Internal Revenue Service

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Person To Contact:
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CC:FIP:B02
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Legend:

Taxpayer =

System =

Corporation A =

Corporation B =

a =

Product =

Stations =

Structures =

b =

c =

d =

e =

f =

Dear :

This is in reply to a letter dated August 8, 2008, requesting rulings on behalf of Taxpayer. Specifically, you have requested a ruling that Taxpayer's Systems, as described herein, are "real estate assets" as defined in section 856(c)(5) of the Internal Revenue Code, for purposes of section 856(c)(4) of the Code. You have also requested a ruling that certain activities conducted by Taxpayer with respect to the System will not cause amounts received by Taxpayer under a lease of the System to be excluded from "rents from real property" under section 856(d).

Facts:

Taxpayer is a domestic corporation that was organized to facilitate the ownership and acquisition of certain assets pending an initial public offering. Taxpayer was formed under the sponsorship of Corporation A, which directly or indirectly owns Taxpayer's stock. It is anticipated that Taxpayer will issue more than a percent of its stock to unrelated third parties. Taxpayer represents that it intends to elect to be treated as a real estate investment trust (REIT) under part II of subchapter M of the Code.

Taxpayer will contribute cash to an entity ("OP") that is classified as a partnership for federal income tax purposes in exchange for a managing interest therein. Taxpayer will be the sole managing member of OP. OP, in turn, will contribute cash to a subsidiary partnership ("Property Partnership") in exchange for substantially all of the interests therein. Property Partnership will use the proceeds to acquire Systems from unrelated third parties. It is also anticipated that certain unrelated third parties owning Systems may contribute those Systems to OP in exchange for interests in OP. OP would contribute those Systems to Property Partnership in exchange for additional interests in Property Partnership.

Taxpayer will not operate the Systems or deliver Product to end users. Rather, Taxpayer, through Property Partnership, will lease the Systems to an entity or entities that will operate the Systems. The lessee of the Systems will be unrelated to Taxpayer for purposes of section 856(d)(2)(B), and will be licensed by state regulators to operate the Systems.

A System is a system of physically connected and functionally interdependent assets designed for the distribution of Product within a local area. No component of the System may be operated for its intended purpose without each of the other component parts of the System. A System is designed and constructed to remain permanently in place. It is not feasible to move all or a substantial part of a System. Each component of a System will remain in place after it becomes affixed to the System (subject to replacement due to failure, obsolescence, or inadequacy). A System is passive and does not include any machinery or equipment that produces Product or any commodity.

A System begins at a specified interconnection point normally located on the outskirts of a municipality served by the System. The interconnection point has a metered connection to interstate or intrastate transmission pipelines. The interconnection point is comprised of structures, pipes, regulators, and meters as well as monitoring and control devices enclosed in an area ranging from approximately one to two acres. From the interconnection point, Product is transported through a system of pipelines of various types substantially all of which are buried. A System includes various interests in or rights to occupy land, including fee ownership, easements, franchises, and/or licenses.

In some cases, a System may span such a long distance that Stations are necessary to add pressure that the System loses from friction in the pipelines over long distances. Stations may include fenced buildings/structures affixed to the ground that house a compressor and portions of the pipeline. The compressors are physically connected to and functionally interdependent with the remainder of the System.

A System also includes pressure reducing stations that contain regulators, valves, or monitoring devices that automatically adjust pressure to keep pipelines within a safe operating range and to ensure that the Product is delivered in compliance with contract requirements. A System also includes a meter affixed to the end-user's building or residence to monitor the Product consumption by the end-user.

In a small minority of cases, a System may include Structures that hold b Product. In some cases, b Product is delivered by truck and pumped into the Structures. The Structures are typically double-wall construction with a reinforced concrete outer wall and steel inner wall. The Structures may be hundreds of feet high and hundreds of feet in diameter and are permanently affixed to the ground.

In a few cases in which a System includes Structures, the Structures will store Product that is already in the System by converting the Product into b Product. Compressors, heating and cooling systems and other equipment that is affixed to and integrated into the pipeline system to allow b Product to be converted back into Product for transport through the pipeline.

Any lessee operating a System will be unrelated to Taxpayer for purposes of section 856(d)(2)(B) and will be licensed by state regulators to operate the system. The leases will be "triple net" lease arrangements in which the lessee is responsible for maintenance and repair of the property and the payment of insurance, taxes, operating expenses and utilities. Property Partnership may fund capital expenditures necessary to maintain, improve, modernize and expand the Systems with rent due under a lease adjusted appropriately. No portion of the rent paid by lessees will be based on lessee's net income or profit within the meaning of section 856(d)(2)(A).

The lessee will own all of the vehicles and equipment to maintain and operate the Systems. The lessee also will employ or contract with all of the service and repair

personnel necessary for maintenance and operation of the Systems. Taxpayer will not be responsible for, and will not furnish any services to a lessee, except for limited activities such as forwarding property tax invoices to a lessee, or making certain capital expenditures in its capacity as owner of the System. Taxpayer represents that it will employ only those persons necessary to engage in the limited, passive activities typically undertaken by a REIT, such as accounting and other support staff necessary to support the functions of Taxpayer's officers. It is estimated that following its initial public offering, Taxpayer will employ c to d persons. On the other hand, it is represented that the lessee's activities will require it to employ between e and f individuals.

Law and Analysis:

Issue 1:

Section 856(c)(4)(A) provides that at the close of each quarter of its tax year, at least 75 percent of the value of a REIT's total assets must be represented by real estate assets, cash and cash items (including receivables), and Government securities.

Section 856(c)(5)(B) defines the term "real estate assets," in part, to mean real property (including interests in real property and interests in mortgages on real property) and shares (or transferable certificates of beneficial interest) in other REITs. Section 856(c)(5)(C) provides that the term "interests in real property" includes fee ownership and co-ownership of land or improvements thereon, leaseholds of land or improvements thereon, options to acquire land or improvements thereon, and options to acquire leaseholds of land or improvements thereon, but does not include mineral, oil or gas royalty interests.

Section 1.856-3(b) of the Income Tax Regulations provides, in part, that the term "real estate assets" means real property. Section 1.856-3(d) provides that "real property" includes land or improvements thereon, such as buildings or other inherently permanent structures thereon (including items which are structural components of such buildings or structures). Local law definitions will not be controlling for purposes of determining the meaning of "real property" for purposes of section 856 and the regulations thereunder. Under this regulation, "real property" includes, for example, the wiring in a building, plumbing systems, central heating or central air-conditioning machinery, pipes or ducts, elevators or escalators installed in a building, or other items which are structural components of a building or other permanent structure. The term does not include assets accessory to the operation of a business, such as machinery, a printing press, transportation equipment which is not a structural component of the building, office equipment, refrigerators, individual air-conditioning units, grocery counters, or furnishings of a motel, hotel, or office building, even though such items may be termed fixtures under local law.

Rev. Rul. 69-94, 1969-C.B 189, concerns whether properties of a railroad, including land with improvements or other inherently permanent structures situated thereon which may be under, along, or adjacent to certain lines of the railroad, and

including the tracks, roadbed, buildings, bridges and tunnels of the railroad, are real property for purposes of section 856. The revenue ruling holds that the railroad properties owned by the trust that are leased to another corporation are not "assets accessory to the operation of a business" within the meaning of section 1.856-3(d), but are "real estate assets" within the meaning of section 856(c).

Rev. Rul. 75-424, 1975-2 C.B. 269, considers whether certain equipment used in connection with the transmission and reception of microwave signals is treated as real property, or assets accessory to a business, for purposes of section 856. The ruling concludes that the building, the heating and air conditioning system, the transmitting and receiving towers, and the chain link fencing are "real estate assets" within the meaning of section 856(c)(5)(B). The antennae, waveguides, transmitting, receiving, multiplex equipment, and prewired modular racks are "assets accessory to the operation of a trade or business" and are not "real estate assets" within the meaning of section 856(c)(5)(B).

In this case, the Systems are designed so that the components, including the Structures that are a small part of the larger Systems to which they are attached, are physically and functionally interdependent. It is not feasible to move all or any substantial part of the System. Each component of the System is intended to serve indefinitely and remain in place once affixed to other System parts.

