

REITs and Tenant Friendly Structures – Private Letter Ruling 200752012

By Daniel F. Cullen

Daniel Cullen provides an overview of the REIT asset and income tests, as well as the specific “real property” and “tenant services” issues addressed in LTR 200752012.

Background

Advances in computer technology and the telecommunications industry have significantly impacted the type of structural components, tenant improvements and related services often desired (or in some cases required) by certain real estate tenants. For example, some high-technology tenants require an uninterrupted, stable source of power for the tenant's space, as well as specified temperature and humidity range requirements. Moreover, it has become common for lease agreements governing such space to provide that the tenants are entitled to reduce their operating-expense reimbursement liability to the landlord, under the lease, if the power source and temperature requirements are not met.

These “tenant-friendly” structures have been around for a while and seem to be growing in popularity. Such structures raise a number of interesting real estate tax issues. A few of these issues were recently addressed in LTR 200752012¹ (the “Ruling”). Specifically, the Ruling addresses whether certain specially outfitted buildings qualify as real property for real estate investment trust (REIT) purposes under Code Sec. 856(c).² In addition, the Ruling evaluates whether certain technology-related services furnished to tenants would cause amounts received by the

REIT's operating partnership to be treated as amounts other than “rents from real property” as required under Code Sec. 856(d).

This article provides an overview of the REIT asset and income tests, as well as the specific “real property” and “tenant services” issues addressed in the Ruling.

REIT Requirements in General

The REIT Asset Requirements

Generally speaking, at the close of each quarter of the REIT's tax year, the REIT generally must satisfy three tests relating to the nature of its assets:

- First, at least 75 percent of the value of a REIT's total assets (the “75-percent Qualified Assets Test”) must consist of interests in real property, interests in mortgages on real property, shares in other REITs, cash, cash items, and government securities (as well as certain temporary investments in stock or debt instruments purchased with the proceeds of new capital raised by the REIT).
- Second, although the remaining 25 percent of a REIT's assets generally may be invested without restriction, securities in this class generally may not exceed either (1) five percent of the value of its total assets as to any one nongovernment issuer, (the “5-percent Value Test”), (2) 10 percent of the outstanding voting securities of any one issuer (the “10-percent Voting Test”), or (3) 10 percent of the value of the outstanding securities of any one issuer (the “10-percent Value Test”).

Daniel F. Cullen is a partner in the Chicago and New York office of Bryan Cave LLP, Chair of the firm's Tax Advice and Controversy Practice, and an adjunct professor of tax law at the DePaul University College of Law.

- Third, not more than 20 percent of the total value of a REIT's assets can be represented by securities of one or more taxable REIT subsidiaries. The securities of a subsidiary (for which a taxable REIT subsidiary (TRS) election has been made) are not subject to the 5-percent Value Test and the 10-percent Voting and Value Tests described above. Instead, a separate asset test applies to TRSs. The rules regarding TRSs contain provisions generally intended to ensure that transactions between a REIT and its TRS occur "at arm's length" and on commercially reasonable terms.³

The Code and regulations provide a notable amount of guidance regarding the definition of "real property." Code Sec. 856 defines the term "real estate assets," in part, to mean 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.⁴ Code Sec. 856 further provides that the term "interests in real property" includes fee ownership and co-ownership of land or improvements thereon, leaseholds of land or improvements thereon, options to acquire land or improvements thereon, and options to acquire leaseholds of land or improvements thereon (but does not include mineral, oil, or gas royalty interests).⁵ Moreover, the regulations under Code Sec. 856 provide that the term "real estate assets" means real property, interests in mortgages on real property (including interests in mortgages on leaseholds of land or other improvements thereon), and shares in other qualified REITs.⁶ The regulations also provide that the term "interests in real property" includes fee ownership and co-ownership of land or improvements thereon, leaseholds of land or improvements thereon, options to acquire land or improvements thereon, and options to acquire leaseholds of land or improvements thereon.⁷ The regulations further provide that:

[T]he term "real property" means land or improvements thereon, such as buildings or other inherently permanent structures thereon (including items that are structural components of those buildings or structures). In addition, real property

includes interests in real property. Local law definitions do not control for purposes of determining the meaning of the term real property as used in Sec. 856 and the regulations thereunder. The term includes, for example, the wiring of a building, plumbing systems, central heating or central air-conditioning machinery, pipes or ducts, elevators or escalators installed in the building, or other items that are structural components of a building or other permanent structure. The term does not include assets accessory to the operation of a business, such as machinery, printing press, transportation equipment that is not a structural component of the building, office equipment, refrigerators, individual air-conditioning units, grocery counters, furnishings of a motel, hotel, or office building, etc., even though those items may be termed fixtures under local law.⁸

Advances in computer technology and the telecommunications industry have significantly impacted the type of structural components, tenant improvements and related services often desired (or in some cases required) by certain real estate tenants.

The definition of "real property" was further developed in Rev. Rul. 75-424,⁹ which addressed whether various components of a microwave transmission system are real estate assets for purposes of Code Sec. 856. In

that ruling, the system consisted of transmitting and receiving towers built upon pilings or foundations, transmitting and receiving antennae affixed to the towers, a building, equipment within the building, and waveguides. The waveguides were transmission lines from the receivers or transmitters to the antennae, and consisted of metal pipes permanently bolted or welded to the tower. The waveguides were never removed or replaced, unless blown off the building by weather. The transmitting, multiplex, and receiving equipment was housed within the building. In addition, pre-wired modular racks were installed in the building to support the equipment that was installed upon them. The racks were completely wired in the factory and then bolted to the floor and ceiling. They were self-supporting and did not depend upon the exterior walls for support. The equipment provided for transmission of audio or video signals through the waveguides to the antennae. Also, installed in the building, was a permanent heating and air conditioning system. The transmission site was

surrounded by chain-link fencing. In light of these (relatively detailed) facts, Rev. Rul. 75-424 held that the building, the heating and air conditioning system, the transmitting and receiving towers, and the fence were all real estate assets for purposes of Code Sec. 856. In contrast, Rev. Rul. 75-424 also concluded that the antennae, waveguides, transmitting, receiving, and multiplex equipment, and the pre-wired modular racks were all assets “accessory” to the operation of a business and, therefore, not real estate assets for purposes of Code Sec. 856.

Rev. Rul. 73-425¹⁰ similarly developed the definition of “real property” for purposes of Code Sec. 856, when it considered whether a mortgage secured by a shopping center and its “total energy system” constituted an obligation secured by real property. Generally speaking, a total energy system is a self-contained facility for the production of all the electricity, steam, or hot water, and refrigeration needs of associated commercial or industrial buildings, shopping centers, apartment complexes, and community developments. In most cases, the system is permanently installed in the building, attached to the building, or may be a separate structure located nearby. The principal components often consist of electric generators powered by turbines or reciprocating engines, waste heat boilers, heat exchangers, gas-fired boilers and cooling units. In addition, each facility includes fuel storage tanks, control and sensor equipment, electrical substations, and air handling equipment for heat, hot water and ventilation. It also includes ducts, pipes, conduits, wiring, and other associated parts, machinery, and equipment. In light of these facts, the ruling held that a mortgage secured by the building and the “total energy system” was a real estate asset, regardless of whether the system was housed in the building it served or in a separate structure apart from the building it served. The ruling derived this conclusion based on the fact that the interest in the related structural component was included with an interest held in a building or inherently permanent structure to which the structural component was functionally related.

REIT Income Requirements

In addition to a number of other statutory requirements outside the scope of this article,¹¹ a REIT must satisfy two separate percentage tests relating to the sources of its gross income for each tax year. For purposes of these tests, where a REIT invests in a partnership, it will be treated as receiving its pro rata

share (based on its capital interest in the partnership) of the gross income and loss of the partnership, retaining the same character in the REIT’s hands as it had in the hands of the partnership.

The 75-Percent Gross Income Test

The first gross income test for a REIT is the “75-percent test” – a requirement that at least 75 percent of the REIT’s gross income for a tax year must be “qualifying income.” Qualifying income generally includes (1) rents from real property (except as modified below); (2) interest on obligations collateralized by mortgages on, or interests in, real property; (3) gains from the sale or other disposition of interests in real property and real estate mortgages, other than gains from property held primarily for sale to customers in the ordinary course of its trade or business (“dealer property”); (4) dividends or other distributions on shares in other REITs, as well as gain from the sale of such shares; (5) abatements and refunds of real property taxes; (6) income from the operation, and gain from the sale, of property acquired at or in lieu of a foreclosure of the mortgage collateralized by such property (“foreclosure property”); (7) commitment fees received for agreeing to make loans collateralized by mortgages on real property or to purchase or lease real property; and (8) income from temporary investments in stock or debt instruments purchased with the proceeds of new capital raised by the REIT.

Code Sec. 856(d) provides that “rents from real property” include (subject to exclusions provided in Code Sec. 856(d)(2)): (1) rents from interests in real property; (2) charges for services customarily furnished or rendered in connection with the rental of real property, whether or not such charges are separately stated; and (3) 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 tax year does not exceed 15 percent of the total rent for the tax year attributable to both the real and personal property leased under, or in connection with, the lease.¹² The regulations further provide 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.¹³

Services rendered to 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 the buildings will be considered a customary service. The regulations provide that the trustees or directors of a 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.¹⁴

For rents received to qualify as rents from real property, the REIT generally must not operate or manage the property or furnish or render certain services to tenants, other than through (1) an “independent contractor” who is adequately compensated and from whom the REIT derives no revenue or (2) through a TRS.¹⁵ The “independent contractor” or TRS requirement, however, does not apply to the extent that the services provided by the REIT are “usually or customarily rendered” in connection with the rental of space for occupancy only and are not otherwise considered “rendered to the occupant.” For both the related-party tenant rules and determining whether an entity qualifies as an independent contractor of a REIT, certain attribution rules apply, pursuant to which ownership interests in certain entities held by one entity are deemed held by certain other related entities.

In addition, Code Sec. 856(d) provides that impermissible tenant service income does not include any amount that would be excluded from unrelated business taxable income under Code Sec. 512(b)(3) if received by an organization described in Code Sec. 511(a)(2). Code Sec. 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. Moreover, the regulations provide that:

The Ruling demonstrates the IRS’s willingness and ability to apply the REIT requirements to today’s complicated technological world . . .

[P]ayments 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 his 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.¹⁶

In general, if a REIT provides impermissible services to its tenants,

none of the rent from that property will qualify for the 75-percent test and 95-percent test (described below).¹⁷ Code Sec 856(d) 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 tenants at the property, or for managing or operating the property.¹⁸ However, rents will not be disqualified if a REIT provides *de minimis* impermissible services. For this purpose, services provided to tenants of a property are considered *de minimis* where income derived from the services rendered equals one percent or less of all income derived from the property (as determined on a property-by-property basis).¹⁹ For purposes of the one-percent threshold, the amount treated as received for any service may not be less than 150 percent of the direct cost incurred by the REIT in furnishing or rendering the service.²⁰

The 95-Percent Gross Income Test

In addition to deriving 75 percent of its gross income from the sources listed above, at least 95 percent of a REIT’s gross income for a tax year must be derived from the above-described qualifying income, or from

dividends, interest or gains from the sale or disposition of stock or other securities that are not dealer property. Dividends from a corporation (including a TRS but not a qualified REIT subsidiary) and interest on any obligation not collateralized by an interest on real property are included for purposes of the 95-percent test, but not (except with respect to dividends from a REIT) for purposes of the 75-percent test. For purposes of determining whether a REIT complies with the 75-percent and 95-percent tests, gross income does not include income from “prohibited transactions” (discussed below).

If a REIT fails to satisfy one or both of the 75-percent or 95-percent tests for any tax year, it may still qualify as a REIT for such year if it is entitled to relief under certain provisions of the Code. These relief provisions generally will be available if its failure to comply was due to reasonable cause and not to willful neglect, and the REIT timely complies with requirements for reporting each item of its income to the IRS. It is not possible, however, to state whether in all circumstances a REIT would be entitled to the benefit of these relief provisions. Even if these relief provisions apply, the REIT still would be subject to a special tax upon the greater of either (1) the amount by which 75 percent of its gross income exceeds the amount of its income qualifying under the 75-percent test for the tax year or (2) the amount by which 95 percent of its gross income exceeds the amount of its income qualifying for the 95-percent income test for the tax year, multiplied by a fraction intended to reflect its profitability.

Rents received from a tenant will not, however, qualify as rents from real property in satisfying the 75-percent test or the 95-percent test if the REIT, or an owner of 10 percent or more of its equity securities, directly or constructively owns (i) in the case of any tenant that is a corporation, stock possessing 10 percent or more of the total combined voting power of all classes of stock entitled to vote, or 10 percent or more of the total value of shares of all classes of stock of such tenant or (ii) in the case of any tenant that is not a corporation, an interest of 10 percent or more in the assets or net profits of such tenant (a “related-party tenant”), unless the related-party tenant is a TRS and certain other requirements are satisfied. In addition, if rent attributable to personal property leased in connection with a lease of real property is greater than 15 percent of the total rent received under the lease, then the portion of rent attributable to such personal property will not qualify as rents

from real property. Moreover, an amount received or accrued generally will not qualify as rents from real property (or as interest income) for purposes of the 75-percent test and 95-percent test if it is based in whole or in part on the income or profits of any person. Rent or interest will not be disqualified, however, solely by reason of being based on a fixed percentage or percentages of gross receipts or sales.

LTR 200752012

LTR 200752012 addressed an interesting situation where a typical one-story building was “tricked-out” with certain tenant-friendly structural components for computer and telecommunication equipment and where the landlord was obligated to provide certain related services. In the Ruling, the Taxpayer was a domestic corporation that intended to elect to be taxed as a REIT (the “REIT”). The REIT intended to be a fully integrated, self-managed company conducting all of its business operations through a newly formed limited partnership (an “OP”), in which it would be the sole general partner and a substantial limited partner.

The OP intended to acquire, purchase, develop and build certain buildings (the “Buildings”) that would be leased to unrelated tenants. The tenants, in turn, would use the leased space to accommodate their computer servers and personnel. The leases had terms ranging from five to ten years and provided for a fixed base rent plus reimbursement of all operating expenses incurred by the OP in operating the property. In addition, in light of certain tenant-friendly structural requirements of the leased space, the leases were to provide that if the OP fails to provide an “uninterruptible, stable source of power to the tenants’ space or does not maintain an environment within the tenants’ space at a specified temperature and humidity range,”²¹ the tenants were entitled to reduce the amount of operating expenses that they were otherwise required to reimburse the OP under the leases.

The initial properties to be acquired by the OP were typical one-story buildings constructed mainly of precast concrete. Within the proposed properties, the tenant space generally would be constructed on “raised flooring to accommodate the electric, ventilation, and air conditioning systems (HVAC) required by tenants.”²² The Buildings differ from other office buildings because of the “magnitude and quality of the electrical power and air conditioning furnished

to tenants and the redundancies built into the electrical and air conditioning systems.”²³ Specifically, the Ruling provided that:

The major [tenant-friendly] structural components of the Buildings are the (1) electrical distribution and redundancy system (the “electrical components”), (2) heating, ventilation and air conditioning system (the “HVAC components”), (3) humidification system (the “humidification components”), (4) security system (the “security components”), (5) the fire protection system (the “fire protection components”), and (6) telecommunication infrastructure (the “telecommunication components”). Each of these components is designed and constructed specifically for the particular Building for which it is a part, and is intended to remain permanently in place. The electrical components are designed to provide an uninterrupted power supply to the property through redundancy. The HVAC components are designed to maintain a room temperature of typically between 65 and 75 degrees Fahrenheit. The humidification components are designed to maintain humidity levels in the tenant’s space in the range of 30-70 percent. The security components typically include a single point of access to the building that is manned at all times (24/7) by a security firm or by an employee of Taxpayer. The fire protection components consist of fire alarms and sprinkler systems. The telecommunications components provide access for tenants to third-party telecommunications providers.

In the Ruling, the REIT represented, and the IRS accepted, that the Buildings’ tenant-friendly components are “inherently permanent structures” and that each of the structural components described above are “designed and constructed to remain permanently in place.”²⁴

In addition, the REIT represented, and the IRS accepted, that services to be provided to tenants of the Buildings consist of “ordinary, necessary, usual, and customary services that relate to the operation or maintenance of the properties.”²⁵ The services would not include “personal services” rendered to a particular tenant, and any service would constitute a personal service to a tenant would be provided either through an independent contractor from whom

the REIT does not derive or receive income, or through a TRS of the REIT that is owned by the OP. Specifically the Ruling provided that the services to be provided by the REIT, through the OP, include: “utilities, controlled humidity, security (as described above), fire protection (as described above), common area maintenance including cleaning and maintenance of public areas, landscaping, and pest control.”²⁶ Additionally, the Ruling provided that, through the OP, the REIT would provide “management, operation, maintenance, and repair of the major [tenant-friendly] building systems and components of the Buildings, including structural components; parking for tenants and their visitors, including reserved and unreserved unattended parking; and telecommunications infrastructure to allow tenants to connect to third-party telecommunication providers.”²⁷

It is important to note that, in the Ruling, the REIT represented, and the IRS accepted, that it performed research regarding services provided by other “similarly situated” real estate owners in connection with similar buildings located in the same geographic markets and determined that the services at issue are customarily rendered in connection with the rental of comparable buildings in the geographic market in which the proposed REIT’s Buildings are located.²⁸

The Real Property Issue

Similar to the properties or structural components described in Rev. Rul. 75-424 and Rev. Rul. 73-425 that qualified as real property for purposes of Code Sec. 856, the Buildings and the structural components described in the Ruling are inherently permanent structures. Although the Buildings and structures help to facilitate the technology businesses of tenants that occupy such buildings, the buildings and structural components themselves are not assets accessory to the operation of a business.²⁹ Accordingly, the Ruling concluded that the Taxpayer’s Buildings, including the tenant-friendly structural components, qualify as real property and real estate assets for purposes of Code Sec. 856.

The Tenant Services Issue

The Ruling also concluded that many of the services described by the REIT in its ruling request, were usual or customary services that are rendered in connection with the operation or maintenance of the properties and were not rendered primarily for

the convenience of tenants. The Ruling noted that other services that may constitute personal services to a tenant will be provided through independent contractors from whom the REIT will not receive or derive any income, or through a TRS owned by the OP. Accordingly, the ruling concluded that the services furnished by the REIT through the OP in connection with the leasing of the Buildings will not cause any amounts received from tenants of the Buildings to be treated as other than “rents from real property” under Code Sec. 856(d).

Conclusion

The Ruling demonstrates the IRS’s willingness and ability to apply the REIT requirements to today’s complicated technological world—including the willingness of the IRS to expand the ambit of services included in the definition of “customary services” provided to a tenant. This willingness and ability of the IRS will be essential in the application of the tax laws of yesterday to the computer technology and the telecommunications industry of today.

ENDNOTES

¹ LTR 200752012 (Sept. 6, 2007).

² All Section references provided for herein refer to the Internal Revenue Code of 1986, as amended (the “Code”).

³ The REIT and a corporate subsidiary in which it owns stock may make a joint election to treat the subsidiary as a TRS. A TRS also includes any corporation other than a REIT, if a TRS owns more than 35 percent of the total voting power or value of the outstanding securities of such corporation. Other than some activities relating to lodging and health care facilities, a TRS generally may engage in any business, including the provision of customary or noncustomary services to tenants of its parent REIT.

⁴ Code Sec. 856(c)(5)(B).

⁵ Code Sec. 856(c)(5)(C).

⁶ Reg. §1.856-3(b)(1).

⁷ Reg. §1.856-3(c).

⁸ Reg. §1.856-3(d).

⁹ Rev. Rul. 75-424, 1975-2 CB 269.

¹⁰ Rev. Rul. 73-425, 1973-2 CB 222.

¹¹ In addition to the gross income tests, a REIT must also satisfy various shareholder requirements, asset-type tests, and distribution requirements. A discussion of these additional REIT qualifications is beyond the scope of this article.

¹² Code Sec. 856(d)(1).

¹³ Reg. §1.856-4(b)(1).

¹⁴ Reg. §1.856-4(b)(5)(ii).

¹⁵ Code Sec. 856(d)(7)(C) provides certain exclusions from impermissible tenant service income. Code Sec. 856(d)(7)(C) provides that for purposes of Code Sec. 856(d)(7)(A), services furnished or rendered, or management or operations provided, through an independent contractor from whom the REIT does not derive or receive any income shall not be treated as furnished, rendered, or provided by the REIT.

¹⁶ Reg. §1.512(b)-1(c)(5).

¹⁷ Code Sec. 856(d)(2)(C).

¹⁸ Code Sec. 856(d)(7)(A).

¹⁹ Code Sec. 856(d)(7)(B) provides that if the

amount of impermissible tenant service income exceeds one percent of all amounts received or accrued during the tax year directly or indirectly by the REIT with respect to the property, the impermissible tenant service income of the REIT will include all of the amounts received or accrued with respect to the property.

²⁰ Code Sec. 856(d)(7)(D) provides that the amounts treated as received by a REIT for any impermissible tenant service shall not be less than 150 percent of the direct cost of the REIT in furnishing or rendering the service.

²¹ See LTR 200752012 (Sept. 6, 2007).

²² *Id.*

²³ *Id.*

²⁴ *Id.*

²⁵ *Id.*

²⁶ *Id.*

²⁷ *Id.*

²⁸ *Id.*

²⁹ For examples, see Reg. §1.856-3(d).

This article is reprinted with the publisher’s permission from the JOURNAL OF PASSTHROUGH ENTITIES, a bi-monthly journal published by CCH, a Wolters Kluwer business. Copying or distribution without the publisher’s permission is prohibited. To subscribe to the JOURNAL OF PASSTHROUGH ENTITIES or other CCH Journals please call 800-449-8114 or visit www.CCHGroup.com.

All views expressed in the articles and columns are those of the author and not necessarily those of CCH or any other person. All Rights Reserved.