tax notes
Volume 148, Number 4 ■ July 27, 2015

(C) Tax Analysts 2015. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

Non-Customary Services Furnished By Taxable REIT Subsidiaries

By Paul W. Decker, David H. Kaplan, and Ameek Ashok Ponda

Reprinted from *Tax Notes*, July 27, 2015, p. 413

taxanalysts®

SPECIAL REPORT

tax notes™

(C) Tax Analysts 2015. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

Non-Customary Services Furnished By Taxable REIT Subsidiaries

By Paul W. Decker, David H. Kaplan, and Ameek Ashok Ponda

Paul W. Decker, David H. Kaplan, and Ameek Ashok Ponda are tax attorneys in the Boston office of Sullivan & Worcester LLP. Ponda is also an adjunct professor with the Boston University School of Law and a recent lecturer on law with the Harvard Law School. The authors wish to thank Cathryn Arnell, Bradley Borden, Patrick Fiel, Dean Halfacre, Brian Hammell, Laura Miller, and Anne Ross for their helpful comments on this report. Any errors or omissions remain the authors' own.

In this report, the authors argue that real estate investment trust revenues from tenants for non-customary services provided by taxable REIT subsidiaries constitute rents from real property under section 856(d) regardless of whether the services are billed to tenants separately or as part of a bundled charge.

Copyright 2015 Sullivan & Worcester LLP.
All rights reserved.

Table of Contents

I.	**Introduction**	413
II.	**The REIT World Before TRSs**	416
	A. The 1960 Standard	416
	B. The 1976 Revisions	417
	C. The 1986 Revisions	419
III.	**The Advent of TRSs**	421
IV.	**Subject Revenues as Qualifying Rents**	423
	A. Congressional Intent	423
	B. The Section 857(b)(7) Structure	424
	C. Rev. Rul. 2002-38	425
	D. Industry Practice	427
	E. Section 856(c)(5)(J)(ii)	428
	F. No Contrary Authority	429
V.	**Conclusion**	429
VI.	**Appendix**	429
	Section 857(b) (2001)	429

I. Introduction

The typical real estate investment trust is a taxpayer, otherwise taxable as a regular C corporation, that continuously complies with numerous, stringent requirements under the code and Treasury regulations, such as the following:

- its share ownership must be sufficiently diversified such that the REIT is neither closely held nor 10 percent-or-more affiliated with its tenants;
- its assets must be principally real property or related to real property leasing, with the possibility of investing in the portfolio securities of other issuers being very limited;
- its gross income must be principally rental revenues and fees for related services, with the balance of any gross income being principally composed of passive investment income such as interest, dividends, and capital gains;
- its subsidiaries, assets, and operations must be properly divided among disregarded entities and partnerships on one hand, and section 856(l) taxable REIT subsidiaries (TRSs) on the other; and
- its distributions to shareholders must be meticulously in sync with its underlying organic documents, pro rata within each class of outstanding shares, and sufficiently large and timely to contemporaneously (or nearly contemporaneously) distribute to shareholders all of its taxable income and any accumulated earnings and profits inherited from regular C corporations.[1]

[1]*See generally* sections 561, 562, 565, 856-860, and 4981. Meeting these numerous, stringent standards requires a REIT to have the right ownership, assets, income streams, and distribution amounts, all accompanied by continuous monitoring. But even so, the financial and tax press contain some shrill voices opposed to the recent (and likely transitory) phenomenon of so-called REIT conversions, with "REIT nativist" commentators decrying any taxpayer or type of real estate being treated as REIT-compliant if it did not come over on the "REIT Mayflower," *i.e.*, either by being a company originally set up as a REIT or investing in a property type held by REITs since 1960. *See*, *e.g.*, Bradley T. Borden, "Rethinking the Tax-Revenue Effect of REIT Taxation," 17 *Fla. T. Rev.* 527, 530 (2015) ("The comparison of REIT spinoffs to [transactions that potentially harm the fisc] borders on misplaced hysteria."); Richard M. Nugent, "REIT Spinoffs: Passive REITs, Active Businesses," *Tax Notes*, Mar. 23, 2015, p. 1513, at p. 1514 ("Traditional REIT spinoffs are fairly well supported by current law and [the] common criticisms of these transactions generally miss the mark."); Nugent, "REIT Spinoffs: Passive REITs, Active Businesses, Part 2," *Tax Notes*, Mar. 30, 2015, p. 1635, at p. 1648 ("Some have suggested

(Footnote continued on next page.)

For more *Tax Notes* content, please visit www.taxnotes.com.

In general, a REIT pays no regular corporate income tax because it receives a deduction for taxable income distributed to its shareholders;[2] however, REITs still pay entity-level income and excise taxes in several circumstances designed to protect the integrity of the corporate income tax base.[3] More important, a REIT's distribution of its taxable income to shareholders will generally be treated as ordinary dividend income (or sometimes as capital gain dividend income)[4] that is subject to far more fulsome taxation at the shareholder level than the dividends paid to shareholders by non-REITs.[5]

As demonstrated by the requirements above, a REIT's primary function under the code is to hold and lease real property for occupancy. As with all landlords, REITs must also provide a variety of related services to their tenants. The extent to which a REIT's revenues from those tenant services qualify for purposes of the 75 percent and 95

---

restricting only the spinoff element of REIT spinoffs. It is unclear what purpose that ban would serve, because REIT spinoffs typically satisfy all the policy and technical requirements of section 355.''). More sober voices, including Treasury and the IRS, recognize that the standards for what constitute real estate have remained essentially unchanged over time, even though the particular types of real estate crucial to the national and global economy will (and should) evolve. For example, the preamble to the proposed REIT real property regulations, REG-150760-13, states that Treasury and the IRS ''view these proposed regulations as a clarification of the existing definition of real property and not as a modification that will cause a significant reclassification of property.'' 79 F.R. 27508, 27510 (May 14, 2014). The preamble makes clear that the definition of real property was never as plain vanilla as the REIT nativists contend, citing published and private rulings dating back to 1969, which for all practical purposes is the dawn of the REIT statute:

> The IRS issued revenue rulings between 1969 and 1975 addressing whether certain assets qualify as real property for purposes of section 856. Specifically, the published rulings describe assets such as railroad properties, mobile home units permanently installed in a planned community, air rights over real property, interests in mortgage loans secured by total energy systems, and mortgage loans secured by microwave transmission property, and the rulings address whether the assets qualify as either real property or interests in real property under section 856. Since these published rulings were issued, REITs have sought to invest in various types of assets that are not directly addressed by the regulations or the published rulings, and have asked for and received letter rulings from the IRS addressing certain of these assets.

Id. at 27508 (footnotes omitted).

Practitioners commended the proposed regulations for their conformity with existing precedent and their articulation of a workable legal standard. *See, e.g.*, comments by the National Association of Real Estate Investment Trusts (NAREIT) on proposed REIT regulations (Aug. 12, 2014); comments by Ameek Ashok Ponda on proposed REIT regulations (Aug. 11, 2014). Indeed, some 55 years ago, REITs may have owned factories to house manufacturing tenants, whereas today a REIT is more likely to own data centers that house technology tenants whose equipment form the backbone of Internet and cloud commerce. *Compare* H.R. Rep. No. 86-2020, at 4 (1960) (stating that REITs can alleviate shortages of private capital ''for individual homes, apartment houses, office buildings, factories, and hotels'') *with* prop. reg. section 1.856-10(g), Example 6 (concluding that a data center's core building systems are real property). For a discussion of some of the more esoteric aspects of REIT conversions, see Ponda, ''How Much Gain Would a REIT Defer if a REIT Could Defer Gain?'' *Tax Notes*, June 4, 2012, p. 1249.

[2]*See generally* sections 561, 562(a), 562(c), 562(e), 565, 857(b)(1)-(3), 857(b)(9), 858, and 860.

[3]*See generally* sections 55(a) (tax on alternative minimum tax items); 337(d)(1) and 1374 (tax on reorganization or liquidation of a C corporation cannot be circumvented through use of REITs); 856(c)(7) (tax on asset test failure remediation); 856(g)(5) (tax on miscellaneous remediation); 857(b)(1)-(3) (tax on income not distributed to shareholders); 857(b)(4) (tax on income from foreclosure property); 857(b)(5) (tax on income test failure remediation); 857(b)(6) (tax on prohibited transactions, such as dealer property gains); 857(b)(7) (tax on misallocations or mispricing involving a TRS); 860 (interest and additions to tax for deficiency dividends); and 4981 (excise tax on delayed distributions to shareholders). Also applicable are reg. sections 1.337(d)-7 (tax on recognized built-in gains inherited from C corporations) and 1.857-11 (interest charge on delayed distributions to shareholders). Further, a REIT's TRSs are regular C corporations under the code, subject to the same corporate income taxes on their income as all other C corporations. *See* sections 11, 163(j), 856(l), and 857(b)(7).

[4]*See* section 857(b)(3).

[5]For example, a REIT's dividend to its shareholders generally cannot qualify for the preferential tax rates on qualified dividend income for noncorporate taxpayers (sections 1(h)(11)(D)(iii) and 857(c)(2)); cannot qualify for the dividends received deduction for corporate taxpayers (sections 243(d)(3) and 857(c)(1)); can be subject to tax as unrelated business taxable income (section 856(h)(3)(C)); can be subject to tax as income effectively connected with a U.S. trade or business (sections 897(h) and 1445(e)(6)-(7); reg. section 1.1445-8; Ponda, ''Foreign Pension Plans Investing in Shares of a U.S. REIT,'' *Tax Notes*, Mar. 24, 1997, p. 1593); and can qualify only under restricted circumstances for the otherwise generally applicable treaty-based reductions in U.S. withholding and income taxes on dividends paid to non-U.S. shareholders (Ponda, *id.*; 2006 U.S. model income tax treaty (Nov. 15, 2006), art. 10, para. 4, at 16-17). *See also* Borden, *supra* note 1, at 579-589 (concerns that REIT conversions damage the fisc are grossly exaggerated, given that over a variety of realistic assumptions regarding shareholder composition and corporate payout ratios, the erosion in the corporate income tax base is generally offset by the higher tax rates (and higher taxes) on the REIT's dividends to its shareholders; thus, REIT conversions generally have only a modest, insignificant net effect on total revenues of the fisc and in some cases may even have a positive impact on those revenues). Moreover, a REIT cannot pass foreign tax credits and similar tax attributes through to its shareholders (unlike a partnership or limited liability company taxed under subchapter K), meaning that the REIT structure can result in those tax attributes being lost forever (section 702; Ponda, ''REITs Abroad,'' in Practising Law Institute's *Tax Strategies for Corporate Acquisitions, Dispositions, Spin-Offs, Joint Ventures, Financings, Reorganizations & Restructurings* (2006-2008), para. I(F); *cf.* section 853 (regulated investment company passthrough of FTCs, but no analogous provision for REITs in sections 856-860)).

(C) Tax Analysts 2015. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

For more *Tax Notes* content, please visit www.taxnotes.com.

percent REIT gross income qualification tests of section 856(c)(2) and (3)[6] has been revisited many times since REITs were introduced in 1960, with each visit by Congress producing more expansive qualification. As discussed below, two intertwined and critical inquiries have generally been at the crux of each iteration of congressional expansion: (1) Is the service customarily provided by similarly situated landlords to similarly situated tenants, and (2) who is the service provider?

The advent of affiliated TRSs as providers of non-customary services to REIT tenants introduced a novel structural paradigm for addressing those critical inquiries. It was also a watershed moment in the effectiveness of the REIT statute[7] and the full realization of the REIT model of real estate ownership and operation.[8] By approaching both critical inquiries in a new way, the TRS structure created the foundation for asking and resolving a third critical question that did not arise under prior law: For purposes of the 75 percent and 95 percent REIT gross income qualification tests, how should a REIT's gross income from tenants for non-customary services supplied through TRSs be treated?

Although this question was both posed and resolved favorably by Rev. Rul. 2002-38,[9] which concluded that the gross income constitutes section 856(d) rents from real property,[10] the ruling's analysis and conclusions are extremely subtle and become clear only after examining the evolution of the REIT statute. To illuminate the full application of Rev. Rul. 2002-38, this report explains and analyzes the treatment of REIT revenues from tenants for services provided to those tenants by a REIT's TRS (1) in cases in which those revenues do not represent section 856(d)(1)(B) charges for services customarily furnished or rendered in connection with the rental of real property[11] and (2) regardless of whether the services are billed to tenants separately or as part of a bundled charge.[12] For purposes of

---

[6]*See supra* text accompanying note 1, and in particular the third bullet point there. The 75 percent REIT gross income qualification test of section 856(c)(3) mandates that 75 percent of the REIT's gross income consist of rental revenues and fees for related services (as well as a few other elements of income consistent with that classification), and the 95 percent REIT gross income qualification test of section 856(c)(2) mandates that 95 percent of the REIT's gross income consist of income qualifying under the 75 percent REIT gross income test plus passive investment income such as interest, dividends, and capital gains.

[7]*See* NAREIT, "REIT Industry Timeline: Celebrating 50 Years of REITs and NAREIT," *available at* http://www.reit.com/timeline/timeline.php.

[8]The REIT model of real estate ownership and operation has many advantages, including providing access to the real estate market for smaller investors, providing investor liquidity, reducing leverage, and generating investor income. As 2013 economics Nobel Prize winner Robert Shiller of Yale University said:

> REITs were created by law in 1960 to democratize the real estate market and make it possible for a broad base of investors to participate in this huge asset class. That was absolutely the right thing to do, because portfolio theory tells us people should diversify across major asset classes, and real estate is one of them.

NAREIT, "The REIT Story," *available at* https://www.reit.com/sites/default/files/media/PDFs/The-Reit-Story.pdf. Another prominent real estate economist, Timothy Riddiough of the University of Wisconsin, found that a "well-structured real estate securitization market," to which REITs contribute, moderates "construction boom and bust tendencies" and thus generates "positive spillover benefits to the economy at large." *Id.*

[9]2002-2 C.B. 4.

[10]Section 856(d) rents from real property satisfy both the 95 percent REIT gross income qualification test and the 75 percent REIT gross income qualification test. *See* section 856(c)(2)(C) and (c)(3)(A).

[11]Section 856(d)(1)(B). *See also* reg. section 1.856-4(b)(1), which states:

> The term "rents from real property", for purposes of paragraphs (2) and (3) of section 856(c), 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 furnished to the tenants of a particular building will be considered as customary if, in the geographic market in which the building is located, tenants in buildings which are of a similar class (such as luxury apartment buildings) are customarily provided with the service. . . . To qualify as a service customarily furnished, the service must be furnished or rendered to the tenants of the [REIT] or, primarily for the convenience or benefit of the tenant, to the guests, customers, or subtenants of the tenant.

In this report, we refer to the standard created by Congress in section 856(d)(1)(B), as implemented by reg. section 1.856-4(b)(1), as the "section 856(d)(1)(B) standard." The section 856(d)(1)(B) standard and its use of the term "customary" is not coterminous with the use of "customary" under reg. section 1.512(b)-1(c)(5) (described *infra* in notes 47-51 and their accompanying text), in which the term has been interpreted in a slightly more limited fashion. *See infra* notes 49, 51, and 57. For purposes of this report, the section 856(d)(1)(B) standard will be used throughout, unless the discussion or context specifically references section 512(b)(3) and reg. section 1.512(b)-1(c)(5) (referred to in this report as the "section 512(b)(3) standard").

