

Internal Revenue Service

Department of the Treasury

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Washington, DC 20224

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Date:
May 10, 2002

Legend:

Trust =

QRS 1 =

QRS 2 =

Operating Partnership =

Date 1 =

a =

b =

Investor =

LLC 1 =

LLC 2 =

LLC3 =

c =

d =

Date 2 =

Dear :

This is in reply to a letter dated December 17, 2001, and subsequent correspondence, requesting a ruling on behalf of Trust. Specifically, you request a ruling that certain reimbursements and other funds collected by Operating Partnership

will be excluded from Trust's gross income for purposes of § 856 of the Internal Revenue Code.

Facts:

Trust is a self-administered and self-managed real estate investment trust (REIT) that develops and operates multifamily apartment communities. QRS 1 and QRS 2 are qualified REIT subsidiaries of Trust. QRS 1 is the sole general partner of, and, together with QRS 2, owns a majority of the limited partnership interests in Operating Partnership. Consequently, as of Date 1, Trust owned a percent of the outstanding common units and b percent of the outstanding preferred units of Operating Partnership. Operating Partnership is a fully-integrated organization with multifamily development, acquisition, operation, and asset management expertise. Trust conducts all of its business through Operating Partnership and its subsidiaries.

Operating Partnership has entered into a Master Agreement with Investor to jointly form limited liability companies (LLCs) as project entities to develop, own, and lease residential rental projects. To date, Operating Partnership and Investor have formed LLC 1, LLC 2, and LLC 3. The Master Agreement provides that Operating Partnership and Investor will be the only members of each LLC and that Operating Partnership will own c percent of the capital interests of each LLC. Operating Partnership has also entered into a Development Agreement and a Management and Leasing Agreement with each LLC, pursuant to which Operating Partnership will perform management and leasing activities on behalf of the LLC.

Development Services

Under the Development Agreements, Operating Partnership will manage and supervise the construction and development of each project. The Development Agreements provide that Operating Partnership, as developer of a project, shall be considered an independent contractor of the LLCs. The LLCs will engage a general contractor to construct the project, using either a third-party general contractor or an affiliate of Operating Partnership. In either case, Operating Partnership is responsible for overseeing the performance of each general contractor.

It is represented that Operating Partnership will perform customary duties related to the development of each residential multifamily rental project, including (but not limited to) providing the following services:

(a) arranging for land surveys, feasibility and engineering studies and other matters relating to the usability of the land and the development of the project;

(b) preparing and submitting to the LLC for its approval, recommendations relating to the construction and development of the project;

(c) ensuring that the general contractor and other design and construction professionals complete the project on schedule and on budget;

(d) ensuring that professionals providing design services maintain sufficient errors and omissions insurance coverage;

(e) monitoring and coordinating the services and performance of the architect, engineer, and general contractor;

(f) obtaining necessary licenses, permits and approvals;

(g) supervising the procurement of bids for construction and development; and

(h) negotiating and preparing contracts.

Operating Partnership will assign certain of its employees to each project to carry out its development responsibilities, including a project manager, an assistant project manager, and an on-site construction superintendent. Each LLC will establish a bank account (the Development Account), which may be part of the same account as the Management Account described below, from which all development related disbursements will be made. Funds may be withdrawn from the Development Account by either an authorized representative of the applicable LLC or Operating Partnership. During the course of construction, Operating Partnership will prepare a draw request summarizing the development costs incurred for the period, and submit the request to the applicable LLC and the Investor. Each request must be accompanied with documentation from the contractor substantiating the expense.

As compensation for the development services, Operating Partnership will receive a development fee equal to the lesser of percent of the total costs of the project or percent of the final project budget (excluding all interest expense). In addition to the development fee, the Development Agreement provides that the LLC will reimburse Operating Partnership for employee expenses including salaries, bonuses, payroll taxes, worker's compensation and health insurance, to the extent contemplated by the project budget, for certain categories of personnel, including the construction project manager, assistant construction project manager, hardscape/graphic design director, telecommunications engineer, and construction safety director. The following types of expenses incurred by Operating Partnership are not reimbursable: internal reporting and accounting services that are considered to be within the reasonable scope of Operating Partnership's development responsibilities to each LLC; costs of forms, papers, ledgers, and other supplies and equipment used in the principal office of each LLC or any of its affiliates; costs of electronic data processing equipment or any pro rata charge thereon; costs of electronic data processing or pro rata charge thereon for data processing provided by computer service companies; and Operating Partnership's office overhead, including executive salaries and transportation expenses of its employees.

Management and Leasing Services

Once a project is complete, Operating Partnership will perform management and leasing services on behalf of each LLC pursuant to a Management and Leasing Agreement that is substantially similar to the agreement dated Date 2, between Operating Partnership and LLC 1. The Management and Leasing Agreement provides that Operating Partnership's relationship to the LLC is that of an independent contractor. Under each Management and Leasing Agreement, Operating Partnership will provide the following services to each LLC:

- (a) implement approved budgets and leasing programs;
- (b) enter into and renew all contracts for water, sanitary and storm sewer, drainage, electricity, steam, gas, telephone, and all other services necessary for the operation of the project;
- (c) purchase all necessary supplies and equipment for the operation of the project;
- (d) monitor the real estate tax assessments of the project and determine their reasonableness in comparison to other similar projects;
- (e) consult with each LLC regarding the condition of the project and the necessity for maintenance, repair, alteration, and restoration, and, at the expense of each LLC, provide through employees or third party contractors all necessary work, labor, and services to maintain and repair the project in first class condition;
- (f) maintain accurate books, records, and accounts of the management, operation and financial condition of the project; and
- (g) lease the property to desirable tenants, negotiate and execute leases with tenants, and collect rent and other charges from tenants.

Operating Partnership will pay all expenses of operating the property (including operating expenses, mortgage interest, and capital expenses) from a Management Account that has been established by each LLC. Alternatively, in the discretion of each LLC, the Management Account may be established in the name of Operating Partnership as managing agent for the LLC. Pursuant to the Management and Leasing Agreement, any funds held in the name of Operating Partnership on behalf of each LLC are required to be held in trust by Operating Partnership for the benefit of the applicable LLC, and Operating Partnership is prohibited from commingling any of its funds in these accounts. All rents and security deposits collected from tenants are paid into the Management Account. Operating Partnership's management fee and reimbursable expenses are paid out of the Management Account.

Operating Partnership is entitled to a management fee of d percent of the gross receipts of the property. Operating Partnership will also be reimbursed for all direct expenses incurred and paid by it in connection with the management, operation, and leasing of the project, other than:

(a) Operating Partnership's central office overhead or other central office general, leasing, or administrative personnel or other expenses;

(b) travel expenses to and from the property;

(c) costs of providing reports and documents required to be provided under the Management and Leasing Agreement (other than the reports by the on-site staff and the auditor's reports); and

(d) costs and expenses attributable to services by off-site personnel in connection with the management of the property, except to the extent provided for in the budget.

Under the Management and Leasing Agreement, Operating Partnership will use its own employees to perform its management and leasing responsibilities and the compensation of the employees will be the responsibility of Operating Partnership. However, Operating Partnership is entitled to be reimbursed for certain costs, including: (i) all costs of full-time, on-site managing and leasing personnel, including salaries, bonuses, payroll taxes, and workers compensation and health insurance, and an appropriate pro rata share of the costs of those employees who are not exclusively assigned to the project; (ii) the allocable cost of landscaping labor and materials provided by Operating Partnership's landscaping division; and (iii) the portion of general liability insurance and property and casualty insurance premiums incurred by Operating Partnership under its master policies that is properly allocable to the LLC, with the general liability premiums being allocated among the properties based on the relative number of units and the property and casualty premiums being allocated based on the properties' relative values. Operating Partnership does not get reimbursed for general overhead costs such as the costs of central office general and administrative personnel, advertising and marketing, legal and accounting, and employee training.

Law and Analysis:

Section 61(a) defines gross income as all income from whatever source derived, including gross income derived from business. An employer, under § 162(a)(1), is allowed a deduction for all ordinary and necessary expenses paid or incurred during the tax year in carrying on a trade or business including a reasonable allowance for salaries and other compensation for personal services actually rendered.

A corporation, trust, or association must satisfy certain income and asset tests under § 856 to be considered a REIT. Section 856(c)(2) provides that at least 95

percent of a REIT's gross income must be derived from certain sources, including dividends, interest, and rents from real property. Section 856(c)(3) provides that at least 75 percent of a REIT's gross income must be derived from certain sources, including rents from real property, interest on obligations secured by real property, and gain from the sale or disposition of real property.

Section 856(i)(1) provides that a corporation that is a qualified REIT subsidiary shall not be treated as a separate corporation, and all assets, liabilities, and items of income, deduction, and credit shall be treated as assets, liabilities, and such items of the REIT.

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 shall be 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 shall retain the same character in the hands of the partners for all purposes of § 856.

Section 1.856-2(c)(1) defines gross income for purposes of § 856 to have the same meaning as that term under § 61 and the regulations thereunder.

