FINAL PRIVATE LETTER RULING

REQUEST LETTER

09-010

April 17, 2009

Utah State Tax Commission
Auditing Division
Private Letter Ruling
210 North 1950 West
Salt Lake City UT 84134

Re: Private Letter Ruling Request Pursuant to
Utah Admin Code R861-1A-34

Dear Sir or Madam

Introduction:

REQUESTING COMPANY hereby submits this request for a Letter Ruling pursuant to Utah Administrative Code R861-1A-34 on behalf of its client, "the Fund", a STATE 1 limited partnership and its subsidiary, "the REIT", a STATE 2 corporation that will elect to be treated as a real estate investment trust for federal income tax purposes. To the best of our knowledge and the knowledge of the Fund and the REIT:

1. The identical issues as presented herein have not otherwise been addressed in statutes, rules, or decisions issued by the commission; and
2. The identical issues as presented herein are not being considered in any matter pending before the commission in an audit assessment, refund request, or other agency action, or in any matter pending before the court on judicial review of a commission decision.

Factual Background

The Fund's activities consist of investing in multi-family residential properties. The Fund is owned 1.25% by "Fund GP", a STATE 1 sing-member limited liability company and the Fund's sole general partner, and 98.75% by various limited partners consisting of U.S. pension funds, other partnerships with various types of investors and other limited partners. None of the Fund's limited partners are associations taxable as corporations for U.S. federal income tax purposes. Fund GP's sole member is "Fund Associates" a STATE 1 limited liability company. Fund Associates is owned 4.95% by "Holdings Inc.", a STATE 1 corporation, treated as an "S" corporation for U.S. federal income tax purposes. Holdings Inc. is the sole general partner of

Fund Associates. The remaining 95.05% of Fund Associates is owned by various individual limited partners. Holdings Inc. is 100% owned by a single individual.

The fund owns 100% of the common stock of the REIT. The REIT's preferred stock is owned by various individual accredited investors. The REIT has acquired a multi-family residential property located in Utah. The REIT Ownership Structure Chart, attached as Exhibit A, hereto, illustrates the above-described structure.

Rights of the Partners under the Fund Partnership Agreement

The Fund's partnership agreement (the "Agreement") provides for the management and operation of the Fund and its business to be vested in Fund GP. Fund GP is authorized to perform the following specific functions: acquire, hold, maintain, operate or develop land, renovate, expend, lease, finance, manage and dispose of investments; and organize wholly-owned or partially-owned subsidiaries of the Fund, including entities organized to operate as REITs. The limited partners of the Fund do not participate in the management of the businesses or affairs of the Fund, except through the operation of the Fund's advisory committee. The advisory committee, which is comprised of one designee of each limited partner must approve the following matters: (i) waiver of conflicts involving Fund GP (ii) decisions to permit a property held in REIT to be disposed of within 24 months of its acquisition, (iii) any decisions to cause a REIT to invest in a joint venture, (iv) the acquisition of any investment that does not meet specified parameters, and (v) certain other matters.

The Agreement also provides that limited partners owning more than 50% of the interests in the Fund may vote to remove Fund GP for (i) a material breach of Fund GP's duties, fraud, gross negligence, or willful or criminal misconduct, (ii) a material breach of an agreement between the Fund and an affiliate of Fund GP, or (iii) the fraud, willful of criminal misconduct or gross negligence of such affiliate. Additionally, beginning 40 months after the final closing of the Fund, Fund GP may be removed, at any time, by limited partners owning more than 75% of the interests in the Fund.

Issue

Whether the REIT falls within the definition of a "captive REIT" set forth in Utah Code Ann. § 59-7-101(6)?

Discussion

Effective January 1, 2008, the Utah State Legislature amended Utah Code Ann. Section § 59-7-105(13) to address attempts to use REITs to shift income between entities and avoid Utah state corporate income taxes.[1] Under section 59-7-105(13) as amended, entities defined as "captive real estate investment trusts" are required, when computing adjusted income, to add back the deduction for dividends paid that is otherwise allowed pursuant to Internal Revenue Code ("IRC") section 857(b)(2)(B).

[1] 2008 UT H.B. 359.

