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Department of the Treasury
Washington, DC 20224

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Person To Contact:
, ID No.

Telephone Number:

Refer Reply To:
CC:FIP:B02
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Date:
September 24, 2019

LEGEND:

Taxpayer	=
ServiceCo	=
AdvisorCo	=
HoldCo	=
Manager	=
OP	=
State	=
Date	=
a	=
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Dear :

This ruling responds to a letter dated November 9, 2018, requesting a ruling on behalf of Taxpayer. Specifically, you have requested a ruling that after the Proposed Transaction (described below) ServiceCo will not fail to qualify as an eligible independent contractor (EIK) within the meaning of section 856(d)(9)(A) of the Code with respect to Taxpayer solely as a result of:

(a) ServiceCo being a brother-sister affiliate of AdvisorCo; and

(b) Taxpayer's taxable REIT subsidiaries (TRSs) receiving the Incentives (defined below) from AdvisorCo.

FACTS

Taxpayer is a State corporation that elected to be treated as a real estate investment trust (REIT) beginning with its first taxable year ended Date. Taxpayer uses an accrual method of accounting and a calendar tax year. Taxpayer's investment strategy focuses on luxury hotels and resorts. Taxpayer owns a hotel properties that Taxpayer represents are leased to Taxpayer's TRSs and are managed by EIKs. Manager, a partnership for federal tax purposes, currently manages b of these hotel properties. Taxpayer has engaged AdvisorCo to provide asset management and advisory services.

HoldCo, a publicly traded corporation, conducts business primarily through its two indirect subsidiaries AdvisorCo and ServiceCo. AdvisorCo and ServiceCo are corporations for federal tax purposes. Currently, Taxpayer owns c percent of HoldCo's

common stock, and Taxpayer's TRSs own an additional d percent. HoldCo indirectly owns e percent of AdvisorCo and ServiceCo. Prior to the Proposed Transaction, Taxpayer and its TRSs will completely dispose of their HoldCo stock.

Periodically, AdvisorCo provides certain non-cash incentives (the "Incentives") to the TRSs of Taxpayer in connection with the acquisition of hotel properties and related assets by Taxpayer. Specifically, AdvisorCo purchases personal property to be used in hotel operations, and through the Incentives permits the TRSs of Taxpayer to use the personal property for a period of time at no cost.[1] Taxpayer represents that the provision of the Incentives, otherwise known as key money, is common in the hospitality industry and that key money is provided to incentivize hotel owners and operators to make additional investments in hotel properties.

ServiceCo owns majority interests in businesses that provide or arrange for the provision of ancillary services and products for the hospitality industry ("Service Providers"). The Service Providers maintain books and records separately from ServiceCo. AdvisorCo and ServiceCo maintain separate books and records and do not conduct business with each other. AdvisorCo receives no funding directly or indirectly from ServiceCo, and has not made any loans to ServiceCo.

Manager, through h wholly owned subsidiaries that are disregarded entities of Manager for federal tax purposes, employs approximately i employees and manages hotel properties owned or leased by other entities including Taxpayer and its TRSs. Manager is j percent owned, directly or indirectly, by an individual ("Individual 1") who serves as HoldCo's, AdvisorCo's, and ServiceCo's chief executive officer and serves as chairman of the board of directors of Taxpayer and HoldCo. A second individual ("Individual 2") directly or indirectly holds the remaining interest in Manager. Individual 1 and Individual 2 are related. Individual 1 owns approximately d percent of Taxpayer's common stock, k percent of HoldCo's common stock, and l percent of HoldCo's convertible preferred stock. Individual 2 owns approximately d percent of Taxpayer's common stock, m percent of HoldCo's common stock, and l percent of HoldCo's convertible preferred stock. Manager's agreements with Taxpayer and Taxpayer's TRSs obligate Manager to qualify as an EIK as defined in section 856(d)(9) at all times.

