Internal Revenue Service

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Person To Contact:
, ID No.
Telephone Number:

Refer Reply To:
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Date:
October 03, 2006

Legend:

Taxpayer =

Year 1 =

Seller =

Relinquished Property =

OP =

LP =

a =

Date 1 =

Purchaser =

b =

c =

d =

e =

Date 2 =

Dear :

This is in reply to a letter dated May 18, 2006, and subsequent submissions, requesting certain rulings on behalf of Taxpayer. You requested a ruling that the exchange of the Relinquished Property in the proposed transaction will not constitute a sale or other disposition of property for purposes of the prohibited transaction rules under section 857(b)(6) of the Internal Revenue Code. You also requested a ruling that in the event 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 used to calculate the 10 percent rule under section 857(b)(6)(C)(iii)(II).

Facts:

Taxpayer is a publicly traded domestic corporation that elected to be taxed as a real estate investment trust (REIT) beginning with its Year 1 tax year. Taxpayer is engaged through its subsidiaries in the acquisition, ownership, management, and redevelopment of apartment properties located throughout the United States.

Seller, a disregarded entity for federal tax purposes, holds legal title to the Relinquished Property. OP, an operating partnership in which Taxpayer owns approximately a percent, owns (directly or through other disregarded entities or through intercompany agreements) b percent of Seller. Taxpayer represents that because Seller is a disregarded entity, OP is the owner of the Relinquished Property for federal income tax purposes. The total adjusted basis of the Relinquished Property is c dollars for federal income tax purposes and d dollars for purposes of calculating earnings and profits.

On Date 1, Seller entered into a sales contract with an unrelated third party, Purchaser, to sell the Relinquished Property for an aggregate price of e dollars. The sale was scheduled to close on or before Date 2. However, instead of selling the Relinquished Property to Purchaser, Seller and Taxpayer want to enter into a deferred like kind exchange under section 1031 and section 1.1031(k)-1 of the Income Tax Regulations, which provides operative rules concerning the treatment of deferred exchanges.

Taxpayer and Seller intend to identify replacement property within 45 days of transferring the Relinquished Property and intend to acquire the qualified replacement property within 180 days of transferring the Relinquished Property. Taxpayer represents that the proposed transaction will constitute a qualified like-kind exchange under section 1031 and the regulations thereunder. The business purpose of the transaction is to allow Taxpayer to divest itself of an investment in a particular segment of the real estate market and replace its investment with similar property in another segment of the market.

Law and Analysis:

Section 857(b)(6) provides, in general, that a REIT shall be subject to a 100 percent tax on the net income derived from a prohibited transaction. A prohibited transaction is defined as a sale or other disposition of property described in section 1221(a)(1) that is not foreclosure property.

Section 857(b)(6)(C) provides a safe harbor from treatment as a prohibited transaction for sales that meet the conditions specified therein. Under this section, the sale or disposition of property will not be considered a prohibited transaction if (i) the REIT has held the property for not less than 4 years; (ii) aggregate expenditures made by the REIT, or any partner of the REIT, during the 4-year period preceding the date of the sale that are includible in the basis of the property do not exceed 30 percent of the net selling price of the property; (iii) (I) during the taxable year the REIT 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 of all the assets of the REIT as of the beginning of the taxable year; (iv) in the case of property, which consists of land or improvements not acquired through foreclosure or lease termination, the REIT has held the property for not less than 4 years for the production of rental income; and (v) if the requirement stated under (iii)(I) is not satisfied, substantially all the marketing and development expenditures with respect to the property were made through an independent contractor (as defined in section 856(d)(3)) from whom the REIT does not derive or receive any income.

Section 1031(a) provides that no gain or loss shall be recognized on the exchange of property held for productive use in a trade or business or for investment if such property is exchanged solely for property of like kind which is to be held either for productive use in a trade or business or for investment. Section 1031(a)(2)(A) provides that the non-recognition of gain or loss rule does not apply to any exchange of property that is stock in trade or other property held primarily for sale. If a taxpayer receives property other than like kind property (“boot”) in addition to like kind property in a section 1031 exchange, the exchange may still qualify as a section 1031 exchange to the extent of the exchanged like kind property, as provided in section 1031(b).

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 shall be recognized, but in an amount not in excess of the sum of money and the fair market value of other property received.

Under section 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 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 partners for all purposes of section 856. Based upon this regulation, Taxpayer is treated as the owner of the Relinquished Property.
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). Taxpayer's proposed transaction appears to be consistent with the Congressional intent of allowing REITs to modify their portfolios without incurring a prohibitive tax. Accordingly, if the proposed 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. The receipt of boot in a like-kind exchange by a REIT does not convert the exchange into a sale, for purposes of the prohibited transaction rules under section 857(b)(6). 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 used for calculating the 10 percent rule in section 857(b)(6)(C)(iii)(II).

No opinion is expressed or implied with regard to whether Taxpayer qualifies as a REIT under subchapter M. In addition, no opinion is expressed or implied as to whether section 1031(a) applies to the proposed transaction. 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 yoursWilliam E. Coppersmith
Chief, Branch 2
Office of Associate Chief Counsel
(Financial Institutions & Products)