Internal Revenue Service

Number: **201320007**
Release Date: 5/17/2013

Index Number: 856.00-00

Department of the Treasury
Washington, DC 20224

Third Party Communication: None
Date of Communication: Not Applicable

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CC:FIP:B02
PLR-132867-12

Date:
February 11, 2013

Legend:

Taxpayer =

State A =

Year 1 =

Date 1 =

Dear :

This is in reply to a letter in which Taxpayer requests rulings in connection with its intent to elect to be taxed as a real estate investment trust ("REIT") under sections 856 and 305 of the Internal Revenue Code.

Taxpayer is a publicly traded State A corporation that intends to elect to be taxed as a REIT. Taxpayer and its direct and indirect subsidiaries ("Taxpayer Group") currently own correctional and detention facilities (the "Facilities"). Taxpayer represents that the Facilities are predominantly real property, and that the personal property used in the Facilities represents less than 15 percent of the value of each Facility.

Following its election to be taxed as a REIT, Taxpayer intends to create one or more taxable REIT subsidiaries ("TRSs") to operate and provide services that it presently provides in connection with the Facilities.

Taxpayer has requested rulings that (1) the Facilities are not "lodging facilities" as defined in section 856(d)(9)(D)(ii) or "health care facilities" in whole or in part under section 856(l)(4)(B); (2) the amounts received under Taxpayer REIT's (as defined later) contracts with government tenants for the Facilities will be treated as "rents from real

property" for purposes of section 856(d)(1); (3) the payments Taxpayer REIT collects on behalf of its TRSs for the Services (as defined later) the TRSs provide at a Financed Facility (as defined later) will not be disqualified income for purposes of the REIT income tests; and (4) Taxpayer REIT's cash and stock distribution election will be treated as a distribution of property with respect to its stock under section 301.

Taxpayer's Current Business

Taxpayer Group contracts with federal, state, and local correctional and detention authorities ("government tenants") that use the Facilities to house their inmates and for certain other administrative purposes. The terms of the contracts range from one year to 25 years, depending on whether renewal options are included.

Taxpayer Group's contracts with government tenants generally fall into one of three categories: Owned and Managed Facilities, Financed Facilities, and Managed-Only Facilities.

Owned and Managed Facilities

In most cases, Taxpayer Group enters into an agreement with a government tenant (the Agreement) that identifies the Facility, allows a government tenant to use the Facility to house its inmates and use space for administrative purposes, and provides for the provision of incarceration services. Under a typical Agreement, Taxpayer Group is compensated for providing both space and services at a Facility at a per diem rate for each inmate, based upon actual occupancy levels, or in some cases, based on a minimum guaranteed occupancy level, with incremental per diem payments for any occupancy exceeding the guaranteed level. The per-diem rate may be adjusted annually to take into account the effects of inflation.

The Agreements typically require Taxpayers Group to provide certain incarceration-related services ("Services") to its government tenants, including:

- Security related services, including inmate security, detention and surveillance, which are generally provided through correctional officers;
- Food service for inmates;
- Rudimentary medical and dental services for inmates;
- Vocational, educational and religious programming for inmates;
- Certain mental health services, including drug rehabilitation and counseling; and
- Inmate transportation

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 these services, Taxpayer Group's employees perform routine medical, dental, and mental health services in a segregated area of the

facility. The space is generally not licensed for any medical purpose and includes only basic medical office equipment. Due to more stringent licensing requirements in some states, three of the Facilities have space that is licensed as an infirmary. However, the medical care provided is no more extensive than at other Facilities. None of the Facilities are licensed as medical facilities that are operated by a provider that is eligible for participation in Medicare.

Financed Facilities

At a small minority of the Facilities, Taxpayer Group enters into an agreement with a government tenant that is substantially similar to the Agreement (or may be in the form of a lease of the Facility to a government tenant along with a separate services agreement), except that the agreement either (i) allows the government tenant to purchase the Facility during the contract term at a price which may be below the fair market value of the Facility; or (ii) provides that ownership of the Facility shall be transferred to the government tenant at no cost at the end of the contract term ("Financed Facilities").[1]

Managed Facilities

In other cases, Taxpayer Group enters into a management agreement with a government agency that provides that Taxpayer Group will provide incarceration services to the agency at the agency's own facility (Management Agreement).

Proposed REIT Election

Taxpayer intends to elect to be treated as a REIT ("Taxpayer REIT") for the taxable year beginning on Date 1. Taxpayer REIT has one class of common stock outstanding, which is publicly traded. Taxpayer's corporate structure will be adapted to include one or more qualified REIT subsidiaries (QRSs). In addition, Taxpayer REIT will form at least one TRS.

Taxpayer REIT expects to continue entering into contracts with government tenants on substantially the same terms and conditions as its current practice. The Services will be provided by Taxpayer REIT's TRS in the manner required by the particular government tenant's contract.

Except where Taxpayer REIT engages a third party to provide certain services, Taxpayer REIT's TRS will use its own employees and bear all of its costs related to the Services provided to the government tenants, including paying its employees' salaries

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[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).

and the costs of equipment and supplies. Taxpayer REIT represents that it will compensate its TRSs on arm's-length terms.

Taxpayer Group expects to assign all of its rights and obligations under each of its Management Agreements to its TRS and the TRS will provide all services required to be provided under each Management Agreement. In connection with each assignment, Taxpayer REIT will likely remain liable to the applicable governmental agency for the performance of those services or may be required to guaranty Taxpayer REIT's TRS's obligations to perform those services in favor of the applicable agency. In all cases, Taxpayer REIT's TRS will indemnify and hold harmless Taxpayer REIT for any liabilities associated with Taxpayer REIT's TRS's failure to perform those services following the effective date of such assignment. New management agreements will either be entered in directly by Taxpayer REIT's TRS or by Taxpayer REIT and assigned to Taxpayer REIT's TRS as described above.

In connection with the REIT election, Taxpayer REIT intends to make a distribution on its Taxpayer REIT stock of all of its accumulated earnings and profits from non-REIT years in Year 1 (the "Proposed Distribution").

Pursuant to the Proposed Distribution, each Taxpayer REIT shareholder may elect to receive its share of the Proposed Distribution in the form of either (a) cash, (b) Taxpayer REIT stock, or (c) a combination of both cash and Taxpayer REIT stock. If a shareholder fails to make a valid election by the election deadline, that shareholder will be deemed to have made an election to be determined by Taxpayer REIT in its sole discretion.

The total number of shares of Common Stock to be received by any shareholder in the Proposed Distribution will be determined, over a period of up to two weeks ending as close as practicable to the record date of the Proposed Distribution, based upon a formula using market prices and designed to equate the value of the number of shares to be received with the amount of cash that could be received instead.

Taxpayer REIT will limit the total amount of the cash in the Proposed Distribution to 20 percent of the value of the Proposed Distribution (the "Maximum Cash Distribution"). If the total number of shares of Taxpayer REIT stock for which an election to receive cash is made would result in the payment of cash in an aggregate amount that is less than or equal to the Maximum Cash Distribution, then all shares for which such cash election is made will receive the distribution entirely in cash. If the total number of shares of Taxpayer REIT stock for which an election to receive cash is made would otherwise result in the payment of cash in an aggregate amount in excess of the Maximum Cash Distribution, then each shareholder electing to receive cash will receive a prorated amount of cash, with the remainder of its distribution paid in the form of shares of Taxpayer REIT stock, but in no event will any shareholder electing to receive cash receive less than 20 percent of its entire

distribution in cash. Any cash paid in lieu of fractional shares will not count towards the Maximum Cash Distribution. In no event will the total amount of cash available in the Proposed Distribution be less than the Maximum Cash Distribution.

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 more limited 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 a 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 XVIII of the Social Security Act with respect to the facility.

Section 856(d)(9)(D)(ii) defines "lodging facility" as a hotel, motel, or other establishment more than one-half of the dwelling units in which are used on a transient basis. The term "transient" is not defined in section 856 or the regulations thereunder. However, for other purposes of the Code, a renter has generally been treated as "transient" if the rental period is less than 30 days. See section 1.48-1(h)(2)(ii) (which concerned definitions under section 48 for purposes of the investment credit under former section 38); Shirley v. Commissioner, T.C. Memo 2004-188.

Ruling 1: The Facilities are not "lodging facilities" as defined in section 856(d)(9)(D)(ii) or "health care facilities" in whole or in part under section 856(l)(4)(B).

The Facilities are not hotels or motels, and the terms range from 1 to 25 years, including extensions, which is not considered transient. Therefore, the Facilities are not lodging facilities, as defined in section 856(d)(9)(D)(ii), for purposes of section 856(l)(3)(A).

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

Although the term "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 Facilities are not related to a health care facility and the medical care provided by those facilities is not part of the primary function of those facilities.

Taxpayer REIT is obligated to provide space that government tenants use to incarcerate prisoners and detainees. As part of its operations, Taxpayer REIT (through its TRS) provides a certain level of shared dining and living space and group activities. The contracts require Taxpayer REIT to provide the Services, including some level of medical, dental, and mental health services, as required by the prisoners and detainees. While Taxpayer REIT's correctional facilities may provide a certain level of medical care, these services are not part of the primary function of the 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 REIT's contracts with government tenants for the Facilities (excluding the Financed Facilities) will be treated as "rents from real property" for purposes of section 856(d)(1).

Under Taxpayer REIT's Facilities contracts, government tenants pay to use specific real property to house their inmates. The contract payments received by Taxpayer REIT are payments for the right to use space within a specific building. Therefore, the contract payments received by Taxpayer REIT will be treated as "rents from real property" under section 856(d). Furthermore, Taxpayer REIT has represented that the aggregate fair market value of the personal property owned by the REIT in the 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 REIT. The fees for the Services will be included in the rent received by Taxpayer REIT, but Taxpayer REIT 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 REIT 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 than Taxpayer REIT, and do not cause any portion of the payments received by Taxpayer REIT that otherwise qualify under section 856(c) 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 REIT will collect the amounts that government tenants pay for the Services in the Financed Facilities on behalf of the TRSs and remit those amounts to the TRSs. Therefore, the payments Taxpayer REIT 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 Taxpayer REIT from government tenants, to the extent they otherwise qualify under section 856(c), to be disqualified for purposes of the REIT income tests.

Ruling 4: Any cash and Taxpayer REIT stock distributed in the Proposed Distribution by Taxpayer REIT will be treated as a distribution of cash and property with respect to its stock to which section 301 applies. Sections 301 and 305(b)(1). Provided that Taxpayer REIT elects to be taxed as, and qualifies as, a REIT as of Year 1, the amount of any distribution of Taxpayer REIT stock received by any shareholder that receives Taxpayer REIT stock in the Proposed Distribution will be considered equal to the amount of cash which could have been received instead by such shareholder. Section 1.305-1(b)(2) and 1.305-2(b), Ex. 2.

In this case, each Taxpayer REIT shareholder may elect to receive its share of the Proposed Distribution in the form of cash, Taxpayer REIT stock, or a combination of both cash and stock. Because shareholders elect what they would receive in the Proposed Distribution, it will be treated as a distribution to which section 305(b)(1) applies. As a result, the Proposed Distribution will be treated as a distribution to which section 301 applies (section 305(b)(1)). The amount of the distribution will be the amount of cash a shareholder could have received in lieu of electing stock (Section 1.305-1(b)(2)).

Conclusion:

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

Based on the facts as represented, we rule that:

(1) The Facilities will not be treated as "lodging facilities" as defined in section 856(d)(9)(D)(ii) or "health care facilities" in whole or in part under section 856(l)(4)(B);

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

(3) The payments Taxpayer REIT 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 Taxpayer REIT, and do not cause any portion of the payments received by Taxpayer REIT, that otherwise qualify under section 856(c) to be disqualified for purposes of the REIT income tests; and

(4) Any cash and Taxpayer REIT stock distributed in the Proposed Distribution by Taxpayer REIT will be treated as a distribution of cash and property with respect to its stock to which section 301 applies. Sections 301 and 305(b)(1). Provided that Taxpayer REIT elects to be taxed as, and qualifies as, a REIT as of 2013, the amount of any distribution of Taxpayer REIT stock received by any shareholder that receives Taxpayer REIT stock in the Proposed Distribution will be considered equal to the amount of cash which could have been received instead by such shareholder. Section 1.305-1(b)(2) and 1.305-2(b), Ex. 2.

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)