Internal Revenue Service

Number: **201614009**
Release Date: 4/1/2016

Index Number: 857.02-03

Department of the Treasury
Washington, DC 20224

[Third Party Communication:
Date of Communication: Month DD, YYYY]

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Refer Reply To:
CC:FIP:B1
PLR-123063-15

Date:
January 04, 2016

Legend:

Taxpayer =

Partnership =

LLC =

Management =

a =

b =

c =

d =

Dear :

This responds to your request for a ruling received July 7, 2015, submitted on behalf of Taxpayer. Taxpayer requests rulings under sections 856 and 857(b)(6) of the Internal Revenue Code of 1986, as amended (the "Code"), in connection with certain sales and exchanges of real property to be undertaken by Taxpayer.

Facts:

Taxpayer is a self-administered and self-managed real estate investment trust ("REIT") that owns, manages, and develops office properties in the United States. Taxpayer owns a a% general partner interest and an b% limited partner interest in Partnership, an operating partnership. Partnership owns c% of LLC, with Taxpayer owning the remaining a% of LLC. Partnership also owns a c% interest in Management, with LLC owning the remaining a% of Management. Partnership, LLC, and Management are partnerships for federal income tax purposes.

Partnership also owns interests in d private REITS ("Captive REITs"), joint ventures, and fee ownership in rental real estate. Taxpayer, through Partnership, typically invests in properties in its portfolio with the intention to hold the property for long-term rental or investment purposes. Partnership is in the process of realigning its portfolio of properties whereby it plans to dispose of a number of its properties through outright sales, like-kind exchanges under section 1031, or asset sales by one of its Captive REITs.

Like-Kind Exchanges

Partnership intends to engage in one or more like-kind exchanges under section 1031 with respect to its real estate assets. In some exchanges, a small amount of boot (less than 10 percent) may be realized by Taxpayer resulting in a recognized gain in the exchange.

Taxpayer represents that the exchanges will be deferred exchanges that comply with the requirements of section 1031(a)(3) and section 1.1031(k)-1 of the Income Tax Regulations (the "Regulations") using the qualified intermediary ("QI") safe harbor of section 1.1031(k)-1(g)(4). In accordance with the exchange agreement, escrow agreement, or trust agreement governing the exchange funds, all the earnings attributable to the exchange funds will be paid to Taxpayer, within the meaning of section 1.468B-6(c)(2).

Sales by Captive REITs

A Captive REIT held by Partnership may dispose of all real properties currently held by the Captive REIT and then the Captive REIT will either liquidate or otherwise distribute the cash from the sale to Partnership. Taxpayer represents that the liquidation of the Captive REIT would be a taxable liquidation under section 331. Taxpayer further represents that the Captive REIT that sells property was formed for independent business reasons and not to avoid the prohibited transaction tax under section 857(b)(6).

Requested Rulings

1. For purposes of section 857(b)(6)(C)(iii)(I), the exchange of the relinquished property in a like-kind exchange under section 1031 will not be treated as a sale. To the extent Taxpayer receives boot in the like-kind exchange, (a) only the same proportion of adjusted basis of relinquished property as boot bears to total consideration received will be counted for purposes of the 10 percent rule in section 857(b)(6)(C)(iii)(II), and (b) only the same proportion of fair market value of relinquished property as boot bears to total consideration received will be counted for purposes of the 10 percent rule in section 857(b)(6)(C)(iii)(III).
2. If Partnership undertakes a deferred like-kind exchange and the proceeds from the sale of Partnership's property are held as exchange funds by the QI, either directly or in a qualified escrow or qualified trust, for purposes of section 856, the assets and income attributed to Taxpayer with respect to the exchange funds are determined as if Partnership held them directly, regardless of whether the exchange is completed, provided that all the earnings attributable to the exchange funds will be paid to Partnership, within the meaning of section 1.468B-6(c)(2).
3. The liquidation of Captive REIT or the distribution of the proceeds from the sale of property by the Captive REIT will not be treated as a sale of property by Taxpayer for purposes of the seven sales limitation under section 857(b)(6)(C)(iii)(I).

Law and Analysis:

Section 1.856-3(g) of the Regulations provides that a REIT that is a partner in a partnership is deemed to own its proportionate share of each of the assets of the partnership and to be entitled to the income of the partnership attributable to that share. For purposes of section 856, the interest of a partner in the partnership's assets is determined in accordance with the partner's capital interest in the partnership. The character of the various assets in the hands of the partnership and items of gross income of the partnership retain the same character in the hands of the partnership for all purposes of section 856.

Ruling #1 Like-Kind Exchange

Section 857(b)(6)(A) of the Code imposes a 100 percent tax on a REIT's net income from prohibited transactions. Section 857(b)(6)(B)(iii) defines the term "prohibited transaction" as the sale or other disposition of property described in section 1221(a)(1) which is not foreclosure property. Section 1221(a)(1) describes "property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business," sometimes referred to as "dealer property."

Section 857(b)(6)(C) provides a safe harbor under which the term "prohibited transaction" does not include a sale of property that is a real estate asset if certain requirements are met. Section 857(b)(6)(C)(iii) sets forth one of these requirements. Section 857(b)(6)(C)(iii) provides that: "(I) during the taxable year the trust does not make more than 7 sales of property (other than sales of foreclosure property or sales to which section 1033 applies), or (II) the aggregate adjusted bases (as determined for purposes of computing earnings and profits) of property (other than sales of foreclosure property or sales to which section 1033 applies) sold during the taxable year does not exceed 10 percent of the aggregate bases (as so determined) of all of the assets of the trust as of the beginning of the taxable year, or (III) the fair market value of property (other than sales of foreclosure property or sales to which section 1033 applies) sold during the taxable year does not exceed 10 percent of the fair market value of all of the assets of the trust as of the beginning of the taxable year."

Section 1031(a) generally provides that a taxpayer recognizes no gain or loss when it exchanges property held for productive use in a trade or business or for investment if such property is exchanged solely for property of like kind that also is to be held for productive use or investment.

Section 1031(b) provides that if an exchange would be within section 1031(a) if not for the fact that the property received in exchange consists not only of property that may be received without the recognition of gain, but also other property or money, then the gain, if any, to the recipient will be recognized, but in an amount not in excess of the sum of money and the fair market value of other property received.

In applying the safe harbor for prohibited transactions, section 857(b)(6)(C)(iii) limits on an annual basis the frequency or scope of transactions that a REIT can enter into by reference to the number of "sales" of property and to the basis or fair market value of property "sold." The legislative history underlying section 857(b)(6) indicates that Congress enacted the prohibited transactions tax to deter REITs from engaging in "ordinary retailing activities such as sales to customers of condominium units or subdivided lots in a development project." See S. Rep. No. 94-938, 94th Cong., 2d Sess. 470 (1976). The legislative history further indicates that Congress believed that "REITs should have a safe harbor within which they can modify the portfolio of their assets without the possibility that a tax would be imposed equal to the entire amount of the appreciation in those assets" and that the restrictions on the availability of the safe harbor would "prevent REITs from using the safe harbor to permit them to engage in an active trade or business such as the development and subdivision of land." S. Rep. No. 95-1263, 95th Cong., 2d Sess. 178-179 (1978).

In the present case, Taxpayer's proposed section 1031 transactions appear to be consistent with the Congressional intent of allowing REITs to modify their portfolios without incurring a prohibitive tax. Accordingly, if each proposed section 1031 transaction satisfies the requirements of section 1031(a) and the Regulations thereunder, it will not be treated as a sale for purposes of the prohibited transaction safe harbor rules under section 857(b)(6)(C).

The receipt of boot in an otherwise qualifying like-kind exchange under section 1031 does not affect the treatment of the property in the exchange. However, a taxpayer receiving boot as part of the exchange transaction will recognize gain, if any, to the extent of the fair market value of the boot received as provided in section 1031(b). The receipt of boot in a like-kind exchange by a REIT does not convert the exchange to a sale for purposes of the prohibited transaction rules under section 857(b)(6). Compare section 1.1031(k)-1(a) (stating that if "the taxpayer actually or constructively receives money or property which does not meet the requirements of section 1031(a) in the full amount of the consideration for the relinquished property, the transaction will constitute a sale, and not a deferred exchange, even though the taxpayer may ultimately receive like-kind replacement property"). However, to the extent that gain is recognized by a REIT on boot received as part of a like-kind exchange transaction, that portion of the transaction may be treated as a sale for purposes of section 857(b)(6). Accordingly, to the extent that Taxpayer receives boot in the proposed transaction, only the same proportion of the adjusted basis of the relinquished property as the boot bears to the total consideration received will be counted for purposes of determining whether Taxpayer exceeds the 10 percent rule in section 857(b)(6)(C)(iii)(II). Further, to the extent that Taxpayer receives boot in the proposed transaction, only the same proportion of fair market value of the relinquished property as boot bears to total consideration received will be counted for purposes of the 10 percent rule in section 857(b)(6)(C)(iii)(III).

Ruling #2 Deferred Like-Kind Exchange using a QI

Section 856(c)(4)(A) provides that at the close of each quarter of its taxable year, at least 75 percent of the value of a REIT's total assets must be represented by real estate assets, cash, and cash items (including receivables), and Government securities. Section 856(c)(5)(B) provides that the term "real estate assets," for purposes of section 856, means real property (including interests in real property and interests in mortgages on real property) and shares (or transferable certificates of beneficial interest) in other REITs that meet the requirements of sections 856 through 859.

Section 856(c)(2) provides that at least 95 percent of a REIT's gross income must be derived from dividends, interest, rents from real property, and gain from the sale or other disposition of stock, securities, and real property. Section 856(c)(3) provides that at least 75 percent of a REIT's gross income must be derived from the

items listed in section 856(c)(2), but not including interest, dividends and gains from the sale or disposition of stock or securities.

Section 1.1031(k)-1 provides rules for the application of section 1031 and the regulations promulgated thereunder in the case of a "deferred exchange." For purposes of section 1031, a deferred exchange generally is an exchange in which, pursuant to an agreement, the taxpayer transfers property held for productive use in a trade or business or for investment and subsequently receives property to be held either for productive use in a trade or business or for investment.

Section 1.1031(k)-1(g)(4) provides that in the case of a taxpayer's transfer of relinquished property involving a QI, the QI is not considered the agent of the taxpayer for purposes of section 1031(a). In such a case, the taxpayer's transfer of relinquished property and subsequent receipt of like-kind replacement property is treated as an exchange, and the determination of whether the taxpayer is in actual or constructive receipt of money or other property before the taxpayer actually receives like-kind replacement property is made as if the QI is not the agent of the taxpayer.

Section 1.1031(k)-1(h)(2) provides that if, as part of a deferred exchange, the taxpayer receives interest or a growth factor, the interest or growth factor will be treated as interest. The taxpayer must include the interest or growth factor in income according to the taxpayer's method of accounting. For rules regarding the current taxation of qualified escrow accounts, qualified trusts, and other escrow accounts, trusts, and funds used during deferred exchanges of like-kind property, section 1.1031(k)-1(h)(2) refers to section 1.468B-6.

Section 1.468B-6(b)(2) defines exchange funds as relinquished property, cash, or cash equivalent that secures an obligation of a transferee to transfer replacement property, or proceeds from a transfer of relinquished property, held in a qualified escrow account, qualified trust, or other escrow account, trust, or fund in a deferred exchange.

Section 1.468B-6(b)(3) defines an exchange facilitator as a qualified intermediary, transferee, escrow holder, trustee, or other party that holds exchange funds for a taxpayer in a deferred exchange pursuant to an escrow agreement, trust agreement, or exchange agreement.

Section 1.468B-6(c)(1) provides that exchange funds are treated as loaned from a taxpayer to an exchange facilitator, and the exchange facilitator must take into account all items of income, deduction, and credit (including capital gains and losses) attributable to the exchange funds.

However, section 1.468B-6(c)(2) provides that exchange funds are not treated as loaned to the exchange facilitator if, in accordance with an escrow agreement, trust agreement, or exchange agreement, all earnings attributable to a taxpayer's exchange

funds are paid to the taxpayer. Under section 1.468B-6(c)(2)(iii), in this circumstance the taxpayer must take into account all items of income, deduction, and credit (including capital gains and losses) attributable to the exchange funds.

In this case, the exchange agreement, escrow agreement, or trust agreement governing the exchange funds directs that all the earnings attributable to the exchange funds will be paid to Taxpayer within the meaning of section 1.468B-6(c)(2). Because Taxpayer is required to take into account the items related to the exchange funds as if Taxpayer owned the funds pursuant to section 1.468B-6(c)(2), Taxpayer will be treated as the owner of the exchange funds for purposes of the income and assets tests under section 856(c).

Ruling #3 Liquidation of Captive REIT

As noted above, section 857(b)(6)(A) imposes a 100 percent tax on a REIT's net income from prohibited transactions. Section 857(b)(6)(C) provides a safe harbor under which the term “prohibited transaction” does not include a sale of property that is a real estate asset if certain requirements are met. One such requirement is that during the taxable year the trust does not make more than 7 sales of property (other than sales of foreclosure property or sales to which section 1033 applies).

Section 331(a) provides that amounts received by a shareholder in a distribution in complete liquidation of a corporation will be treated “as in full payment in exchange for the stock.” Thus, when Captive REIT liquidates pursuant to section 331, the amounts Partnership receives upon the liquidation are treated as in full payment in exchange for the stock of the Captive REIT and not from the sale of the Captive REIT’s property.

Further, if Captive REIT does not liquidate under section 331 but distributes the cash from the proceeds of its sales to Partnership, there is no sale of the Captive REIT’s property by Taxpayer. Therefore, the liquidation of Captive REIT or the distribution of the proceeds from the sale of property by the Captive REIT will not be treated as a sale of property by Taxpayer for purposes of the 7 sales limitation under section 857(b)(6)(C)(iii)(I).

Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter. In particular, no opinion is expressed with regard to whether Taxpayer qualifies as a REIT under subchapter M of the Code. Furthermore no opinion is expressed or implied regarding whether any transaction addressed in this letter otherwise constitutes a prohibited transaction as defined under section 857(b)(6)(B)(iii).

This ruling is directed only to the taxpayer requesting it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

Sincerely,

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Robert A. Martin
Sr. Tech. Rev. Branch 1
Office of Associate Chief Counsel
(Financial Institutions & Products)

Enclosures:
Copy of this letter
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cc: