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Date:
February 06, 2013

Legend:

Taxpayer =

State =

Year =

LLC =

LP1 =

LP2 =

LP3 =

Trust =

LP4 =

Lessee =

a =

b =

c =

d =

e =

f =

g =

h =

i =

k =

l =

m =

n =

Dear

This is in reply to a letter in which Taxpayer requests a ruling in connection with its election to be taxed as a real estate investment trust ("REIT") under sections 856-860 of the Internal Revenue Code of 1986, as amended (the "Code"). Specifically, Taxpayer requests a ruling that certain payments under the Surface Lease, described below, will constitute "rents from real property" under sections 856(c)(2) and (c)(3).

Facts:

Taxpayer is a State Corporation that has elected to be taxed as a REIT since Year. Taxpayer owns a percent of LLC and b percent of LP1. LLC, in turn, owns c percent of LP1. Thus, Taxpayer owns a percent of LP1. Taxpayer also owns a c percent interest in LP2. LP2 owns a d percent interest in LP3, and Taxpayer directly owns c percent of LP3. Therefore, Taxpayer directly and indirectly owns approximately e percent of LP3. Trust, which is not related to Taxpayer, owns c percent of LP3. Trust also owns an f percent interest in LP4; the remaining d percent interest in LP4 is owned by individuals and Taxpayer.

Taxpayer or its predecessors have owned, directly or indirectly, certain real property for over g years. The property includes both surface rights ("Surface Land") and sub-surface mineral rights ("Mineral Rights"). LP1 and LP4 own the Surface Land which is approximately h acres. LP3 owns the Mineral Rights underneath the Surface Land. LP3 has no surface rights, through easement or otherwise, to gain access to the minerals it owns below the surface. The split in ownership between the Surface Land

and the Mineral Rights has been in place for over i years and thus pre-dates the REIT election of Taxpayer.

LP3 and Lessee have entered into a Subsurface Lease which covers the Mineral Rights lying beneath the Surface Land, pursuant to which Lessee will extract oil and gas and other hydrocarbons from the leased land. Lessee will make royalty payments to LP3, which are determined based on the gross sales proceeds received for oil and gas produced from the leased land multiplied by a royalty percentage. LP3 will allocate the royalty payments pro-rata to its partners. Taxpayer intends to include its share of the royalty payments received by LP3 from Lessee under the Subsurface Lease as non-qualifying income for purposes of the 95 percent income test under section 856(c)(2) and the 75 percent income test under section 856(c)(3).

The Surface Land includes an approximately k acre site located within the Surface Land determined to be the appropriate site for access to the Mineral Rights ("Drill Site"). The Mineral Rights, however, do not include either the Surface Land or the right to access the Surface Land. Taxpayer will purchase an l percent undivided tenant in common ("TIC") interest in the Drill Site from LP4. Therefore, LP4 and Taxpayer will each own an l percent undivided TIC interest in the Drill Site (Taxpayer and LP4, together, as "Lessors"). Lessors have entered into a lease with Lessee granting Lessee access to the Surface Land ("Surface Lease").

Pursuant to the Surface Lease, the rent payable by Lessee to Lessors will be the greater of (i) $m per month, or (ii) n percent of the gross sale proceeds received by Lessee of all oil and gas produced at the premises and sold by Lessee during the applicable month, less a small transportation cost. Taxpayer represents that rental payments due under the Surface Lease are at arm's-length terms and at fair market value. Rental payments pursuant to the Surface Lease are not dependent on the net profits of Lessee.

The Surface Lease is a triple net lease. In addition to the rent payable to the Lessors, Lessee pays all taxes, insurance and maintenance expenses that arise from the use of the Drill Site. The Surface Lease does not give Lessors the right to, or control over, any Mineral Rights. Under the Surface Lease, Lessors expressly grant Lessee the right to raze the existing premises for purposes of conducting oil and gas operations, subject to restoration requirements at the end of the Surface Lease.

Taxpayer represents that the Surface Lease and Subsurface Lease are separate contracts, which where independently negotiated, and are based on independent business reasons and economics.

Law and Analysis:

Whether Amounts Received from the Surface Lease Constitute Rents from Real Property

Section 856(c) provides that, to qualify as a REIT for any taxable year under part II of subchapter M, an entity must derive at least 95 percent of its gross income (excluding gross income from prohibited transactions) from the sources listed in section 856(c)(2), which includes rents from real property, and at least 75 percent of its gross income (excluding gross income from prohibited transactions) from sources listed in section 856(c)(3), which also includes rents from real property.

Section 856(d)(1) provides that, subject to the exclusions in section 856(d)(2), the term "rents from real property" includes (among other things) "rents from interests in real property." In turn, section 856(c)(5)(C) provides that the term "interests in real property" includes fee ownership and co-ownership of land or improvements thereon, but does not include mineral, oil, or gas royalty interests.

Section 1.856-3(g) provides that 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 will be deemed to be entitled to the income of the partnership attributable to such share. The character of the various assets in the hands of the partnership and items of gross income of the partnership remains the same in the hands of the partners for all purposes of section 856.

Section 1.856-4(a) provides that, subject to the exceptions of sections 856(d) and 1.856-4(b), the term "rents from real property" means, generally, the gross amounts received for the use of, or the right to use, real property of the REIT. Section 856(d)(2)(A) provides that, subject to certain exceptions, the term "rents from real property" does not include "any amount received or accrued…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 1.856-4(b)(3) provides that an amount received or accrued as rent which consists, in whole or in part, of one or more percentages of the lessee's receipts or sales in excess of determinable dollar amounts may qualify as "rents from real property" if (i) the determinable amounts do not depend on the income or profits of the lessee and (ii) the percentages and determinable amounts are fixed at the time the lease is entered into and are not renegotiated during the term of the lease in a manner which has the effect of basing rent on income or profits. It further provides that an amount will not qualify as "rents from real property" if, considering the lease and all the surrounding circumstances, the arrangement does not conform with normal business practice but is in reality used as a means of basing rent on income or profits.

The legislative history underlying the tax treatment of REITs indicates that the central concern behind the gross income restrictions is that a REIT's gross income should largely be composed of passive income. For example, H.R. Rep. No. 2020, 86th Cong., 2d Sess. 4 (1960) at 6, 1960-2 C.B. 819, at 822-823 states, “[o]ne of the principal purposes of your committee in imposing restrictions on types of income of a qualifying real estate investment trust is to be sure the bulk of its income is from passive income sources and not from the active conduct of a trade or business.”

Revenue Ruling 64-75, 1964-1 C.B. 228, holds that where the owner of undivided interests in mineral-bearing real property subject to leases under which the minerals are extracted in exchange for payments that are determined primarily by reference to the amount of minerals mined, the owner's interests in the real properties are “mineral royalty interests” rather than “real estate assets” for purposes of section 856(c)(5), and revenues derived from its leases do not qualify as “rents from real property” under sections 856(c)(2) and (3). The owner's property interest was deemed a mineral, oil, or gas royalty interest because the receipts fell “within the normal and ordinary meaning of the term ‘royalty.”’

In *Sierra Club, Inc. v. Commissioner*, 86 F.3d 1526, 1531 (9th Cir. 1996), the court found that the ordinary meaning of the term royalty is “a payment made to the owner of property for permitting another to use the property,” and that “[t]he payment is typically a percentage of profits or a specified sum per item sold; the property is typically either an intangible property right ... or a right relating to the development of natural resources.” Therefore, the court found that it was the “nature of the property the owner is permitting another to use” that differentiates royalty from rent. *Id.* at 1531 n.12. The court based its conclusion on definitions of “royalty” in Webster's Ninth New Collegiate Dictionary (“share of the product or profit reserved by the grantor [especially] of an oil or mining lease ...”) and Black's Law Dictionary (“compensation for the use of property, usually copyrighted material or natural resources” and a “share of product or profit reserved by owner for permitting another to use the property”). *Id.* at 1531.

The rent payable pursuant to the Surface Lease is compensation for the use of, or right to use, real property. Further, Taxpayer represents that the rents it received in exchange for Lessee’s right to use the Drill Site were negotiated at arm’s length, and comprise the greater of a fixed rental amount or percentage rents based on gross sales proceeds, thus qualifying such percentage rents for the parenthetical exception contained in section 856(d)(2)(A). Such rents would not constitute prohibited royalty payments as defined by *Sierra Club, Inc.* and Rev. Rul. 64-75 because the property covered by the Surface Lease does not include the oil and gas on which the rents are based. The Surface Lease rents are not amounts reserved by Lessors for permitting Lessee to extract the oil and gas because the Lessors do not own the oil and gas upon which the rents are calculated. Rather, the Surface Lease rents are compensation solely for the use of the Surface Land. Therefore, the amounts paid to Taxpayer with

respect to the Surface Lease constitute “rents from real property” under sections 856(c)(2) and (c)(3).

This ruling’s application is limited to the facts, representations, Code sections, and regulations cited herein. Because there is some overlap in ownership between the owners of the Surface Land and Mineral Rights, the contingent payment set forth under the Surface Lease must reflect an arm’s length value. No opinion is expressed with regard to whether the Surface Lease payments are based on arm’s-length terms and at fair market value. In addition, no opinion is expressed with regard to whether Taxpayer otherwise qualifies as a REIT under subchapter M of the Code.

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 representative.

Sincerely,

Robert A. Martin
Robert A. Martin
Sr. Tech. Reviewer, Branch 1
Office of Associate Chief Counsel
(Financial Institutions and Products)

Enclosures:
Copy of this letter
Copy for § 6110 purposes