Internal Revenue Service

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Department of the Treasury
Washington, DC 20224

Person To Contact:

Telephone Number:

Refer Reply To:
CC:FIP:1 – PLR-138026-03
Date: December 2, 2003

Legend:

Taxpayer =

State =

LP =

a =

Cities =

Dear :

This responds to a letter dated June 20, 2003, and supplemental correspondence, requesting a ruling on behalf of Taxpayer. You have requested a ruling that in the situations described below, Taxpayer's share of otherwise qualifying income will not be excluded from “rents from real property” pursuant to section 856(d)(2)(C) of the Internal Revenue Code.

Facts:

Taxpayer was established under State law and has elected to be treated as a real estate investment trust (REIT) pursuant to subchapter M of Chapter 1 of the Code. Taxpayer is the managing general partner of LP, and owns approximately a percent of the outstanding common units of the partnership. LP owns and operates office buildings (Properties) in the Cities through separate limited liability companies or partnerships (collectively, the Property-Owning Entities). Taxpayer represents that the described activities are performed by officers of Taxpayer and employees of LP; and

that all services and activities performed by Taxpayer for the Properties are performed by Taxpayer as a partner in LP.

In connection with leasing office space in the Properties, tenants often request that capital improvements be made to their space (build-outs). The following situations describe the manner in which a build-out request may be handled. In each situation, each of the third-party providers will satisfy the requirements for independent contractor status within the meaning of section 856(d)(3).

Situation 1: Taxpayer will arrange for the construction of an addition to, or the alteration of, space leased to tenants pursuant to the tenants' specifications. Taxpayer will engage independent contractors to construct the capital improvements and perform renovations. Taxpayer will not derive any income from the independent contractors. Taxpayer will pay for the improvements, and the costs of the improvements will be reflected in the rent negotiated or renegotiated with the tenant. Taxpayer intends to treat itself as the owner of the improvements for federal tax purposes.

Situation 2: Taxpayer will arrange for the construction of an addition to, or the alteration of, space leased to tenants pursuant to the tenant's specifications. Independent contractors will be engaged by Taxpayer to construct the capital improvements and perform renovations. The improvements and renovations will be paid for by the tenant. Taxpayer will either pay for the work and then seek reimbursement from the tenant, or collect all charges for the work from the tenant and remit those amounts to the independent contractors. Taxpayer will bear none of the costs of the work and will not derive income from the work of the independent contractors.

Situation 3: The tenant will arrange for the construction of an addition to, or the alteration of, its leased space. Independent contractors engaged by the tenant will construct the capital improvements and perform renovations. The tenant will pay for the improvements and make the payments directly to the independent contractors. Taxpayer will bear none of the costs of the work and will not derive income from the work of the independent contractors.

Situation 4: Taxpayer will arrange for the construction of an addition to, or the alteration of, space leased to tenants pursuant to the tenant's specifications. Independent contractors engaged by Taxpayer will construct the capital improvements and perform renovations. Taxpayer will pay for a portion of the improvements, typically expressed as a specified dollar amount per square foot of leased space, and the tenant will pay for the balance. Either Taxpayer will pay for the work performed and then seek reimbursement from the tenant for the tenant's share; or Taxpayer will collect from the tenant all charges for the work performed by the independent contractors for which the tenant is responsible, and remit those amounts to the independent contractors.

Taxpayer will not derive income from the work performed by the independent contractors.

In each of the situations described above, Taxpayer's employees may supervise and coordinate the construction project. Specifically, the employees may supervise architects and contractors, and review design proposals, to insure that the improvements will not impair the value of leased space. The employees also will insure that the improvements are in compliance with building codes and zoning restrictions, and are aesthetically pleasing. Taxpayer's employees will make certain that the construction activities do not disturb other tenants. However, Taxpayer's employees will not perform any actual physical construction. In Situations 2, 3 and 4, the tenant may be charged a fee for the services of Taxpayer's employees, either based on Taxpayer's out-of-pocket costs for the supervisory services, or equal to a specified percentage of the tenant's portion of the construction costs.

Taxpayer represents that these activities are of a type customarily furnished, rendered, or arranged for by landlords in connection with the ownership, operation and leasing of space in similar properties in the Cities in which the Properties are located.

