Internal Revenue Service

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Person To Contact:
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Refer Reply To:
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PLR-104525-13
Date:
June 20, 2013

Legend:

Taxpayer	=
State A	=
Date 1	=
Date 2	=
Date 3	=
Month 1	=
Properties	=
x	=
y	=
Company A	=
Company B	=
TRS A	=
Company C	=
Company D	=

Dear :

This is in reply to a letter dated January 23, 2013, requesting a ruling on behalf of Taxpayer. You have requested rulings regarding Taxpayer and its taxable REIT subsidiaries ("TRSs") under section 856.

Facts:

Taxpayer, a State A corporation, is a publicly traded real estate investment trust ("REIT") that elected to be taxed as a REIT effective for its tax year that began Date 1. Taxpayer has intended to qualify as a REIT at all times since. Taxpayer owns a geographically diverse portfolio of Properties in two countries.

Company A is the parent company of Company B, an entity which has elected to be taxed as an association. Company A owns all of the stock of Company B. Company C is a newly formed LLC formed by Company B. Company D is a limited liability company owned by Company C and Company B. Company C and Company D elected to be taxed as associations effective as of the date of their formation by Company B.

In Month 1, Taxpayer engaged in a number of transactions involving the parties discussed above ("the Restructuring Transaction"). Immediately after the Restructuring Transaction, Taxpayer owned100 percent of the membership interests in Company C and x percent of the stock in Company A. The Company A stock was immediately contributed to the capital of Company C resulting in only momentary ownership of the stock by Taxpayer. On Date 3, Taxpayer, Company C, and Company D made joint elections for Company C and Company D to be taxed as TRSs effective as of the date they were acquired by Taxpayer, Date 2.

Company D currently leases Properties that are managed and operated by Company B as an independent contractor. Company B is also the eligible independent contractor ("EIK") for certain Properties which Taxpayer leases to TRS A.

Credit facility

Company C (a TRS of Taxpayer) will provide one or more lines of credit and/or one of more funded loans ("the Credit Facility") to Company A (the parent company of Taxpayer's EIK), as borrower (the "borrower"). The Credit Facility may be utilized by the borrower for general working capital purposes, including without limitation, operating expenditures, capital improvements, mergers and acquisitions, development of additional Properties, and other operating/business needs. The Credit Facility will be secured and/or unsecured (but will be guaranteed by Company A and all of its

subsidiaries to the extent they are contractually permitted to do so), bear a market rate of interest and payable at scheduled payment dates. The interest and principal will not be contingent on the profits, cash flow, or discretion of the borrower. Taxpayer represents that the Credit Facility will qualify as straight debt as defined in section 1361(c)(5) (without regard to section 1361(c)(5)(B)(iii)) for purposes of section 856(m)(2).

Guarantee

Company C or another TRS of Taxpayer ("Taxpayer's TRS") may guarantee a secured and/or unsecured, arms-length negotiated loan to Company A from an unrelated third party financial institution or other lender. This loan will be a direct obligation of Company A solely to the third party lender who will have all the lender rights and obligations afforded by normal lending practices. Company C and Taxpayer's TRS will be subrogated to the full rights of the lender in the event of payment under the guarantee.

Taxpayer represents that, in the event of payment, the guaranteed debt of Company A, in the hands of Company C or Taxpayer's TRS, will qualify as straight debt within the meaning of section 1361(c)(5) (without regard to section 1361(c)(5)(B)(iii)).

Automatic Redemption

In order to ensure that Company C's voting control with respect to the shares of Company A stock it holds does not exceed x percent at any time, Company A has amended and restated its certificate of incorporation whereby in the event that the y percent collective stock ownership of the other shareholders is to be reduced, Company A must offer to redeem the requisite number of Company A shares held by Company C in order to limit its ownership to x percent or less ("the Automatic Redemption"). If such offer is not extended by Company A, any and all redemptions of the other shareholders are null and void ab initio. However, in the event that this mechanism does not effectively limit Company C's ownership to x percent, the amended certificate of incorporation provides that the requisite number of Company A shares held by Company C will automatically be redeemed at their original cost in order to limit Company C's voting power and value to no more than x percent of the total. The proceeds that become payable to Company C due to the Automatic Redemption will increase the amount due to Company C under the Credit Facility effective on the date of the Automatic Redemption. Interest will accrue on all such amounts in the same manner as interest accrues on the Credit Facility.

Taxpayer represents that at no time and under no circumstances will Company C be permitted to have more than a x percent vote or value based on its share ownership, even if there is a period of time between the event causing the redemption and the recording of the proceeds to the credit facility. The redemption will be effective the

moment the share ownership exceeds x percent even if Company C is not made aware of the events until later. Furthermore, Company C and Company A will establish procedures to monitor stock ownership and to ensure the timely redemption of any excess shares and the increase in the Credit Facility. The Automatic Redemption pertains only to the voting stock.

Requested Rulings:

Taxpayer has requested the following rulings:

1.) To the extent the Credit Facility, as adjusted by the proceeds of any automatic redemption, meets the definition of straight debt within the meaning of section 1361(c)(5) (without regard to section 1361(c)(5)(B)(iii)), as provided in section 856(m)(2)(A), it will not be taken into account as a security in determining Company C's ownership of Company A securities under section 856(l)(2)(B).
2.) In the event of payment under the guarantee by Company C or Taxpayer's TRS of the Company A third party loan, the loan in the hands of either Company C or Taxpayer's TRS will not be taken into account as a security in determining Company C or Taxpayer's TRS's ownership of Company A securities under section 856(l)(2)(B).
3.) The Automatic Redemption will prevent Company C from possessing, at any time, more than x percent of the total voting power of Company A securities under section 856(l)(2)(A).
4.) The Restructuring Transaction will not result in Taxpayer, Company C, Company D, Taxpayer's TRS, TRS A, or any of their affiliates being considered to be directly or indirectly operating or managing a health care facility within the meaning of section 856(l)(3).
5.) The Restructuring Transaction will not cause the rent paid by TRS A to Taxpayer to fail to qualify for the section 856(d)(8)(B) exception for related party rents received from a TRS, and the rent will be qualifying income for purposes of the REIT gross income tests under sections 856(c)(2) and (c)(3).
6.) The Restructuring Transaction will not cause Company B to fail to qualify as an EIK under section 856(d)(9)(A) with respect to the Properties it manages or operates for TRS A.

Law & 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)(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)(A) provides that any corporation in which a TRS owns directly or indirectly more than 35 percent of the total voting power of the outstanding securities of another corporation shall be treated as a TRS. Section 856(l)(2)(B) provides that any corporation in which a TRS owns directly or indirectly more than 35 percent of the total value of the outstanding securities of another corporation shall be treated as a TRS. Section 856(l)(2) provides that for purposes of section 856(l)(2)(B), securities described in section 856(m)(2)(A) are not taken into account.

Section 856(l)(3)(A) provides that the term TRS does not include a corporation that directly or indirectly operates or manages a lodging facility or a health care facility.

Section 856(m)(2)(A) refers to securities that are straight debt, as defined in section 1361(c)(5) (without regard to section 1361(c)(5)(B)(iii).

In Rev. Rul. 72-320, 1972-1 C.B. 270, a small business corporation created another corporation and transferred assets in connection with a reorganization under section 368(a)(1)(D) in exchange for stock in the new corporation. Immediately thereafter, stockholders of the original corporation exchanged their stock for the stock of the new corporation in a transaction that qualified under section 355. The revenue ruling holds that the momentary ownership of stock in the new corporation did not terminate the original corporation's election as a small business corporation because more than momentary control of the new corporation was never contemplated.

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, 2003-2 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.

Rulings 1-3

The first three requested rulings concern whether section 856(l)(2) (without regard to section 856(l)(3)(A)) will cause Company A to be treated as a TRS due to Company C's interest in Company A. Under section 856(l)(2), if a TRS owns directly or indirectly more than 35 percent of the total voting power or value of the outstanding securities of another corporation, that corporation will be treated as a TRS. Taxpayer has requested rulings that neither the Credit Facility nor the guarantee will be taken into account as a security in determining Company C's ownership of Company A securities under section 856(l)(2)(B). Taxpayer has further requested that the Automatic Redemption will ensure that Company C's voting control with respect to stock held in Company A will not exceed x percent.

