

INTERNAL REVENUE SERVICE  
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April 26, 1999

**Legend:**

Company =

State =

Date 1 =

Exchange =

a =

b =

Subsidiary =

Operating Partnership =

c =

Corporation 1 =

Corporation 2 =

Dear

This is in reply to a letter dated December 30, 1998, and subsequent correspondence, requesting a ruling on behalf of Company. You have requested a ruling that based upon the facts and representations submitted, the rents that Operating Partnership receives from a subsidiary of Newco after the spin-off of Newco from Company, but before the end of the year in which the spin-off occurs, will not be excluded from "rents from real property" under § 856(d)(1) of the Internal Revenue Code.

**Facts:**

Company is a State corporation that elected to qualify as a real estate investment trust (REIT) beginning with its tax year ended Date 1. Company's common stock is traded on the Exchange

and, on average, a shares (out of a total of b shares outstanding) are traded each business day.

It is represented that Subsidiary is a REIT and qualified REIT subsidiary of Company. Subsidiary is the sole general partner of, and currently owns approximately a c percent partnership interest in Operating Partnership, a State limited partnership. The remainder of the partnership interests in Operating Partnership are owned by individuals, limited liability companies, partnerships, trusts, and corporations, two of which are closely-held corporations owned by individuals that are limited partners of Operating Partnership, one of which is a publicly-owned corporation, and one of which is a charitable foundation.

Company, through Operating Partnership and Operating Partnership's subsidiary partnerships, owns limited-service and extended-stay hotels. Currently, Operating Partnership leases the hotels to affiliates of Corporation 1, and to a subsidiary of Corporation 2 (the Lessees). Company and Operating Partnership are not affiliated or commonly managed with Corporation 1, Corporation 2 or their Lessees in any way. In addition, Company does not own, directly or indirectly, 10 percent or more of the voting power or total number of shares of either Lessee, within the meaning of § 856(d)(2)(B).

For valid business reasons, Operating Partnership plans to form a new corporation (Newco) that will be taxable as a C corporation for federal tax purposes. Operating Partnership will contribute cash or other liquid assets to Newco, and immediately thereafter will distribute all of Newco's stock proportionately to the partners of Operating Partnership, including Company. Company, in turn, will immediately distribute the Newco stock it receives from Operating Partnership to its shareholders. Prior to the spin-off, at a time when neither Newco nor any wholly-owned subsidiary of Newco is a tenant of Company or Operating Partnership, Operating Partnership will momentarily own all of the outstanding Newco stock. Immediately after the stock of Newco is distributed to the partners of Operating Partnership, Company will momentarily own approximately c percent of Newco. It is represented that in both cases the ownership of Newco by Operating Partnership and Company will be solely to facilitate the spin-off.

Company does not intend to treat the distribution of Newco stock as a tax-free spin-off under § 355. In connection with the spin-off, Newco's stock will be registered with the Securities and Exchange Commission so that the Newco stock will be freely tradeable by Company's shareholders following the spin-off. It is not certain whether Newco's stock initially will be traded on

an exchange or national market. There will be no requirement the Company and Newco stock trade together on a paired or stapled basis. Furthermore, although the ownership of Company and Newco will be the same immediately following the spin-off, the common stock of Company and Newco will be traded independently, and it is therefore expected that, over time, the ownership of Company and Newco will diverge significantly. Company represents that after the spin-off neither Company nor any of Company's subsidiaries will own any equity interest in Newco and, to the best of Company's knowledge, no shareholder of either Company or Newco will own 10 percent or more of the shares of stock of the other, taking into account the constructive ownership rules of § 318(a), as modified by § 856(d)(5).

After the spin-off, it is expected that Newco will form wholly owned corporate subsidiaries (Newco Subsidiaries.) Both Newco and the Newco Subsidiaries will be fully subject to the corporate income tax. It is anticipated that Newco will engage in activities that, if engaged in by Company, would generate nonqualifying income for purposes of § 856(c). Those activities will likely include leasing and operating hotels owned by Operating Partnership or unrelated third parties. However, at the time of the spin-off, Newco will not have entered into, or reached a binding agreement to enter into, any leases with either Company or Operating Partnership. It is expected that Newco will enter into any such leases through the Newco Subsidiaries.

#### **Law, Analysis and Holding:**

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(c)(4)(B) provides that not more than 25 percent of the value of a REIT's total assets may be represented by securities (other than those includible under subparagraph A), not greater than 5 percent of the value of the total assets of the REIT may be invested in one issuer, and the securities may not represent more than 10 percent of the outstanding voting securities of the issuer.

Section 856(d)(1) defines for purposes of §§ 856(c)(2) and (3) the term "rents from real property" to include: rents from interests in real property, charges for services customarily furnished or rendered in connection with the rental of real property, and rent attributable to personal property which is

leased under or in connection with a lease of real property if such personal property does not exceed 15 percent of the total rental for the taxable year attributable to both the real and personal property so leased.

Section 856(d)(2)(B) provides, in part, 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, in the case of a corporation, stock of the corporation possessing 10 percent or more of the combined voting power of all classes of stock entitled to vote, or 10 percent or more of the total number of shares of all classes of stock of the corporation. Section 1.856-4(b)(4) of the Income Tax Regulations interprets § 856(d)(2)(B) to disqualify amounts received by persons owned in whole or part by a REIT at any time during the taxable year. The regulation requires, in relevant part, that where a REIT receives, directly or indirectly, any amount of rent from any corporation in which it owns any proprietary interest, the REIT shall submit, at the time it files its return for the taxable year a schedule setting forth the name and address of the corporation, the amount received as rent from the corporation, and the highest percentage of the total combined voting power of all classes of its stock entitled to vote, and the highest percentage of the total number of shares of all classes of its outstanding stock owned by the REIT at any time during the REIT's taxable year.

Section 856(d)(5) provides that for purposes of § 856(d), the rules prescribed by § 318(a) for determining the ownership of stock shall apply in determining the ownership of stock, assets, or net profits of any person; except that "10 percent" shall be substituted for "50 percent" in subparagraph (C) of §§ 318(a)(2) and 318(a)(3).

Under § 1.856-3(g), 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 § 856, the interest of a partner in the partnership's assets shall be 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 shall retain the same character in the hands of the partners for all purposes of § 856.

In order for rents received by Operating Partnership from Newco or a subsidiary of Newco to be treated as rents from real property under § 856(d), Company must not be treated as owning directly or indirectly, at any time during Company's taxable year, 10 percent or more of the total combined voting power or

total number of shares of all classes of Newco's stock.

The Internal Revenue Service has considered the treatment of the momentary ownership of stock for purposes of facilitating a divisive corporate reorganization in the context of a small business corporation. 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 § 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 § 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. Similar treatment is appropriate in the present situation.

Accordingly, based on the facts as represented, we conclude that the momentary ownership of Newco by Company in the proposed transaction will not result in the disqualification of rental payments from Newco or a subsidiary of Newco as "rents from real property" within the meaning of § 856(d) of the Code.

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. No opinion is expressed concerning whether Company or any other entity qualifies as a REIT under § 856 of the Code prior to or following the proposed transaction described above. In particular, except as ruled above, no opinion is expressed as to whether the income from any lease mentioned above qualifies as "rents from real property" under § 856(d).

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

Sincerely yours,

Assistant Chief Counsel  
(Financial Institutions & Products)

By: \_\_\_\_\_  
Alvin J. Kraft  
Chief, Branch 1

Enclosure:  
Copy of this letter  
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