[12]The IRS recently opened a regulations project regarding "clarifying the definition of income in section 856(c)(3) for purposes of the [REIT] qualification tests." Treasury, "2014-2015 Priority Guidance Plan," at 12, item 11 (Aug. 26, 2014). During a NAREIT conference on March 31, 2015, a branch chief noted that the IRS was "looking at all of the different aspects of REIT income testing. There's a lot in there. It's a lot more complex than what is real property." Amy S. Elliott, "REIT Industry Stressed Over Preferential Dividend Ruling," *Tax Notes*, Apr. 6, 2015, p. 58. This report illustrates that complexity and provides an analysis consistent with the code and prior guidance. We recommend that the conclusions of Rev. Rul. 2002-38, as articulated and explicated in this report, be preserved in any future regulations that touch on the topic.

(C) Tax Analysts 2015. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

For more *Tax Notes* content, please visit www.taxnotes.com.

this report, the term "subject revenues" refers to a REIT's section 61 gross income from all revenues for TRS-provided non-customary services, whether the associated charges to tenants are itemized separately or part of an overall bundled charge to tenants.[13]

II. The REIT World Before TRSs

A. The 1960 Standard

When REITs were created in 1960, Congress excluded from the definition of rents from real property amounts when the REIT directly furnished or rendered services to the tenants or managed the property.[14] Thus, initially, Congress did not want REITs to provide services to their tenants directly. Instead, as a practical matter, the statute permitted a REIT to provide those services only through an independent contractor.[15]

To implement the law, regulations first proposed in 1961 stated that all REIT income attributable to tenant services (and, through guilt by association, apparently all income from a property where the REIT performed tenant services) did not constitute rents from real property. Accordingly, a REIT could not perform those services without running afoul of the REIT gross income tests, and any fees for those services had to be included in the income of an independent contractor rather than the REIT.[16] However, the final regulations issued in 1962, T.D. 6598,[17] "extensively revised the proposed regulations on the issue of 'independent contractor'" and introduced the concept of "customarily provided services" to the REIT lexicon.[18] They retained the proposed regulations' requirement that all services provided by a REIT landlord to its tenants be provided through an independent contractor, but they created two separate regimes for those services: one for services for which no separate charge was made (limited to customarily provided services)[19] and one for all services for which a separate charge was made (including customarily provided services with a separate charge *and* all non-customarily provided services).[20] The combination of the 1960 code and the 1962 final regulations is referred to in this report as "the 1960 standard."

The 1960 standard made a slight bow to commercial reality by treating the full amount received by a REIT landlord from its tenant as rents from real property in the case of customary services for which no separate charge was made.[21] However, a REIT was still required to furnish those services through an independent contractor, and the facilities through an which those services were furnished were required to be maintained and operated by an independent contractor[22] that had to be "adequately compensated" by the REIT.[23] Meanwhile,

---

[13]As Rev. Rul. 2002-38 makes abundantly clear, in a typical commercial setting, the REIT itself bills and collects for subject revenues, and accordingly the REIT itself has section 61 gross income for those amounts, which is the starting point for REIT 75 percent and 95 percent gross income testing under section 856(c)(2) and -(3), according to reg. section 1.856-2(c)(1).

[14]H. Rep. No. 86-2020 (June 28, 1960). *See* former section 856(d)(3) (1960).

[15]*Id.*

[16]Prop. reg. section 1.856-4(b)(3)(i) (Jan. 19, 1961). To be precise, this proposed regulation provided that "certain amounts, although received or accrued for the use of, or the right to use, real property of the [REIT], will not be includible as 'rents for real property' for the purposes of the gross income requirements," including:

> any amount received or accrued, directly or indirectly, with respect to any real property if the [REIT] furnishes or renders services to the tenants of such property, or manages or operates such property, other than through an independent contractor from whom the [REIT] itself does not derive or receive any income. . . . If any services are performed for tenants, such services must be performed by, and the charges therefor (whether such charges are separately stated or included in the amount paid as rent) must be included in the income of, an independent contractor. . . . Thus, the [REIT] must not receive any income which is attributable to the services performed for the tenants of the [REIT] by an independent contractor.

Thus, the amount that the REIT landlord would have to pay the independent contractor would have to at least equal the amount that the REIT received from the tenants for the services (or the amount it was deemed to receive, in the case of bundled service charges). Apparently, if the REIT retained even a penny of services income, the entire amount of rent that it received (including for basic occupancy) would fail to qualify as rents from real property. However, then as now, normal commercial practice required landlords to provide services to tenants. *See infra* text accompanying note 28. As a result, a contemporary commentator noted that "more time was devoted to the concept of 'independent contractor' at the hearings [on] the [proposed] regulations than to all the other problems combined." Theodore Lynn, "Real Estate Investment Trusts: Problems and Prospects," 31 *Fordham L. Rev.* 73, 90 (1962).

[17]27 F.R. 4089 (Apr. 28, 1962).

[18]Lynn, *supra* note 16, at 91.

[19]Former reg. section 1.856-4(b)(3)(i)(*b*) (1962). New subdivision (*b*) was titled "Customary Services for Which No Separate Charge Is Made."

[20]Former reg. section 1.856-4(b)(3)(i)(*c*) (1962). New subdivision (*c*) was titled "Services for Which a Separate Charge Is Made."

[21]Former reg. section 1.856-4(b)(3)(i)(*b*) (1962). This result was achieved by stating in new subdivision (*b*) (but not in (*c*)) that:

> for purposes of [the REIT provisions], an amount will not be disqualified as "rent" if services, such as are usually or customarily furnished or rendered in connection with the mere rental of real property, are furnished or rendered to tenants of the property through an independent contractor.

[22]*Id.*

[23]Former reg. section 1.856-4(b)(3)(i)(*d*) (1962). The term "adequately compensated" was given a lengthy definition that

(Footnote continued on next page.)

(C) Tax Analysts 2015. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

For more Tax Notes content, please visit www.taxnotes.com.

services for which a separate charge was made, regardless of whether the services were customary or non-customary, required the independent contractor to bear the cost of the services and to receive and retain the entire amount of the separate charge.[24] The 1962 final regulations enumerated services that may be customary and services that were usually non-customary,[25] although it provided no means of discerning if or when the services were to be considered customary.

Although the 1962 final regulations were a substantial improvement over the 1961 proposed regulations, the 1960 standard's shortcomings remained obvious to many. As a former commissioner of internal revenue noted at the time regarding the new regime, "Favorable tax treatment does not assure favorable investment."[26] He believed that the most difficult aspect of the 1960 standard was the relationship between the REIT and the independent contractor.[27] Another commentator of the time expressed the problem succinctly:

> The emphasis on the distinction between active and passive income probably devolved from the fact that mutual funds have only passive income; yet the ownership of securities differs substantially from that of real estate. Ownership of real estate today is hopelessly encumbered with management functions, as well as the duty to provide certain incidental services, and these management functions and services result in income, "active" income no less. Needless to say, it is often "good management" and the incidental services which make one multiple-occupancy building more desirable (and hence more valuable) than another.[28]

A third commentator noted that the "independent contractor concept, so vague in theory, may become chaos in practice."[29] Congress kept revisiting tenant services and the independent contractor/REIT relationship over the next 40 years to bring order to the chaos.

B. The 1976 Revisions

The weaknesses of the 1960 standard, including the differentiated treatment between customary services bundled in the rental charge versus customary services for which a separate charge was made, did not permit the REIT format to be a useful vehicle for real estate ownership and investment, defeating the very purpose of the statute.[30] In 1976 Congress made a first attempt to address those weaknesses. The Tax Reform Act of 1976 (P.L. 94-455) provided that rents from real property included "charges for services customarily furnished or rendered in connection with the rental of real property, whether or not such charges are separately stated."[31] It also set standards regarding when services provided by a landlord to a tenant should be considered customary.[32] In explaining those changes, the Senate report stated:

> Under present law, amounts received by a REIT for services rendered to tenants, where no separate charge is made, will qualify for the

---

can be summarized as a requirement that the independent contractor receive fair market value for its services.

