Internal Revenue Service

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Department of the Treasury
Washington, DC 20224

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October 29, 2003

Legend:

Taxpayer =

Trust =

Beneficiaries =

a =

LLC 1 =

Property A =

LLC 2 =

Property B =

b =

c =

LLC 3 =

Property C =

LP 1 =

LP2 =

Date 1 =

Dear :

This is in reply to a letter dated May 20, 2003, and subsequent submissions, requesting a private letter ruling on behalf of Taxpayer. You have requested a ruling that in determining Taxpayer's gross income under § 856(c) of the Internal Revenue Code, Taxpayer will not take into account its allocable share of certain amounts attributable to LLC 3, to the extent that such amounts are attributable to ground rents received by LLC 3 from LLC 2 and do not exceed Taxpayer's allocable share of deductions attributable to the ground rents paid by LLC 2.

Facts:

Taxpayer is a domestic corporation that is wholly-owned by Trust. Trust has several wholly-owned subsidiaries (the Subsidiaries) that are either inactive or own interests in partnerships (or limited liability companies treated as partnerships) that directly or indirectly own real estate. Taxpayer intends to elect REIT status for its 2004 taxable year. Taxpayer represents that prior to the effective date of its conversion to a REIT, Trust will distribute free of any liens, pledges, encumbrances or other restrictions, at least c percent of the common stock of Taxpayer to the Beneficiaries in equal proportions.

Taxpayer's primary assets include an a percent indirect interest in LLC 1, which owns Property A, an a percent indirect interest in LLC 2, which owns Property B, and a b percent interest in LLC 3, which owns Property C. Taxpayer owns its interest in LLC 2 and LLC 3 indirectly through wholly-owned subsidiary corporations that own interests in entities that are classified as partnerships for federal tax purposes. Upon conversion, Taxpayer's wholly-owned subsidiaries through which it owns interests in Property B and Property C will be treated as qualified REIT subsidiaries. The remaining interests in LLC 1, LLC 2, and LLC 3 are owned by third party investors that are unrelated to Taxpayer.

Pursuant to the partnership agreement for LP1, dated Date 1, through which Taxpayer indirectly owns its interest in Property C, partnership income and losses that are not associated with a Capital Transaction are to be allocated in accordance with the partner's percentage interests in the partnership. A Capital Transaction is defined by the partnership agreement as the sale of the land held by the partnership; insurance recoveries and condemnation awards upon damage or destruction of the land; or a refinancing of the property. To the extent that a Capital Transaction arises, net gains or net losses from such transaction are to be allocated to the partners in accordance with the partner's respective percentage interest in the partnership.

The partnership agreement for LP2, dated Date 1, through which Taxpayer indirectly owns its interest in Property B, also provides that income and losses of the partnership, with the exception of those recognized from a Capital Transaction (as defined above), are to be allocated in accordance with the partner's percentage interests in the partnership. To the extent that a Capital Transaction occurs, net gains from the transaction will be allocated first to the partners so that their capital accounts are proportionate to their percentage interests, and thereafter in accordance with their percentage interests in the partnership.

The office building owned by LLC 2 is leased to tenants that are unrelated to Taxpayer, the Subsidiaries or the third-party investors that hold interests in the building. However, the land underlying the office building is leased by LLC 2 under a ground lease from LLC 3. Consequently, a portion of Taxpayer's a percent allocable share of the gross rents from the office building (through its interest in LLC 2) is paid to LLC 3 as ground rents. Taxpayer is allocated its proportionate share of the ground rents received by LLC 3 from LLC 2. Also, for purposes of determining its taxable income, Taxpayer is allocated a deduction for its a percent share of LLC 2's ground rent expense. Accordingly, Taxpayer's gross income for federal tax purposes includes both its share of the rents from Property B and its share of the ground rents from Property C, which are funded by the rents from Property B. LLC 2 is thus a tenant of LLC 3 and a related party to Taxpayer within the meaning of section 856(d)(2)(B)(ii) because of Taxpayer's greater than ten percent profits interest in LLC 2. Based on expected ground rents (including increases), the portion of Taxpayer's gross income attributable to its allocable share of the LLC 3 ground rents will exceed five percent of Taxpayer's gross income.

Law and Analysis:

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."

Under § 1.856-3(g) of the Income Tax Regulations, 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 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 § 856.

Section 856(d)(1) provides that "rents from real property" include (subject to exclusions provided in § 856(d)(2)): (A) rents from interests in real property; (B) charges for services customarily furnished or rendered in connection with the rental of real property, whether or not such charges are separately stated; and (C) rent attributable to personal property leased under, or in connection with, a lease of real property, but only if the rent attributable to the personal property for the taxable year does not exceed 15 percent of the total rent for the tax year attributable to both the real and personal property leased under, or in connection with, the lease.

Section 856(d)(2)(B)(ii) provides that for purposes of sections 856(c)(2) and (3), 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, in the case of a 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) provides that for purposes of section 856(d), the rules prescribed by section 318(a) apply in determining the ownership of stock, assets, or net profits of any person; except that (A) “10 percent” should be substituted for “50 percent” in subparagraph (C) of paragraphs (2) and (3) of section 318(a), and (B) section 318(a)(3)(A) shall be applied in the case of a partnership by taking into account only partners who own (directly or indirectly) 25 percent or more of the capital interest, or the profits interest, in a partnership.

Taxpayer owns more than 10 percent of LLC 2 through attribution under sections 856(d)(5) and 318(a). Consequently, if Taxpayer’s allocable share of the ground rents received by LLC 3 from LLC 2 is treated as income under section 856(c), that income will be excluded from “rents from real property” as related party rents under section 856(d)(2)(B).

Pursuant to section 1.856-3(g), Taxpayer will be allocated a percent of the gross income derived by LLC 2 from Property B. Taxpayer also will be allocated b percent of the gross income derived by LLC 3 from the ground rents of Property C. Because the only source of income for LLC 3 is the ground rents paid by LLC 2, Taxpayer’s allocable share of the income from LLC2 will be double counted to the extent of Taxpayer’s b

percent indirect capital interest in LLC 3 if it is included in Taxpayer's allocable share of LLC 3's gross income for purposes of section 856(c).

Accordingly, based upon the information submitted and representations made, for purposes of determining Taxpayer's gross income under section 856(c), amounts paid to LLC 3 by LLC 2 as ground rents for Property C will be disregarded to the extent that those amounts do not exceed Taxpayer's allocable share of deductions attributable to the ground rents paid by LLC2 to LLC 3.

Except as specifically ruled upon above, no opinion is expressed concerning any federal income tax consequences relating to the facts herein under any other provision of the Code. Specifically, we do not rule whether Taxpayer will otherwise qualify as a REIT under part II of subchapter M of Chapter 1 of the Code.

This ruling is directed only to the taxpayer requesting it. Taxpayer should attach a copy of this ruling to each tax return to which it applies. Section 6110(k)(3) of the Code provides that this ruling may not be used or cited as precedent.

Sincerely,

_____
Kate Sleeth
Assistant to the Chief, Branch 1
Office of Associate Chief Counsel
(Financial Institutions and Products)

Enclosures:
Copy of this letter
Copy for § 6110 purposes

cc: