

**Internal Revenue Service**

Department of the Treasury

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Washington, DC 20224

Person to Contact:

Telephone Number:

Refer Reply To:

CC:FIP:B02-PLR-126208-01

Date:

March 21, 2002

Legend

Trust A	=
Limited Partnership B	=
State C	=
D percent	=
E percent	=
F percent	=

Dear \_\_\_\_\_ :

This is in response to a ruling request dated May 9, 2001, that you submitted on behalf of Trust A as its authorized representative. Trust A requests rulings that:

1. A loan secured by 100 percent of the membership interest of a limited liability company that is disregarded as a separate entity for federal income tax purposes under Treasury Regulation section 301.7701-3(b)(1), and substantially all of the assets of which consist of real property, is a "real estate asset" for purposes of section 856(c)(4)(A) of the Code.
2. A loan secured by a partnership interest in a partnership, substantially all of the assets of which consist of real property, is a "real estate asset" for purposes of section 856(c)(4)(A) of the Code.

FACTS

Trust A is a publicly held New York Stock Exchange listed company that has elected to be treated as a real estate investment trust under section 856 et seq., of the Internal Revenue Code (the "Code"). Trust A owns substantially all of its assets and conducts all of its operations through Limited Partnership B, a State C limited partnership. Trust A is the sole general partner of Limited Partnership B and owns approximately D percent of Limited Partnership B.

PLR-126208-01

Limited Partnership B owns or has an interest in numerous commercial office properties. Limited Partnership B owns such properties either directly or indirectly through ownership interests in affiliated partnerships and limited liability companies, substantially all of which are controlled by Limited Partnership B. In connection with its business of investing in commercial office properties, Limited Partnership B and its affiliates (hereafter referred to collectively as "Limited Partnership B") make loans to owners of commercial office properties. In some cases, instead of making loans to the entities directly owning the commercial office properties, Limited Partnership B makes loans to the owners of such entities, secured by a pledge of the borrowers' ownership interests in the property owning entities. Limited Partnership B requests rulings with regard to the following such transactions.

Transaction 1:

In the first transaction, a limited liability company ("LLC 1") owns 100 percent of a commercial office building ("Property 1") and no other significant assets. Substantially all of Property 1 qualifies as "real property" for purposes of section 856(c)(5)(B) of the Code. Property 1 is subject to a first mortgage loan (the "First Mortgage Loan") in favor of an unrelated third party lender. The value of Property 1 substantially exceeds the outstanding balance of the First Mortgage Loan. However, the terms of the First Mortgage Loan prohibit any second mortgage liens on Property 1 and also prohibit LLC 1 from incurring any other debt.

One hundred percent of the ownership interest in LLC 1 is owned by another limited liability company ("LLC 2"). LLC 2 has no significant assets other than its 100-percent ownership interest in LLC 1. Instead of making a loan to LLC 1, Limited Partnership B will make a loan (the "Mezzanine Loan") to LLC 2, secured by LLC 2's 100-percent ownership interest in LLC 1. Limited Partnership B will be granted a first priority security interest in the pledged ownership interest. The Mezzanine Loan will be a non-recourse loan with the only security being LLC 2's interest in LLC 1. The net value of Property 1 will equal or exceed the principal amount of the Mezzanine Loan.

Because LLC 1 is a single member limited liability company that has not elected to be treated as a corporation for federal tax purposes, it is disregarded as an entity separate from its owner, LLC 2, under section 7701 of the Code and section 301.7701-3(b)(1) of the Income Tax Regulations. Accordingly, for federal income tax purposes, LLC 2 is treated as the owner of Property 1.

In the event of a default and foreclosure upon the Mezzanine Loan, Limited Partnership B's first priority security interest will place Limited Partnership B's claim ahead of any claims of LLC 2's other creditors. Further, under the terms of the Mezzanine Loan, in the event of a default and foreclosure, Limited Partnership B will replace LLC 2 as the 100 percent owner of LLC 1. Because LLC 1 is a disregarded entity not treated as an entity separate from its owner for federal income tax purposes, Limited Partnership B

PLR-126208-01

would be treated as the owner of Property 1 for federal income tax purposes, subject to the rights of the lender under the First Mortgage Loan.

Transaction 2:

In the second transaction, a limited partnership ("LP 3") owns 100 percent of a commercial office property ("Property 2") and no other significant assets. Substantially all of Property 2 qualifies as "real property" for purposes of section 856(c)(5)(B) of the Code. Property 2 is subject to a first mortgage loan ("First Mortgage Loan 2") in favor of an unrelated third party lender. The value of Property 2 substantially exceeds the outstanding balance of First Mortgage Loan 2

LP 3 has four partners, including a limited liability company ("LLC 4"). LP 3 and LLC 4 each have multiple owners, and neither LP 3 nor LLC 4 has elected to be treated as a corporation. Therefore, under section 301.7701-3(b)(1) of the Income Tax Regulations, both LP 3 and LLC 4 are treated as partnerships for federal income tax purposes. Limited Partnership B will make a loan (the "Partnership Interest Loan") to LLC 4. However, because LLC 4 is only one of the partners in LP 3, Limited Partnership B will be unable to have the Partnership Interest Loan secured by a direct mortgage lien on Property 2.

LLC 4's allocable share of the net value of the real estate owned by LP 3 will equal or exceed the principal amount of the Partnership Interest Loan at the time of the original loan and at the time of additional borrowing for money by LP 3. The Partnership Interest Loan will be secured by LLC 4's E percent partnership interest in LP 3. Limited Partnership B will be granted a first priority security interest in the pledged partnership interest. The Partnership Interest Loan will be a non-recourse loan with the only security being LLC 4's interest in LP 3. LLC 4 has no significant assets other than its partnership interest in LP 3.

The partnership agreement for LP 3 permits the pledge by LLC 4 of its partnership interest in LP 3 to secure the Partnership Interest Loan with the consent of the general partner of LP 3. The general partner of LP 3 has consented to the pledge by LLC 4 of its partnership interest to secure the Partnership Interest Loan. Further, Limited Partnership B indirectly owns approximately F percent of the general partner of LP 3 and has managerial control of LP 3.

Under the terms of the Partnership Interest Loan, upon a default by LLC 4 and a failure of LLC 4 to cure that default within the requisite time period, Limited Partnership B will have the right to foreclose upon LLC 4's E percent partnership interest in LP 3. Upon a foreclosure, Limited Partnership B's first priority security interest will place Limited Partnership B's claim ahead of any claims of LLC 4's other creditors. Further, in the event of a default and foreclosure upon the Partnership Interest Loan, the general partner of LP3 will consent to the admission of Limited Partnership B as partner in place of LLC 4. Therefore, upon a default and foreclosure of the Partnership Interest Loan,

PLR-126208-01

Limited Partnership B will become the direct owner of the E percent partnership interest in LP 3, and thus an indirect owner of Property 2.

## LAW AND ANALYSIS

Section 856(a) of the Code provides that a trust shall not be considered a real estate investment trust (a "REIT") for any taxable year unless certain requirements are satisfied.

Section 856(c)(4)(A) of the Code provides that at the close of each quarter of its taxable 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)(4)(B)(i) of the Code provides that, at the close of each calendar quarter, no more than 25 percent of a REIT's total assets can be represented by securities (other than those included in Section 856(c)(4)(A)). Section 856(c)(4)(B)(iii) prohibits a REIT from owning at the end of any calendar quarter specified amounts of securities of any one issuer, other than securities included in section 856(c)(4)(A) and securities of a taxable REIT subsidiary.

Section 856(c)(5)(B) of the Code provides that the term "real estate assets" means 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 that meet the requirements of section 856 through 859.

Section 1.856-3(d) of the Income Tax Regulations provides that the term "real property" means land or improvements thereon, such as buildings, and that the term "real property" includes interests in real property. Section 1.856-3(d) further provides that "local law definitions will not be controlling for purposes of determining the meaning of the term "real property" as used in section 856 and the regulations thereunder."

Under section 301.7701-3(b)(1)(i) of the regulations, certain entities (including limited liability companies) with a single member that do not elect to be treated as corporations will be disregarded as entities separate from their owners for federal income tax purposes.

Section 1.856-3(g) of the regulations provides that in the case of a real estate investment trust which is a partner in a partnership, the trust 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 purposes of section 856, the interest of a partner in the partnership's assets will be determined in accordance with his 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 section 856. Thus, for example, if the trust owns a 30-percent capital interest in a partnership

PLR-126208-01

which owns a piece of rental property the trust will be treated as owning 30 percent of such property and as being entitled to 30 percent of the rent derived from the property by the partnership.

In Rev. Rul. 77-459, 1977-2 C.B. 239, a real estate investment trust made a construction loan to a partnership and as security for the loan, the partnership assigned its interest in an Illinois land trust to the real estate investment trust. The partnership was the sole beneficiary of the land trust and the sole asset of the land trust was real property. In that instance, the Service concluded that the loan constituted a “real estate asset” under section 856(c)(5)(A) of the Code.

Section 1.856-3(g) of the regulations recognizes that if a real estate investment trust is a partner in a partnership, the real estate investment trust will be considered to own the partnership’s real estate assets in the same proportion as its capital interest in the partnership. Further, the rules contained in section 1.856-3(g) are equally applicable to a tiered partnership arrangement. Based on the facts presented, the principles of section 1.856-3(g) provide a sufficient nexus between the Partnership Interest Loan and the real property owned by LP 3 to qualify the Partnership Interest Loan as a “real estate asset” under section 856(c)(5)(B) of the Code. Further, under the facts presented, the same rationale extends to the situation involving the 100 percent owned entity that is treated as a disregarded entity under section 7701 of the Code and section 301.7701-3(b)(1).

## CONCLUSIONS

Under the fact presented and the representations made, we conclude as follows:

1. To the extent that the net value of Property 1 equals or exceeds the principal amount of the Mezzanine Loan on the date of the initial loan, and on the date of any additional borrowings, the Mezzanine Loan qualifies as a “real estate asset” for purposes of section 856(c)(4)(A) of the Code.
2. To the extent that the net value of the pledged partnership interests’ share of the real property held by LP 3 equals or exceeds the principal amount of the Partnership Interest Loan on the date of the initial loan, and on the date of any additional borrowings, the Partnership Interest Loan qualifies as a “real estate asset” within the meaning of section 856(c)(5)(B) of the Code for purposes of section 856(c)(4)(A) of the Code.

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, and no opinion is expressed as to the federal income tax consequences of the transaction described above under any other provision 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.

PLR-126208-01

In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent the taxpayer and to the second authorized representative listed on the Power of Attorney.

A copy of this letter must be attached to any income tax return to which it is relevant.

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