Law and Analysis:

Section 856(c) provides that to qualify as a REIT, a corporation must: (1) derive at least 95 percent of its gross income (excluding gross income from prohibited transactions) from sources listed in section 856(c)(2), which includes dividends, interest, rents from real property, and certain other items; and (2) derive at least 75 percent of its gross income (excluding gross income from prohibited transactions) from sources listed in section 856(c)(3), which includes rents from real property and certain other items.

Section 1.856-3(g) of the Income Tax Regulations provides that a REIT that is a partner in a partnership is 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 that share. For purposes of section 856, the partner's interest in the partnership's assets is determined in accordance with the partner's capital interest in the partnership.

Section 856(d)(1) defines the term "rents from real property" to include (A) rents from interests in real property, (B) charges for services customarily rendered in connection with the rental of real property, whether or not such charges are separately stated, and (C) 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 the personal property for the taxable year does not exceed 15 percent of the total rent for the taxable year for both the real and personal property under the lease.

Section 1.856-4(b)(1) provides that services furnished to tenants of a particular building will be considered customary if, in the geographic market in which the building is located, tenants in buildings that are of a similar class are customarily provided with the service.

Section 856(d)(2)(C), however, excludes "impermissible tenant service income" from the definition of rents from real property. Section 856(d)(7)(A) defines impermissible tenant service income to include, with respect to any real or personal property, any amount received or accrued directly or indirectly by a REIT for services furnished or rendered by the REIT to tenants of the 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)(i) excludes from the definition of impermissible tenant service income amounts received for services furnished or rendered through an independent contractor from whom the REIT does not derive or receive any income. Similarly, section 856(d)(7)(C)(ii) excludes amounts that would be excluded from unrelated business taxable income (UBTI) under section 512(b)(3) if received by an organization described in section 511(a)(2).

Section 512(b)(3) provides, in relevant part, that rents from real property are excluded from the computation of UBTI. Section 1.512(b)-1(c)(5) provides that payments for the occupancy of space where services are also rendered to the occupant, are not rents from real property. Generally, services are considered rendered to the occupant if they are primarily for the occupant's convenience and are other than those usually or customarily rendered in connection with the rental of space for occupancy only.

Section 1.856-4(b)(5)(ii) provides 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. 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 each situation presented in this case, all of the actual construction will be performed by independent contractors as defined in section 856(d)(3). Although in some instances Taxpayer may act as a conduit for payments from tenants to the independent contractors, Taxpayer will not receive or derive income from the

independent contractors. Taxpayer will bear none of the costs of the work. Therefore, under section 856(d)(7)(C)(i), construction services provided to tenants will not give rise to impermissible tenant service income.

The activities conducted directly by Taxpayer's employees are either services that are not primarily for the convenience or benefit of tenants or are among the fiduciary duties described in section 1.856-4(b)(5)(ii). Accordingly, any income derived from these activities will not be treated as impermissible tenant service income under sections 856(d)(2)(C) and (d)(7)(A).

Conclusion:

Based on the information submitted and representations made, we conclude that the activities described in Situations 1, 2, 3 and 4 will not cause the Taxpayer's allocable portion of amounts received from tenants of the Properties to be treated as impermissible tenant service income and excluded from rents from real property pursuant to section 856(d)(2)(C).

Except as specifically ruled upon above, no opinion is expressed concerning any federal income tax consequences relating to the facts herein under any other provision of the Code. Specifically, we do not rule whether Taxpayer otherwise qualifies as a REIT under part II of subchapter M of Chapter 1 of the Code. Also, no ruling is given with respect to the treatment of any amount received by Taxpayer from any tenant attributable to the work performed by an independent contractor that is in excess of the actual cost of the work performed and not specified in the tenant's lease.

This ruling is directed only to the taxpayer requesting it. Taxpayer should attach a copy of this ruling to each tax return to which it applies. Section 6110(k)(3) of the Code provides that this ruling may not be used or cited as precedent.

Sincerely,

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Elizabeth A. Handler
Chief, Branch 1
Office of Associate Chief Counsel
(Financial Institutions and Products)

Enclosures:
Copy of this letter
Copy for § 6110 purposes