A real estate investment trust will be classified as a "captive real estate investment trust ("captive REIT") if it satisfies the following criteria:

(i) the shares or beneficial interests of the real estate investment trust are not regularly traded on an established securities market, and
(ii) more than 50% of the voting power or value of the shares or beneficial interest of the real estate investment trust are directly, indirectly, or constructively owned or controlled by a controlling entity.[2]

A controlling entity is "an association taxable as a corporation under the Internal Revenue Code" that is not exempt from federal income taxation" and "directly, indirectly or constructively holds more than 50% of the voting power . . . or the value of the share or beneficial interests" of the REIT.[3] Although the REIT meets the first criteria in that its shares are not regularly traded on an established securities market, it is our belief that is does not satisfy the second criteria regarding the ownership or control of the voting power and value of the shares or beneficial interests of the REIT.

Ownership of Voting Power and Value of REIT shares

Based on the ownership structure of the REIT, it is clear that not more than 50% of the REITs voting power or value is owned directly or indirectly by a controlling entity. The REITs voting stock (i.e., its common shares) are owned directly by the Fund, which cannot be classified as a controlling entity because it is classified as a partnership for federal income tax purposes, not as a corporation. The REITs preferred stock is owned directly by individual investors. With respect to the indirect ownership of the REIT, 98.75% of the REITs common stock is owned by various limited partners of the Fund consisting of U.S. pension funds, other partnerships with various types of investors and other limited partners. These limited partners do not meet the controlling entity definition due to the fact that they are either exempt from federal income taxation or not taxable as corporations for federal income tax purposes. Additionally, none of the limited partners owns more than 50% of the Fund.

Control of Voting Power and Value of REIT shares

There is no issue regarding direct control of the REITs voting power and value. As previously noted, the direct owner of the REITs voting (common) stock and majority of the REIT's value, the Fund, cannot meet the controlling entity definition due to its classification as a partnership for federal income tax purposes. The remaining value for the REIT, in the form of preferred shares, as owned directly by individual shareholders.

There is concern with respect to indirect or constructive control of the REIT under the current structure, as the statute does not clearly indicate what "control" is for purposes of this provision. More particularly, it is unclear whether Holdings Inc., through its indirect ownership in the REIT, would be deemed to indirectly or constructively control more than 50% of the voting power or value of the REITs shares.

[2] Utah Code Ann. §59-7-101(6).
[3] Utah Code Ann. §59-7-101(8).

In determining the issue of control, several states that have adopted captive REIT provisions similar to section 59-7-105(13) have looked to the constructive ownership rules of IRC section 318 for guidance. The attribution rules of Code section 318 were enacted in the Internal Revenue Code of 1954, to clear up uncertainty with respect to corporate redemptions over the question of "control."[4] The section 318 attribution rules, as they apply to partnerships such as the Fund, are based on the presumption that control resides in the partner that is deemed to own the stock.[5] A REIT's shares owned by a partnership are attributed proportionately to each partner,[6] with proportionality defined by the partner's interest in the partnership.[7] A partner's interest in a partnership reflects the manner in which the partners have agreed to share the economic benefit or burden (if any) corresponding to the income, gain, loss, deduction, or credit (or item thereof) that is allocated, [8] often the partner's capital interest is used as that proxy where at a point in time, how would such economic benefit or burden be allocated if all assets were liquidated at their fair market value.

Applying the provisions of IRC section 318 to the facts at issue, the common shares of the REITs directly owned by the Fund are considered to be owned proportionately by the Fund's partners, none of who owns more than a 50% share in the Fund. Thus, it would not be possible for any single entity to have more than 50% control over the REIT.