Similar to the tracks and other railroad components described in Rev. Rul. 69-94, a System is a passive conduit that does not include any machinery or equipment capable of producing Product or any commodity. Even in situations in which Product is b, the Structures and other equipment are used only to enable the storage and ultimate distribution of Product by the lessee and not for any active function such as the production or generation of Product or any other commodity.

Based upon the information submitted and representations made, we conclude that the Systems are inherently permanent structures that are not accessory to the operation of a business. Accordingly, the Systems are real estate assets within the meaning of sections 856(c)(4)(A) and (c)(5)(C).

Issue 2:

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."

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

Section 1.856-4(a) defines the term “rents from real property” generally as the gross amounts received for the use of, or the right to use, real property of the REIT.

Section 1.856-4(b)(5)(ii) provides that trustees or directors of the REIT are not required to delegate or contract out their fiduciary duty to manage the trust itself, as distinguished from rendering or furnishing services to the tenants of the property or managing or operating the property. Thus, the trustees or directors may do all those things necessary, in their fiduciary capacities, to manage and conduct the affairs of the REIT itself including establishing rental terms, choosing tenants, entering into renewal of leases, and dealing with taxes, interest, and insurance relating to the REIT’s property. The trustees may also make capital expenditures with respect to the REIT’s property (as defined in section 263).

Section 856(d)(2)(C) excludes from the definition of “rents from real property” any impermissible tenant service income as defined in section 856(d)(7). Section 856(d)(7)(A) provides, in relevant part, that the term impermissible tenant service income means, with respect to any real or personal property, any amount received or accrued directly or indirectly by the REIT for managing or operating such property. Section 856(d)(7)(B) provides that de minimis amounts of impermissible tenant service income, i.e., amounts less than one percent of all amounts received or accrued by the REIT with respect to a particular property during the taxable year, will not cause otherwise qualifying amounts to not be treated as rents from real property.

Section 856(d)(7)(C) excludes from the definition of impermissible tenant service income amounts received for services furnished or rendered, or management or operation provided, through an independent contractor from whom the trust itself does not derive or receive any income. Similarly, subparagraph (C) excludes amounts that would be excluded from unrelated business taxable income under section 512(b)(3) if received by an organization described in section 511(a)(2).

Section 512(b)(3) provides, in part, 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, such as for the use or occupancy of rooms or other quarters in hotels, boarding houses or apartment houses furnishing hotel services, or in tourist camps or tourist homes, motor

courts or motels, or for the use or occupancy of space in parking lots, warehouses or storage garages, do not constitute rent from real property. Generally, services are considered rendered to the occupant if they are primarily for the tenant's convenience and are other than those usually or customarily rendered in connection with the rental of rooms or other space for occupancy only.

Taxpayer represents that it will not directly or indirectly be providing any services to a lessee under the lease. The limited activities in which Taxpayer is involved are not services rendered for the convenience of a lessee under section 1.512(b)-1(c)(5). Trustees or directors of Taxpayer also may perform fiduciary functions as provided in section 1.856-4(b)(5)(ii). Accordingly, based on the information submitted and representations made, we conclude that Taxpayer's activities with respect to the Systems will not cause amounts received under leases of the Systems to be treated as other than "rents from real property" under section 856.

No opinion is expressed or implied with regard to whether Taxpayer otherwise qualifies as a REIT under subchapter M. Furthermore, no opinion is expressed or implied concerning the federal income tax treatment of Taxpayer under any section of the Code other than those upon which this ruling is based. Specifically, no opinion is expressed concerning whether the assets comprising a System are functionally interdependent, or whether Structures are structural components of a System, under any section of the Code other than section 856. For example, no opinion is expressed or implied on whether the Systems constitute section 1245 property or section 1250 property, or what asset classes the Structures and other tangible depreciable assets of the Systems (excluding any building) fall into under Rev. Proc. 87-56, 1987-2 C.B 674, for purposes of sections 167 and 168.

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,

David B. Silber
David B. Silber
Chief, Branch 2
Office of Associate Chief Counsel
(Financial Institutions & Products)