Internal Revenue Service

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Washington, DC 20224

Person to Contact:

Telephone Number:

Refer Reply To:
CC:DOM:FI&P:1-PLR-105850-99
Date:
December 15, 1999

Legend:

Company =

Year 1 =

Operating Partnership =
a =

b =

c =

d =

e =

Management Company =

Company C =
f =

Year 2 =

Company D =

g =

Partnership A =

h =

Dear:

This is in reply to your letter dated March 4, 1999, and subsequent submissions,

requesting rulings on behalf of Company. You have requested several rulings concerning the treatment of various activities for purposes of § 856(d) of the Internal Revenue Code. Specifically, you have requested the following rulings:

1) The Partnerships (described below) will not be deemed to be providing any services to tenants by reason of (a) the leases between Company C and the Partnerships, (b) any agreements between Company C and the tenants, and (c) services performed by Company C in providing music to common areas of Company Properties.

2) The Partnerships will not be deemed to be providing services to tenants by reason of (a) the services performed by Company D on behalf of the Partnerships in connection with cleaning common areas of Company Properties, (b) the leases between the Partnerships and Company D, and (c) agreements between Company D and certain tenants of Company Properties pursuant to which Company D would clean and maintain the space leased to those tenants or provide other services to those tenants.

(3) Base rent and percentage rent received by the Partnerships from Company D will qualify as rents from real property within the meaning of § 856(d); and,

(4) Company will recognize impermissible tenant service income from the “Approved Company” program (described below) in an amount equal to the greater of (i) the income derived from the “Approved Company” program or (ii) 150 percent of the direct cost of the Approved Company Program. However, the designation of Company D as an approved company and the services provided by Company and its affiliates in connection with the “Approved Company” program will not cause the base rent and percentage rent accrued by Company pursuant to the lease with Company D to fail to qualify as rents from real property within the meaning of § 856(d).

FACTS:

Company is a self-administered and self-managed real estate investment trust (REIT) engaged primarily in owning, operating, managing, leasing, acquiring, expanding, and developing regional malls and community shopping centers. Following a merger in Year 1, Company contributed its real estate properties (Properties) to Operating Partnership in exchange for units in Operating Partnership. After the merger, Company holds directly and indirectly, a percent of the Operating Partnership’s units. Company, through Operating Partnership and other partnerships in which Operating Partnership holds an interest (cumulatively, the Partnerships), owns or holds an interest in b shopping centers, malls, and retail centers located in c states. Operating Partnership also holds d percent of the preferred stock and e percent of the common stock of Management Company, which provides management services to Company

properties not directly or indirectly wholly-owned by Company as well as to retail shopping facilities owned by third parties.

Management Company, as general partner, owns a f percent interest in the profits and capital of Partnership A. Operating Partnership, the limited partner of Partnership A, owns a g percent profits and capital interest in Partnership A. Partnership A's employees are management-level employees, who perform services for both Management Company and Company. Many of Partnership A's employees perform services for more than one entity, including Management Company, Company, affiliates of Company, and Operating Partnership. Partnership A was organized to allocate the costs of those employees to the appropriate entity. The costs of Partnership A plus a g percent markup are allocated among the entities for which the employees of Partnership A perform services. The allocation is based on the amount of time that the employees devote to each entity. The allocated costs consist of all costs incurred by Partnership A including rent, salaries, employment taxes, equipment and supplies. Company, Operating Partnership, Management Company, and Partnership A maintain separate books and records.

Company C leases space on the roofs and portions of utility closets of certain Properties. Company C installs satellite antennae or dishes on the leased roof space to receive and transmit signals via satellite. The signals include digital music, commercial television, audio messages, and audio advertisements. The installed equipment also transmits credit information, business information, and records to and from the Properties. Neither Company nor any affiliate of Company owns, or has the right to acquire, any equity interest in Company C.

Company C offers services to tenants of the Properties. None of the services that Company C offers to tenants is required to be provided by any of the Partnerships. Tenants are under no obligation to subscribe to the services offered by Company C. Tenants contract directly with Company C for those services, and the terms of the agreements between Company C and tenants are determined solely by negotiations between Company C and tenants. Company C is responsible for its own marketing strategies.

Under its leases, Company C pays a minimum rent of h dollars per annum and percentage rent comprising (1) a percentage of the gross receipts in excess of a specified amount derived by Company C from tenants of a Property, and (2) a percentage of each Property's allocable share of the advertising revenue derived by Company C from businesses (including tenants) that place advertisements on audio and video signals transmitted by Company C, including advertisements on background music. Gross receipts do not include (1) performance rights fees payable by Company C to any organization from which Company C obtains a license in order to broadcast music or performances that are protected by copyright, (2) reimbursements for repair

or maintenance of its equipment, and (3) insurance proceeds from damages to equipment and any warranty claims against equipment manufacturers. Company represents that while its leases permit Company C to reduce gross receipts by performance rights fees, Company will not treat any rent (base or percentage) from Company C as income that is described in § 856(c)(2) or (3).

Company C also provides music in the common areas of many of the Properties. Company pays a monthly fee to Company C based upon the number of Properties in which Company C provides music.

In Year 2, the Partnerships retained Company D to provide facility services for common areas of Properties located within specific geographic areas, including cleaning and maintenance of common areas, repair and maintenance of HVAC systems, and landscaping services. The charge for these services is part of the common area charges, which are allocated among tenants and included in the computation of additional rent or minimum rents paid by the tenants. Company and its affiliates do not own or have the right to acquire any equity interest in Company D.

Company D provides all of the supplies and equipment necessary to clean and maintain the common areas and all of the employees to perform the services. Company D also maintains a small office in most of the Properties. Company represents that the cleaning and maintenance of common areas is the type of service usually or customarily performed in connection with the rental of space for occupancy only and is not treated as a service rendered to a tenant.

Company D also performs facility services for some Property tenants, but tenants are not required to retain Company D. Any agreement for the performance of services by Company D for a tenant are directly negotiated between Company D and the tenant. Under no circumstances does Company D perform services for tenants that Company or any affiliate of Company is required to perform.

Company D pays a fixed rent for the space it rents at each Property. The rent is not based on Company D's income or profits. Company D and the Partnerships desire to amend the leases to provide for a sliding scale of percentage rent based on gross receipts of Company D from (a) cleaning the common areas of the Property and (b) cleaning tenant space and providing other services to tenants within the Property.

Company has an "Approved Company" program (Program) in which businesses that have provided outstanding service to the Properties are awarded a "seal of approval". These businesses are permitted to use the award in promotional materials and other marketing activities. Company and the Partnerships will also make available and distribute to tenants a list of businesses recommended by Company. Marketing activities by Company employees or any of its affiliates on behalf of the approved

companies are nominal and consist primarily of distributing to tenants printed information regarding approved companies. Tenants are not required to use the services of any business designated as an approved company, and no approved company would perform services that are required to be performed by a Partnership or a Company affiliate. Company will not be involved in disputes between tenants and approved companies or in the operation of an approved company's business. Company or the Partnerships may receive compensation from a business that is designated as an approved company. In some cases the compensation may be a fixed amount; in other cases the compensation may be based upon a percentage of gross receipts derived from goods and services provided to tenants. Company represents that the Program results in substantial part from Company's desire to provide incentives to the businesses providing services to the Properties and to provide for the efficient management of the Properties.

Company represents that it will receive only nominal income and will incur only nominal costs in connection with the Program. It will treat as impermissible tenant service income the greater of (i) the income directly or indirectly received from the Program or (ii) 150 percent of the direct cost incurred in connection with the Program. Company further represents that the amount of income directly or indirectly received with respect to any of the Properties will be less than 1 percent of all amounts received with respect to such Property.

Law:

Section 856(c)(2) provides that at least 95 percent of a REIT's gross income must be derived from, among other sources, "rents from real property."

Section 856(c)(3) provides that at least 75 percent of a REIT's gross income must be derived from, among other sources, "rents from real property."

Under § 1.856-3(g) of the Income Tax Regulations, a REIT that is a partner in a partnership is deemed to own its proportionate share of each of the assets of the partnership and to be entitled to the income of the partnership attributable to that share. For purposes of § 856, the interest of a partner in the partnership's assets shall be determined in accordance with the partner's capital interest in the partnership. The character of the various assets in the hands of the partnership and items of gross income of the partnership shall retain the same character in the hands of the partners for all purposes of § 856.

Section 856(d)(1) provides that "rents from real property" include (subject to exclusions provided in § 856(d)(2)): (A) rents from interests in real property; (B) charges for services customarily furnished or rendered in connection with the rental of real property, whether or not such charges are separately stated; and (C) 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 taxable 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.

Section 1.856-4(b)(1) provides that, for purposes of § 856(c)(2) and (3), 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. 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.

Section 856(d)(2)(C) provides that any impermissible tenant service income is excluded from the definition of "rents from real property". Section 856(d)(7)(A) 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.

Section 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. Section 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.

Section 856(d)(7)(C) provides certain exclusions from impermissible tenant service income. Section 856(d)(7)(C) provides that for purposes of § 856(d)(7)(A), services furnished or rendered, or management or operation 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, and there shall not be taken into account any amount which would be excluded from unrelated business taxable income under § 512(b)(3) if received by an organization described in § 511(a)(2).

Section 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.

Section 1.512(b)-1(c)(5) provides that payments 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.

Rev. Rul. 98-60, 1998-51 I.R.B. 6, provides that rents received or accrued in a tax year with respect to a property that are attributable to impermissible tenant services that exceed one percent of the rents derived from that property, rather than from a single tenant of that property, will cause all of the income derived from the property to fail to qualify as “rents from real property”.

Analysis:

Under § 856(d)(1), in order for income from a service to be treated as rents from real property, the service must be customary and furnished in connection with the rental of real property. In the present case, the Partnerships’ rental of space to Company C is unrelated to the rental of space to other tenants. Also, Company C’s agreements with other tenants are unrelated to the Partnerships’ leases with those other tenants. Accordingly, the Partnerships will not be deemed to be providing any services to tenants by reason of (a) its leases with Company C, or (b) Company C’s agreements with other tenants.

Tenant leases at the Properties do not require the Partnerships to provide background music in the common areas of the malls. Background music in the common areas is not a service rendered primarily for the convenience of tenants just as the cleaning and maintenance of common areas are not services rendered for the convenience of tenants. Section 1.512(b)-1(c)(5). Accordingly, the Partnerships will not be deemed to be providing any non-customary services for the convenience of tenants of the Properties by reason of the provision of music in common areas by Company C under an agreement with the Partnerships.

Section 1.512(b)-1(c)(5) provides, in relevant part, that the cleaning of public entrances, exits, stairways, and lobbies is not considered a service rendered to the

occupant. Similarly, the common area cleaning services performed under the agreement between the Partnerships and Company D is not a service rendered to the occupant of a Property at which Company D performs the services. Accordingly, the cleaning of common areas by Company D pursuant to an Agreement with the Partnerships will not be considered a service for the convenience of tenants and will not cause rents received from other tenants of Properties to be treated as other than rents from real property. Also, leases between the Partnerships and Company D will not be considered the provision of services to other tenants of the Properties at which Company D leases space.

Any services performed by Company D for other tenants of the Properties are separately negotiated by those parties and do not involve the Partnerships in any way. Tenants are not required by the Partnerships to use the services of Company D. Accordingly, any services performed by Company D for other tenants of the Properties will not be treated as services provided directly or indirectly by the Partnerships for purposes of § 856(d).

Company concedes that tenants of the Properties receive a benefit from receiving information regarding the businesses that are designated as “approved companies under the Program. Tenants that are “approved companies” may also benefit by including the designation in their marketing materials and by the information provided by Company regarding its “approved companies”. Consequently, the Program is a service furnished or rendered by Company to tenants of a Property and any amount of income received or accrued directly or indirectly resulting from the Program will be impermissible tenant service income under § 856(d)(7), for purposes of § 856(d)(2)(C). Accordingly, Company will recognize impermissible tenant service income from the Program as determined under § 856(d)(7). The designation of Company D as an “approved company” will not cause the rents received by Company to be treated as other than rents from real property under § 856(d) if Company’s impermissible tenant service income will be less than 1 percent of all amounts received with respect to the Property.

Other Information:

Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any aspect of the transaction discussed in this letter. No opinion is expressed concerning whether Company qualifies as a REIT under § 856 prior to or following the merger discussed above. Also, no opinion is expressed or implied concerning the treatment of rents received by Company following the amendment of any lease with Company C for purposes of § 856(c)(2) or (c)(3).

Additionally, no opinion is expressed whether Company meets the 10 percent voting securities requirement of § 856(c)(4)(B) with respect to Management Company,

as a result of Company's interest in Operating Partnership. Furthermore, no opinion is expressed on the characterization under § 856 of income received directly or indirectly by Company from Management Company.

This ruling is directed only to the taxpayer(s) requesting it. Section 6110(k)(3) provides that it may not be used or cited as precedent.

Sincerely yours,
Assistant Chief Counsel
(Financial Institutions & Products)
By: Jonathan Zelnik
Assistant to the Chief, Branch 1

Enclosure:
Copy of this letter
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