[24]Former reg. section 1.856-4(b)(3)(i)(*c*) (1962). This requirement was broken into two parts. For non-customary services:

> The cost of such services must be borne by the independent contractor, a separate charge must be made therefor, and the amount thereof must be received and retained by the independent contractor; no amount attributable to such services shall be included in the gross income of the [REIT].

And for customary services:

> If a separate charge is made for the customary services described in (b) of this subdivision, such charge must be made, and the amount thereof must be received and retained, by the independent contractor rather than by the [REIT].

[25]*See* former reg. section 1.856-4(b)(3)(i)(*b*)-(*c*) (1962).

[26]Mortimer Caplin, "Foreword," 48 *Va. L. Rev.* 1007, 1009 (1962).

[27]*Id.*

[28]J.B. Riggs Parker, "REIT Trustees and the 'Independent Contractor,'" 48 *Va. L. Rev.* 1048, 1051 (1962). This commentator also examined the 1960 standard and found it wanting because the REIT itself was merely an aggregation of individual properties requiring the management and services that the 1960 standard forbade the REIT from supplying directly:

> The apparent conclusion is that only a true *uncontrolled*, *unsupervised* "agency law" type of independent contractor will qualify under the REIT tax provisions. . . . The REIT trustees are, in effect, *required by the Code* to delegate to a real estate management company the duty of managing individual properties and providing services to the tenants of such properties if such services are necessary or desirable and proper, and to *relinquish control* over the real estate management company in the performance of those management functions. . . . [The regulation] seems to assume that the distinction between the REIT trustee's fiduciary duty to manage the "trust itself" and managing or "operating the property" of the trust is obvious. Such an assumption appears to be at least an oversimplification. What is the "trust itself" other than an agglomeration of properties which must be individually managed? [Emphasis in original.]

Id. at 1053-1054.

[29]Lynn, *supra* note 16, at 92.

[30]A Goldman Sachs report from 1996 stated that only 10 REITs of any real size existed during the 1960s but that those REITs had "miniscule" portfolios of real property when compared with other property owners. *See* Ralph L. Block, *Investing in REITs: Real Estate Investment Trusts* 110-111 (2006) (quoting the report's finding that REIT industry-wide real estate investments in the 1960s amounted to slightly more than $200 million).

[31]Section 856(d)(1)(B), which is still in effect today.

[32]*See supra* text accompanying note 25.

(C) Tax Analysts 2015. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

For more Tax Notes content, please visit www.taxnotes.com.

> 75-percent and 95-percent source tests if the services are customary and are furnished by an independent contractor. However, if a separate charge is made for customary services furnished by an independent contractor, the income tax regulations take the position that the amount of the charge must be received and retained by the independent contractor and not by the REIT. This restriction on separate charges for customarily furnished services does not follow normal commercial practice. Consequently, the committee amendment and House bill provide that amounts received by a REIT as charges for services customarily furnished or rendered in connection with the rental of real property will be treated as rents from real property whether or not the charges are separately stated.[33]

At the same time, TRA 1976 created a standard for determining the circumstances under which services should be considered customary for section 856(d) purposes:

> The committee intends that, with respect to any particular building, services provided to tenants should be regarded as customary if, in the geographic market within which the building is located, tenants in buildings which are of a similar class (for example, luxury apartment buildings) are customarily provided with the service.[34]

Thus, TRA 1976 followed normal commercial practice and overturned the artificial differentiation in the 1960 standard between bundled customary services and separately stated customary services. Accordingly, after TRA 1976 all amounts received by a REIT for customary services constituted rents from real property under section 856(d)(1)(B), regardless of whether a separate charge or an allocation was made. However, the prohibition on a REIT providing services directly instead of through an independent contractor remained in the code.[35]

In response to TRA 1976, the IRS revised the regulations governing section 856(d) rents from real property.[36] In the revised regulations, all services (whether customary or non-customary) still had to be provided through an independent contractor,[37] but a REIT could now treat any amounts received from tenants from the provision of customary services as rents from real property (whether those services were bundled with the rent or separately stated).[38] A new regulation addressing the treatment of independent contractors was put in place to address the rendering of non-customary services, which was substantially similar to the provision in the 1960 standard.[39] Under this new regulation, the only way a REIT landlord could deliver non-customary services to its tenants was to meet each of the following six requirements of the code and Treasury regulations:

---

[33]S. Rep. No. 94-938, at 473-474 (June 10, 1976).

[34]*Id.* As part of its customary services analysis in TRA 1976, the legislative history also stated that the submetering of electricity (and, by extension, other utilities) by a REIT landlord should be considered a customary service. For the long-standing definition of submetering, see Morway Picket, ''The Legal Status of the Submeterer of Electric Current,'' 37 *Col. L. Rev.* 227 (1937) (''Submetering is the term applied to the remetering and resale of public utility services, purchased by the building owners through a master meter at wholesale rate, to their tenants at retail rates.''). Before TRA 1976 it was unclear how submetering should be treated by a REIT landlord. It was clear that the provision of utilities by a landlord was a customary service for a tax-exempt landlord under the section 512(b)(3) standard. *See*, *e.g.*, Rev. Rul. 69-178, 1969-1 C.B. 158 (the rental of a meeting hall where only usual and customary services — but including all utilities — were provided by the landlord-generated rents from real property for a tax-exempt entity). But in the 1960 standard, submetering was listed under ''services for which a separate charge is made,'' a provision that included both separately charged customary services and all non-customary services. *See* former reg. section 1.856-4(b)(3)(i)(*c*) (1962). In Rev. Rul. 75-340, 1975-2 C.B. 270, the IRS implied that submetering was a non-customary service, differentiating between the situation where ''a separate charge is made for a usual or customary service'' and the situation ''where electric current is purchased by the [REIT] and then sold to tenants at a price in excess of the purchase price (for example, submetered).'' After TRA 1976, however, the IRS abandoned this implied nuance.

[35]*See* former section 856(d)(2)(C) (1976):

> For purposes of paragraphs (2) and (3) of subsection (c), the term ''rents from real property'' does not include . . . any amount received or accrued, directly or indirectly, with respect to any real or personal property if the [REIT] furnishes or renders services to the tenants of such property, or manages or operates such property, other than through an independent contractor from whom the [REIT] itself does not derive or receive any income.

Even with TRA 1976's improvements to the REIT structure, the public equity market capitalization of the REIT industry was smaller at the end of 1979 than it had been at the end of 1972. *See* Block, *supra* note 30, at 113.

[36]The IRS proposed new regulations on July 7, 1978, and finalized them with only minor, inconsequential changes in T.D. 7767, 46 F.R. 11282 (Feb. 6, 1981). In a key revision, the TRA 1976 standard adopted by Congress for determining which services should be considered customary (see *supra* text accompanying note 34) replaced the enumerated lists of customary and non-customary services in the 1960 standard. The version of reg. section 1.856-4(b)(1) that was adopted as part of T.D. 7767 is still in effect today.

[37]*See*, *e.g.*, reg. section 1.856-4(b)(1): ''The service must be furnished through an independent contractor from which the [REIT] does not derive or receive any income.''

[38]*Id. See supra* text accompanying note 31.

[39]*See infra* note 42.

(C) Tax Analysts 2015. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

For more *Tax Notes* content, please visit www.taxnotes.com.

- the REIT and the independent contractor had to be less than 35 percent affiliated;[40]
- the REIT could not earn interest, dividend, rental, or other income from the independent contractor;[41]
- the charges for the services had to be separately stated;
- the service revenues had to be collected by the independent contractor;
- the service revenues had to be retained by the independent contractor; and
- the independent contractor had to be adequately compensated.[42]

These six independent contractor rules were split in applicability: the first two applied to all services provided by independent contractors, whereas the last four applied only to the provision of noncustomary services by the independent contractor. Yet, even after all the useful changes made by TRA 1976, there was still the fundamental problem of the 1960 structure for both customary and noncustomary services: a REIT was required to ''relinquish control'' over the services to an ''uncontrolled, unsupervised'' agent.[43]

C. The 1986 Revisions

Congress returned to the REIT provisions a decade later, in the Tax Reform Act of 1986 (P.L. 99-514). Again, a main focus was the REIT's inability to control the services provided to tenants. TRA 1986 was the first legislation to provide that a REIT could actively provide services to tenants without using an independent contractor. As the 1986 blue book put it:

> The Congress believed that [the] requirements of present law, that are intended to assure that the REIT is more a passive entity than one engaged in an active trade or business, may be overly restrictive and should be liberalized consistent with maintaining the essential passivity of the REIT. Congress believed that REITs should be permitted to perform certain services in connection with the rental of real property without being required to use an independent contractor (to assure that rents from such property are considered to qualify as ''rent from real property''). The Congress believed that the same standard should be applied to REITs for the purpose of determining whether amounts being received are from the passive rental of real property or from an active trade or business, that is applied to tax-exempt entities in determining whether amounts are treated as income from an ''unrelated trade or business.''[44]

This liberalization was implemented by TRA 1986, which added a new exception to former section 856(d)(2)[45] to treat as qualifying rents from real property ''any amount if such amount would be excluded from unrelated business taxable income under section 512(b)(3) if received by an organization described in section 511(a)(2).''[46] The new exception explicitly made reg. section 1.512(b)-1(c)(5) and the section 512(b)(3) a standard part of the REIT rules.[47] Accordingly, the test used by the IRS exempt organizations group to determine

[40]*See* section 856(d)(3).

[41]*See infra* note 42. *See also* section 856(d)(7)(C)(i).

[42]*See* reg. section 1.856-4(b)(5)(i):

> No amount . . . qualifies as ''rents from real property'' if the [REIT] furnishes or renders services to the tenants of the property . . . other than through an independent contractor from whom the [REIT] itself does not derive or receive any income. . . . 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.

[43]*See supra* note 28.

[44]Joint Committee on Taxation, ''General Explanation of the Tax Reform Act of 1986,'' at 391 (1986 blue book).

[45]*See supra* note 35.

[46]Former section 856(d)(2) (last sentence) (1986), reformulated in 1997 as section 856(d)(7)(C)(ii), which is still in effect today. As Rev. Rul. 98-60, 1998-2 C.B. 751, makes clear, section 856(d)(7)(C)(ii) and its incorporated section 512(b)(3) standard are not concerned with a too-literal application of the statutory ''would be [as] if'' wording, but instead create an outright exemption for any property-related services that a tax-exempt organization may perform without being in receipt of unrelated business taxable income.

[47]When Congress originally created the rules governing UBTI for some nonprofits, it left to the regulations most of the tough choices regarding real estate rental and services income. *See*, *e.g.*, S. Rep. No. 81-2375 (1950) (noting that some types of investment income ''have long been recognized as a proper source of revenue for educational and charitable organizations and trusts''). Reg. section 1.512(b)-1(c)(2), included in T.D. 6301, 23 F.R. 5192 (July 9, 1958), provided the first real guidance for those nonprofits regarding the treatment of investment income from rental real estate and services — and, with the exception of a few minor, insignificant changes (including the substitution of the term ''rents from real property'' for the term ''rentals from real estate'' and its later renumbering as reg. section 1.512(b)-1(c)(5)), this same regulation has provided the standard for nonprofits to use in differentiating UBTI from nontaxable rents from real property for more than 55 years. A variant of the section 512(b)(3) standard is also used in other areas of the code and regulations. *See*, *e.g.*, the self-employment regulations, reg. section 1.1402(a)-4(c)(1)-(2) (titled, respectively, ''No services rendered for occupants'' and ''Services rendered for occupants'').

(C) Tax Analysts 2015. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

For more *Tax Notes* content, please visit www.taxnotes.com.

whether services performed for a tenant of a nonprofit organization give rise to rents from real property under the section 512(b)(3) standard became the standard for services that a REIT could perform directly for its tenants without needing to use an independent contractor. The plain, unambiguous language[48] of reg. section 1.512(b)-1(c)(5) sets out a two-prong test[49]:

> For purposes of this paragraph, payments for the use or occupancy of rooms and other space where services are also rendered to the occupant [do] not constitute rent from real property. Generally, services are considered rendered to the occupant *if* they are provided 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.[50] [Emphasis added.]

Accordingly, clearing either prong of the above test would mean that the particular service is not considered rendered to the occupant, and the associated payments would therefore not be disqualified from section 512(b)(3) rents from real property.

Thus, by incorporating the section 512(b)(3) standard, TRA 1986 permitted REITs (for the first time) to directly render customary services to tenants without using an independent contractor and to include the amounts received for those services in section 856(d) rents from real property. If the section 512(b)(3) standard (and thus, as a practical matter, also the section 856(d)(1)(B) standard)[51] were satisfied, *all* revenues from the provision of those services qualified as rents from real property, regardless of whether they were bundled or separately stated under section 856(d)(1)(B) and regardless of whether they were provided at cost or at a markup over cost.[52]

For example, the archetypal service performed by a landlord, and explicitly noted as a customary service in the 1960 standard, is the provision of

---

[48]As the Supreme Court has repeatedly confirmed, the ''plain meaning rule'' of statutory construction means that the plain meaning of a statute or regulation ''must prevail.'' *Atlantic Mutual Insurance v. Commissioner*, 523 U.S. 382, 387 (1998). *See*, *e.g.*, *Gitlitz v. Commissioner*, 531 U.S. 206, 219-220 (2001) (holding that the plain meaning of the code permitted S corporation shareholders to deduct previously suspended losses).

[49]Both the IRS and the courts have interpreted reg. section 1.512(b)-1(c)(5) as containing a two-prong test. *See*, *e.g.*, Internal Revenue Manual section 7.27.6.7.4.5, ''Rendering of Personal Services,'' which, similar to, and using wording almost identical to, reg. section 1.512(b)-1(c)(5), shows two prongs as separate requirements introduced by an ''if'' and connected by the conjunction ''and'':

> 1. Payment for the use or occupancy of rooms or other space where services are also rendered to the occupant does not constitute rent from real property. . . .
>
> 2. Generally, services are considered rendered to the occupant *if* they are primarily for his/her convenience *and* are different from those usually or customarily rendered in connection with the rental of rooms or space for occupancy only. [Emphasis added.]

See also Ocean Pines Association, Inc. v. Commissioner, 135 T.C. 276, 287 (2010):

> But the test in the regulation for determining whether the services are rendered to the occupant (and therefore disqualify the organization from using the rental exception) is not whether the services provided are substantial, but whether the services are (1) ''primarily'' for the ''convenience'' of the occupant and (2) are ''other than those usually or customarily rendered in connection with the rental of rooms or other space for occupancy only.''

IRS private letter rulings have also noted the two-prong test. *See*, *e.g.*, LTR 200241050 (requested ruling 7) (''Even if the Service determines that the marketing and promotional activities related to the Property fail to meet the *two-prong test* of section 1.512(b)-1(c)(5) of the Income Tax Regulations'' (emphasis added).).

[50]The regulations do not explain further what is meant by ''provided primarily for [the tenant's] convenience.'' On closer inspection, some services that might seem oriented to tenant convenience are in fact more closely related to property-wide safety and security. *See*, *e.g.*, LTR 9014022, in which an apartment REIT:

(Footnote continued in next column.)

> will continue a longstanding practice of changing light bulbs in certain built-in light fixtures located in particular apartments. These fixtures constitute valuable and integral components of the apartment properties and the Company's policy of insisting that light bulbs (which are paid for by the tenant) in these fixtures be removed and replaced only by management personnel is designed to reduce breakage of these valuable fixtures.

See also LTR 8914048 (apartment REIT may ''install and/or remove air conditioning units during a tenant's lease term as is also usual and customary. In connection with the installment and removal of such units [the REIT] may charge a small fee'').

[51]In theory, this exception for section 512(b)(3) in former section 856(d)(2) (now in section 856(d)(7)(C)(ii)) did not mean that any service qualifying under the section 512(b)(3) standard automatically satisfied the section 856(d)(1)(B) standard, but in practice this is so. *Cf.* LTR 200101012 (holding that the provision of Internet, telephone, cable television, security services, and computer room facilities in some apartment complexes is exempt under section 512(b)(3) (and also under the section 856(d)(1)(B) standard), but the provision of private shuttle bus services for tenants of the apartment complexes is exempt only under the section 856(d)(1)(B) standard enumerated in section 856(d)(7)(C)(i)). In words often attributed to Yogi Berra: ''In theory there is no difference between theory and practice. In practice there is.''

[52]For example, on submetering of utilities, LTR 200148074 and LTR 200147058 both clearly state that the landlord ''will retain the difference between the price it charges its tenants and the amount it owes the utility provider for the Utility Services, which may result in a profit to the'' landlord and conclude that:

> any income derived by the [landlord] in connection with the provision of electricity, water, sewer and gas service is not service income, but is includable in ''rents from real property'' within the meaning of section 512(b)(3) of the Code, whether or not the charges for electricity, water, sewer or gas service are separately stated or are incorporated into the tenant's rental obligations.

(C) Tax Analysts 2015. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

For more *Tax Notes* content, please visit www.taxnotes.com.

utilities.[53] Under TRA 1986, REITs could now provide utility services directly without any involvement from an independent contractor.[54] Accordingly, REITs could now be engaged in the active trade or business of providing customary services satisfying the section 512(b)(3) standard to tenants. In response to TRA 1986, the IRS published a ruling appropriately changing its position about REIT involvement in a trade or business.[55]

Of course, REITs could also continue to provide customary services through independent contractors and continue to treat the amounts received for those services as rents from real property.[56] In effect, TRA 1986 created a middle ground for REIT tenant services that satisfy the section 856(d)(1)(B) standard but not the section 512(b)(3) standard. Those middle ground services could not be performed by the REIT directly but could be performed by an independent contractor under an arrangement with the REIT that had to satisfy the first two (but not necessarily the last four) independent contractor rules discussed in Section II.B.[57] However, TRA 1986 did not affect the treatment of non-customary services provided by a REIT to its tenants. Those still had to be performed by an independent contractor under an arrangement that satisfied all six rules in reg. section 1.856-4(b)(5)(i), meaning that a REIT was still required to relinquish control over some of its customary services and all of its non-customary services to an uncontrolled, unsupervised agent.[58]

III. The Advent of TRSs

After almost 40 years of REITs being handicapped in attracting and competing for tenants, the REIT Modernization Act of 1999 (RMA) finally removed the barrier that prevented REIT landlords from being able to control and supervise the offering of non-customary services to their tenants. The RMA was included in the Ticket to Work and Work Incentives Improvement Act of 1999 (P.L. 106-170) and became effective January 1, 2001. It created a new type of REIT subsidiary, the section 856(l) TRS, that would be permitted to perform non-customary services for tenants that otherwise would have to be done by one or more independent contractors. The tradeoff was that unlike other REIT subsidiaries (but like an independent contractor), a TRS would be fully taxable. When introducing the RMA in the House, then-Rep. Bill Thomas, the principal sponsor of the act, said:

> Our legislation would allow REITs to create taxable subsidiaries that would be allowed to

---

[53]*See supra* note 34. Reg. section 1.512(b)-1(c)(5) specifies that "the furnishing of heat and light" is a service that clears the two-prong test, even though at some level furnishing a utility is for the benefit of the tenant and in theory does not pass the first prong of the section 512(b)(3) standard — yet, it is considered so basic to the rental relationship that it has been designated as the archetypical good service that satisfies reg. section 1.512(b)-1(c)(5). *See, e.g.*, Rev. Rul. 69-178; LTR 199952084 (ruling in favor of a REIT when "the telecommunication services provided to tenants of the Properties are similar to the provision of services by public utilities and are essential for business communications and information transmission"). *Cf.* reg. section 1.856-4(b)(1) ("The furnishing of water, heat, light, and air-conditioning . . . are examples of services which are customarily furnished to" tenants); prop. reg. section 1.856-10(d)(3)(iii)(D) (performance of "a utility-like function" supports real property treatment).

[54]*See supra* text accompanying note 47.

[55]*See supra* text accompanying note 44. In Rev. Rul. 2001-29, 2001-1 C.B. 1348, the IRS acknowledged the impact of the TRA 1986 change:

> Consequently, as a result of the 1986 amendment, a REIT is permitted to perform activities that can constitute active and substantial management and operational functions with respect to rental activity that produces income qualifying as rents from real property under section 856(d).
>
> * * *
>
> A REIT can be engaged in the active conduct of a trade or business within the meaning of section 355(b) solely by virtue of functions with respect to rental activity that produces income qualifying as rents from real property within the meaning of section 856(d).

[56]As the 1986 blue book, *supra* note 44, at 395, clearly explained: "The Act does not alter the provision of prior law under which amounts received by a REIT are treated as rents from real property if the REIT provides customarily furnished services to its tenants through an independent contractor."

For a general background on customary services performed by REITs under these code provisions and their associated regulations (including reg. section 1.856-4(b)(1)), see, *e.g.*, Peter J. Genz, "REIT Customary Services Issues," 2007 *ABATAX-CLE* 0928051 (Sept. 6, 2007), updated Feb. 20, 2015 (manuscript in possession of the authors).

[57]*See, e.g.*, Rev. Rul. 2004-24, 2004-1 C.B. 550 ("The definition of rents from real property in section 856(d), which applies to REITs, differs significantly in scope and structure from the definition of rents from real property under section 512(b)(3), which applies to exempt organizations."); LTR 200101012 (holding that the provision of Internet, telephone, cable television, security services, and computer room facilities in some apartment complexes are exempt under section 512(b)(3) (which, as described *supra* at text accompanying note 51, is as a practical matter encompassed by the section 856(d)(1)(B) standard), but the provision of private shuttle bus services for tenants of the apartment complexes meets only the section 856(d)(1)(B) standard). *See also* LTR 200008036, LTR 9642027, and LTR 9316024 (involving various transportation services apparently provided to tenants under the section 856(d)(1)(B) standard but not the section 512(b)(3) standard, although the facts and exposition are not entirely clear). Significantly, according to reg. section 1.856-4(b)(5)(i), these middle-ground services need to meet only the first two, but not all six, of the independent contractor requirements enumerated in Section II.B. *See supra* text accompanying notes 40-42.

[58]*See supra* note 28.

(C) Tax Analysts 2015. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

For more *Tax Notes* content, please visit www.taxnotes.com.

perform noncustomary services to REIT tenants without disqualifying the rents a REIT collects from tenants, that is, performance of these services would no longer trigger a technical violation of the REIT rules.[59]

In his introductory remarks for the RMA in the Senate, then-Sen. Connie Mack concurred:

> As a result [of the customary services rule], REITs increasingly have been unable to compete with privately-held partnerships and other more exclusive forms of ownership. Today, the rules prevent REITs from offering the same types of customer services as their competitors, even as such services are becoming more central to marketing efforts.
>
> * * *
>
> Certainly, this is not consistent with what Congress intended when it created REITs, and when it modified the REIT rules over the years. In keeping with the Congressional mandate to provide a sensible and effective way for the average investor to benefit from ownership of income-producing real estate, REITs should be able to provide *a range of services* through taxable subsidiaries.[60] [Emphasis added.]

The Senate report noted the control issue that existed under the independent contractor regime, stating:

> Certain kinds of activities that relate to the REIT's real estate investments should be permitted to be performed *under the control of the REIT*, through the establishment of a "taxable REIT subsidiary" where there are rules that limit the amount of the subsidiary's income that can be reduced through transactions with the REIT.[61] [Emphasis added.]

Thus, with the introduction of TRSs, REITs could finally compete for tenants with other, more flexible types of landlords without first involving an uncontrolled and unsupervised agent.[62] But with the advent of TRSs creating a novel structural paradigm for tenant services by permitting for the first time a REIT-controlled entity to be the provider for noncustomary services, the TRS structure created the foundation for asking and resolving an entirely new third question: Do subject revenues qualify as section 856(d) rents from real property?[63]

In the figure, subject revenues compose the outermost ring, which is shaded green (for unbundled service charges) and orange (for bundled service charges). The inner circle consists of charges for services that qualify as usual and customary under both reg. sections 1.512(b)-1(c)(5) (the section 512(b)(3) standard) and 1.856-4(b)(1) (the section 856(d)(1)(B) standard), while the middle ring consists of charges for services that qualify as customary only under reg. section 1.856-4(b)(1) (only the

[59]145 *Cong. Rec.* E795 (Apr. 28, 1999).

[60]145 *Cong. Rec.* S5377 (May 14, 1999).

[61]S. Rep. No. 106-201, at 57 (Oct. 6, 1999). The Clinton administration also agreed with this change, as shown in its proposed 2000 budget:

> Many of the businesses performed by the REIT subsidiaries are natural outgrowths of a REIT's traditional operations, such as third-party management and development businesses. While it is inappropriate for the earnings from these non-REIT businesses to be sheltered through a REIT, it also is counter-intuitive to prevent these entities from taking advantage of their evolving experiences and expanding into areas where their expertise may be of significant value.

Treasury, "Explanation of the REIT-Related Items in the Fiscal Year 2000 Budget" (Feb. 1, 1999). The administration's caveat was satisfied in the enacted legislation in two ways: (1) the TRS vehicle created to render non-customary services is fully taxable, so all of its revenue is fully exposed to federal income tax; and (2) improper allocations of revenues between the REIT and its TRS could trigger the 100 percent "redetermined rents" penalty tax discussed in Section IV.B *infra*.

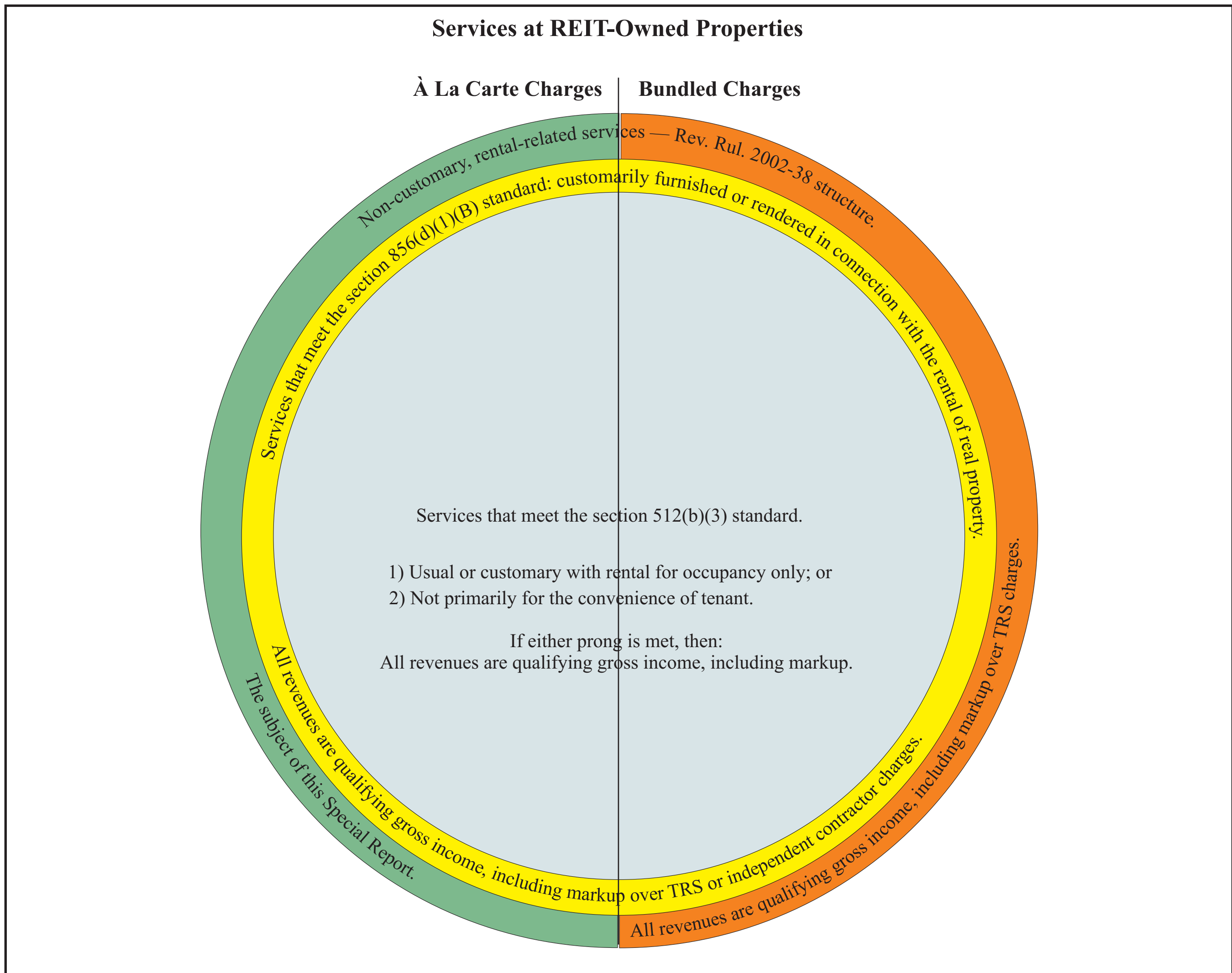
(Footnote continued in next column.)

[62]*See supra* note 28. In general, a TRS may engage in any manner of business activity, regardless of whether it is related to the provision of services to REIT tenants, except that section 856(l)(3) prohibits a TRS from operating or managing a lodging facility or a healthcare facility (as well as providing specific franchise or license rights for those facilities). This prohibition concerns day-to-day management and operations, not the type of supervisory functions described in reg. section 1.856-4(b)(5)(ii) and LTR 7930040. *See, e.g.*, LTR 201232032; *see also* section 856(d)(7)(A), (d)(8)(B) (second sentence), (d)(9)(A), (d)(9)(B), and (d)(9)(E). Further, a REIT's investment in the equity and debt of its TRSs, together with other nonqualifying assets, generally cannot exceed 25 percent of the REIT's total assets. *See* section 856(c)(4)(A) (25 percent limit as the mathematical complement of the 75 percent REIT asset test requirement) and section (c)(4)(B)(ii) (direct limit of 25 percent on securities of TRSs); and text accompanying note 1 (in particular the second and fourth bullet points there). For these purposes, however, a REIT's investment in TRS debt securities, to the extent secured by mortgages on real property, or a REIT's investment in TRS equity or debt securities, to the extent and for the duration qualifying as a temporary investment of new capital, will qualify as a real estate asset that counts toward the 75 percent REIT asset test requirement and is therefore not a security subjected to the 25 percent limit. *See* section 856(c)(4)(A), (c)(4)(B), (c)(5)(B), and (c)(5)(D); reg. section 1.856-3(c) ("The term 'securities' does not include 'interests in real property' or 'real estate assets' as those terms are defined in section 856 and" reg. section 1.856-3); LTR 201503010, LTR 201431020, LTR 201315007, LTR 201129007, LTR 200705001, and LTR 200630010 (debt securities of a TRS adequately secured by real estate are not securities for purposes of section 856(c)(4)(B)(ii)); and LTR 9342021 (long-term investment can qualify as a temporary investment of new capital for a temporary duration).

[63]*See supra* text accompanying notes 6-13.