Under the Proposed Transaction, ServiceCo will acquire all interests in Manager, after which Manager will become a disregarded entity of ServiceCo for federal tax purposes. The same h disregarded entities of Manager will continue to employ the employees through which Manager currently acts, and the h disregarded entities will be responsible for employment taxes of those employees. AdvisorCo and ServiceCo will continue to be indirect subsidiaries of HoldCo and brother-sister affiliates. AdvisorCo and ServiceCo will continue to operate as separate entities that keep separate books

[1] To date, AdvisorCo has entered into a formal agreement with Taxpayer to provide the Incentives, with values up to $f and options to increase the value of the Incentives to $g.

and records. AdvisorCo and ServiceCo (through disregarded entities) will each have separate employees, but will share the same CEO and will share a limited number of overlapping employees performing general and administrative (G&A) functions, such as office administration, human resources, and information technology. The overlapping employees performing G&A functions will represent less than d percent of ServiceCo's employees. After the Proposed Transaction, AdvisorCo and ServiceCo will consolidate their respective office lease agreements and allocate rent between the entities based on the relative space used by each. AdvisorCo and ServiceCo will each have at least b board members, of which one may be overlapping, but at least n will not be overlapping. From time to time, a TRS of Taxpayer may provide additional compensation for exemplary management by awarding stock grants or other equity interests in Taxpayer to employees of ServiceCo. As of the date of the Proposed Transaction, ServiceCo will be actively engaged in the trade or business of operating qualified lodging facilities for persons that are not related persons to Taxpayer or its TRSs as determined under section 856(d)(9)(A).

Taxpayer represents that after the Proposed Transaction: (1) ServiceCo will not own, directly or indirectly, more than 35 percent of the shares or certificates of beneficial interest in Taxpayer; (2) not more than 35 percent of the total combined voting power or 35 percent of the total shares of all classes of stock of ServiceCo will be owned directly or indirectly by one or more persons owning 35 percent or more of the shares or certificates of beneficial interest in Taxpayer as determined under section 856(d)(3); (3) ServiceCo and any related persons, when entering into any management agreement or similar contract with any TRS of Taxpayer, will be actively engaged in the trade or business of operating qualified lodging facilities for at least one person that is not a related person to Taxpayer or its TRSs as determined under section 856(d)(9)(A); (4) each management contract under which ServiceCo manages (or will manage) hotel properties for any TRS of Taxpayer represents (or will represent) an arm's length arrangement reflecting market terms that are consistent with the terms that other unrelated parties would have established in the same transaction under similar circumstances; (5) ServiceCo and any business owned by ServiceCo will not lend or otherwise transfer money to AdvisorCo to fund the Incentives, and the Incentives provided by AdvisorCo will not depend on the relationship between Taxpayer and ServiceCo; (6) ServiceCo will not hold any interest in AdvisorCo or any company through which AdvisorCo conducts asset management or advisory business; (7) AdvisorCo will not hold any interest in ServiceCo or any other company through which ServiceCo conducts the hotel management business; and (8) Taxpayer will not own any stock of HoldCo, AdvisorCo, or ServiceCo.

LAW AND ANALYSIS

Section 856(c)(2) provides that at least 95 percent of a REIT's gross income must be derived from, among other sources, rents from real property.

Section 856(c)(3) provides that at least 75 percent of a REIT's gross income must be derived from, among other sources, rents from real property.

Section 856(d)(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 such 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 such person.

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 EIK.

Section 856(d)(3) defines an independent contractor as (A) any person who does not own, directly or indirectly, more than 35 percent of the REIT's shares, or certificates of beneficial interest; and, (B) 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), if such person is not a corporation, not more than 35 percent of the interest in whose assets or net profits is owned directly or indirectly, by one or more persons owning 35 percent or more of the shares or certificates of beneficial interest in the REIT.

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

Rev. Rul. 74-471, 1974-2 C.B. 198, considers a situation in which a REIT entered into an investment advisory agreement with the same corporation that acted as its property manager. The ruling holds that the corporation's status as an investment advisor disqualifies it as an independent contractor for property management services. Consequently, any rents received by the REIT from properties managed by the corporation do not qualify as rents from real property for purposes of section 856(d)(3).

In Rev. Rul. 73-194, 1973-1 C.B. 335, a REIT entered into a partnership with X corporation to construct and hold apartment buildings for investment. The partnership employed a management company to manage an apartment building. 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, 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 qualifying 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. The ruling concludes that the management company meets the definition of an independent contractor in section 856(d)(3) as to the REIT and was employed in an arm's length transaction with a fee equal to the going rate charged by other management companies for such services. Therefore, the income received by the REIT from the partnership was not disqualified as rents from real property due to the relationship between the REIT's partner (X corporation), Y corporation, and the management company.

Rev. Rul. 75-136, 1975-1 C.B. 195, concerns whether a wholly owned subsidiary of a REIT's corporate investment advisor may 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 advisor 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 advisor is not precluded from qualifying as an independent contractor if the subsidiary 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.

Rev. Rul. 77-23, 1977-1 C.B. 197, considers a situation in which an individual who was both a trustee and a salaried employee of a REIT was also the sole shareholder and a director of a corporation that served as the REIT's property manager. The individual also held less than ten percent of the shares of beneficial interest in the REIT. Although the property management company was directly related to the individual who was a trustee, employee, and shareholder of the REIT, the ruling holds that the property manager is not precluded from qualifying as an independent contractor. In citing Rev. Rul. 75-136, Rev. Rul. 77-23 explains that the proper relationship to be examined to determine "independent contractor" status is the

relationship between the REIT and the property manager, and not the relationship between the property manager and the REIT's trustee or investment advisor.

In Rev. Rul. 2003-86, 2003-2 C.B. 290, a REIT owned all of the stock of a TRS. The TRS was a partner in a partnership with a corporate independent contractor as described in section 856(d)(3). The partnership provided certain non-customary services to the REIT's tenants. Although the REIT did not directly receive income from the partnership, the REIT indirectly held an interest in the partnership 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 partnership was through the TRS, the ruling states that the services provided by the partnership are provided by the TRS to the extent of the TRS's interest in the partnership. Accordingly, the ruling concludes that the REIT will not be treated as providing impermissible tenant services.

Taxpayer represents that after the Proposed Transaction, ServiceCo will operate as a separate entity from AdvisorCo, maintain its own books and records, and, aside from the very limited employee sharing and common single officer and director arrangement described above, have separate employees and officers from AdvisorCo. Taxpayer further represents that each management contract under which ServiceCo will manage hotel properties for a TRS of Taxpayer will represent an arm's length arrangement reflecting market terms that are consistent with the terms that other unrelated parties would have established in the same transaction under similar circumstances. Additionally, Taxpayer represents that ServiceCo will not own more than 35 percent of the shares or certificates of beneficial interest in Taxpayer, and not more than 35 percent of the total combined voting power or 35 percent of the total shares of all classes of stock of ServiceCo will be owned, directly or indirectly, by persons owning 35 percent or more of the shares or certificates of beneficial interest in Taxpayer. Despite an overlapping officer and director, a limited number of shared employees performing G&A functions, and common elements of ownership, ServiceCo and AdvisorCo, will operate as distinct, independent entities after the Proposed Transaction. Moreover, Taxpayer and ServiceCo will deal with each other solely at arm's length. Under these facts, ServiceCo will not fail to qualify as an EIK under section 856(d)(9) with respect to Taxpayer solely due to its brother-sister affiliation with AdvisorCo.

Through the Incentives, AdvisorCo will make personal property available to the TRSs of Taxpayer without requiring a commensurate payment from the TRSs. Taxpayer represents that the Incentives derive from AdvisorCo's desire to incentivize the acquisition of additional hotel properties by Taxpayer, and the Incentives will not depend on the relationship between Taxpayer and ServiceCo. Taxpayer further represents that each management contract under which ServiceCo manages hotel properties for a TRS of Taxpayer will represent an arm's length arrangement reflecting market terms that are consistent with the terms that other unrelated parties would have

established in the same transaction under similar circumstances. Additionally, Taxpayer represents that AdvisorCo will receive no funding directly or indirectly from ServiceCo and will not make any loans to ServiceCo. Under these facts, ServiceCo will not fail to qualify as an EIK under section 856(d)(9) with respect to Taxpayer solely due Taxpayer's TRSs receiving the Incentives from AdvisorCo.

CONCLUSION

Based on the information submitted and representations made by Taxpayer, we rule that after the Proposed Transaction, ServiceCo will not fail to qualify as an EIK within the meaning of section 856(d)(9) with respect to Taxpayer solely as a result of (a) ServiceCo being a brother-sister affiliate of AdvisorCo, and (b) Taxpayer's TRSs receiving the Incentives from AdvisorCo.

This ruling's application is limited to the facts, representations, Code sections, and regulations cited herein. 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. Specifically, we do not rule whether any arrangement discussed herein represents an arm's length arrangement that reflects market rates and commercially reasonable terms. Additionally, no opinion is expressed on the federal tax treatment of the Incentives. Further, no opinion is expressed whether ServiceCo otherwise qualifies as an EIK, or Taxpayer otherwise qualifies as a REIT, under subchapter M, part II of Chapter 1 of the Code.

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. 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,

Andrea M. Hoffenson_____
Andrea M. Hoffenson
Branch Chief, Branch 2
Office of Associate Chief Counsel
(Financial Institutions & Products)