Internal Revenue Service

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Person to Contact:

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CC:FIP:2/PLR-131062-01
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Legend:

Company =

Management =

Partnership =

BC-TRS =

BC-JV =

Operator =

Operator Group =

Operator 2 =

HC-TRS =

Parent =

State A =

State B =

State C =

Trust =

Date 1 =

x =

y =

Dear :

This letter is in response to a letter dated June 1, 2001, submitted on behalf of Company, requesting various rulings relating to Company's status as a real estate investment trust ("REIT") under section 856 of the Internal Revenue Code.

Company, a publicly held State A corporation, is a calendar year taxpayer that uses the accrual method of accounting, and that has elected to be treated as a REIT under section 856 of the Code. Company owns substantially all of its assets and conducts all of its operations through Partnership, a State B limited partnership. The Partnership owns or has an interest in a large number of commercial office properties (each a "Property") throughout the United States. The Partnership owns substantially all of such Properties either directly or indirectly through ownership interests in affiliated partnerships and limited liability companies, substantially all of which are controlled by the Partnership.

The Partnership owns taxable corporations through which it conducts the management of properties that are not wholly owned by the Partnership, provides certain services to tenants, and provides access to tenants to service providers. The Partnership generally owns, directly or indirectly, one hundred percent of the capital stock of these taxable corporations, each of which has elected to be treated as a taxable REIT subsidiary under section 856(l) of the Code. Management is one such corporation.

In connection with its business of investing in, owning and operating the Properties, the Partnership and its subsidiaries sometimes enter into strategic relationships with service providers who provide services related to the management and operation of commercial office properties. The Partnership also acquires certain limited assets that do not qualify as real estate assets for purposes of section 856(c)(4) of the Code.

FACTS

A. Rents Paid by a Taxable REIT Subsidiary Joint Venture

BC-TRS, a State B corporation, is a wholly-owned subsidiary of Management that, pursuant to section 856(l)(2) of the Code is a taxable REIT subsidiary (TRS). Operator is a State B corporation that is unrelated to Company and the Partnership. BC-JV is a State B limited liability company that was formed by BC-TRS and Operator with each owning 50% of the capital stock of BC-JV. BC-JV is managed on a day-to-day basis by Operator under the auspices of an operating board consisting of four individuals, two of whom are to be designated by BC-TRS and the other two to be

designated by Operator.

BC-JV leases office space at several Properties from the Partnership and is expected to lease space at additional Properties pursuant to a Master Lease Agreement which contemplates that a separate lease will be entered into with respect to each Property where the Partnership and BC-JV agree to locate a business center. Each lease will permit BC-JV to establish and operate a business center in the leased space, including the right to license or sublease the temporary use of all or a portion of the space to third parties for general office use. BC-TRS together with Operator and certain members of the Operator Group will be required individually to guarantee the payment of 50% of the payment obligations of BC-JV to the Partnership under the lease. At certain Properties, the total space leased by BC-JV may exceed 10% of the leased space at the building but it will not in any event exceed 20% of the leased space at the building.

The Partnership is free to negotiate rental fees with BC-JV and any other tenant, whether the tenant operates a business center or not. The Partnership is not required to confer any benefits or privileges to BC-JV that it does not offer to other tenants. If, however, Partnership and BC-JV sign a business center lease in a building, during the term of that lease Operator has a right of first refusal with respect to any additional space in that particular building that Partnership plans to lease or use for operation as a business center, and, if Operator exercises its rights of first refusal, BC-TRS has a right to participate with Operator, in which case Operator will assign the lease to BC-JV. Partnership has granted similar exclusions or rights of first refusal to other tenants engaged in other types of business at its Properties. Except in this limited circumstance, BC-JV has no rights of first refusal or other similar rights to lease space in Partnership buildings.

B. Services Provided to Tenants by a TRS Joint Venture

The Partnership anticipates that Management, directly or indirectly through one of its taxable REIT subsidiaries will enter into one or more unincorporated TRS joint ventures with unrelated third party service providers (“Providers”). The TRS joint ventures will likely be organized as limited liability companies or general partnerships, but in any event, will be treated as partnerships for federal income tax purposes. The Providers will qualify as independent contractors with respect to Company under section 856(d)(3) of the Code. The Providers will provide services to tenants at one or more of the Properties that would be considered non-customary services and/or services rendered primarily for the convenience of the tenant. These services might include specialized tenant cleaning services, customized business conference centers, and planning other customized business operational services. Pursuant to the terms of the service agreements between the Partnership and the TRS joint ventures, the fees for non-customary services provided by a TRS joint venture will be received directly by the TRS joint venture and will be shared, net of operating and other expenses of the TRS joint venture, between Management and the Provider. The Partnership will not receive any direct payments from either the TRS joint venture or from the Provider.

C. Taxable REIT Subsidiary Leases Unique Space in a Building

Management, through a wholly-owned taxable REIT subsidiary (HC-TRS) operates health clubs at several buildings owned by the Partnership. The space rented to HC-TRS at any particular property generally is space that is unmarketable for traditional office use and is unique space within the particular building. That is, within any given building, there may not be any space similar to the space rented to the HC-TRS that is rented to unrelated third parties. However, HC-TRS rents the particular space for an amount that is comparable to amounts paid for similar spaces in other Properties that are leased to unrelated third parties in the same geographic area.

D. TRS Election by Corporation in Which the Company Owns Stock Only Indirectly Through the Corporate Parent

The Partnership currently owns preferred stock representing approximately 10 percent of the outstanding equity in a national executive office suites business (Operator 2) that has elected to be treated as a taxable REIT subsidiary with respect to the Company. Operator 2 leases space at certain Properties to operate its business, which consists of providing temporary office space, office equipment, secretarial and technical assistance on a short-term basis. Pursuant to a proposed restructuring of Operator 2, Partnership's preferred stock interest will be converted into common stock of the entity that will become the 100 percent parent (Parent 2) of Operator 2. Thereafter, the Partnership will indirectly own stock in Operator 2 through its ownership of stock in Parent 2, that will represent less than 5 percent of the outstanding equity of Parent 2. Parent 2 will not be directly engaged in providing services to tenants at any of the Properties. Partnership expects that Parent 2 and Operator 2 will agree that Operator 2 will continue to elect to be a taxable REIT subsidiary with respect to Company, but that Parent 2 will not elect to be treated as a taxable REIT subsidiary with respect to Company.

E. Treatment of Loans Made to Partnerships in Which the Company Owns Equity

In connection with its business of owning and operating commercial office properties, the Partnership sometimes makes loans to partnerships or joint ventures that own commercial office properties and in which the Partnership owns an interest. In one instance the Partnership has made a loan to a limited liability company (Borrower) in which the Partnership owns an x percent membership interest. The owner of the remaining y percent membership interest is unrelated to either the Company or the Partnership. Borrower is treated as a partnership for federal income tax purposes. The loan from Partnership to Borrower is not secured by real estate.

F. Treatment of Assets Transferred to a Protective Trust

The Trust is a State C trust that was established by the Partnership and Management in order to protect the Company's REIT qualification in light of the asset test set forth in section 856(c)(4)(B)(iii)(III) of the Code. That section prohibits a REIT from owning securities of any issuer that have a value that exceeds 10 percent of the total outstanding value of that issuer. For this purpose, the term securities generally includes debt obligations of the issuer, unless the debt obligation is secured by a mortgage on real estate or its terms are such that it qualifies for the straight debt safe harbor set forth in section 856(c)(7). This prohibition applies regardless of the value of the security relative to the overall value of the assets of the REIT.

Prior to Date 1, the Company and the Partnership conducted extensive due diligence to identify all assets owned directly or indirectly by the Partnership that might reasonably be considered to violate the prohibition set forth in section 856(c)(4)(b)(iii)(III). Any assets that were identified as such were either transferred to a taxable REIT subsidiary of the Company or were restructured so that they no longer would violate that prohibition. The Company and the Partnership intend to conduct similar due diligence in the future. However, due to the magnitude of the Partnership's assets, and the complexity and national scope of its operations, there is some risk that one or more assets that would violate the prohibition might have been overlooked or may inadvertently be acquired in the future.

Given these concerns, on Date 1, the Partnership and Management established the Trust. The trustee of the Trust is the Partnership and the sole beneficiary is Management. The Trust's estate is defined under its declaration of trust to consist of all assets that the Partnership could not own without causing the Company to violate the 10 percent limitation set forth in section 856(c)(4)(B)(iii)(III). Pursuant to the terms of the Trust, any such property that otherwise would be considered to be owned by the Partnership or any subsidiary shall be deemed automatically, and without the need for further action by the Partnership or the relevant subsidiary, to have been transferred to the Trust on the day before the last day of the applicable calendar quarter. Under the terms of the Trust, Management, as the sole beneficiary, can demand the payment of the Trust's income and principal at any time. For federal income tax purposes, all income of the Trust will be reported on the tax returns of Management. Accordingly, any income attributable to any assets that are determined to have been transferred to the Trust will be subject to corporate income tax as income of Management. The Partnership and the Company believe that the Trust would be effective under state law to transfer the assets that it purports to transfer.

APPLICABLE LAW

REIT Income Tests

Section 856(c) of the Code provides that for a corporation to be qualified to be taxable as a REIT for any taxable year at least 95 percent of its gross income must be

derived from certain specified sources, including rents from real property, and at least 75 percent of its gross income must be derived from real property interests. Section 856(d)(1) provides that, subject to section 856(d)(2), the term rents from real property includes, inter alia, rents from interests in real property and charges for services customarily furnished or rendered in connection with the rental of real property, whether or not such charges are separately stated.

Section 1.856-(4)(a) of the regulations provides that the term rents from real property means the gross amounts received for the use of, or the right to use, real property of the REIT. Section 1.865-4(b) of the regulations provides that the term rents from real property includes charges for services customarily furnished or rendered in connection with the rental of real property, whether or not the charges are separately stated. Services rendered to tenants of a particular building will be considered customary if, in the geographic market in which the building is located, tenants in buildings of a similar class are customarily provided with the service.

Impermissible Tenant Service Income

Section 856(d)(2)(C) excludes from the term rents from real property any impermissible tenant service income. Section 857(d)(7)(A) provides that the term impermissible tenant service income includes, with respect to any real or personal property, any amount received or accrued directly or indirectly by the REIT for (i) services furnished or rendered by the REIT to the tenants of such property, or (ii) managing or operating such property.

Section 856(d)(7)(C)(i) provides that services, management, or operations provided through an independent contractor from whom the REIT itself does not derive or receive any income or through a taxable REIT subsidiary of the REIT will not be treated as provided by the REIT. Section 856(d)(7)(C)(ii) provides that any amount which would be excluded from unrelated business taxable income under section 512(b)(3) if received by an organization described in section 511(a)(2) will not constitute impermissible tenant services income.

Section 856(d)(7)(B) provides that if the amount of impermissible tenant service income received or accrued directly or indirectly by a REIT with respect to a property for any taxable year exceeds one percent of all amounts received or accrued directly or indirectly by the REIT with respect to such property, the impermissible tenant service income of the REIT with respect to the property shall include all such amounts.

Section 856(d)(3) provides that an independent contractor is any person (i) who does not own, directly or indirectly, more than 35 percent of the shares or certificates of beneficial interest in the REIT; and (ii) if the person is a corporation, not more than 35 percent of the voting power or total number of shares of whose stock, or if the 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 of certificates of beneficial interest in the REIT.

Section 1.856-4(b)(5) provides that no amount received or accrued, directly or indirectly, with respect to any real property qualifies as rents from real property if the REIT furnishes or renders services to the tenants of the property or manages or operates the property, other than through an independent contractor from whom the trust itself does not derive or receive any income. This section provides further that the requirement that the trust not receive any income from an independent contractor requires that the relationship between the two be an arm's-length relationship. To the extent that services (other than those customarily furnished or rendered in connection with the rental of real property) are rendered to the tenants of a property by an independent contractor, the cost of the services must be borne by the independent contractor, a separate charge must be made for the services, the amount of the separate charge must be received and retained by the independent contractor, and the independent contractor must be adequately compensated for the services.

Section 512(b)(3) provides, inter alia, that there shall be excluded from the computation of unrelated business taxable income all rents from real property and all rents from personal property leased with such real property, if the rents attributable to such personal property are an incidental amount of the total rents received or accrued under the lease, determined at the time the personal property is placed in service.

Section 1.512(b)-1(c)(5) provides that payments for the use or occupancy of rooms and other space where services are also rendered to the occupant do not constitute rent from real property. Generally, services are considered rendered to the occupant if they are primarily for his convenience and are other than those usually or customarily rendered in connection with the rental of rooms or other space for occupancy only. The supplying of maid services, for example, constitutes such service; whereas the furnishing of heat and light, the cleaning of public entrances, exits, stairways, and lobbies, and the collection of trash are not considered as services rendered to the occupant. Payments for the use or occupancy of entire private residences or living quarters in duplex or multiple housing units, or offices in any office building, are generally treated as rent from real property.

Rent Received From a Related Party

Section 856(d)(2)(B) provides that the term 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, (i) in the case of any person that is a corporation, stock of such person 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 person; or (ii) 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)(5) requires that for purposes of determining the ownership of stock, assets, or net profits under section 856(d) the constructive ownership rules of section 318(a) apply, as modified by subparagraphs (A) and (B) of section 856(d)(5).

Section 856(d)(8) provides that rent received by a REIT from its taxable REIT subsidiary will not be excluded from rents from real property under section 856(d)(2) if the terms of the limited rental exception of section 856(d)(8)(A) are met. The requirements of section 856(d)(8)(A) are met with respect to any property if at least 90 percent of the leased space of the property is rented to persons other than taxable REIT subsidiaries of such trust and other than persons described in section 856(d)(2)(B), but only to the extent that the amounts paid to the REIT as rents from real property (without regard to section 856(d)(2)(B)) from such property are substantially comparable to such rents made by the other tenants of the REIT's property for comparable space.

Taxable REIT Subsidiaries

Section 856(l) of the Code provides that a taxable REIT subsidiary means with respect to a REIT, a corporation (other than a REIT) if (A) the REIT directly or indirectly owns stock in such corporation and (B) the REIT and such corporation jointly elect that such corporation shall be treated as a taxable REIT subsidiary. Section 856(l)(2) provides that the term taxable REIT subsidiary also includes with respect to a REIT any corporation in which a taxable REIT subsidiary of the REIT owns directly or indirectly either securities possessing 35 percent of the total voting power of the outstanding securities of such corporation or securities having a value of more than 35 percent of the total value of the outstanding securities of such corporation. Section 856(l)(3) provides that a corporation that directly or indirectly operates or manages a lodging facility or health care facility or any corporation which directly or indirectly provides to any other person rights to any brand name under which any lodging facility or health care facility is operated shall not be a taxable REIT subsidiary.

REIT Asset Test

Section 856(a)(7) provides that a REIT must meet the requirements set forth in section 856(c) of the Code. Section 856(c)(4)(A) provides that at the close of each quarter of its taxable year, at least 75 percent of the value of the REIT's total assets must be represented by real estate assets, cash, and cash items (including receivables), and government securities. Section 856(c)(4)(B)(i) provides that, at the close of each calendar quarter, no more than 25 percent of a REIT's total assets can be represented by securities (other than those included in section 856(c)(4)(A)).

Section 856(c)(4)(B)(iii) prohibits a REIT from owning, at the end of any calendar quarter, specified amounts of certain securities. Specifically, except with respect to securities included in section 856(c)(4)(A) and securities of a taxable REIT subsidiary:

(I) not more than 5 percent of the value of a REIT's total assets may be represented by securities of any one issuer; (II) a REIT may not hold securities possessing more than 10 percent of the total voting power of the outstanding securities of any one issuer; and (III) a REIT may not hold securities having a value of more than 10 percent of the total value of the outstanding securities of any one issuer.

REIT Investments in Partnerships

For purposes of the income and assets set forth in section 856(c) and (d), section 1.856-3(g) of the regulations provides that a REIT is treated as owning its proportionate share of the assets of a partnership in which it is a partner and as deriving its proportionate share of the gross income of the partnership attributable to those assets. For purposes of this rule, the interest of a partner in the partnership's assets and income is determined in accordance with its capital interest in the partnership.

ANALYSIS AND CONCLUSIONS

A. Section 856(d)(8) provides that rents paid to a REIT by a TRS will not be disqualified as rents from real property under the related party rent provisions of section 856(d)(2)(B) so long as the limited rental exception of section 856(d)(8)(A) is met. Section 1.856-3(g) of the regulations provides that where a REIT is a partner in a partnership, the REIT will be deemed to own its proportionate share of each of the assets of the partnership and will be deemed to be entitled to the income of the partnership attributable to such share. The regulation also provides that if, for example, a REIT owns a 30-percent capital interest in a partnership which owns a piece of rental property the REIT will be treated as owning 30 percent of such property and as being entitled to 30 percent of the rent derived from the property by the partnership.

In the instant case, BC-JV is treated as a partnership for federal income tax purposes and therefore, is ineligible to be a TRS of the Company. However, BC-JV is a lessee of the Partnership; and BC-TRS, a wholly owned TRS of the Company, is a 50 percent partner in BC-JV. Accordingly, consistent with the aggregate theory of partnerships, as a partner in BC-JV, BC-TRS should be viewed as owning directly 50 percent of the income and assets of BC-JV. Company represents that because BC-JV is a pass-through entity for tax purposes, BC-TRS accounts for its 50 percent allocable share of BC-JV's income and deductions, including rental expense, on its tax return. Under these circumstances, we conclude that:

1. The percentage portion of the space that is leased to BC-JV that corresponds to the capital interest of BC-TRS in BC-JV will be treated as leased to BC-TRS, and that percentage portion of the space that is leased to BC-JV that corresponds to the capital interest of Operator in BC-JV will be treated as leased to Operator;

2. The portion of the rental payments received by the Company from BC-JV with respect to the portion of the space that is treated as leased to BC-TRS will not fail to qualify as rents from real property by reason of being received from a related party under section 856(d)(2)(B) if the terms of the limited rental exception of section 856(d)(8)(A) are met with respect thereto; and

3. The portion of the rental payments received by the Company from BC-JV with respect to the portion of the space that is treated as leased to Operator will not fail to qualify as rents from real property by reason of being received from a related party under section 856(d)(2)(B) if the Operator is not related to the Company for purposes of section 856(d)(2)(B).

B. Under section 856(d)(7)(C))(i) services furnished to tenants of the Company through a TRS of the Company will not be treated as having been furnished by the Company for purposes of determining the amount of any impermissible tenant service income to the Company. Since the TRS joint ventures with unrelated third party Providers are treated as partnerships for federal tax purposes, they are not eligible to make a TRS election. However, the Company's only interest in the TRS joint ventures is through Management, which is itself a TRS. Consistent with the aggregate theory of partnership taxation that is applied to REITs for purposes of the income and asset tests under section 1.856-3(g), Management as a partner in the TRS joint venture, is entitled to its proportionate share of the income of the TRS joint venture. That income includes income from services rendered by the TRS joint venture to tenants of the Company. Since the applicable joint venture agreements provide that fees for any impermissible services will be received directly by the TRS joint venture and that the Partnership will not receive any direct payments from either the TRS joint venture or the third party Provider, we conclude that:

1. Services provided by a TRS joint venture to tenants at a Property are treated as being provided by a taxable REIT subsidiary to the extent of the capital interest of Management in the TRS joint venture and as being provided by Provider to the extent of the capital interest of Provider in the TRS joint venture; and

2. That portion of the services provided by a TRS joint venture that are treated as provided by Provider will be considered furnished or rendered by an independent contractor from whom the Company does not derive income so long as Provider qualifies as an independent contractor with respect to the Company and the Company itself does not derive or receive income from the Provider.

C. In order to meet the limited rental exception of section 856(d)(8)(A), amounts paid to a REIT as rents from real property must be substantially comparable to rents made by the other tenants of the REIT's property for comparable space. In the instant case, space leased by HC-TRS is unmarketable for traditional office use and is unique at the various Properties. Remaining leased space at such Properties, although all or substantially all leased to unrelated tenants, is not comparable in terms of character or use to the space rented to HC-TRS. In these circumstances, where no comparable leased space exists within a Property, section 856(d)(8)(A) may be satisfied by comparing the rent paid by HC-TRS to rent paid by unrelated tenants for comparable space in the same geographic area.

Accordingly, we conclude that amounts paid to the Company by HC-TRS for the rental of space at a Property with respect to which there is no comparable space at such Property will not fail to qualify for the limited rental exception of section 856(d)(8)(A) so long as the rent paid by such TRS is substantially comparable to rents paid by unrelated tenants for comparable space in the same geographic area.

D. Section 856(l) provides that a REIT and a corporation may elect to have the corporation treated as a TRS of the REIT if the REIT directly or indirectly owns stock in such corporation. In the case of Operator 2, the Company will not own any stock in Operator 2 directly, but the Company through the Partnership will have an indirect ownership interest in Operator 2 through the Partnership's ownership of Parent 2 stock. There is no requirement that Parent 2 be a TRS in order for Operator 2 to be treated as a TRS. The Company's indirect proprietary interest in Operator 2 through its ownership of stock in Parent 2 is sufficient basis to make an election to treat Operator 2 as a TRS of the Company.

Accordingly, we conclude that Operator 2 will continue to be treated as a taxable REIT subsidiary of the Company under section 856(l) so long as the Company indirectly owns stock in Operator 2 by virtue of a direct stock ownership in Parent 2, even though Parent 2 does not elect to be treated as a taxable REIT subsidiary with respect to the Company.

E. The Partnership's loan to Borrower in which Partnership owns an x percent interest is not secured by real estate. Pursuant to section 1.856-3(g) of the regulations Company, by virtue of its ownership of the Partnership, must account for x percent of Borrower's income and assets as if such amounts were derived or owned directly by the Company. Under section 856(c)(4)(B)(iii)(III), the Company is required to consider the value of the Loan in determining whether it holds securities that represent more than 10 percent of the Borrower's total outstanding securities. Since the Company already treats as its own income and assets, its allocable share of Borrower's income that is used to repay the loan and the Borrower's assets that were financed with the loan, the portion of the debt securities of the Borrower owned by the Company that correspond to the Company's ownership interest in the Borrower should not be recounted for

purposes of section 856(b)(4)(B).

Accordingly, we conclude that for purposes of section 856(c)(4)(B), the portion of the Loan made by the Partnership to the Borrower that corresponds to the Partnership's percentage capital interest in the Borrower will be disregarded.

F. The Trust is designed to serve as a fail safe measure to ensure that the Company is in compliance with the various REIT asset tests in cases where assets may be owned or acquired that would cause the REIT to fail the test of section 856(c)(B)(iii)(III). The Trust indenture provides that assets, the ownership of which would cause the Company to fail such test, are automatically transferred to the Trust for the exclusive benefit of Management, and therefore, the Company will have no proprietary interest in the transferred assets from and after the date of transfer. The Company represents that it has been advised by counsel that the terms of the Trust are enforceable under State C law and that Company, the Partnership and Management have and will continue to use their best efforts to enforce the provisions of the Trust and to give effect to all transfers required pursuant to the terms of the Trust. Moreover, the Company represents that it will monitor the composition of its assets so as to ensure that the Trust is in compliance with the various REIT asset tests and review the composition of its assets not less frequently than on a quarterly basis. Under these circumstances, we conclude that for purposes of section 856(c)(4)(B)(iii)(III), any assets that otherwise would be treated as owned by the Company in violation of that prohibition are owned by the Trust for the exclusive benefit of Management and are not owned by the Company.

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.

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.

A copy of this letter must be attached to any income tax return to which it is relevant.

In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to the taxpayer.

Sincerely,
William E. Coppersmith
Chief, Branch 2
Office of Associate Chief Counsel
(Financial Institutions & Products)

cc: