199952084

Internal Revenue Service

Department of the Treasury

Index Number: 856.04-00

Washington, DC 20224

Person to Contact:

Telephone Number:

Refer Reply To:
CC:DOM:FI&P:2-PLR-103427-99
Date:
September 30, 1999

LEGEND:

Trust =

State A =
City A =
a =
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This letter responds to your submission dated February 2, 1999, and subsequent correspondence, in which you requested rulings on behalf of Trust, a State A business trust that has elected to be taxable as a real estate investment trust ("REIT") pursuant to section 856(c)(1) of the Internal Revenue Code.

FACTS

A. The Trust

Trust invests in office and industrial properties primarily located in the City A metropolitan area. Trust owns approximately a% of the common units and all of the preferred units in an operating partnership ("OP") that acquires, holds and manages income producing commercial office buildings and industrial properties. OP owns these properties through single member limited liability companies ("LLCs") and interests in limited partnerships ("LPs") or LLCs, which are treated as partnerships for Federal income tax purposes. Generally, OP owns b% or more of the partnership or member interests. The remaining interest is owned by Trust or a qualified REIT subsidiary as defined in section 856(i). OP also owns all of the non-voting preferred stock of a corporation ("PSS"), the voting stock of which is owned by officers of Trust. PSS is

currently engaged in third party construction, management, leasing and other service businesses.

OP proposes to provide some or all of the real estate development, engineering, architectural and construction activities in connection with both its existing properties and properties that it intends to build for itself or acquire in the future (OP's existing and future acquired properties, collectively, "Property" or the "Properties"). OP and/or PSS are partners and/or may become partners in joint ventures ("JV Partnerships") with third parties to own, acquire and/or construct real property ("JV Properties") and provide management, construction, and development services with respect to these JV Properties. Trust represents that these arrangements will be entered into for the purpose of long-term investment in real property and not with the intent to sell developed property to third parties. All services provided to the Properties will also be provided to the JV Properties.[1]

In connection with this ruling, Trust represents that all property management, capital improvement and other activities described below are customarily provided to tenants by owners of rental properties of a similar class and located in the same geographical area as the Properties within the meaning of section 856(d)(1)(B). Additionally, Trust represents that any noncustomary services will be provided by third-party independent contractors within the meaning of section 856(d)(3) from whom neither Trust nor the OP will derive any income. To the extent that services (other than those customarily furnished or rendered in connection with the rental of real property) are rendered to the tenants of the property, the cost of the services will be borne by the independent contractor, a separate charge will be made for the services, the amount of the separate charge will be received and retained by the independent contractor and the independent contractor will be adequately compensated for the services.

B. Property Management and Other Activities

1. Lease Administration and Accounting Functions

OP and/or PSS employees (the "Employees") intend to solicit prospective tenants, draft and negotiate terms of leases (and renewals) with new and existing tenants, perform billing, bookkeeping and lease tracking functions, collect and deposit rents and account for other property and lease receipts and disbursements. The Employees may ensure compliance with lease terms and enforce remedies against tenants in default, handle inquiries and complaints, conduct credit and reference checks, and market and advertise the Properties. The Employees may also negotiate

[1] Hereinafter, the term "Property" or "Properties" includes "JV Properties."

and execute contracts in connection with managing and operating the Properties, including contracts for water, sewer, electricity, gas, telephones, security, pest control, and elevator and boiler maintenance.

2. Utility Services

OP provides or intends to provide utility services such as electricity, gas and water to its tenants. OP will charge its tenants for their estimated allocable share of electricity, gas and water as provided in each tenant's lease. In certain Properties, OP may "master meter" water and sewer services. In this regard, OP may purchase electricity and gas at wholesale rates and then submeter such utilities at retail rates to its tenants and may make a profit on the provision of such service. OP also anticipates including an allocable share of its administrative overhead at cost in providing such services.

OP will furnish heat, light, air conditioning, ventilation, storm and sanitary drainage. OP may charge tenants for after business hours air conditioning or heat, which may result in a lower common area maintenance charge for the remaining tenants who do not utilize such services. OP will include a profit factor in any such charge.

3. Other Property Services

In the common areas, OP will furnish background music, snow removal, pest control, landscaping services, fire protection (e.g., sprinklers and alarms), and sprinkler systems. OP will supply tenants with a telephone number for tenants' use in communicating information regarding the Properties. OP will provide for trash collection by a waste management company. OP also will provide maintenance and repair services, such as repairing and repainting buildings and other structures, repairing roofs, repairing, resurfacing and restriping parking lots, and repairing and replacing ducts, conduits and similar items.

Additionally, OP will provide regularly scheduled painting within the tenant's space as specified in the lease. For example, a typical lease provides for regularly scheduled maintenance painting once during the lease term, which on average is ten years. Trust represents that no touch-up or decorative painting will be provided by the Trust to its tenants.

4. Telecommunication Services

OP will permit local telephone companies to provide pay telephones in exchange for a rental fee for the telephone space. OP will not be responsible for the installation, maintenance and repair of such telephones.

OP intends to enter into cable lease and easement agreements with third parties such as internet service providers, broadcasters, long distance operators and other service providers (the "Companies"). The Companies will place antennas (including microwave antennas), cable, terminals and other cable-related equipment on the Properties. The agreements will permit Companies to service equipment on the Properties. OP may also grant an exclusive easement to the Companies to enter the common areas to maintain the equipment.

The Companies will provide telecommunication services to the tenants of the Properties. Telecommunication services include the transmission and provision of telephone and other communications, cable, e-mail, video communications, electronic research, internet access, communications networking, safety and security systems and environmental control systems. Employees or the Companies will install a network of voice, video and data communication systems. The systems will be owned either by OP or by the Companies. OP will either receive an access fee from the Companies or OP will charge the Companies a percentage of the Company's gross sales for providing telecommunication services to tenants.

OP will not directly solicit its tenants with respect to cable, antenna or internet transmission services. However, OP may sell Companies advertisement space in the Trust's newsletter or make available informational brochures. Trust will treat the income from the sale of the advertisement space as income that does not qualify under section 856(c).

Trust represents that the telecommunication services provided to tenants of the Properties are similar to the provision of services by public utilities and are essential for business communications and information transmission. Trust also represents that the telecommunication services provided to tenants of the Properties are not customized to fit the specific needs of a particular tenant. The tenants are offered a menu of services that are generally available to other customers of a telecommunication provider.

5. Other Leasing Activity

OP may rent space and furnish utilities at the Properties to third party suppliers for vending machines in the common areas (e.g., soda machines, newspaper racks, and automatic teller machines). The third party suppliers will be solely responsible for

installing, maintaining and repairing such vending machines. The Employees, or independent service providers under the Employees' supervision, may provide general maintenance in the area around the telephone or vending machines.

OP will lease a portion of its Properties to tenants and/or non-tenants for the right to use a portion of its Properties to erect billboards in exchange for rent.

OP intends to lease executive office space to a third party tenant ("Primary Tenant"). The Primary Tenant will sublet the office space to other tenants ("Sub Tenants"). Each Sub Tenant will lease its portion of the occupied space on that floor. The Primary Tenant will receive a base rent amount and may receive additional amounts based on the Sub Tenant's gross receipts. OP will derive rent from the Primary Tenant equal to a fixed base rent plus a percentage of the Primary Tenant's gross receipts.

OP also intends to lease conference rooms located on the Properties to tenants of that Property. OP will only provide basic room set-up and clean-up services for the use of the conference rooms. The set-up will include making sure the correct number of tables and chairs are available in the room. OP will charge for the use of the conference room on a short-term rental basis.

OP intends to lease space to a third-party concierge service company pursuant to an arm's length negotiation. The concierge company operates as an independent business under its own name and offers its services to the general public as well as to Trust's tenants. Tenants will separately contract with the concierge company. No fee will be charged to the tenants by OP for the presence of the concierge company.

6. Parking Services

Generally, OP will provide parking lots for its tenants and their customers and guests on a no-charge and unreserved basis. In some cases, a parking fee will be charged. The fee will be either separately identified in the monthly rent or included in the total of the monthly rent payment.

At some Properties, OP anticipates that leases may entitle tenants to a specified number of reserved parking spaces assigned to them for no additional fee. At some Properties, tenants may be entitled to the exclusive use of a specified number of spaces, but they have no claim to any particular spaces. At all Properties, certain spaces will be reserved for the handicapped, as required by federal, state, or local law. OP will also provide maintenance, lighting and snow removal for the parking lots.

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7. Engineering and Janitorial Services

Employees will perform routine common area janitorial and cleaning services. These services include the cleaning of windows, public entrances, exits, stairwells, lobbies and restrooms. Employees will also provide emergency janitorial services, which tenants may not be equipped to handle and for which an independent contractor would be impracticable.

Employees will repair and maintain the common area ceilings, walls, stairs, stairwells, hallways, doors, floors, floor coverings, moldings, door strikes and kickplates. Employees will repair or replace overhead and other general light switches and outlets, lighting fixtures, lightbulbs, ballasts and speakers. Employees may design, produce and hang signage in the common areas and lobbies, though independent contractors will perform the actual construction. OP intends to allow regularly scheduled carpet cleaning within tenant space during tenant occupancy to be performed by an independent contractor.

8. Security Related Activities

Employees will provide routine security guard services in the common areas of the Properties for the protection of the Properties, tenants, and their guests and customers. At certain Properties, the Employees may provide 24-hour security service in the common areas of the Properties. Employees will also provide ordinary and necessary security repairs to card access mechanisms, door strikes and security system wire cables in the common areas up to and including the perimeter of leased space.

Employees will repair or replace broken or damaged locks within common areas up to and including the perimeter of leased space. Employees will also repair or replace broken or damaged locks within tenant space where the locks are part of a building-wide system. For example, in certain properties, office buildings utilize a master key system where all lock cores in a building, including tenant offices, are keyed off of a "grand master." Buildings are keyed in this fashion to comply with the applicable fire code and regulations, as well as for security reasons.

C. Capital Improvement Activity

OP and/or PSS intend to perform capital improvements for certain Properties. Capital improvements are part of the creation of space necessary for a landlord to lease real property to prospective tenants. OP and/or PSS will pay for a certain amount of capital improvements at the tenant specified space ("Capital Payment"). The Capital

Payment is provided for in the lease and is then factored into the future rent stream, an amount which is market driven.

Capital improvements occur solely as an inducement for a prospective tenant to enter into a lease arrangement (including renewals and lease extensions) and are part of an up-front negotiation between the landlord and tenant. Substantially all of the improvements are performed prior to, and as a condition to, each tenant's occupancy and rent obligation. Trust represents that any capital improvements that exceed the Capital Payment will be performed by an independent contractor.

D. Joint Venture Activity

OP and/or PSS are partners in JV Partnerships with third parties to acquire or construct real JV Property for itself and provide management, construction, or development services with respect to these JV Properties. In these arrangements, OP or PSS will hold a fixed or varying capital and profits interest in the JV Partnerships, with the remaining interest held by third parties. The Trust will have a substantial ownership interest in properties held by the JV Partnership based on Trust's capital interest in OP. OP and/or PSS, as partners in the JV Partnerships, are and/or will be entitled to fee income from the JV Partnership for the performance of certain services. The fee income may be derived from lease commissions, construction supervision fees, management fees, project management fees, development fees, loan guarantee fees and property management fees ("Fee Income").

LAW AND ANALYSIS

Section 856 provides that to qualify as a REIT, a corporation must: (1) derive at least 95% of its gross income (excluding gross income from prohibited transactions) from sources listed therein which include dividends, interest, rents from real property and certain other items; (2) derive at least 75% of its gross income (excluding gross income from prohibited transactions) from sources listed therein which include rents from real property and certain other items; and (3) have at least 75% of the value of its assets represented by real estate assets, cash and cash items (including receivables) and government securities.

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 both the real and personal property leased under, or in connection with, a lease of real property, but only if the rent attributable to such personal property for the

taxable year does not exceed 15 percent of the total rent for the year attributable to both the real and personal property leased under, or in connection with, such lease.

Section 856(d)(2)(C) excludes from the definition of "rents from real property"' any impermissible tenant service income as defined in section 856(d)(7). Section 856(d)(7)(A) provides, in relevant part, that the term impermissible tenant service income means, with respect to any real or personal property, any amount received or accrued directly or indirectly by the real estate investment trust for managing or operating such property. Section 856(d)(7)(B) provides that de minimis amounts of impermissible tenant service income, i.e., amounts less than one percent of all amounts received or accrued by the REIT with respect to a particular property during the taxable year, will not cause otherwise qualifying amounts to not be treated as rents from real property.

Section 856(d)(7)(C) excludes from the definition of impermissible tenant service income amounts received for services furnished or rendered, or management or operation provided, through an independent contractor from whom the trust itself does not derive or receive any income. Similarly, subparagraph (C) excludes amounts that 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 512(b)(3) provides, in part, that there shall be excluded from the computation of unrelated business taxable income all rents from real property and all rents from personal property leased with such real property, if the rents attributable to such personal property are an incidental amount of the total rents received or accrued under the lease, determined at the time the personal property is placed in service.

Section 1.512(b)-1(c)(5) provides that payments for the use or occupancy of rooms and other space where services are also rendered to the occupant, such as for the use or occupancy of rooms or other quarters in hotels, boarding houses or apartment houses furnishing hotel services, or in tourist camps or tourist homes, motor courts or motels, or for the use or occupancy of space in parking lots, warehouses or storage garages, do not constitute rent from real property. Generally, services are considered rendered to the occupant if they are primarily for the tenant's convenience and are other than those usually or customarily rendered in connection with the rental of rooms or other space for occupancy only. The supplying of maid service, for example, constitutes such service; whereas the furnishing of heat and light, the cleaning of public entrances, exits, stairways and lobbies, and the collection of trash are not considered as services rendered to the occupant. Payments for the use or occupancy of entire private residences or living quarters in duplex or multiple housing units or offices in an office building are generally treated as rent from real property.

Rev. Rul. 69-178, 1969-1 C.B. 158, holds that amounts received by an exempt organization for the occasional use by others of its meeting hall are "'rents from real property'" within the meaning of section 512(b)(3). The only services provided by that exempt organization consisted of the provision of utilities and janitorial services. Rev. Rul. 80-297, 1980-2 C.B. 196, holds that the leasing of tennis facilities to a third party without services and for a fixed fee is excluded from unrelated business taxable income as rent from real property under section 512(b)(3) and the regulations thereunder. Rev. Rul. 80-298, 1980-2 C.B. 197, holds that income from the lease of a football stadium by an exempt university to a professional football team is not excluded from unrelated business taxable income as rent from real property under section 512(b)(3) and the regulations thereunder because the university provided substantial services for the convenience of the team.

The Report of the Conference Committee on the Tax Reform Act of 1986, H.R.Rep. No. 99-841, 99th Cong., 2d Sess. 1 (1986), 1986-3 (Vol. 4) C.B. 1, 220, in discussing section 856(d)(2)(C), provides that:

> The conferees wish to make certain clarifications regarding those services that a REIT may provide under the conference agreement without using an independent contractor, which services would not cause the rents derived from the property in connection with which the services were rendered to fail to qualify as rents from real property (within the meaning of section 856(d). The conferees intend, for example, that a REIT may provide customary services in connection with the operation of parking facilities for the convenience of tenants of an office or apartment building, or shopping center, provided that the parking facilities are made available on an unreserved basis without charge to the tenants and their guests or customers. On the other hand, the conferees intend that income derived from the rental of parking spaces on a reserved basis to tenants, or income derived from the rental of parking spaces to the general public, would not be considered to be rents from real property unless all services are performed by an independent contractor. Nevertheless, the conferees intend that the income from the rental of parking facilities properly would be considered to be rents from real property (and not merely income from services) in such circumstances if services are performed by an independent contractor.

Section 1.856-4(b)(1) provides that services provided to tenants of a particular building will be considered customary if, in the geographic market in which the building is located, tenants in buildings which are of a similar class are customarily provided with the service. Such services include the furnishing of water, heat, light, air conditioning and telephone answering services. Where it is customary in a particular geographic

marketing area to furnish electricity or other utilities to tenants in buildings of a particular class, the submetering of such utilities to tenants in such buildings will be considered a customary service.

Section 1.856-4(b)(5)(ii) provides that trustees or directors of the REIT are not required to delegate or contract out their fiduciary duty to manage the trust itself, as distinguished from rendering or furnishing services to the tenants of its property or managing or operating the property. Thus, the trustees or directors may do all those things necessary, in their fiduciary capacities, to manage and conduct the affairs of the trust itself including establishing rental terms, choosing tenants, entering into renewal of leases, and dealing with taxes, interest and insurance relating to the REIT's property. The trustees or directors may also make capital expenditures with respect to the REIT's property and may make decisions as to repairs of the property the cost of which may be borne by the REIT. See also Rev. Rul. 67-353, 1967-2 C.B. 252.

In this case, Trust represents that all capital improvement, property management and other activities described above are customarily provided to tenants by owners of rental properties of a similar class and located in the same geographical area as the Properties within the meaning of section 856(d)(1)(B). To the extent Trust's capital improvement activity does not exceed the agreed upon Capital Payment that is provided for in each lease and then factored into the future rent stream, such activity will not be considered rendered primarily for the convenience of the tenants under section 1.512-1(c)(5) for purposes of section 856(d)(7). The property management and other activities described above also are not rendered primarily for the convenience of the tenants. As a result, the services fall within the exception provided in section 856(d)(7)(C)(ii).

Section 1.856-3(g) provides, in part, that in the case of a REIT which is a partner in a partnership, as defined in section 7701(a)(2) and the regulations thereunder, the REIT 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 shall 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.

Based on section 1.856-3(g), a REIT's share of income and assets in a partnership includes its proportionate share of income and assets based on that partnership's capital interest in a lower-tier partnership. Accordingly, for purposes of section 856 of the Code, Trust will be deemed to receive its proportionate share of OP's income, which will include OP's share of JV Partnership's Fee Income.

Subject to certain exceptions, section 1.856-4(a) defines the term "rents from real property" generally to mean the gross amounts received for the use of, or the right to use, real property of the REIT. Gross amounts are generally not reduced for items such as management fees.

As determined under section 1.856-3(g), to the extent the Fee Income is proportionate to the Trust's deemed ownership in the JV Properties, Fee Income will already be reflected in Trust's share of rents from the JV Properties. Thus, this portion of the Fee Income will not be treated as a separate item of gross income and, therefore, will be disregarded for purposes of applying the gross income tests under sections 856(c)(2) and 856(c)(3). The amount of the Fee Income that is derived from services performed for other partners in the JV Partnerships will be treated as other than "rents from real property" for purposes of section 856.

CONCLUSIONS

Based on the facts as represented by the Trust, we rule that:

(1) The property management and other activities to be performed at the Properties by OP and/or PSS employees will not cause otherwise qualifying "rents from real property" to be excluded under section 856(d)(2)(C).

(2) The capital improvement activity performed by the Employees with respect to certain Properties, to the extent such activity does not exceed the agreed upon Capital Payment that is specified in each lease and factored into the future rent stream, will not cause otherwise qualifying "rents from real property" to be excluded under section 856(d)(2)(C).

(3) As determined under section 1.856-3(g), the Trust's allocable share of amounts received by OP as fees for property management and other activities described above will qualify as "rents from real property" within the meaning of section 856(d).

(4) As determined under section 1.856-3(g), the Trust's allocable share of amounts received by OP for capital improvement activity, to the extent such activity does not exceed the agreed upon Capital Payment that is specified in each lease and factored into the future rent stream, will qualify as "rents from real property" within the meaning of section 856(d).

(5) As determined under section 1.856-3(g), the Trust's allocable share of Fee Income generated by the JV Partnerships will be disregarded for

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purposes of the gross income tests under section 856. The amount of the Fee Income that is derived from services performed for other partners in the JV Partnerships will be treated as other than "rents from real property" for purposes of section 856.

Except as specifically set forth above, no opinion is expressed regarding the federal tax consequences of the transactions described above under any other provision of the Code. Specifically, no opinion is expressed regarding the qualification of the Trust as a REIT for federal tax purposes. Furthermore, no opinion is expressed concerning whether Trust meets the ten percent voting securities limitation of § 856(c)(4)(B) through its interest in PSS or whether Trust's subsidiaries qualify as qualified REIT subsidiaries under section 856(i).

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

A copy of this letter should be attached to the federal income tax returns of the Trust for the taxable year in which the transactions covered by this ruling are consummated.

In accordance with the power of attorney on file, we are sending this letter to the Trust's authorized representatives.

Sincerely,

Assistant Chief Counsel
(Financial Institutions & Products)

By: William E. Coppersmith
William E. Coppersmith
Chief, Branch 2