

**Internal Revenue Service**

Department of the Treasury

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Person to Contact:

Telephone Number:

Refer Reply To:  
CC:FIP:B01-PLR-111509-00  
Date:  
October 2, 2000

**Legend:**

Trust =  
State =

Date 1 =

Date 2 =

Exchange =

a =

OP =

b =

c =

d =

e =

f =

Dear :

This is in response to a letter dated June 2, 2000, requesting a ruling on behalf of Trust. Trust has requested a ruling that a reduction in the permitted percentage of ownership of its outstanding stock for the reason described below will not cause Trust's stock to fail to be transferable shares as required by § 856(a)(2) of the Internal Revenue Code.

**Facts:**

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Trust was established under State law as a subchapter C corporation on Date 1 and elected to be treated as a real estate investment trust (REIT) under § 856 for its first tax year ended Date 2. Trust's stock is publicly traded on the Exchange, a national stock exchange.

Trust owns approximately a percent of the partnership interests in OP, a limited partnership that owns retail shopping centers. Since its inception, Trust's operations have resulted in a net operating loss (NOL) carryforward of approximately b dollars for federal income tax purposes.

Trust's Amended and Restated Articles of Incorporation (Charter) provides that no shareholder may own more than c percent of the value of Trust's outstanding stock (except under certain prescribed circumstances). Trust is concerned that the current stock ownership limitation would allow stock transactions to occur that would cause an ownership change that would trigger limitations on the use of NOLs under § 382.

To address its concerns over the potential for an inadvertent ownership change, Trust proposes to amend its Charter to reduce the c percent ownership limitation to d percent. Trust currently has in excess of e shareholders and there are only f existing shareholders who own in excess of d percent of the outstanding stock but less than c percent. The existing ownership limit of c percent will continue to apply to those f shareholders.

Trust represents that the loss of the NOL carryforwards could jeopardize its ability to retain its REIT status. In the event that Trust recognizes income in future years with no corresponding cash receipts (e.g. accrual of unpaid rent or other "phantom income"), or makes any expenditures that are not currently deductible for federal income tax purposes, the inability to offset its taxable income with the NOL deductions could impair Trust's ability to meet the dividend distribution requirement of § 857(a).

### **Law, Analysis, and Conclusion:**

Section 856(a)(2) provides that beneficial ownership of a REIT must be evidenced by transferable shares, or by transferable certificates of beneficial interest. Section 1.856-1(d)(2) of the Income Tax Regulations provides that provisions in a REIT's corporate charter or bylaws that permit the trustee or directors to redeem shares or refuse to transfer shares in any case in which the trustee or directors, in good faith, believe that a failure to redeem shares or that a transfer of shares would result in the loss of status as a REIT will not render the shares "nontransferable."

Section 382 places a limitation on the amount of income that may be offset by NOL carryforwards. Under § 382(a), a "new loss corporation" cannot deduct "pre-

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change” losses in excess of the § 382 limitation. One necessary element for the § 382 limitation to be triggered is an “ownership change.”

Section 382(k)(1) defines a “loss corporation” to mean any corporation entitled to a NOL carryover. Under § 382(g)(1), there is an ownership change if, immediately after any owner shift involving a 5-percent shareholder, the percentage of the stock of the loss corporation owned by 1 or more 5-percent shareholders has increased by more than 50 percentage points, over the lowest percentage of stock of the loss corporation owned by such shareholders at any time during the testing period set forth in § 382(i).

In the present case, Trust is concerned that the current stock ownership limit would allow stock transactions to occur that would cause an ownership change with respect to Trust, trigger the § 382 limitation on the use of its NOL carryforwards, and jeopardize its ability to retain its REIT status. Consequently, Trust seeks to amend its Charter to forestall the possibility of an ownership change under § 382.

In 1976, § 856 was amended to allow corporations that meet the statutory requirements of that section to qualify as REITs. The term “transferable” is not defined in the Code. Prior to its amendment in 1997, § 301.7701-2(a)(1) of the Procedure and Administration regulations identified four characteristics that distinguish a corporation from other business entities. They were: 1) continuity of life, 2) centralization of management, 3) liability for corporate debts limited to corporate property, and 4) free transferability of interests. Former § 301.7701-2(e)(1) provided that an organization has the corporate characteristic of free transferability of interests if each of the members or those members owning substantially all of the interests in the organization have the power, without the consent of the other members, to substitute for themselves in the same organization a person who is not a member of the organization. For this power of substitution to exist in the corporate sense, the member must be able, without the consent of the other members, to confer upon the member’s substitute all the attributes of the member’s interest in the organization. The characteristic of free transferability does not exist if each member can, without the consent of the other members, assign only the right to share in profits but cannot assign the rights to participate in the management of the organization.

It has been held that a requirement of consent prior to a transfer, if not unreasonably withheld, will not violate the free transferability standard. A reasonable restriction on the transfer of shares is not the sort of limitation on transferability contemplated by the regulation. See Larson v. Commissioner, 66 T.C. 159, 183 (1976). Although the regulation is not currently effective, it remains instructive to determine whether interests in Trust are “transferable” within the meaning of § 856(a)(2).

In the present case, the proposed ownership limitation is a reasonable and minor limitation on the potential universe of stock transferees that is intended to preserve certain favorable tax attributes and safeguard Trust’s status as a REIT. Each

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shareholder has a ready market for transferring shares through the Exchange at fair market value to anyone that will not cause the transferee to exceed the ownership limitation. Accordingly, we rule that Trust's proposed amendment to its Charter to reduce the stock ownership limitation, as described above, will not cause Trust's stock to fail to be transferable for purposes of § 856(a)(2).

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 Trust qualifies as a REIT under § 856 of the Code prior to or following the proposed transaction described above.

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 yours,  
Acting Associate Chief Counsel  
(Financial Institutions & Products)  
By: Alvin J. Kraft  
Chief, Branch 1

Enclosure:  
Copy of this letter  
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