Section 856(l)(2) states that for purposes of 856(l)(2)(B), securities described in section 856(m)(2)(A) are not taken into account. The securities described in section 856(m)(2)(A) are straight debt securities, as defined in section 1361(c)(5) (without

regard to section 1361(c)(5)(B)(iii) (“straight debt securities”). Taxpayer has represented that the Credit Facility is a straight debt security. Therefore, it is not taken into account as a security in determining Company C’s ownership of Company A securities under section 856(l)(2)(B). Taxpayer has further represented that, in the event of payment under the guaranteed debt, such debt will be a straight debt security in the hands of Company A. Therefore, in the event of payment, such debt will not be taken into account as a security in determining Company C’s ownership of Company A securities under section 856(l)(2)(B).

After the Restructuring Transaction, Company C owns x percent of the stock of Company A. In order to ensure that Company C’s voting control with respect to stock held in Company A will be less than 35%, Company A has amended and restated its certificate of incorporation to include the Automatic Redemption. Taxpayer represents that at no time and under no circumstances will Company C be permitted to have more than a x percent vote or value based on its share ownership, even if there is a period of time between the event causing the redemption and the recording of the proceeds to the Credit Facility. The redemption will be effective the moment the share ownership exceeds x percent even if Company C is not made aware of the events until later. Taxpayer further represents that Company C and Company A will establish procedures to monitor stock ownership and to ensure the timely redemption of any excess shares and the increase in the Credit Facility.

In considering the treatment of the momentary ownership of stock for purposes of facilitating a divisive corporate reorganization in the context of a small business corporation the Service held that the momentary ownership of stock in the new corporation did not terminate the original corporation's election as a small business corporation because more than momentary control of the new corporation was never contemplated. Similar treatment is appropriate with respect to the Automatic Redemption. The automatic redemption ensures that, at the most, Company C will own more than x percent of the stock of Company A only momentarily. Therefore, the Automatic Redemption will prevent Company C from possessing, at any time, more than x percent of the total voting power of Company A securities for purposes of section 856(l)(2)(A).

Rulings 4-6

The three additional rulings concern Company C's ownership of a loan (the Credit Facility) to Company A. Notwithstanding a ruling that the Credit Facility does not result in Company C owning more than 35 percent of the total value of Company A securities, there is an issue as to whether providing a loan to a company that operates or manages a lodging or health care facility is considered indirectly participating in such activity as prohibited under section 856(l)(3). Because they are related parties, this issue exists as well for Taxpayer, Company D, Taxpayer's TRS, TRS A and any of their affiliates.

There is no rule of attribution that applies to sections 856(c)(2), (3) or (4) that would cause the assets and activities of a separate corporation to be attributable to a REIT. Similarly, owning less than 35 percent of the total voting power or value of outstanding securities is not enough to attribute the activities of a corporation to the TRS for purposes of section 856(l). Company C is not required to look through a corporation to which it has provided a loan. Therefore, neither Taxpayer, Company C, Company D, Taxpayer's TRS, TRS A, or any of their affiliates will be considered to be directly or indirectly operating or managing a health care facility within the meaning of section 856(l)(3).

Another issue is whether Company B will fail to qualify as an EIK under section 856(d)(9)(A) as a result of the fact that Company C, and, indirectly, Taxpayer, may receive income from Company A through the Credit Facility. Because Company A is the parent company of Company B, Taxpayer may indirectly receive income from Company B as well. However, the income Taxpayer receives from Company B is not derived from or dependent on Taxpayer's relationship with Company B. Furthermore, the Credit Facility bears a market rate of interest. Under these facts, we do not believe Company B will fail to qualify as an EIK under section 856(d)(9)(A) with respect to the Properties it manages or operates for TRS A. Likewise, the rent paid by TRS A to Taxpayer will not fail to qualify for the section 856(d)(8)(B) exception for related party rents received from a TRS, and the rent will be qualifying income for purposes of the REIT gross income tests under section 856(c)(2) and (c)(3).

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 the guarantee discussed above is a security. Furthermore, we do not rule on whether the Credit Facility is a straight debt security and whether, in the event of payment, the guaranteed debt in the hands of Company C is a straight debt security. In addition, except as provided in this letter, we do not rule on the tax consequences of the Automatic Redemption.

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 to the Branch Chief, Branch 2
Office of the Associate Chief Counsel
(Financial Institutions & Products)