Part I

Section 856.--Definition of Real Estate Investment Trust

26 C.F.R. 1.856-1: Definition of a real estate investment trust.

Rev. Rul. 98-60

ISSUE

If a real estate investment trust (REIT) receives "impermissible tenant service income" within the meaning of § 856(d)(7) of the Internal Revenue Code for services rendered by the REIT to one or more tenants of a multi-tenant property, in what situations will other amounts received by the REIT with respect to the property continue to qualify as "rents from real property" under § 856(d)?

FACTS

Situation 1

Y, a REIT that files its returns on a calendar year basis, owns a high-rise apartment building, Building P. Building P has 100 apartments, of which 95 are standard, unfurnished apartments rented on an annual basis. The remaining five apartments are guest apartments. A guest apartment is a furnished apartment available for lease on a short-term basis to guests of tenants. Employees of Y render maid service in connection with the lease of guest apartments. Y also provides heat and light to all of the tenants in Building P. Y does not render any other services to the tenants of Building P or engage in any other activity at

Building P that could give rise to impermissible tenant service income.

For 1998, Y derives a total of $1,000X from all the tenants of Building P, of which $90X is from visitors who rented guest apartments. Of the $90X received from tenants of the guest apartments, the amount received with respect to maid service is $9X, which is greater than 150 percent of the direct costs of Y in rendering the service. Of the $1,000X received from all the tenants, the amount paid to Y for heat and light is $100X ($1X for each unit, including the guest units), which also is greater than 150 percent of the direct costs of Y for providing heat and light. The amount of rent attributable to personal property leased in connection with the rental of each guest apartment in Building P for 1998 does not exceed 15 percent of the total rent for such apartment attributable to both the real property and the personal property as provided in § 856(d)(1).

Situation 2

The facts are the same as those in Situation 1 except that Y derives $110X from visitors who rented guest apartments. Of the $110X received from tenants of the guest apartments, the amount received with respect to maid service is $11X, which is greater than 150 percent of the direct costs of Y in rendering the service.

LAW AND ANALYSIS

For an entity to qualify as a REIT, the entity must derive at least 95 percent of its gross income from certain sources described in § 856(c)(2) and at least 75 percent of its gross

income from certain sources described in § 856(c)(3). Rents from real property are among the sources described in both § 856(c)(2) and § 856(c)(3).

Section 856(d)(1) provides that rents from real property include (subject to the exclusions in § 856(d)(2)): (i) rents from interests in real property, (ii) charges for services customarily furnished or rendered in connection with the rental of real property (whether or not the charges are separately stated), and (iii) rent attributable to personal property that 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 year attributable to both the real and personal property leased under, or in connection with, the lease.

Section 856(d)(2)(C) (as modified by the Taxpayer Relief Act of 1997) excludes from the definition of rents from real property any impermissible tenant service income as defined in § 856(d)(7). Section 856(d)(7)(A) provides that impermissible tenant service income means, with respect to any real or personal property, any amount received or accrued directly or indirectly by a REIT for furnishing or rendering services to the tenants of the property or managing or operating the property.

Section 856(d)(7)(C)(i) excludes from impermissible tenant service income amounts received for services furnished or rendered, or management or operation provided, through an independent contractor from whom the REIT itself does not derive or receive any income.

Section 856(d)(7)(C)(ii) excludes from the definition of impermissible tenant service income any amount that would be excluded from unrelated business taxable income (UBTI) under § 512(b)(3) if received by an organization described in § 511(a)(2). Section 512(b)(3)(A)(i) excludes rents from real property from UBTI. Section 1.512(b)-1(c)(5) of the Income Tax Regulations provides, however, 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. Under § 1.512(b)-1(c)(5), the provision of maid service is given as an example of a service that is considered rendered to the occupant. Maid service provided by an employee of a REIT is, therefore, an impermissible tenant service that gives rise to impermissible tenant service income under § 856(d)(7). Conversely, under § 1.512(b)-1(c)(5), the provision of heat and light is given as an example of a service that is not considered rendered to the occupant. Accordingly, the provision of heat and light by a REIT is a permissible tenant service.

Section 1.512(b)-1(c)(5) taints all payments received under a lease as other than rents from real property where any impermissible tenant service is provided to the tenant. Accordingly, a strict application of § 1.512(b)-1(c) in the context of § 856(d)(7)(C)(ii) could cause all tenant service income (that is, service income and income from management and

operations) derived under a lease to fail to qualify for this exception where any impermissible tenant service is rendered to the tenant. However, the legislative history discussing § 856(d)(7) indicates that only income attributable to impermissible tenant services should be treated as impermissible tenant service income after the application of § 856(d)(7)(C)(ii) (unless § 856(d)(7)(B) applies). H.R. Conf. Rep. No. 105-220, 105th Cong., 1st Sess. 696 (1997) ("The value of the impermissible services may not exceed one percent of the gross income from the property" (emphasis added)). Accordingly, under § 856(d)(7)(C)(ii), an amount attributable to a service or activity is excluded from impermissible tenant service income unless the service or activity to which that amount relates would cause the related rents to be treated as UBTI if received by an organization described in § 511(a)(2).

Section 856(d)(7)(D) provides that the amount treated as received for any service (or management or operation) must not be less than 150 percent of the direct cost of the REIT in furnishing or rendering the service (or providing the management or operation).

Section 856(d)(7)(B) provides that, if the amount of impermissible tenant service income with respect to a property for any taxable year exceeds one percent of all amounts received or accrued during such taxable year directly or indirectly by the REIT with respect to the property, the impermissible tenant service income of the REIT with respect to the property includes all such amounts.

In Situation 1, the $9x attributable to the impermissible tenant services rendered to tenants of the guest apartments is impermissible tenant service income within the meaning of § 856(d)(7). Thus, pursuant to § 856(d)(2)(C), the $9x fails to qualify as rents from real property. Because the provision of heat and light is a permissible tenant service, no amount attributable to this service (including amounts paid by tenants of the guest units) is treated as impermissible tenant service income in applying the one percent de minimis rule. The $9x of impermissible tenant service income received by Y from Building P for 1998 does not exceed one percent of the $1,000x received or accrued directly or indirectly by Y with respect to Building P. Therefore, the rendering of impermissible tenant services to tenants of the guest apartments does not prevent otherwise qualifying amounts received by Y from the tenants of Building P (including tenants of the guest apartments) from qualifying as rents from real property under § 856(d), and the total impermissible tenant service income received with respect to Building P is $9x.

In Situation 2, the $11x attributable to the impermissible tenant services rendered to tenants of the guest apartments is impermissible tenant service income within the meaning of § 856(d)(7). The $11x of impermissible tenant service income received by Y from Building P for 1998 exceeds one percent of the $1,000x received or accrued directly or indirectly by Y with respect to Building P. Therefore, all $1,000x derived by Y from

Building P is impermissible tenant service income that, pursuant to § 856(d)(2)(C), fails to qualify as rents from real property.

Rev. Rul. 72-353, 1972-2 C.B. 413, illustrates how § 856(d)(2)(A), which excludes rents derived under net profit leases from the definition of rents from real property, is applied in a multiple tenant situation. In Rev. Rul. 72-353, a REIT leased office space in a building to 10 different tenants under separate leases. Nine of the leases provided for a fixed-sum rental. The tenth lease, however, provided for a rental based on a percentage of the tenant's net profits. Rev. Rul. 72-353 holds that the payments by the tenth tenant to the REIT, which do not qualify as rents from real property, do not prevent amounts paid to the REIT by the other tenants of the office building that otherwise qualified as rents from real property from so qualifying.

Section 856(d)(7)(B) allows a REIT to provide a limited amount of impermissible tenant services with respect to property without causing all of the income from the property to fail to qualify as rents from real property. In the case of many of the services that Congress intended to cover, it would be very difficult to allocate the services to particular tenants. Consistent with this intent, § 856(d)(7)(B) expressly applies on a property-by-property basis. Consequently, the one-percent limitation in that section is applied to aggregate amounts received with respect to a property.

Rev. Rul. 72-353, which makes a determination under

§ 856(d)(2)(A) on a lease-by-lease basis, is distinguishable. Section 856(d)(2)(A) relates to contingent rents determined by reference to any person's income or profits derived from a property. In contrast to amounts allocable to tenant services, the presence or absence of contingent rents can be determined on a lease-by-lease basis in all cases.

HOLDING

(1) In Situation 1, only the $9x attributable to the impermissible tenant services rendered to tenants of the guest apartments fails to qualify as rents from real property.

(2) In Situation 2, all $1,000x of income derived from Building P fails to qualify as rents from real property.

EFFECT ON OTHER REVENUE RULINGS

Rev. Rul. 72-353 is distinguished.

DRAFTING INFORMATION

The principal author of this revenue ruling is Eric E. Boody of the Office of Assistant Chief Counsel (Financial Institutions and Products). For further information regarding this revenue ruling contact Mr. Boody on (202) 622-3960 (not a toll-free call).