**Internal Revenue Service**

Number: **200310014**
Release Date: 3/7/2003
Index Number: 856.01-00

Department of the Treasury

Washington, DC 20224

Person to Contact:

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Refer Reply To:
CC:FIP:2 PLR-165019-01
Date:
December 2, 2002

Legend

Group =

PHC =

R =

OP =

MP =

X =

Y =

YSUB =

Z =

ZSUB =

State 1 =

State 2 =

Exchange =

*a* =

*b* =

*c* =

*d* =

*e* =

*f* =

*g* =

*h* =

*i* =

*j* =

*k* =

*l* =

*m* =

*n* =

*p* =

Dear :

This is in reply to a letter dated November 27, 2001, and subsequent correspondence, requesting a private letter ruling regarding a trust that has elected to be treated as a real estate investment trust ("REIT") that owns direct and indirect interests in partnerships and companies that seek to qualify as taxable REIT subsidiaries ("TRSs"). Your letter requests the following rulings:

> (1) For purposes of section 1.856-3(g) of the income tax regulations, a REIT partner's capital interest in a partnership equals the quotient obtained by dividing the REIT's capital account balance by the sum of all partners' capital account balances.
>
> (2) For purposes of section 1.856-3(g), a partnership's capital interest in a

partnership in which it is a partner is the quotient obtained by dividing the partner partnership's capital account balance by the sum of all partners' capital account balances.

(3) If a REIT is a partner in a partnership ("first partnership") that is a partner in another partnership ("second partnership"), for purposes of section 1.856-3(g), the REIT's capital interest in the second partnership is the product of its capital interest in the first partnership multiplied by the first partnership's capital interest in the second partnership.

(4) Payments by a TRS for services rendered by a partnership in which the REIT parent of the TRS is not a partner are not includible in the gross income of the partnership.

FACTS

R is a State 1 corporation that has elected to be treated as a REIT. Its stock trades on Exchange.

R has outstanding more than one class of stock. A class of preferred stock in R "tracks" R's preferred equity interest in OP, a partnership.

OP is a State 2 limited partnership for federal tax purposes.

R conducts most of its business through OP. R owns an approximate *a*% general partnership interest in OP. R also holds what it describes as a preferred equity interest in OP.

R is OP's managing partner. As managing partner, R is engaged in the ownership, management, leasing, acquisition, development and expansion of shopping centers and interests therein. As of December 31, 2000, R's portfolio included *b* centers in *c* states, and *d* more centers were expected to open in 2001.

OP owns *e*% of the voting stock of X, *f*% of the stock of Y, and *f*% of the stock of Z. R has elected with X, Y, and Z to treat X, Y, and Z as TRSs.

Y owns *f*% of the stock of YSUB and Z owns *f*% of the stock of ZSUB. YSUB and ZSUB are intended to be TRSs under section 856(l)(2) of the Internal Revenue Code. ZSUB provides services to tenants of OP that would produce impermissible tenant service income within the meaning of section 856(d)(7)(A) if those services were performed by OP.

Group owns all of PHC, which owns *g*% of the voting stock of X.

PHC, X, and OP own, respectively, .00*g*%, *h*%, and *g*.*i*% of MP, a partnership. MP provides services relating to property management, leasing, development, acquisition, and other administrative services to R and OP. MP also provides services to shopping centers owned by others. MP has approximately *j* employees. Approximately *k* employees work at MP's headquarters and approximately *l* work on-site at shopping centers.

MP owes Z approximately $*m* million (the "Loan"), evidenced by a promissory note providing for monthly payments of interest and payment on demand for principal and accrued, unpaid interest. The note provides that MP may prepay the Loan at its option.

Z owes OP $*n* million (the "Reloan"), evidenced by a promissory note providing for monthly payments of interest and payment on demand for principal and accrued, unpaid interest. The note provides that Z may prepay the Reloan at its option.

Z also has the right to borrow up to $*c* million (the "Credit Line") from OP. The Credit Line is evidenced by a promissory note providing for monthly payments of interest and payment on demand for principal and accrued, unpaid interest. The note provides that Z may prepay the Credit Line at its option.

Z will contribute $*p* million, or approximately 93% of what MP owes Z, to MP in exchange for a partnership interest in MP. MP will revalue its property and restate the capital account balances of the other partners as permitted by section 1.704-1(b)(2)(iv)(f) of the regulations. Z's contribution will not affect the amount it owes MP under the Loan.

OP plans to contribute all of its voting stock in X to Z concurrently with Z's contribution to MP in exchange for a partnership interest.

X, Y, YSUB, ZSUB, and/or any of their subsidiaries may contract to perform services for unrelated third parties or for tenants of OP. Employees of MP may be used to perform the services that the TRSs contract to perform. Each TRS and MP will enter into a cost-sharing arrangement whereby each TRS will reimburse MP for a portion of the costs of the employees based upon the portion of services rendered by the employees that relates to the activities of that TRS, and each TRS's proportionate share of MP's general and administrative overhead expenses. The portion of the services rendered by MP's employees that relates to the activities of each TRS will be determined on an arm's-length basis based on the estimated time spent or the number of entities sharing services. Likewise, the allocation of general and administrative overhead expenses will be arm's-length and equitable. There will be no profit element built into this arrangement.

## LAW

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 1.856-3(g) of the regulations provides that a REIT that is a partner in a partnership 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. For the purpose of section 856 of the Code, its interest in the partnership's assets shall be determined in accordance with its capital interest in the partnership.

Section 1.856-2(c)(1) provides that the term "gross income" has the same meaning as that term has under section 61 of the Code and the regulations thereunder. Section 61(a) of the Code defines gross income as all income from whatever source derived.

In Rev. Rul. 84-138, 1984-2 C.B. 123, a regulated investment ("RIC") company owned all of the stock of a subsidiary corporation that was also a RIC. The parent RIC paid all of the subsidiary's expenses, and the subsidiary would reimburse the parent for those expenses. Neither the parent nor the subsidiary was in the business of providing services of the type that were reimbursed. The ruling holds that the reimbursements were not gross income to the parent, but were instead repayment of a loan. Repayment of a loan is not gross income to the payee. See Rev. Rul. 84-138, citing Glendinning, McLeish & Co., Inc. v. Commissioner, 24 B.T.A. 518 (1931), aff'd. 61 F.2d 950 (2d Cir. 1932), XII-1 C.B. 279, and General Management Corp. v. Commissioner, 46 B.T.A. 738 (1942), aff'd. on other grounds, 135 F.2d 882 (7th Cir. 1943), cert. denied, 320 U.S. 757 (1943).

## ANALYSIS

Section 1.856-3(g) of the regulations does not define the term "capital interest." A partner's capital account generally reflects its net investment in partnership capital and the partnership agreement requires that liquidating distributions be made in accordance with positive capital account balances. A partner's capital account may therefore reflect a partner's net investment in the partnership's assets for purposes of section 1.856-3(g). Consequently, a partner's capital account balance as a portion of the sum of all partners' capital account balances may be used to define its capital interest.

Section 1.856-3(g) of the regulations is equally applicable to a tiered partnership arrangement. Consequently, for purposes of section 1.856-3(g), R has a capital interest in MP because R has a capital interest in OP and OP has a capital interest in

MP.

Neither the TRSs nor MP is in the business of providing the services for which the TRSs will reimburse MP and there is no profit element in the reimbursements. The situation in the present case is analogous to the situation described in Rev. Rul. 84-138. The reimbursements are repayments of loans and not gross income to MP.

## CONCLUSION

Based on the information and representations submitted, it is ruled as follows:

(1) For purposes of the gross income and asset tests under section 856(c) of the Code, R's share of gross income and assets from its indirect interest in MP will be determined based on the the product of (i) R's capital interest in OP, expressed as a percentage, multiplied by (ii) OP's capital interest in MP, expressed as a percentage.

(2) Solely for purposes of section 856(c) of the Code, R's capital interest in OP will be determined by dividing its capital account, as determined and maintained under the regulations under section 704(b) of the Code, by the sum of all partner's capital accounts as so determined and maintained.

(3) Solely for purposes of section 856(c) of the Code, OP's capital interest in MP will be determined by dividing its capital account, as determined and maintained under the regulations under section 704(b) of the Code, by the sum of all partner's capital accounts as so determined and maintained.

(4) Amounts paid by each TRS to MP as reimbursement for personnel costs and other shared expenses will not be considered gross income to MP to the extent that MP does not perform the same services for third parties as those for which the TRS reimburses MP. Consistent with this treatment, MP will not be entitled to a deduction for the reimbursed expenses.

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 taxpayers requesting it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

In accordance with the terms of a power of attorney on file in this office, copies of this letter are being sent to your authorized representatives.

Sincerely yours,

William E. Coppersmith

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