

Internal Revenue Service

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Person To Contact:
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Legend

X =

Y =

State =

Product A =

Lessee A =

Feedstock A =

Feedstock B =

Location =

n1 =

n2 =

n3 =

n4 =

n5 =

n6 =

Dear _____ :

This letter responds to a letter dated December 22, 2016, and subsequent correspondence, submitted on behalf of X by X's authorized representative, requesting rulings under section 7704(d)(1) of the Internal Revenue Code (Code).

FACTS

X is a State law corporation. Y is a State law limited liability company wholly owned by X, interests in which may be sold in an initial public offering. X represents that Y will be engaged in the production and marketing of Product A, a nitrogen-based fertilizer. X represents that Y will sell Product A in bulk to customers operating in agricultural and non-agricultural industries. X further represents that all of the Product A produced by Y is marketable as fertilizer for agricultural purposes.

X owns an n1-acre campus and entered into a ground lease with Lessee A with respect to a portion of the campus (the "Site"). Lessee A owns and operates a processing plant on the property it leases from X. In addition to the land, the campus has utilities infrastructure for providing electricity, water, and sewage services to Lessee A. X intends to transfer to Y the assets currently owned by X, including the property leased to Lessee A and assign the Amended Lease to Y.

Flat Rent and Percentage Rent

Under the Amended Lease, in consideration for the use of, or the right to use, a portion of the Site, Lessee A will pay an amount equal to the sum of the Flat Rent currently called for under the lease, the Feedstock A Percentage Rent, and the Feedstock B Percentage Rent (the Feedstock A Percentage Rent and the Feedstock B Percentage Rent together referred to as the "Percentage Rent"). The Flat Rent is equal to \$n2. The Feedstock A Percentage Rent is equal to n3% of Lessee A's sales of Feedstock A to Y. The Feedstock B Percentage Rent is equal to a percentage of Lessee A's sales of Feedstock B to Y. The percentage with respect to the Feedstock B Percentage Rent is equal to the following formula: the difference between the market price agreed upon by the parties of Feedstock B and the current price of Feedstock B (\$n4) divided by the market price of Feedstock B.

The Fees

In addition to the Flat Rent and Percentage Rent, Lessee A pays the Utilities Overhead Fee of \$n5 per year subject to a consumer price index adjustment, for certain utilities

overhead. Lessee A also pays the Pollution Control Fee to cover the overhead and maintenance of the sewage treatment system at a charge of \$n6 per thousand gallons of effluent emanating directly from Lessee A's operations. X charges Lessee A for maintaining X's infrastructure in the manner described in this letter. X represents that the maintenance performed by X is only with respect to the infrastructure owned by X, not the infrastructure owned by Lessee A.

Infrastructure

X owns wires and other electrical infrastructure (electrical panels, breakers, switchgear and poles) that carry electricity from a substation located on X's campus, but owned by the local utility, to X's tenants. X's electrical infrastructure connects to Lessee A's infrastructure at the border of Lessee A's ground lease and the electrical infrastructure that carries electricity within the bounds of Lessee A's ground lease is owned by Lessee A.

Water arrives on the campus through underground pipes owned by X, which transport water from the Location. Water is then carried to Lessee A's plant through pipes located beneath the land subject to the ground lease. Ownership of the water piping system is divided at the point where Lessee A's ground lease starts, so that pipes outside of the ground lease area are owned by X and those within the ground lease area are owned by Lessee A. The structures owned by X that are related to the provision of water to tenants include water pipes and pumps and a water clarifier. X represents that the amount of water supplied by the _____ is grossly inadequate to provide the water needed by Lessee A for its processing activity.

Sewage is carried away from Lessee A's plant through X's underground drainage system consisting of piping and various sump pumps. Similar to water pipes, ownership of sewage pipes is divided at the perimeter of Lessee A's ground lease area.

Fees for Services

The Utilities Overhead Fee covers Lessee A's share of the maintenance of the electrical infrastructure owned by X that provides electricity to Lessee A's leased property. The maintenance activities include inspection, cleaning, testing of safety systems, and overhaul and repair of components that can wear out (the "Electric Services"). X does not maintain the infrastructure owned by Lessee A. The Utilities Overhead Fee also covers the infrastructure and maintenance of the water delivery system (the "Water Services"). The Utilities Overhead Fee does not include charges for the actual usage of water.¹ Furthermore, X represents that it is providing water only to its tenants on the campus and no water is being sold to others, such as to neighboring properties

¹ The separate charge for water usage also pays for the treatment of the water.

Lessee A also pays a Pollution Control Fee to cover the infrastructure and maintenance of the sewage treatment system. The sources of the waste that feed into the sewage system consist primarily of two types: (i) sewage and rainwater collection and (ii) waste water that is “blow down/purge” from Lessee A’s cooling towers, boilers, and water purification units. X represents that it is able to isolate and account for the amount of the Pollution Control Fee that comes from each of these two types and will not treat the portion of the Pollution Control Fee that is paid for blowdown/purge as rents from real property. The waste treatment system is used by all tenants as well as X. The Pollution Control Fee does not cover the cost of treating the sewage, only the cost of maintaining the system that allows Lessee A to tie into X’s system and to move Lessee A’s sewage through and along X’s pipes.

X represents that the Electric Services that are paid for as part of the Utilities Overhead Fee and the services that are paid for under the Pollution Control Fee are services that are customarily rendered with respect to similar ground leases within the geographic market where the land is located. However, the immediate geographic area does not contain a similar industrial complex with ground leases for Feedstock A and fertilizer plants and sharing of feedstock and product among multiple manufacturers within one campus that requires the Water Services. X further represents that it is customary to provide the Water Services to lessees at similar industrial parks located in remote areas and if a similar industrial park were constructed in the geographic area, the owner would also need to provide such services.

LAW AND ANALYSIS

Section 7704(a) provides a general rule that, except as provided in section 7704(c), a publicly traded partnership shall be treated as a corporation.

Section 7704(b) provides that the term “publicly traded partnership” means any partnership if (1) interests in that partnership are traded on an established securities market, or (2) interests in that partnership are readily tradable on a secondary market (or the substantial equivalent thereof).

Section 7704(c)(1) provides that § 7704(a) does not apply to a publicly traded partnership for any taxable year if such partnership meets the gross income requirements of § 7704(c)(2) for the taxable year and each preceding taxable year beginning after December 31, 1987, during which that partnership (or any predecessor) was in existence.

Section 7704(c)(2) provides, in relevant part, that a partnership meets the gross income requirements of § 7704(c)(2) for any taxable year if 90 percent or more of the gross income of the partnership for the taxable year consists of qualifying income.

Section 7704(d)(1)(C) defines the term “qualifying income” to include real property rents, among other sources. Under section 7704(d)(3)(A), the term “real property rent” means amounts which would qualify as rent from real property under section 856(d) if such section were applied without regard to paragraph (2)(C) thereof (relating to independent contractor requirements) (emphasis added).

Section 7704(d)(1)(E) provides that the term “qualifying income” includes income and gains derived from the exploration, development, mining or production, processing, refining, transportation (including pipelines transporting gas, oil, or products thereof), or the marketing of any mineral or natural resource (including fertilizer, geothermal energy, and timber).

The Conference Report accompanying the Omnibus Budget Reconciliation Act of 1987 states:

Income and gains from certain activities with respect to minerals or natural resources are treated as passive-type income. Specifically, natural resources include fertilizer, geothermal energy, and timber, as well as oil, gas or products thereof. For this purpose, fertilizer includes plant nutrients such as sulphur, phosphate, potash, and nitrogen that are used for the production of crops and phosphate-based livestock feed.

H.R. Rep. No. 495, 100th Cong., 1st Sess. 943 (1987), 1987-3 C.B. 946-47.

Section 856(d)(1) provides that “rents from real property” include (subject to exclusions provided in section 856(d)(2)): (A) rents from interests in real property; (B) charges for services customarily furnished or rendered in connection with the rental of real property, whether or not such charges are separately stated; and (C) rent attributable to personal property leased under, or in connection with, a lease of real property, but only if the rent attributable to the personal property for the taxable year does not exceed 15 percent of the total rent, based on the average fair market values of the real property and personal property, for the taxable year attributable to both the real and personal property leased under, or in connection with, such lease.

Section 856(d)(2)(A) provides that rents from real property do not include amounts received or accrued, directly or indirectly, 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 of sales).

Section 856(d)(2)(C) provides that any impermissible tenant service income is excluded from the definition of “rents from real property.” Section 856(d)(7)(A) defines “impermissible tenant service income” to mean, with respect to any real or personal

property, any amount received or accrued directly or indirectly by the REIT for services furnished or rendered by the REIT to the tenants of such property, or for managing or operating the property.

Section 856(d)(7)(C) provides certain exclusions from impermissible tenant service income. Section 856(d)(7)(C) provides that for purposes of section 856(d)(7)(A), (i) services furnished or rendered, or management or operation provided, through an independent contractor from whom the REIT does not derive or receive any income or through a taxable REIT subsidiary ("TRS") of the REIT shall not be treated as furnished, rendered, or provided by the REIT, and (ii) there shall not be taken into account any amount which would be excluded from unrelated business taxable income under section 512(b)(3) if received by an organization described in section 511(a)(2).

Section 1.856-4(a) of the Income Tax Regulations provides, in relevant part, that 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 real estate investment trust ("REIT").

Section 1.856-4(b)(1) of the Income Tax Regulations provides that the term "rents from real property" includes charges for services customarily furnished or rendered in connection with the rental of real property, whether or not the charges are separately stated. Services furnished to the tenants of a particular building will be considered customary if, in the geographic market in which the building is located, tenants in buildings of a similar class are customarily provided with the service. In particular geographic areas where it is customary to furnish electricity or other utilities to tenants in buildings of a particular class, the submetering of those utilities to tenants in such buildings will be considered a customary service.

Section 1.856-4(b)(3) of the Income Tax Regulations provides that no amount received or accrued, directly or indirectly, with respect to any real property qualifies as "rents from real property" where the determination of the amount depends in whole or part on the income or profits derived by any person from the property. However, any amount so accrued or received 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.

The Flat Rent and Percentage Rent qualify as rents from real property as rent from an interest in real property, the Site. Furthermore, the Flat Rent and Percentage Rent are not excluded from rents from real property as rents depending in whole or part on the income or profits derived by any person from the property because the Percentage Rent is based on a fixed percentage of sales.

Section 7704(d)(3)(A) directs us to apply the definition of the term "rents from real property" set forth in section 856(d) without regard to paragraph (2)(C) thereof (relating to independent contractor requirements). Accordingly, publicly traded partnerships are not bound by the requirement that income from customary services must be either

performed by an independent contractor or be services that would be excluded from unrelated business taxable income under section 512(b)(3) to qualify as real property rent. Therefore, income earned for customary services furnished or rendered by a publicly traded partnership in connection with the rental of real property may constitute real property rent for purposes of section 7704(d)(3) without regard to the impermissible tenant service income rules and exceptions under section 856(d)(7). Since the Fees are earned in connection with the lease of real property to Lessee A, and X represents that the services performed for the Fees are services customarily furnished or rendered in connection with the rental of real property of a similar class in the geographic area in which the subject real property is located, the Fees constitute real property rents for purposes of section 7704(d)(3).

CONCLUSION

Based solely on the materials submitted and the representations made, we conclude that income derived by Y from the production, storage, transportation, and marketing of Product A to both agricultural and non-agricultural customers is qualifying income for purposes of section 7704(d)(1)(E). This ruling only applies, however, to the extent that the products in question are of a grade that is consistent with industry standards for agricultural uses as a fertilizer and such product in the form sold is commonly sold and used as a fertilizer. In addition, this ruling does not apply to retail sales made directly to end users.

We also rule that the Flat Rent and Percentage Rent constitute rents from real property. Furthermore, the income from the Fees as payment for the enumerated services performed under the Agreement in connection with the rental of real property constitute rents from real property as charges for services customarily furnished or rendered in connection with the rental of real property under section 856(d)(1)(B), without regard to whether such amounts are excluded as impermissible tenant service income under section 856(d)(2)(C). Therefore, the Fees constitute qualifying income under section 7704(d)(1)(C) as “real property rents” within the meaning of that section.”

Except as specifically provided, we express or imply no opinion as to the federal tax consequences of any aspect of any transaction or items discussed or referenced in this letter. In particular no opinion is express as to whether Y will meet the 90 percent gross income requirement of section 7704(c)(1) or whether any other type of income not addressed in this ruling is qualifying income under section 7704(d). In addition, no opinion is expressed or implied as to the application of section 856(d) in any other context.

This ruling is directed only to the taxpayer requesting it. However, in the event of a technical termination of Y under section 708(b)(1)(B), the resulting partnership may continue to rely on this ruling in determining its qualifying income under section

7704(d)(1). 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,

Laura C. Fields

Laura C. Fields
Senior Technician Reviewer, Branch 1
Office of the Associate Chief Counsel
(Passthroughs & Special Industries)

Enclosures (2)
Copy of this letter
Copy for § 6110 purposes

cc: