

IRS RULES ON JOINT VENTURE PROVIDING SERVICES TO TENANTS OF REIT

An entity can qualify as a real estate investment trust (a “REIT”) for federal income tax purposes only if at least 95 percent of the gross income of the entity is of certain specified classes, including rent. Amounts paid to the REIT qualify as “rent” only if a number of requirements are satisfied. If services are provided to tenants of the REIT, and such services are not customarily provided to tenants of properties of that class in the geographical area, subject to a de minimis exception, ALL rent received with respect to the property during the year will not qualify as “rent” unless the services are rendered either by a “taxable REIT subsidiary” (a “TRS”) or by an independent contractor (an “IK”) but only if the REIT does not receive or derive income from the IK.

In a recently published Ruling, Revenue Ruling 2003-86, the IRS considered a situation where various noncustomary services had been provided to tenants of a REIT by a TRS owned by the REIT and other noncustomary services had been provided by an IK. The TRS and IK formed a 50-50 partnership to perform the services previously rendered by the TRS and the IK individually. Tenants contracted directly with and compensated the TRS and the IK prior to formation of the partnership, and contracted with the partnership after its formation.

The IRS ruled that this arrangement would not cause the rent to be disqualified. Apparently the IRS was willing to look through the partnership, reasoning that if the services in question could be performed individually by the TRS and the IK, they could be performed by a partnership consisting of such entities.

The Ruling notes that the REIT may indirectly receive income from the partnership, since 50 percent of the income of the partnership will be allocated to the TRS, and the TRS may pay dividends to the REIT. The Ruling considers the possible application of Section 856(d)(7)(A) of the Internal Revenue Code of 1986 (the “Code”), which provides that amounts received directly or indirectly by a REIT for services furnished or rendered to tenants constitute impermissible tenant service income. The Ruling does not conclude that the partnership qualifies as an IK from which the REIT does not derive income and so does not apply the exception for IKs. Rather, the Ruling concludes that the services provided by the partnership are treated as provided by the TRS to the extent of the TRS’s 50 percent interest in the partnership, and then applies the exception in Section 856(d)(7)(C)(i) of the Code for services furnished or rendered through a TRS.

The Ruling assumes as a fact that Tenants contracted directly with and compensated the TRS and the IK, *i.e.*, the services were not provided under lease, with the REIT contracting with and paying the partnership to perform the services, but the Ruling does not indicate the significance of this fact. This is consistent with the approach of the IRS in two private letter rulings, LTR 200234054 and LTR 200327048. Both of these private letter rulings apply Treasury Regulation Section 1.856-4(b)(5)(i), which states that:

To the extent that services (other than those customarily furnished or rendered in connection with the rental of real property) are rendered to the tenants of the property by the independent contractor, the cost of the services must be borne by the independent contractor, a separate charge must be made for the services, the amount of the separate charge must be received and retained by the independent contractor, and the independent contractor must be adequately compensated for the services.

It appears to be the view of the IRS that noncustomary services must not only be performed by a TRS or an IK from which the REIT derives no income, but that the requirements of Treasury Regulation Section 1.856-4(b)(5)(i) must be met, most notably that the TRS or the IK must bill and collect an arm's-length separate charge for the services. Thus, the cost of the noncustomary services may not simply be incorporated into the lease and added into the rent charged, in the view of the IRS, notwithstanding the exception in Section 856(d)(7)(C)(i) for services performed by a TRS or an IK.

In a separate Revenue Procedure, 2003-66, the IRS set forth conditions in which rent paid to a REIT by partnership joint ventures of the type described above will be treated as qualifying rent. Section 856(d)(2)(B) generally provides that amounts received by a REIT will not qualify as rent if the REIT owns 10 percent or more of the entity paying the rent. Section 856(d)(8)(A) creates an exception to the preceding rule and provides that amounts paid to a REIT by a TRS shall not be excluded from rents from real property by reason of Section 856(d)(2)(B) if at least 90 percent of the leased space of the property is rented to persons other than TRSs of the REIT and related parties described in Section 856(d)(2)(B), but only to the extent that the amounts paid to the REIT by the TRS as rents from real property are substantially comparable to such rents paid for comparable space by the other tenants of the REIT's property.

Revenue Procedure 2003-66 simply applies Section 856(d)(8)(A) to the TRS joint venture fact pattern. The Revenue Procedure provides that the IRS will treat rents from such a joint venture as qualifying rents if two requirements are met. First, the rents must be substantially comparable to rents paid by the other tenants of the REIT's property for comparable space. Second, at least 90 percent of the leased space of the REIT's property must be rented to persons other than (i) TRSs of the REIT or (ii) certain related parties (including TRS joint ventures).

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July 22, 2003

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