

Section 856.—Definition of Real Estate Investment Trust

(Also § 857.)

REIT noncustomary service income.

Guidance is provided under sections 856 and 857(b)(7) of the Code when a REIT forms a taxable REIT subsidiary (TRS) to provide noncustomary services to tenants of the REIT and no service charges are separately stated from the rents paid by the tenants to the REIT.

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ISSUE

If a real estate investment trust (REIT) forms a taxable REIT subsidiary (TRS) to provide noncustomary services to tenants of the REIT and no service charges are separately stated from the rents paid by the tenants to the REIT, how is the REIT's income from the services treated under §§ 856 and 857(b)(7) of the Internal Revenue Code?

FACTS

Situation 1

Corporation *R*, which has elected to be a REIT as defined in § 856, owns residential apartment buildings. *R* forms a wholly-owned subsidiary, corporation *T*, to provide housekeeping services to ten-

ants of *R*'s apartment buildings. The services do not qualify as customary services under § 1.856-4(b)(1) of the Income Tax Regulations. *R* and *T* jointly elect under § 856(l) to treat *T* as a TRS of *R*.

Employees of *T* perform all of the housekeeping services received by *R*'s tenants, including administration and management of the services. *T* pays all costs of providing the services, such as its employees' salaries and the costs of their uniforms, equipment, and supplies. To carry out the housekeeping operations, *T* also rents space in *R*'s apartment buildings in accordance with § 856(d)(8)(A). *T* makes no payments to *R* other than its rental payments for that space. The annual value of the housekeeping services provided at each property exceeds one percent of the total annual amount received by *R* from the property.

Charges to the tenants for the housekeeping services are not separately stated from the rents that the tenants pay to *R* for the use of their apartments. *T* does not enter into contracts with the tenants for the performance of the housekeeping services. *R* compensates *T* for providing the services by paying *T* an amount that is 160 percent of *T*'s direct cost of providing the services. *T* reports the full amount of *R*'s payment as gross income on *T*'s federal income tax return.

Situation 2

The facts are the same as in *Situation 1* except that *R* compensates *T* for providing the services by paying *T* an amount that is 125 percent of *T*'s direct cost of providing the services, and that payment is less than the arm's length charge under § 482 for providing the services.

LAW

For taxable years beginning after December 31, 2000, §§ 856 and 857(b)(7) provide special rules for a corporation that is a TRS within the meaning of § 856(l). Those rules, which allow a TRS to provide noncustomary services to tenants of its REIT, govern the relationship between the REIT and the TRS.

To qualify as a REIT, an entity must derive at least 95 percent of its gross income from sources listed in § 856(c)(2) and at least 75 percent of its gross income from sources listed in § 856(c)(3). "Rents

from real property" are among the sources listed in both of those sections. Section 856(d)(1) defines rents from real property to include rents from interests in real property, charges for services customarily rendered in connection with the rental of real property, and rent attributable to certain leased personal property. However, § 856(d)(2)(C) excludes "impermissible tenant service income" from the definition of rents from real property. Pursuant to § 856(d)(7)(A), impermissible tenant service income means, with respect to any real property, any amount received by a REIT for services rendered by the REIT to tenants of the property. Section 856(d)(7)(C)(i) provides that services rendered through a TRS are not treated as rendered by its REIT for purposes of § 856(d)(7)(A). Thus, services rendered by a TRS do not give rise to impermissible tenant service income.

Section 857(b)(7)(A) imposes for each taxable year of a REIT a tax equal to 100 percent of "redetermined rents." Section 857(b)(7)(B)(i) provides that redetermined rents mean rents from real property (as defined in § 856(d)) to the extent the amount of the rents would (but for § 857(b)(7)(E)) be reduced on allocation under § 482 to clearly reflect income as a result of services rendered by a TRS to a tenant of its REIT. Section 482 provides that when two or more organizations, trades, or businesses are owned or controlled directly or indirectly by the same interests (controlled organizations), the Secretary may allocate gross income between or among those controlled organizations if the Secretary determines that such allocation is necessary to clearly reflect the income of any of those controlled organizations. Pursuant to § 1.482-1(b)(1), the standard applied in determining the true taxable income of a controlled organization is that of an organization dealing at arm's length with an uncontrolled organization. Section 1.482-2(b)(3) defines an arm's length charge for services provided between controlled organizations, regardless of whether the services are an integral part of either organization's business activity (the § 482 arm's length charge). Section 857(b)(7)(E) provides that the imposition of tax under § 857(b)(7)(A) is in lieu of allocation under § 482.

Section 857(b)(7)(B)(ii) through (vii) contains exceptions, or safe harbors, from the 100 percent tax on redetermined rents. For example, pursuant to § 857(b)(7)(B)(vi), the definition of redetermined rents does not apply to any service rendered by a TRS to a tenant of its REIT if the gross income of the TRS from the service is at least 150 percent of the TRS's direct cost in rendering the service. Other safe harbors in § 857(b)(7)(B) cover customary services, services giving rise to *de minimis* amounts, services priced comparably to those provided by the TRS to unrelated persons, certain services with separately stated charges, and services excepted by the Secretary.

ANALYSIS

If a REIT forms a TRS to provide non-customary services to the REIT's tenants and no service charges are separately stated from the tenants' rents, a primary question in determining the treatment of the REIT's income from the services is whether they are considered to be rendered by the REIT, or by the TRS, for purposes of § 856(d)(7). If rendered by the TRS and hence described in § 856(d)(7)(C)(i), the services do not give rise to impermissible tenant service income. All relevant facts and circumstances must be considered in determining the provider of the services for this purpose.

In *Situations 1* and *2*, charges to the tenants for the housekeeping services are not separately stated from the rents that the tenants pay to *R* for the use of their apartments. As a result, the amounts of the rents reflect the availability and use of those services. In other words, *R* receives greater rental payments than it would have received if the services had not been provided to its tenants. However, the structure of the 100 percent tax on redetermined rents indicates that Congress did not intend the lack of a separately stated service charge, by itself, to cause services to be treated as rendered by a REIT, rather than its TRS. In *Situations 1* and *2*, employees of *T* perform all of the housekeeping services received by *R*'s tenants, including administration and management of the services. *T* pays all costs of providing the services, such as its employees' salaries and the costs of their uniforms, equipment, and supplies. *T* also rents

space to carry out the housekeeping operations and makes no payments to *R* other than its rental payments for that space. For purposes of § 856(d)(7)(C)(i), in those circumstances the services are considered to be rendered by *T*, rather than *R*, even though no service charges are separately stated from the tenants' rents. Accordingly, the services do not give rise to impermissible tenant service income and thus do not cause any portion of the rents received by *R* to fail to qualify as rents from real property under § 856(d).

As rents from real property, those rents are subject to being treated as redetermined rents under § 857(b)(7)(B)(i). That section provides that redetermined rents mean rents from real property (as defined in § 856(d)) to the extent the amount of the rents would (but for § 857(b)(7)(E)) be reduced on allocation under § 482 to clearly reflect income as a result of services rendered by a TRS to a tenant of its REIT. Section 482 allows the Secretary to allocate income from a REIT to its TRS to reflect the § 482 arm's length charge for the TRS's services. However, the 100 percent tax on redetermined rents is not imposed with respect to services described in a safe harbor of § 857(b)(7)(B).

In *Situation 1*, *R* compensates *T* for providing the housekeeping services by paying it an amount that is 160 percent of *T*'s direct cost of providing the services, and *T* reports the full amount of *R*'s payment as gross income on *T*'s federal income tax return. Pursuant to the safe harbor of § 857(b)(7)(B)(vi), the definition of redetermined rents does not apply to any service rendered by a TRS to a tenant of its REIT if the TRS's gross income from the service is at least 150 percent of its direct cost in rendering the service. In *Situation 1*, that safe harbor protects *R* from imposition of the 100 percent tax on redetermined rents. However, if the amount paid by *R* to *T* is less than the § 482 arm's length charge for providing the services, income is allocable from *R* to *T* under § 482 to reflect that charge. Section 857(b)(7)(E) does not preclude allocation under § 482 of income on which the 100 percent tax is not imposed. Income so allocated from *R* to *T* under § 482 would be deductible by *R* under § 162 and thus would reduce *R*'s

taxable income, but not its gross income. Such allocation under § 482 would not cause any portion of the rents received by *R* to fail to qualify as rents from real property under § 856(d).

In *Situation 2*, *R* compensates *T* by paying it an amount that is 125 percent of *T*'s direct cost of providing the services, and that payment is less than the § 482 arm's length charge. In *Situation 2*, no safe harbor protects *R* from imposition of the 100 percent tax on redetermined rents. As a result, § 857(b)(7)(A) imposes on *R* a tax equal to the amount that would (but for imposition of that tax) be allocated under § 482 from *R* to *T* to reflect the § 482 arm's length charge for providing the services. In other words, the tax is equal to the amount by which the § 482 arm's length charge exceeds the payment from *R* to *T*. Pursuant to § 857(b)(7)(E), imposition of that tax is in lieu of allocation of the same amount from *R* to *T* under § 482. Imposition of that tax does not cause any portion of the rents received by *R* to fail to qualify as rents from real property under § 856(d).

HOLDINGS

(1) In *Situation 1*, the housekeeping services are considered to be rendered by *T*, rather than *R*, for purposes of § 856(d)(7)(C)(i). Accordingly, the services do not give rise to impermissible tenant service income and thus do not cause any portion of the rents received by *R* to fail to qualify as rents from real property under § 856(d). The safe harbor of § 857(b)(7)(B)(vi) protects *R* from imposition of the 100 percent tax on redetermined rents. However, if the amount paid by *R* to *T* represents less than the § 482 arm's length charge for providing the services, income is allocable from *R* to *T* under § 482. Income so allocated from *R* to *T* under § 482 would be deductible by *R* under § 162 and thus would reduce *R*'s taxable income, but not its gross income. Such allocation under § 482 would not cause any portion of the rents received by *R* to fail to qualify as rents from real property under § 856(d).

(2) In *Situation 2*, the housekeeping services are considered to be rendered by *T* for purposes of § 856(d)(7)(C)(i). Accordingly, the services do not give rise to impermissible tenant service income and thus do not cause any portion of the

rents received by *R* to fail to qualify as rents from real property under § 856(d). However, no safe harbor protects *R* from imposition of the 100 percent tax on re-determined rents. Section 857(b)(7)(A) imposes on *R* a tax equal to the amount by which the § 482 arm's length charge for providing the services exceeds the payment from *R* to *T*. Imposition of that tax is in lieu of allocation of that amount from *R* to *T* under § 482 and does not cause any portion of the rents received by *R* to fail to qualify as rents from real property under § 856(d).

DRAFTING INFORMATION

The principal author of this revenue ruling is Jonathan D. Silver of the Office of Associate Chief Counsel (Financial Institutions and Products). For further information regarding this revenue ruling, contact Mr. Silver at (202) 622-3920 (not a toll-free call).