In Rev. Rul. 84-138, 1984-2 C.B. 123, a regulated investment company (RIC) and its wholly-owned subsidiary shared facilities and some personnel. It was agreed that the RIC would pay all the expenses for general and administrative overhead, including personnel costs and the subsidiary would reimburse the RIC for its pro rata share of the expenses on an arm's length basis. The ruling, in distinguishing Jergens Co. v. Commissioner, 40 B.T.A. 868 (1939), states that the RIC was not engaged in the business of receiving compensation for services of the type that were reimbursed. Instead, reimbursements to the RIC from the subsidiary were merely repayments of advances made on behalf of the subsidiary. Accordingly, the ruling holds that the reimbursements were not included in the RIC's gross income under § 61, and, therefore, were not subject to the gross income requirement of § 851(b)(2).

Rev. Rul. 57-104, 1957-1 C.B. 166, considers whether the amount paid by a taxpayer to an independent contractor as reimbursement for the costs of a union negotiated qualified pension plan for the contractor's employees will be deductible to the taxpayer and included in the income of the contractor. The taxpayer, a shipowner, contracted with a stevedore contractor to handle its cargoes. Pursuant to their contract, the taxpayer reimbursed the contractor for the amount required to be contributed by the contractor to the pension trust. The ruling holds that the amount paid by the taxpayer as a reimbursement is part of the cost of the services rendered by the independent contractor to the taxpayer, and, as such, is a deductible expense to the taxpayer under § 162. The ruling also holds that the reimbursement of amounts contributed to the trust

on behalf of its employees is includible in the gross income by the contractor under § 61.

In the instant case, Operating Partnership, pursuant to an agreement with each LLC, provides development and management services for each of the projects and is compensated for its services. The employee expenses and other costs for which Operating Partnership is reimbursed under the Development Agreements and the Management and Leasing Agreements are integrally related to the services being performed by Operating Partnership for the LLCs. Accordingly, unlike the situation in Rev. Rul. 84-138, and like the situation in Rev. Rul. 57-104, Operating Partnership is generally in the business of receiving compensation for services of the type that are being reimbursed. Therefore, the amounts received as reimbursements under the Development and Management and Leasing Agreements are includible in the gross income of the Operating Partnership. However, Operating Partnership is not in the business of underwriting or acting as an agent or broker for general liability, property and casualty or other insurance. Therefore, reimbursements received from each LLC for its share of master policies underwritten by third party insurers do not constitute gross income to Operating Partnership.

Funds collected in the Management and/or Development Accounts (the Accounts) of the LLCs and used by Operating Partnership to pay expenses of the LLCs do not constitute gross income to Operating Partnership and Trust. The Accounts were established to enable Operating Partnership to pay expenses of the project that are the responsibility of the LLC and to hold income and funds associated with a project that belong to the LLC. Where the Accounts are established in the name of Operating Partnership, funds in the Accounts are required to be held in trust for the benefit of the LLC, and Operating Partnership is prohibited from commingling any of its own funds with the funds in the Account. Accordingly, Operating Partnership lacks any right or interest in the funds in the Accounts. Therefore, amounts paid into the Accounts will not constitute gross income to Operating Partnership, and Trust will not derive income from Operating Partnership based upon the amounts paid into the Accounts.

Holdings:

1) The amounts received from the LLCs by Operating Partnership as reimbursements for expenses it incurred in performing services under the Management and Leasing Agreements and Development Agreements are includible in the gross income of Operating Partnership, and, therefore, are gross income to Trust. The reimbursements includible in the gross income of Operating Partnership shall not include amounts attributable to reimbursements for general liability and property and casualty insurance obtained on the projects of the LLCs.

2) Funds collected in the Accounts that are used by Operating Partnership to pay expenses of operating the projects of the LLCs will not constitute gross income to Operating Partnership, and, therefore, will not be gross income to Trust.

This ruling is directed only to the taxpayer(s) requesting it. Section 6110(k)(3) provides that it may not be used or cited as precedent. No opinion is expressed or implied as to the federal tax consequences of this transaction under any provision not specifically addressed herein. Furthermore, no opinion is expressed concerning whether Trust otherwise qualifies as a REIT under subchapter M, part II of Chapter 1 of the Code. Also, no ruling was requested and no opinion is given concerning the treatment of Operating Partnership's share of amounts received for performing services for each LLC that are derived from Operating Partnership's interest in each LLC.

Sincerely yours,
Patrick E. White
Assistant to the Chief, Branch 1
Office of Associate Chief Counsel
(Financial Institutions & Products)

Enclosure:

Copy of this letter
Copy for § 6110 purposes

cc: