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Department of the Treasury
Washington, DC 20224

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Person To Contact:
, ID No.
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Refer Reply To:
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PLR-155564-06

Date:
September 20, 2007

Dear :

Company =
Date 1 =
Operating Partnership =

This letter is in response to your letter dated December 1, 2006 requesting a ruling that Excess Rent Payments (as described below) received by the Company through its general partnership interest in Operating Partnership will not be excluded from the term "rents from real property" within the meaning of section 856(d)(1)(A) of the Code by reason of being based on the income or profits derived by any person from the property, within the meaning of section 856(d)(2)(A) of the Code.

FACTS:

The Company owns or has an interest in a portfolio of commercial real estate properties. The Company has elected to be taxed as a real estate investment trust ("REIT") under sections 856 through 860 of the Code commencing with the taxable year ending Date 1. The Company represents the following.

The Company is the majority owner and sole general partner of Operating Partnership. Through Operating Partnership, the Company leases space to tenants. Some of the Operating Partnership's leases were originally negotiated and entered into by the Operating Partnership directly, while others were negotiated by parties unrelated to the

Company and inherited when the Operating Partnership acquired properties from their former owners. These leases typically provide for fixed rent, often with specified escalations over time or in connection with renewals or extensions of the original lease term. Less frequently, the Operating Partnership's leases provide for rent based in whole or in part on a fixed percentage or percentages of gross receipts or sales, as permitted under section 856(d)(2)(A) of the Code.

The Operating Partnership does not typically lease any material amount of personal property to tenants, lease property to tenants that are related to the Company, or receive more than a de minimis amount of "impermissible tenant service income" within the meaning of section 856(d)(1), 856(d)(2)(B), and 856(d)(7) of the Code, respectively. Moreover, leases are entered into with the expectation that tenants will remain at and occupy the leased space for the full term of the lease, and the rent payable under the leases is not based "in whole or in part on the income or profits derived by any person from such property" within the meaning of section 856(d)(2)(A) of the Code.

The Operating Partnership's leases sometimes contain provisions that permit the tenant to sublease all or a portion of the leased space to a subtenant, with the Company's consent, provided that the tenant pays the Company all or a specified percentage of the excess of (i) the rent received by the tenant from the subtenant over (ii) the rent paid by the tenant with respect to the subleased space ("Excess Rent Payments"). In some cases, the leases provide that tenants may deduct improvement costs, leasing commissions and/or other reasonable costs of subleasing the space from the amount of rent received from a subtenant for purposes of determining the amount of any Excess Rent Payments that tenant is obligated to pay to the Operating Partnership. The Company represents that all amounts received by tenants of the Operating Partnership from their subtenants are "qualified rents" within the meaning of section 856(d)(6)(B) of the Code.

Because the Operating Partnership's leases permit subleasing of all or a portion of the leased space, subleases may, in some cases, concern less than "substantially all" of the space leased from the Operating Partnership by the tenant (within the meaning of section 856(d)(6)(A) of the Code), either because the tenant is only able to sublease unneeded space in discrete pieces over time, or because the tenant wishes or needs to retain a significant portion of the leased space for itself. Because market rental rates at the Operating Partnership's properties have generally appreciated over time, sublease rents may be greater on a per square foot basis than the rental amount due under the original lease, resulting in an obligation on the part of the tenant to make Excess Rent Payments to the Operating Partnership.

LAW AND ANALYSIS:

Section 856 of the Code imposes certain limitations on REITs. Two of these limitations are in the form of an income test. Section 856(c)(2) requires that at least 95 percent of

a REIT's gross income (excluding gross income from prohibited transactions) must be derived from certain categories of income, including rents from real property. Section 856(c)(3) requires that at least 75 percent of a REIT's gross income (excluding gross income from prohibited transactions) must be derived from certain sources, including rents from real property.

Section 856(d)(1) of the Code defines the term "rents from real property" to include (subject to the exclusions under section 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 which is leased under, or in connection with, a lease of real property, but only if the rent attributable to such personal property does not exceed 15 percent of the total rent for the taxable year attributable to both the real and personal property lease under, or in connection with, such lease.

Section 1.856-4(a) of the Income Tax Regulations provides that, in general, the term "rents from real property" means the gross amount received for the use of, or the right to use, real property of the REIT.

Section 856(d)(2)(A) of the Code provides that the term "rents from real property" does not include, except as provided in section 856(d)(4) (dealing with contingent rents) and section 856(d)(6), any amount received or accrued, directly or indirectly, with respect to any real or personal property, if the determination of such amount depends in whole or in part on the income or profits derived by any person from such property (except that any amount so received or accrued shall not be excluded from the term rents from real property solely by reason of being based on a fixed percentage or percentages of receipts or sales).

Section 856(d)(6)(A) of the Code provides that if a REIT receives or accrues, with respect to real or personal property, amounts from a tenant that derives substantially all of its income with respect to such property from the subleasing of substantially all of such property, and if a portion of the amount such tenant receives or accrues, directly or indirectly, from subtenants consists of "qualified rents," then the amounts which the REIT receives or accrues from the tenant shall not be excluded from the term "rents from real property" by reason of being based on the income or profits of such tenant to the extent that amounts so received or accrued are attributable to "qualified rents" received or accrued by such tenant. Section 856(d)(6)(B) of the Code defines the term "qualified rents" for purposes of section 856(d)(6)(A) to mean any amount which would be treated as rents from real property if received by the REIT.

Section 856(d)(6) of the Code was enacted as part of the Tax Reform Act of 1986, 1986-3 (Vol. 1) C.B. 1, 219-20. The legislative history of section 856(d)(6) shows that Congress intended to allow rent from a prime tenant based on the tenant's net income from the rental of the property to qualify as rent from real property where the REIT is not

participating in the profits of any active business other than that pertaining to the rental of its own property. S. Rep. No. 313, 99th Cong., 2d Sess. 776 (1986), 1986-3 (Vol. 3) C.B. 776.

The Report of the Senate Finance Committee that accompanied the Tax Reform Act of 1986 provides:

> The committee understands that lessors of real property frequently lease property to a prime tenant and agree to accept as rent a fixed amount plus a percentage of the prime tenant's profits from the rental of the property. Since the rent from the prime tenant is based in part on the prime tenant's net profits in such a transaction, the portion based on the net profits would not qualify as rent from real property of the REIT. Nevertheless, if the prime tenant's rent from the property is dependent only on rents received from the property, (including rents based on the gross receipts of the subtenants), then the REIT in this situation is not participating in the profits of any active business other than that pertaining to the rental of its own property. Accordingly, the committee believes that rents that are based on the net income of the tenant should be treated as qualifying rents for the REIT provided that the tenant's profits are derived only from sources that would be qualifying rent from real property if earned directly by the REIT.

S. Rpt. 99-313, 1986-3 C.B. (Vol. 3) 776.

Section 856(d)(6) of the Code is not applicable because the leases at issue allow a tenant to sublease all or part of its space and, therefore, the Company cannot be certain that a tenant will derive substantially all of its income with respect to the property from the subleasing of substantially all of the property.

The Excess Rent Payments represent a share of the Company's profit from the increased rental value of its properties. The leases permit the prime tenant to share that appreciation with the REIT. Under these facts, the REIT is not participating in the profits of any active business other than that pertaining to the rental of its own property. As the legislative history of the Tax Reform Act of 1986 cited above suggests, in such a case, the Company has not received income of the type to which the exclusion provision of section 856(d)(2)(A) of the Code was intended to apply.

Therefore, based on the facts presented and the representations made, we conclude that the Excess Rent Payments received or accrued by the Company will not be excluded from the term "rents from real property" within the meaning of section 856(d)(1)(A) of the Code by reason of being based on the income or profits derived by any person from the property, within the meaning of section 856(d)(2)(A).

No opinion is expressed concerning the tax consequences of the above transaction under any other section of the Code. Specifically, no opinion is expressed or implied

regarding whether the Company otherwise qualifies as a REIT under subchapter M or whether amounts received or accrued by the Company under the lease otherwise qualify as rents from real property under section 856(d)(1)(A) of the Code.

This ruling is directed only to the taxpayer who requested it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

Pursuant to the power of attorney on file, a copy of this ruling has been sent to your authorized representative.

Sincerely,

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