

INTERNAL REVENUE SERVICE  
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October 28, 1998

Legend:

Company =

Partnership =

State A =

State B =

State C =

State D =

State E =

Year a

X% =

Y% =

Z% =

This responds to a letter dated October 27, 1997, and subsequent communications submitted on behalf of the Company, a State A corporation 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**

Through its Z% general partnership interest in the Partnership the Company is engaged in the ownership, operation, leasing, acquisition and management of certain office properties (the Properties) located in States B, C, D, and E. The tenants of the Properties represent a broad cross-section of the businesses and firms operating in the Company's geographic area. Also through the Partnership, the Company owns, manages and leases two multi-family residential rental properties. Each of the Properties is held by a sub-tier partnership in which the Company holds a 99 percent or more limited partnership interest

with a qualified REIT subsidiary of the Company owning a general partnership interest.

The Company performs substantially all leasing and management activities with respect to the Properties in house. The Properties are leased to tenants on a full-service basis with the landlord being obligated to pay either (i) an amount equal to the tenant's proportionate share of taxes, insurance and operating expenses (including utilities) up to the amount incurred during the tenant's first year of occupancy or (ii) a negotiated amount approximating the tenant's pro rata share of such items. The tenant is obligated to pay its pro rata share of increases in these expenses.

The Company generally employs an on-site manager for each Property and pays independent contractors, as defined in section 856(d)(3) of the Code, to perform maintenance and repair services, both during the lease term and after lease termination, that include landscaping, cleaning, and general maintenance of common areas, painting and HVAC repair. The Company derives no income from these independent contractors.

As part of the process of negotiating a lease for space in one of the Company's properties, prospective Tenants may request tenant improvement work regarding the premises. For such work, the Company generally grants the tenants a specific dollar allowance per square foot, which is taken into account in determining the amount of rent to be paid by the Tenant and is recovered by the Company over the term of the lease. Tenant improvement work generally includes such things as installing window treatments and carpeting or other floor covering, adding or removing walls, reconfiguring office and common space layout, installing the desired lighting and adding or removing HVAC equipment. Company typically hires independent contractors who prepare the plans and perform the physical work. Employees of the Company review the plans and supervise the installation and construction of all tenant improvement work from inception through completion. The purpose of Company's supervision is to maintain the security of its assets by ensuring, the quality of the independent contractor's work, adherence to building code requirements, and timely completion of the work. Company supervision also prevents or minimizes any disturbances to other tenants of the building. In calculating the amount of the tenant improvement allowance, Company includes a fee for its supervisory services that is equal to between X% and Y% of the estimated amount payable to the independent contractors.

In some instances, a tenant may prefer either to pay for the tenant improvement work in a lump sum at the beginning of the lease or to engage the independent contractor directly. In these instances, Company employees provide the same type of supervisory

functions listed above. If the Company engages the independent contractor, the Company will bill the tenant for an amount equal to the fee due the independent contractor plus a fee for the Company's supervisory services equal to between X% and Y% of the amount payable to the independent contractor. Similarly, if the tenant engages and pays the independent contractor directly, the Company bills the tenant for supervisory services performed by the Company's employees.

Company represents that all of the foregoing activities and services furnished and rendered to the Tenants (including all of the construction supervisory services and activities described in connection with construction allowance projects) are customarily furnished or rendered to Tenants in connection with the rental of space in the Properties, both in the geographic area in which the Company operates, and on a nationwide basis.

#### **APPLICABLE LAW**

Section 856(d)(1) of the Code provides that the term "rents from real property" includes (subject to the exclusions in section 856(d)(2)) rents from interests in real property, charges for services customarily furnished or rendered in connection with the rental of real property (whether or not such charges are separately stated) and rent attributable to personal property which is 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 the lease.

Section 856(d)(2)(C) of the Code 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. Subparagraph (A) does not take into account any amount that would be excluded from unrelated

business taxable income under section 512(b)(3) of the Code if received by an organization described in section 511(a)(2) of the Code.

Section 1.856-3(g) of the regulations provides that a REIT which is a partner in a partnership will be deemed (1) to own its proportionate share of each of the assets of the partnership, and (2) to be entitled to the income of the partnership attributable to such share. For the purpose of section 856 of the Code, its interest in the partnership's assets shall be determined in accordance with its capital interest in the partnership.

Section 1.856-4(b)(1) of the regulations 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) of the regulations 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.

#### **ANALYSIS**

The Company is a general partner in the Partnership, owning Z% of the partnership interests in the Partnership. Under section 1.856-3(g) of the 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, whose character in the hands of the partnership retains its character in the hands of the REIT for all purposes of section 856 of the Code. Accordingly, if the services provided to the Properties by the

Company or by its independent contractors are services that a REIT is permitted to perform under sections 856(d)(1)(B) and 856(d)(2)(C) of the Code, then the trust's allocable portion, determined under section 1.856-3(g) of the regulations, of otherwise qualifying income earned by Partnership from the Properties will qualify as "rents from real property" within the meaning of section 856(d)(2) of the Code.

In this case, the Company has represented that it will perform directly only services that are customarily provided to tenants of a similar class of building in the geographic regions in which in which the Properties are located. These services are not rendered primarily for the occupants' convenience and are services that are customarily rendered in connection with the rental of space for occupancy only. Any services that are rendered primarily for the occupants' convenience, or are not customarily rendered in connection with the rental of rooms or space for occupancy only, will be performed by independent contractors. Consequently, the performance by Company and its independent contractors of the services described above will not cause amounts received by the Company in connection with the performance of services by it or the Partnership to fail to qualify as rents from real property.

#### CONCLUSIONS

Based on the facts as represented by the Company, we conclude as follows:

(1) Amounts received by the Company with respect to the performance of the services described above will not cause otherwise qualifying amounts received from tenants to be excluded from the definition of "rents from real property" contained in section 856(d)(2) of the Code.

(2) Amounts received by the Company from tenants with respect to tenant improvement work that is paid to independent contractors who perform the work constitute rents from real property within the meaning of section 856(d) of the Code.

(3) The receipt from tenants, and retention by the Company of amounts in excess of amounts paid to independent contractors for tenant improvement work will not cause any other amounts received from tenants to fail to qualify as rents from real property within the meaning of section 856(d).

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 Company as a REIT for federal tax purposes.

This ruling is directed only to the taxpayer who requested it. Section 6110(k)(3) of the Code 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 Company's authorized representative.

Sincerely yours,

Assistant Chief Counsel  
(Financial Institutions & Products)

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By: William E. Coppersmith  
Chief, Branch 2