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PLR-134716-07

Date:

March 26, 2008

TY:

LEGEND

Taxpayer =

Operating Company =

Historic Building =

Date 1 =

Date 2 =

Affiliate A =

Affiliate B =

Government Entity 1 =

Government Entity 2 =

Government Entity 3 =

Construction Company =

Building 1 =

Building 2 =

Site =

Zone A =

University =

State =

City =

Station =

X =

Governmental Lease =

Government Parking Area =

Zone B =

A square feet	=
B square feet	=
C square feet	=
D square feet	=
Year A	=
Year B	=
Year C	=
Year D	=
Z percent	=
SB/SE Official	=

Dear _____ :

This is in response to your letter dated July 25, 2007, and subsequent correspondence requesting rulings under section 168 (h)(1)(B) of the Internal Revenue Code on behalf of Company regarding a multifaceted transaction that includes the rehabilitation of Historic Building.

FACTS

Taxpayer is a limited partnership treated as a partnership for federal income tax purposes. All of its partners are wholly owned (indirectly) by Operating Company, through two taxable REIT subsidiaries. Company acquired Historic Building on Date 1, and is in the process of rehabilitating it. Before Historic Building is placed in service, at least one more limited partner will be admitted to Taxpayer. Taxpayer will likely enter into a master lease structure and elect to pass through Federal rehabilitation tax credits available with respect to the rehabilitation of Historic Building to one of the new limited partners or to its affiliate, as master tenant of Historic Building ("Master Tenant").

Affiliate A, a Delaware limited partnership, and Affiliate B, a Delaware limited partnership, are wholly owned (indirectly) by Operating Company and are treated as disregarded entities (and as part of Operating Company) for federal income tax purposes. Taxpayer, Affiliate A, and Affiliate B are coordinating efforts to rehabilitate Historic Building and construct Building 1 and Building 2 located on Site, which is in the Zone A section of City. Building 1 is an office building owned by Affiliate B located across the street from Station, which is owned by X. Historic Building is located across the street from Station, and Building 2 will be built on an annex site located across the street from Historic Building and currently leased to Affiliate A. Affiliates of Construction Company have significant involvement in the planning and construction of the Historic Building, as construction and development manager, and of the garage, as construction manager.

Until the fifth anniversary of the date the rehabbed Historic Building is placed in service, Operating Company (or its successors or assigns) will, directly or indirectly, (i) own at least twenty percent of all “profits interests” and “capital interests” (as defined in Rev. Proc. 93-27, 1993-2 C.B. 343) in each of the entities owning buildings or condominiums comprising its Site project (excluding any condominiums that are sold to parties unrelated to Operating Company, and (ii) serve as a general partner in each of such ownership entities, engaging in active and substantial management functions with respect to the entities’ respective businesses (which may include property management and leasing services).

In Year A, Government Entity 2 chose Construction Company as its developer to find appropriate uses for Historic Building, the annex site, a surface lot, and a vehicle maintenance facility, all of which are located in Zone A of City. A preliminary report prepared by Construction Company showed plans for towers at the sites where towers are currently planned for the annex site, and suggested initiating discussions with X regarding land acquisition and infrastructure development. In Year B, a working group that included representatives of Operating Company and Construction Company, together with representatives of an independent real estate service company, depicted towers at the sites currently planned for the annex, as well as another tower at the site currently occupied by Building 1.

In Year B, University signed a letter of intent to acquire Historic Building, the annex site, a surface lot, and a vehicle maintenance facility from Government Entity 2. University then approached Construction Company about assuming University’s obligation to purchase Historic Building, the annex site or the vehicle maintenance facility. In late Year B, Construction Company began discussions with Government Entity 3 regarding a potential relocation of Government Entity 1’s offices in City to the Historic Building. Subsequently, Construction Company presented preliminary concept plans for the rehabilitation of the Historic Building, the demolition of the annex, and the construction of a new building on the annex site, for use and occupancy by Government Entity 1. The Governmental Lease and current plans for the rehabilitation of the Historic Building are the products of those discussions.

In order to promote redevelopment of economically distressed communities, State enacted legislation permitting designation of certain zones (i.e., Zone B in City) throughout State. Qualified businesses that operate in such zones are allowed certain tax exemptions, deductions, abatements and credits. Historic Building, Building 1 and Building 2 are all located in Zone B in City.

Through Affiliate B, Operating Company began planning to construct and lease Building 1 while investigating other activities in Zone B. Building 1 is located across the street from Station and was constructed on land owned by X but leased to Affiliate B under a ninety-nine year lease. Building 1 is located near the Station to take advantage of convenient rail transportation for employees of businesses leasing space in Building 1.

Building 1 is connected to the Station by an above street-level public bridge Building 1. Construction of most of the tenant finish for Building 1 has been completed and a certificate of occupancy for the core and shell has been issued. Building 1 contains A square feet of net rentable floor space.

Historic Building and the annex site on which Building 2 will be constructed were owned by Government Entity 2 until Date 1. On that date, Taxpayer acquired Historic Building, and University acquired the annex site. Affiliate A then executed three 90-year ground leases with University for the annex site, on which Operating Company plans to cause Affiliate A or one or more other affiliates to construct Building 2, which will include at least one tower and a garage. Taxpayer agreed to lease the rehabilitated Historic Building to Government Entity 2, and Affiliate A agreed to lease the Government Parking Area to Government Entity 2 ("Master Lease"). On or about Date 2, Government Entity 2 (as sublessor) and Government Entity 3 (as sublessee) executed Governmental Lease, under which Government Entity 3 agreed to sublease the rehabilitated Historic Building and the Government Parking Area. Government Entity 2 will assign Governmental Lease to Taxpayer (or to the Master Tenant), and the Taxpayer (or the Master Tenant) will become the lessor under the Governmental Lease, once there is substantial completion of the Premises or any portion thereof (as such terms are defined in the Governmental Lease).

Historic Building is listed on the National Register of Historic Places. Beginning in Year C, Company will "substantially rehabilitate" the Historic Building and to demolish the annex (except for the annex tunnel). After the annex site is cleared, utilities and infrastructure will be installed, and piles will be driven to provide the foundation for Building 2. Soon thereafter, it is anticipated that construction of the garage will commence followed by one or both towers that will constitute Building 2. Taxpayer represents that it will commence construction of one, but possibly two towers (hereinafter "Included Towers") within 9 months following commencement of construction of the garage. If construction of only one tower is commenced within 9 months of the commencement of construction of the garage, the second tower will not be treated as part of the Site "project" for purposes of this private letter ruling.

Due to construction complexity and other delays, the Included Towers will likely be placed in service after the tax year in which the Historic Building and the garage are placed in service. The Included Towers will include office space and may include space for a hotel, retail and residential use. The hotel space may be sold to an unrelated third party as a separate condominium, and the residential space may be sold to unrelated third parties as separate residential condominiums. Any spaces in the Included Towers which are sold to unrelated third parties are not included in the computation of net rentable floor space in the Site project.

Under the Governmental Lease, Government Entity 3 will lease the renovated Historic Building and the Government Parking Area in the garage. The Government Parking

Area will be available exclusively for possession, use and occupancy by Government Entity 3 under the Governmental Lease. Government Parking Area will not be available for vehicular access by the general public or by anyone other than Government Entity and/or Government Entity 3 and their employees and guests. Government Parking Area will be separated from other parking areas by a security gate restricting vehicular access. Elevator access to Government Parking Area will be limited to such employees and guests. Government Parking Area will include at least 1200 parking spaces but may increase if certain options under the Governmental Lease are exercised.

The rehabilitated Historic Building will comprise approximately B square feet of net rentable floor space. The initial occupancy date of Historic Building and Government Parking Area under Governmental Lease is anticipated for the summer of Year D. There may be changes in the precise mix and configuration of space, but not less than C square feet of net rentable floor space will be constructed on the annex site as part of Building 2 in the form of some combination of (i) office, residential, hotel and/or retail space in the Included Towers (excluding any Sold Condominium), and (ii) retail space, Government Parking Area and dedicated parking areas in the garage.

According to the submission, Operating Company will create a fully supported business center rather than a single building. Benefits to Operating Company from the development of Site, including the renovation of the Historic Building and the construction of Building 1 and Building 2 include (i) the ability to solidify and strengthen the overall design integrity and economic viability of the entire Site; (ii) economies of scale in marketing and managing the overall Site; (iii) the ability to offer prospective tenants a broad range of leasing options within the Site; and (iv) the ability to utilize a single maintenance operation to work on the entire Site, allowing for economic sharing of equipment and personnel. To effectively manage the Site, Operating Company will have a single maintenance operation and a centralized managerial structure, which will be responsible for delivering property management and maintenance services to the entire Site. Tenants located in any building of the overall development will access the same property management organization to address their operational requirements. A series of walkways, tunnels and pedestrian bridges will connect the buildings in the Site. A bus service will transport tenants and visitors among the various Site buildings. Moreover, in order to create a consistent architectural theme and landscaping design which will integrate the entire Site, a single architect has been retained as the master plan executive architect for the Operating Company's overall Site. This architect served as building architect for Building 1 and will serve as architect for Building 2.

The submission also makes significant representations:

(1) The economic substance of the Governmental Lease is that of a "true lease" such that Taxpayer will be treated as the owner of the Historic Building, and Affiliate A (or another affiliate of Operating Company) will be treated as the owner Government Parking Area in Building 2 for federal income tax purposes;

- (2) The rehabilitation of the Historic Building and the construction of Building 1 and Building 2 are all part of one plan or scheme to redevelop part of a Zone B;
- (3) Governmental Lease does not include any renewal option;
- (4) The initial term of the Governmental Lease plus any service contract or similar arrangement involving the property leased under the Governmental Lease will not exceed twenty (20) years as measured from the first day any part of the leased premises is delivered by the landlord and accepted as substantially complete by the tenant under the Governmental Lease (excluding pre-substantial completion access allowed to the tenant and its contractors to complete tenant improvements or to prepare for occupancy);
- (5) No lease of space in Building 1 by Affiliate B or any other affiliate of Operating Company to a "tax-exempt entity" (as defined in § 168(h)(2) of the Code) that is executed before the fifth anniversary of the first day the rehabilitated Historic Building is placed in service (the "Fifth Anniversary"), will have a lease term, including any fixed rate renewal option and any service contract or similar arrangement involving the leased space, which exceeds twenty years. (For purposes of this private letter ruling, an option to renew a lease at a rental rate equal to a fair market value determined at the time of renewal is not treated as a "fixed rate renewal option.");
- (6) No lease of space in Building 2 by Affiliate A or any other affiliate of Operating Company to a tax-exempt entity that is executed before the Fifth Anniversary will have a lease term, including any fixed rate renewal option and any service contract or similar arrangement involving the leased space, which exceeds twenty years;
- (7) There is not now, and will not be, any up-front understanding, informal arrangement or similar agreement between Affiliate A or any other affiliate of Operating Company and any tax-exempt entity lessee that any fair market value renewal option which may be granted under a lease of space in Building 2 executed before the Fifth Anniversary will be applied by the parties without regard to the actual fair market value rental of the premises at the time of renewal;
- (8) There is not now, and will not be, any up-front understanding, informal arrangement or similar agreement between Affiliate B and any other affiliate of Operating Company and any tax-exempt entity lessee that any fair market value renewal option which may be granted under a lease of space in Building 1 executed before the Fifth Anniversary will be applied by the parties without regard to the actual fair market value rental of the premises at the time of renewal;
- (9) No portion of Building 1, the Historic Building, or Building 2 will be financed, directly or indirectly, by an obligation the interest on which is exempt from tax under § 103(a);

(10) The Governmental Lease does not include, and neither Government Entity 3 nor a "related entity" under § 168(h)(4) holds, a fixed or determinable price purchase or sale option or its equivalent with respect to all or any part of the premises leased under the Governmental Lease;

(11) No lease executed between Affiliate A or any other affiliate of Operating Company and any tax-exempt entity lessee before the Fifth Anniversary will include, and no such tax-exempt lessee or a related entity will hold, a fixed or determinable price purchase or sale option or its equivalent with respect to Building 2 or any part thereof;

(12) No lease executed between Affiliate B or any other affiliate of Operating Company and any tax-exempt entity lessee before the Fifth Anniversary will include, and no such tax-exempt lessee or a related entity will hold, a fixed or determinable price purchase or sale option or its equivalent with respect to Building 1 or any part thereof; and

(13) Upon completion, the buildings on the Site will contain approximately the number of square feet of "Net Rentable Floor Space" set forth below.

<u>Building</u>	<u>Net Rentable Floor Space</u>
Building 1	A square feet
Historic Building	B square feet
Building 2	C square feet
Total Net Rentable Floor Space	D square feet

You have requested two rulings:

Ruling Request No. 1: Neither the Historic Building nor any part thereof nor any of the improvements to be made in rehabilitating the Historic Building will be treated as "tax-exempt use property" under §§ 168(h)(1)(B)(i) and 47(c)(2)(B)(v) of the Code; and

Ruling Request No. 2: For purposes of applying § 168(h)(1)(B) to Taxpayer's rehabilitation and leasing of Historic Building, the "property" will include all of the net rentable floor space in the Historic Building, Building 1, and Building 2.

LAW AND ANALYSIS

Section 168(h)(1)(B)(i) states that, in the case of non-residential real property, the term "tax-exempt use property" means that portion of the property leased to a "tax-exempt entity" in a "disqualified lease." Under § 168(h)(1)(B)(ii), the term "disqualified lease" means any lease of the property to a tax-exempt entity, but only if: (l) part or all of the

property was financed (directly or indirectly) by an obligation the interest on which is exempt from tax under § 103(a) and such entity (or a related entity) participated in such financing, (II) under such lease there is a fixed or determinable price purchase or sale option which involves such entity (or a related entity) or there is the equivalent of such an option, (III) such lease has a lease term in excess of 20 years, or (IV) such lease occurs after a sale (or other transfer) of the property by, or lease of the property from, such entity (or a related entity) and such property has been used by such entity (or a related entity) before such sale (or other transfer) or lease.¹

Under § 168(h)(1)(B)(iii), property will be considered "tax-exempt use property" only if the portion of the property leased to tax-exempt entities in disqualified leases is more than 35 percent of the property (the "35-percent exception"). Section 168(h)(1)(B)(iv) provides that improvements to a property (other than land) will not be treated as a separate property.

Section 1.168(j)-1T, Q&A-6, of the temporary Income Tax Regulations provides that the phrase "more than 35 percent of the property" means more than 35 percent of the net rentable floor space of the property. The net rentable floor space in a building does not include the common areas of the building, regardless of the terms of the lease. For purposes of the "more than 35 percent of the property" rule, two or more buildings will be treated as separate properties unless they are part of the same project, in which case they will be treated as one property. Two or more buildings will be treated as part of the same project if the buildings are constructed under a common plan, within a reasonable time of each other, on the same site and will be used in an integrated manner.

The Governmental Lease and the lease by Taxpayer to Government Entity 2 as they relate to the Historic Building would each be a "disqualified lease" under

¹ For purposes of § 168(h)(1)(B)(ii)(I), Taxpayer represents that the Historic Building, Building I, and Building 2 will not be financed with tax-exempt debt. For purposes of § 168(h)(1)(B)(ii)(II), Taxpayer represents that there is no fixed or determinable price purchase or sale option or the equivalent of such an option for the benefit of Government Entity 3 or any other tax-exempt lessee, or any related entity, with respect to any of the buildings. For purposes of § 168(h)(1)(B)(ii)(III), the Taxpayer represents that the term of the Governmental Lease and any other leases with tax-exempt entity lessees at the Site, including any fixed price renewal option and any service contract or similar arrangement with respect to the leased space, will be no greater than 20 years. Any renewal option terms will be at a fair market value rental rate determined at the time of renewal and, therefore, should not be taken into account. Therefore, neither the Governmental Lease, nor any other lease of the Historic Building, Building I, or Building 2 would presently be a "disqualified lease" under these provisions.

§ 168(h)(1)(B)(ii)(IV) (the "Use After Transfer Rule") because the Historic Building has been used by the Government Entity 2, a governmental entity, and will, after the acquisition of such property by Operating Company, be leased to Government Entity 3 for use by Government Entity 1, both of which are related entities to Government Entity 2 under §§ 168(h)(2)(A)(i) and 168(h)(4)(A). However, § 168(h)(1)(B)(iii) provides that property will not be treated as "tax-exempt use property" if the portion of the property leased to tax-exempt entities in disqualified leases is no more than 35 percent of the property. Although the Taxpayer acknowledges that the Historic Building will be subject to a "disqualified lease" under the Use After Transfer Rule, Taxpayer posits that the 35-percent threshold in § 168(h)(1)(B)(iii) will not be crossed because Building 1, the Historic Building, and Building 2 comprise a single "project" (i.e., one property for purposes of § 168(h)) under Q&A 6 of the temporary regulations, and thus less than 35 percent of the total net rentable floor space of that project (i.e., the net rentable floor space of only the Historic Building) will be subject to a disqualified lease. Therefore, no portion of the property will be "tax-exempt use property" within the meaning of § 168(h)(1)(B).

For purposes of determining if the buildings in this case should be considered part of a single "project" for purposes of Q&A-6 of the temporary regulations and § 168(h)(1)(B)(iii), Taxpayer posits that the buildings here are constructed under a common plan, within a reasonable time of each other, located on the same site, and will be used in an integrated manner.

Taxpayer represents that the rehabilitation of the Historic Building and the construction of Building 1 and Building 2 are all part of one plan or scheme to redevelop part of a Zone (see Representation 2). We have no facts or reason to doubt or challenge this representation. For instance, early plans done by landscape architects envision this area as a single development. Further, a single architect will serve as the site plan architect for the Site. There will be a consistent architectural theme and landscape design throughout the Site.

The submission also indicates that the construction of Building 1, the renovation of the Historic Building, and the construction of Building 2 will all be completed within a reasonable time of each other. Construction work on the Historic Building and Building 2 was to begin within approximately twelve months following completion of construction of Building 1. However, commencement of this construction will be delayed due to the complexities of the negotiations between the parties. Nevertheless, planning for renovation of the Historic Building and construction of Building 2 began before completion of construction of Building 1.

The facts show that these buildings will be constructed on the same site (i.e., the Site) separated only by public streets and the Station, which will serve as the focal point of this development. Building 1, the Station, the Historic Building and Building 2 will be

interconnected through a sky bridge, walkways, bus service, transportation tunnel, etc. These buildings are all located within the same, discreet Zone.

Lastly, the facts in the submission indicate that Operating Company will operate the various components of the Site in an integrated manner. For instance, the Operating Company will market and manage the Site as a single development, seeking economies of scale and the benefits of a significant amount of diverse space available for lease at one site.

The Taxpayer's facts and representations support the treatment of the development as "one project" being constructed pursuant to a common plan that will be completed within a reasonable time, on the same site and used in an integrated manner. Based upon these facts and representations concerning whether the development is one "property" within the meaning of that term in Q&A-6, we conclude that the Historic Building, Building 1, and Building 2 constitute one "property" for purposes of the 35-percent rule in § 168(h)(1)(B)(iii).

We also note that Building 2 and Building 1 will be newly-constructed improvements to land and will be separate properties from the original, no longer existing structures. As a result of the application of the separate improvements rule in § 168(h)(1)(B)(iv), the Use After Transfer Rule of § 168(h)(1)(B)(ii)(IV) will not apply to Building 1 or Building 2, which will not be used or occupied by Government Entity 2 (or a related party) prior to transfer to the Operating Company. See Report of the Senate Finance Committee, S. Rpt. No. 98-169 (1984) to the Deficit Reduction Act of 1984, at pages 129-132.

According to the figures for net rentable floor space provided by the Taxpayer, the percentage of the "property" subject to a disqualified lease is approximately Z percent (i.e., determined by a fraction the numerator of which is the net rentable floor space of the Historic Building (B square feet) and the denominator of which is the total net rentable floor space of the entire project (D square feet)), which is less than the 35 percent threshold in § 168(h)(1)(B)(iii). Consequently, no portion of the Historic Building, Building 1 or Building 2 will be treated as "tax-exempt use property" under § 168(h)(1)(B).

We therefore rule that with respect to the Taxpayer's first ruling request, neither the Historic Building nor any part thereof nor any of the improvements to be made in rehabilitating the Historic Building will be treated as "tax-exempt use property" under §§ 168(h)(1)(B)(i) of the Code. We further rule that with respect to the Taxpayer's second ruling request No. 2, for purposes of applying § 168(h)(1)(B) to Taxpayer's rehabilitation and leasing of Historic Building, the "property" will include all of the net rentable floor space in the Historic Building, Building 1 and Building 2.

Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any aspect of the transaction described above under any other

provision of the Code, including § 47. Accordingly, no opinion is expressed regarding whether the rehabilitation of Historic Building is a "substantial rehabilitation" or a "certified rehabilitation" within the meaning of the applicable rehabilitation credit provisions under § 47, or whether expenditures incurred to rehabilitate Historic Building are "qualified rehabilitation expenditures" under those provisions.

This ruling is directed only to the taxpayer on whose behalf it was requested. Section 6110(k)(3) provides that it may not be cited or used as precedent.

In accordance with the power of attorney, we are sending copies of this letter to your authorized representatives. We are also sending a copy of this letter to the SB/SE Official.

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.

A copy of this letter must be attached to any income tax return to which it is relevant. Alternatively, taxpayers filing their returns electronically may satisfy this requirement by attaching a statement to their return that provides the date and control number of the letter ruling.

The rulings contained in this letter are based upon information and representations submitted by Taxpayer and accompanied by a penalty of perjury statement executed by an appropriate party. While this office has not verified any of the material submitted in support of the request for rulings, it is subject to verification on examination.

Sincerely,

William A. Jackson
Branch Chief, Branch 5
Office of Chief Counsel
(Income Tax & Accounting)