Even absent the provisions of IRC section 318, Holdings Inc. should not be deemed to constructively or indirectly control more than 50% of the voting power or value of the REIT shares. Under the terms of the Agreement, the Fund's limited partners are granted a significant measure of control over the parameters within which the Fund's general partner, Fund GP, may operate. As previously noted, an advisory committee comprised of one designee of each limited partner must approve the following partnership matters: (i) waiver of conflicts of interest involving Fund GP, (ii) decisions to permit a property held in a REIT to be disposed of within 24 months of its acquisition, (iii) any decisions to cause a REIT to invest in a joint venture and (iv) the acquisition of any investment that does not meet specified parameters. Additionally, limited partners owning more than 50% of the interests in the Fund may vote to remove Fund GP for (i) a material breach of Fund GP's duties, fraud, gross negligence, or willful or criminal misconduct, (ii) a material breach of an agreement between the Fund and an affiliate of Fund GP, or (iii) the fraud, willful or criminal misconduct or gross negligence of such affiliate. Finally, beginning 40 months after the final closing of the Fund, Fund GP may be removed, at any time, by limited partners owning more than 75% of the interests in the Fund.

Since Holdings Inc.'s indirect or constructive control of the REIT is derived entirely from its indirect ownership interest in Fund GP, it can not have any greater rights than those granted to Fund GP under the terms of the Agreement. Based on rights granted to the Fund's limited partners under the terms of the Agreement discussed above, it is our believe that neither Holdings Inc. nor any other entity can be deemed to indirectly or constructively control more than 50% of the REITs voting power or value of the REITs shares.

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[4] H. Rept. No. 1337, 83d Cong., 2d Sess. (1954) A96, U.S. Code Cong. & Adm. News 4061 (1954).
[5] IRC § 318(a)(5)(A).
[6] IRC § 318(a)(2)(A).
[7] Treas. Reg. § 1.318-2(c) Ex. 1.
[8] Treas. Reg. § 1.704-1(b)(3)(i).

The REIT is not engaged in tax avoidance activities

Assuming arguendo, that Holdings Inc. was deemed to indirectly or constructively control 50% or more of the REIT's voting powder or the value of the REIT's shares, neither the REIT nor any of its direct or indirect owners is engaged in the tax avoidance activities that the captive REIT legislation was meant to address. The legislature enacted this provision in response to the state tax minimization strategies employed by large retail companies as demonstrated in the state of North Carolina's battle with Wal-Mart. Under that strategy, retail corporations were creating abusive captive REITs to hold their own operating real estate properties, such as stores and office space. The retail company would have all of their stores pay rent to the REIT for use of the store space, then the REIT would issue dividends to another subsidiary of the retail company. The captive REIT would not be subject to tax on the rental income since it would take a deduction for the dividends paid to its shareholders; the corporation would not be subject to state taxes since it would deduct the rental expense paid to the REIT against the amount of the dividends received from the REIT. By disallowing the dividends paid deduction for captive REITs, Utah has sought to eliminate the ability of retail corporations to reduce of avoid paying state income taxes.

With respect to the situation at hand, the REIT is not being used for tax avoidance purposes. First, the Fund invests in real estate, and the REIT was enacted specifically to be an efficient way to hold real estate investments. Furthermore, the REIT is not in the business of renting space to Holdings Inc. or any other of its direct or indirect owners. Finally, the Fund itself is a pass-through entity not subject to Utah income taxation, and is owned in large part by other by tax-exempt investors who themselves are not subject to income taxes. Thus, the Fund and its investors have no motive to avoid state taxes through the use of a captive REIT nor is there opportunity to distort taxable income among the entities involved.

Ruling Requested

Based on the facts and analysis presented herein, we respectfully request the following rulings:

(1) that the REIT does not fall within the definition of a "Captive real estate investment trust" set forth in Utah Code Ann. Section 59-7-101(6)(a); and
(2) That in determining its Utah taxable income, the REIT will not be subject to the provisions of Utah Code Ann. Section 59-7-105(13) which requires an addition to adjusted income for the amount of the deduction for dividends paid allowed under Internal Revenue Code section 857(b)(2).

If you require additional information or would like to discuss this request further, please call me at PHONE. Thank you in advance for your consideration.

Very Truly Yours,

REQUESTING COMPANY
NAME
TITLE

RESPONSE LETTER

December 1, 2009

NAME
TITLE
REQUESTING COMPANY
ADDRESS

RE: Private Letter Ruling Request–Determination of Whether REIT Presented is a Captive REIT Under Utah Corporate Tax Law.

Dear NAME:

You have presented facts about a Real Estate Investment Trust ("REIT") and requested a ruling on whether the REIT falls within the definition of a captive REIT as defined in Utah Code Ann. § 59-7-101(6) and whether the REIT will be subject to the provisions of Utah Code Ann. § 59-7-105(13). In your request letter, you have provided information about the following entities:

1. REIT Inc. owns Utah real estate. It has common and preferred stock: 100 percent of the common stock is owned by Fund LP, and 100 percent of the preferred stock is owned by individual shareholders.

2. Fund LP owns 100 percent of the common stock of REIT, Inc. It is owned as follows: 1.25 percent by the sole general partner Fund GP LLC and the remaining 98.75 percent by limited partners.

3. Individual Shareholders of the REIT own 100 percent of the preferred stock of REIT, Inc. These shareholders are various individual accredited investors.

4. Fund GP LLC, a single member LLC, is the sole general partner of Fund LP. Fund GP LLC is wholly owned by Fund Associates LLC.

5. Limited Partners of the Fund LP own 98.75 percent of Fund LP. These investors consist of U.S. pension funds and other partnerships with various types of investors and other limited partners. None of the limited partners own more than 50 percent of Fund LP.

6. Fund Associates LLC owns 100 percent of Fund GP LLC and is owned as follows: 4.95 percent by Holdings, Inc., which acts as the sole general partner, and the remaining 95.05 percent by limited partners.

7. Holdings Inc., an S corporation, owns 4.95 percent of Fund Associates LLC and acts as its sole general partner. Holdings, Inc. is 100 percent owned by an individual.

8. Limited Partners of Fund Associates LLC owns 95.05 percent of Fund Associates LLC. These investors include various individual limited partners.

9. Individual owns 100 percent of Holdings, Inc. and is a person, in the traditional sense of the word.

Additionally, during a telephone conversation you also provided that the various individual shareholders and limited partners of REIT Inc., Fund LP, and Fund Associates LLC are all investors of the nature of pension funds and partnerships. You stated that none is a corporation or association taxed as a corporation for federal tax purposes. Also, you stated that there is no overlapping ownership between these investors and Fund LP, Fund GP LLC, Fund Associates LLC, Holdings Inc., or the Individual. You also stated that that no entity has filed an election with the IRS to be treated as an association taxable as a corporation.

I. Applicable Law

Utah Code Ann. § 59-7-101(21) [1] defines a REIT as follows:

Real estate investment trust' is as defined in Section 856, Internal Revenue Code.

Utah Code Ann. § 59-7-101(6)(a) defines a captive REIT as follows:

"Captive real estate investment trust" means a real estate investment trust if:
(i) the shares or beneficial interests of the real estate investment trust are not regularly traded on an established securities market; and
(ii) more than 50% of the voting power or value of the shares or beneficial interests of the real estate investment trust are directly, indirectly, or constructively:
(A) owned by a controlling entity of the real estate investment trust; or
(B) controlled by a controlling entity of the real estate investment trust.

Utah Code Ann. § 59-7-101(8)[2] defines a controlling entity of a captive REIT as follows:

(a) "Controlling entity of a captive real estate investment trust" means an entity that:
(i) is treated as an association taxable as a corporation under the Internal Revenue Code;
(ii) is not exempt from federal income taxation under Section 501(a), Internal Revenue Code; and

[1] Prior version at § 59-7-101(22) (2008).
[2] Prior version at § 59-7-101(7) (2008). Section 59-7-101(8)(b)(iii) mentions a "foreign real estate investment trust" which is defined in Utah Code Ann. § 59-7-101(17). However, no facts presented suggest that a foreign real estate investment trust is involved in this ruling.

(iii) directly, indirectly, or constructively holds more than 50% of:
(A) the voting power of a captive real estate investment trust; or
(B) the value of the shares or beneficial interests of a captive real estate investment trust.

(b) "Controlling entity of a captive real estate investment trust" does not include:
(i) a real estate investment trust, except for a captive real estate investment trust;
(ii) a qualified real estate investment subsidiary described in Section 856(i), Internal Revenue Code, except for a qualified real estate investment trust subsidiary of a captive real estate investment trust; or
(iii) a foreign real estate investment trust.

. . . .

Utah Code Ann. § 59-7-101(10) defines corporation as follows:

"Corporation" includes:
(a) entities defined as corporations under Sections 7701(a) and 7704, Internal Revenue Code; and
(b) other organizations that are taxed as corporations for federal income tax purposes under the Internal Revenue Code.

Utah Code Ann. § 59-7-101(24) defines S corporation as follows:

"S corporation" means an S corporation as defined in Section 1361, Internal Revenue Code.[3]

Utah Code Ann. § 59-7-104 imposes a minimum tax on corporations, stating:

(1) Each domestic and foreign corporation, except those exempted under Section 59-7-102, shall pay an annual tax to the state based on its Utah taxable income for the taxable year for the privilege of exercising its corporate franchise or for the privilege of doing business in the state.
(2) The tax shall be 5% of a corporation's Utah taxable income.
(3) The minimum tax a corporation shall pay under this chapter is $100.

Utah Code Ann. § 59-7-105 to 105(13) states:

In computing adjusted income the following amounts shall be added to unadjusted income:

. . . .

(13) the amount of the deduction for dividends paid, as defined in Section 561, Internal Revenue Code, that is allowed under Section 857(b)(2)(B), Internal Revenue Code, in computing the taxable income of a captive real estate investment trust, if that captive real estate investment trust is subject to federal income taxation.

[3] Prior version at § 59-7-101(26) (2008).

I.R.C. § 7701(a) includes definitions, one of which is for corporation. I.R.C. § 7701(a)(3) defines corporation as follows:

> The term "corporation" includes associations, joint-stock companies, and insurance companies.

I.R.C. § 7704 is titled "Certain Publicly Traded Partnerships Treated as Corporations." I.R.C. § 7704(a) provides that the general rule that a publicly traded partnership is treated as a corporation. I.R.C. § 7704(b) defines publicly traded partnership, and the remaining subsections of I.R.C. § 7704 provide further instruction about such partnerships.

I.R.C. § 11 imposes tax on corporations, stating in part:

> (a) Corporations in general—A tax is hereby imposed for each taxable year on the taxable income of every corporation.
> (b) Amount of tax
> (1) In general—The amount of the tax imposed by subsection
> (a) shall be the sum of—
> (A) 15 percent of so much of the taxable income as does not exceed $50,000,
> (B) 25 percent of so much of the taxable income as exceeds $50,000 but does not exceed $75,000,
> (C) 34 percent of so much of the taxable income as exceeds $75,000 but does not exceed $10,000,000, and
> (D) 35 percent of so much of the taxable income as exceeds $10,000,000.
> . . . .

I.R.C. § 1361(a) defines S corporations, stating:

> S corporation defined
> (1) In general—For purposes of this title, the term ''S corporation'' means, with respect to any taxable year, a small business corporation for which an election under section 1362(a) is in effect for such year.
> (2) C corporation—For purposes of this title, the term ''C corporation'' means, with respect to any taxable year, a corporation which is not an S corporation for such year.

I.R.C. § 1363(a) provides that S corporations are generally not subject to taxes imposed under Chapter 1, stating:

> Except as otherwise provided in this subchapter [Subchapter S], an S corporation shall not be subject to the taxes imposed by this chapter [Chapter 1—Normal Taxes and Surtaxes].

I.R.C. § 1366(a) explains how the items of an S corporation pass through to its shareholders, stating in part:

> Determination of shareholder's tax liability
> (1) In general—In determining the tax under this chapter of a shareholder for the shareholder's taxable year in which the taxable year of the S corporation ends (or for the final taxable year of a shareholder who dies, or of a trust or estate which terminates, before the end of the corporation's taxable year), there shall be taken into account the shareholder's pro rata share of the corporation's—
> (A) items of income (including tax-exempt income), loss, deduction, or credit the separate treatment of which could affect the liability for tax of any shareholder, and
> (B) nonseparately computed income or loss.
>
> For purposes of the preceding sentence, the items referred to in subparagraph (A) shall include amounts described in paragraph (4) or (6) of section 702(a).

I.R.C. § 1371(a) states in part:

> Application of subchapter C rules—Except as otherwise provided in this title [Title 26—Internal Revenue Code], and except to the extent inconsistent with this subchapter [Subchapter S], subchapter C shall apply to an S corporation and its shareholders.

II. Analysis

REIT Inc. is not a captive REIT under Utah law because none of the entities in its ownership structure meets the definition of controlling entity, which is an entity treated as an association taxable as a corporation under the I.R.C.

Under § 59-7-101(6)(a)(ii), a captive REIT must have a controlling entity. Under § 59-7-101(8) a controlling entity has three characteristics, one of which is that it "is treated as an association taxable as a corporation under the Internal Revenue Code." Utah Code § 59-7-101(10) defines corporation to include "entities defined as corporations under Sections 7701(a) and 7704, Internal Revenue Code." I.R.C. § 7701(a)(3) defines broadly the term "corporation" to include associations, joint-stock companies, and insurance companies. I.R.C. § 7701 provides that publicly traded partnerships are treated as corporations, but this section does not apply to the facts of this ruling. While an S corporation meets the I.R.C. definition of a corporation, we must still analyze whether an S corporation is "*taxable as a corporation* under the [I.R.C.]" for § 59-7-101(8). (Emphasis added).

I.R.C. § 11 imposes tax on corporations based on their taxable incomes. I.R.C. § 1361(a) defines S corporations, separating it from C corporations. I.R.C. § 1363(a) provides that S corporations are generally not subject to taxes imposed under Chapter 1, which includes I.R.C. § 11. Instead, under I.R.C. § 1366(a), items of an S corporation pass through to its shareholders.

Therefore, S corporations are not subject to the tax on corporations found in I.R.C. § 11, and S corporations are not entities "taxable as a corporation under the [I.R.C.]" for Utah Code § 59-7-101(8). Because S corporations are not taxable as a corporation, they cannot be controlling entities under § 59-7-101(6)(a)(ii).

Other language in the Utah Code also suggests that an S corporation is not "taxable as a corporation." The Utah Code provides that an S corporation is " defined in Section 1361, Internal Revenue Code." I.R.C. § 1361(a) defines S corporations as not being C corporations. C corporations are subject to I.R.C. § 11, which S corporations are not. Similarly, Utah Code § 59-7-104 imposes Utah tax on a "corporation" based on its Utah taxable income. An S corporation is not subject to this tax.

Finally, I.R.C. § 1371(a) cannot be read to make an S corporation "taxable as a corporation." While I.R.C. § 1371(a) provides that the statutes of subchapter C generally apply to S corporations, such applications are limited when other areas of I.R.C. provides otherwise. Because I.R.C. § 1363(a) provides that S corporations, specifically, are not subject to the tax on corporations, any statutes of subchapter C providing otherwise cannot be applied to the S corporations.

In this case, all entities in REIT Inc.'s ownership structure are not "taxable as a corporation under the [I.R.C.]" Fund LP, Fund GP LLC, Fund Associates LLC, and Individual are clearly not corporations, and according to your facts, they did not file elections with the IRS to be treated as associations taxable as corporations. For the Individual shareholders of the REIT, the Limited Partners of the Fund LP, and the Limited Partners of Fund Associates LLC, you specifically stated that none of these are corporations or associations taxed as corporations for federal tax purposes. For Holdings Inc., you have provided that it is an S corporation with a single owner. We have found in this ruling that an S corporation is not "taxable as a corporation under the [I.R.C.];" therefore, Holdings Inc. is also not taxable as a corporation. Because all entities in the ownership structure are not taxable as corporations, there is no controlling entity and REIT Inc. cannot be a captive REIT under Utah law.

You also requested that we rule REIT Inc. is not subject to the provisions of § 59-7-105(13) when determining its Utah taxable income. Because REIT Inc. is not a captive REIT, it is not subject to the provisions of § 59-7-105(13), which only apply when "computing the taxable income of a captive [REIT]."

III. Conclusion

REIT Inc. is not a captive REIT under Utah law. Our conclusions are based on the facts as described. Should the facts be different, a different conclusion may be warranted. If you feel we have misunderstood the facts as you have presented them, if you have additional facts that may be relevant, or if you have any other questions, please contact us.

For the Commission,

R. Bruce Johnson
Commissioner

RBJ /aln
09-010