible for participation in the Medicare program under Title XVII of the Social Security Act [subchapter XVIII of chapter 7 of Title 42 (42 U.S.C.A. § 1395 et seq.)] with respect to the facility.

Ruling 1: The Residential Facilities and Non-Residential Facilities are not "health care facilities" in whole or in part under section 856(l)(4)(B).

The Residential Facilities and Non-Residential Facilities are not hospitals, nursing facilities, assisted living facilities, qualifying continuing care facilities or other licensed facilities that were eligible for participation in Medicare. Therefore, unless they are congregate care facilities, the Residential Facilities and Non-Residential Facilities are not health care facilities.

Although congregate care facility is not defined in either the statute or the regulations, there are commonly used definitions of congregate care. The common theme among these definitions is the sharing of living space, dining space, transportation, and group activities. The definitions do not describe any level of medical or health care services. Nevertheless, further refinement to these definitions is needed for section 856 definitional purposes.

Congregate care facility must be read in context. Section 856(l)(4)(B) and section 856(e)(6)(D)(ii) describe various facilities that provide health care, not as an auxiliary function, but as part of the primary function of the facility (e.g., hospitals and nursing facilities) or in connection with a facility that has the primary function of providing health care (e.g., assisted living facilities). We conclude that it is not enough that a facility that meets the general definitions of congregate care offers medical services; to be a congregate care facility under section 856(l)(4)(B), the facility's health care concerns must be part of the primary function of the facility or sufficiently related to

the provision of health care as implied under section 856(l)(4)(B). In the present case, the Residential and Non-Residential Facilities are not related to a health care facility and the medical care provided by the those facilities is not part of the primary function of those facilities.

Taxpayer is obligated to provide space that government tenants use to incarcerate prisoners and detainees. As part of its operations, Taxpayer provides a certain level of shared dining and living space and group activities. The contracts require Taxpayer to provide the Services, including some level of medical, dental, and mental health services, as required by the prisoners and detainees. While Taxpayer's correctional facilities may provide a certain level of medical care, these services are not part of the primary function of the Residential and Non-Residential Facilities and thus these facilities are not congregate care facilities within the meaning of 856(e)(6)(D)(i).

Ruling 2: The amounts received under Taxpayer's contracts with government tenants for the Residential Facilities (excluding the Financed Facilities) will be treated as "rents from real property" for purposes of section 856(d)(1).

Under Taxpayer's owned and leased Residential Facilities contracts, government tenants pay to use specific real property to house their prisoners, detainees, probationers, and parolees. The contract payments received by Taxpayer are payments for the right to use space within a specific building. Therefore, the contract payments received by Taxpayer will be treated as "rents from real property" under section 856(d). Furthermore, Taxpayer has represented that the aggregate fair market value of the personal property owned by the REIT in the Residential Facilities is less than 15 percent of the aggregate fair market value of all property provided under the contracts. Because less than 15 percent of the contract fees is attributable to personal property under section 856(d)(1)(C), the entire contract fee will be treated as "rents from real property" within the meaning of section 856(d).

The Services provided to government tenants will be provided by a TRS of Taxpayer. The fees for the Services will be included in the rent received by Taxpayer, but Taxpayer will compensate the TRS on an arm's-length basis for providing the Services. All costs associated with providing the Services will be paid by the TRS. Accordingly, income from the Services provided by the TRS to government tenants will be excepted from the definition of impermissible tenant service income, and the amounts received by Taxpayer from government tenants will not be treated as other than rents from real property under section 856(d).

Ruling 3: The payments Taxpayer collects on behalf of its TRSs for the Services the TRSs provide at a Financed Facility[2] are considered to be rendered by the TRS, rather

[2] This includes payments made in connection with a lease arrangement that may be recharacterized as a loan.

than the REIT, and do not cause any portion of the payments received by the REIT that otherwise qualify to be disqualified for purposes of the REIT income tests.

Taxpayer represents that it will assign the service components of its Financed Facilities contracts to its TRSs, which will be fully responsible for directly providing the Services in those facilities. Taxpayer will collect the amounts that government tenants pay for the Services in the Financed Facilities on behalf of the TRSs and remit these amounts to the TRSs.

Taxpayer collects the charges for these services on behalf of the TRSs. Therefore, these arrangements do not cause payments Taxpayer collects on behalf of its TRSs for the Services the TRSs provide at a Financed Facility are considered to be rendered by the TRS, and do not cause any portion of the payments received by the REIT to the extent they otherwise qualify to be disqualified for purposes of the REIT income tests.

Conclusion:

Based on the facts as represented, we rule that:

(1) The Residential Facilities and Non-Residential Facilities will not be treated as "health care facilities" in whole or in part under section 856(l)(4)(B);

(2) The amounts received under Taxpayer's contracts with government tenants for the Residential Facilities will be treated as "rents from real property" for purposes of section 856(d)(1); and

(3) The payments Taxpayer collects on behalf of its TRSs for the Services the TRSs provide at a Financed Facility are considered to be rendered by the TRS, rather than the REIT, and do not cause any portion of the payments received by the REIT that otherwise qualify to be disqualified for purposes of the REIT income tests.

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 on whether Taxpayer otherwise qualifies as a REIT under part II of subchapter M of Chapter 1 of the Code. We also do not rule on whether a contract for a Financed Facility is treated in part as a loan from Taxpayer to a government tenant with respect to the Financed Facility. Furthermore, we do not rule whether payments received by the REIT on behalf of its TRS at a Financed Facility constitute gross income under section 61. In addition, we do not rule on whether Taxpayer's TRSs are adequately compensated for the Services.

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.

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,

Jonathan D. Silver

Jonathan D. Silver
Assistant Branch Chief, Branch 2
Office of Associate Chief Counsel
(Financial Institutions & Products)