(C) Tax Analysts 2015. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

For more *Tax Notes* content, please visit www.taxnotes.com.



section 856(d)(1)(B) standard).[64] Both inner circle and middle ring services have been acknowledged since TRA 1976 and TRA 1986 to represent section 856(d) rents from real property, whether bundled with the rent or separately charged. But what about subject revenues? If collected by the REIT, do they also represent rents from real property? Does it matter if they are bundled or separately charged? Should it matter?

The treatment of subject revenues from bundled services charges was answered clearly by Rev. Rul. 2002-38.[65] As discussed in Section IV.C below, when analyzing a fact pattern that involved bundled charges for a non-customary housekeeping service, Rev. Rul. 2002-38 concluded that the entire amount received by the REIT (including the bundled service charges for non-customary services) constituted rents from real property and were thus subject to any required redetermination of rents under section 857(b)(7). However, some have posited a distinction, similar to the 1960 standard,[66] between bundled subject revenues versus separately stated subject revenues, whereby separately stated subject revenues collected by a REIT might not represent section 856(d) rents from real property.

IV. Subject Revenues as Qualifying Rents

There are at least six interconnected and mutually reinforcing reasons why subject revenues (whether bundled or separately stated) constitute section 856(d) rents from real property.

A. Congressional Intent

As shown below, Congress intended that all subject revenues be treated as section 856(d) rents

[64] *See supra* note 57.

[65] *See supra* note 9.

[66] *See supra* text accompanying notes 19-24.

(C) Tax Analysts 2015. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

For more *Tax Notes* content, please visit www.taxnotes.com.

from real property. The RMA itself does not distinguish between separately stated versus bundled subject revenues, so the legislative history must be examined to see if that differentiation was intended.

The principal sources of legislative history regarding the treatment of TRS activities are the Senate report for the RMA and the 2000 blue book, the latter of which says:

> A taxable REIT subsidiary can engage in certain business activities that under prior law could disqualify the REIT because, but for the provision, the taxable REIT subsidiary's activities and relationship with the REIT would have prevented certain income from qualifying as rents from real property. Specifically, the subsidiary can provide services to tenants of REIT property (even if such services were not considered services customarily furnished in connection with the rental of real property [under the section 856(d)(1)(B) standard]), and can manage or operate properties, generally for third parties, without causing *amounts received or accrued* directly or indirectly *by the REIT for such activities* to fail to be treated as rents from real property.[67] [Emphasis added.]

In parsing the above legislative intent, three points stand out. First, the legislative history uses the phrase "amounts received or accrued" rather than "rents received or accrued," which implies that *all amounts* received by a REIT, including amounts for non-customary services, are intended to be included in rents from real property. That is, the legislative intent is clearly to include all of a REIT's receipts or accruals, not just charges for occupancy and customary services. Second, the term "such activities" specifically refers to services provided to tenants of REIT property that give rise to subject revenues, which again makes clear that subject revenues are encompassed by the legislative intent. Third, the legislative history makes no distinction between subject revenues that are separately stated versus those that are bundled with basic rent or customary services charges, and Congress has never created that distinction. (In fact, with TRA 1976, Congress overturned the distinction that the IRS created in the 1960 standard.[68]) Accordingly, there is no basis in the legislative history to distinguish between separately stated versus bundled subject revenues.

[67]JCT, "General Explanation of Tax Legislation Enacted in the 106th Congress," JCS-2-01, at 70 (Apr. 19, 2001) (2000 blue book); *see also* S. Rep. No. 106-201, at 59 (Oct. 6, 1999) (using identical language to the 2000 blue book except for verb tenses and a typo).

[68]*See supra* Section II.

While the above legislative history uses double negatives ("without causing [subject revenues] to fail to be treated" as section 856(d) rents from real property), the rule that it created is in fact meant as an affirmative rule, particularly when read in the context of how tenant services were treated before the RMA[69]: Subject revenues *are* section 856(d) rents from real property. As explained below, this affirmative rule is confirmed by the structure of section 857(b)(7) and by Rev. Rul. 2002-38.

B. The Section 857(b)(7) Structure

As shown below, the statutory structure of the section 857(b)(7) 100 percent penalty tax is predicated on, and only consistent with, treating subject revenues as rents from real property. With the advent of TRSs as providers of services to REIT tenants, Congress gave the IRS a powerful new antiabuse tool: section 857(b)(7) (reproduced in the Appendix, *infra* Section VI), which was designed to prevent REITs from profiting through the misallocation of revenue or profit in arrangements involving their TRSs.[70] Added to the code by the RMA,[71] section 857(b)(7) provides for a 100 percent penalty tax that can be imposed only on redetermined rents, redetermined deductions, and excess interest, each as defined in section 857(b)(7). Redetermined rents are defined to include only section 856(d) rents from real property.[72] When the penalty tax is applied, it supersedes the application of section 482 remedies,[73] because it is a more powerful tool. However, this tool can be applied only to amounts that constitute section 856(d) rents from real property in the first place. Thus, for the entire legislative structure of penalties to work as intended for TRS-provided services, subject revenues must constitute rents from real property.

[69]*See supra* Section II.

[70]*See supra* note 61.

[71]The wording of section 857(b)(7) in the RMA was corrected by a technical corrections bill (fixing a nit in section 857(b)(7)(B)(ii) that referenced paragraph "(7)(C)(i)" instead of "(7)(C)(ii)") before the January 1, 2001, effective date of the TRS provisions. *See* Consolidated Appropriations Act of 2001 (P.L. 106-554), Appendix G (H.R. 5662), section 311(b). The corrected wording, which represents the wording of this provision as of January 1, 2001, is used in the Appendix, *infra* Section VI.

[72]*See* section 857(b)(7)(B)(i). That redetermined rents must first be section 856(d) rents from real property has been true throughout the entire existence of section 857(b)(7), as amended from time to time. The section 857(b)(7) concepts of redetermined deductions and excess interest are limited to deductions by the TRS for payments to the REIT; by definition, they cannot cover a REIT's undercompensation of its TRS for services provided by the TRS to REIT tenants, because only redetermined rents can do that. *See* section 857(b)(7)(C)-(D).

[73]*See* section 857(b)(7)(E).

(C) Tax Analysts 2015. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

For more *Tax Notes* content, please visit www.taxnotes.com.

The above point is particularly obvious in light of former section 857(b)(7)(B)(ii), which was deleted in a 2004 legislative change but was still in effect when Rev. Rul. 2002-38 was issued.[74] Former section 857(b)(7)(B)(ii) exempted services described within section 856(d)(1)(B) or section 512(b)(3) from the then reach of the 100 percent penalty tax. Sections 856(d)(1)(B) and 512(b)(3) cover all customarily provided services performed by REITs or their TRSs. Thus, under the statutory structure initially created by the RMA, if section 857(b)(7) redetermined rents did not apply to subject revenues, the provision would have applied to nothing at all because former section 857(b)(7)(B)(ii) exempted everything that satisfied the section 856(d)(1)(B) standard.[75]

Accordingly, an interpretation under which subject revenues were not rents from real property would have rendered the section 857(b)(7) redetermined rents provision entirely superfluous. One of the few universally accepted canons of statutory construction is that any interpretation that renders a statutory term as surplusage or a nullity is strongly disfavored.[76] In sum, subject revenues must have been section 856(d) rents from real property; otherwise, section 857(b) redetermined rents as initially created by the RMA would be surplusage. The later amendment to section 857(b)(7) has not affected the original intent to include subject revenues within section 856(d) rents from real property and thus within the reach of the section 857(b)(7) 100 percent penalty tax.[77]

Further, former section 857(b)(7)(B)(v) (current section 857(b)(7)(B)(iv)) specifically excluded some separately charged services from the reach of the 100 percent penalty tax on redetermined rents. If separately charged subject revenues were not intended by the RMA to be included in section 856(d) rents from real property, this exclusion would have been mere surplusage because *all* separately charged subject revenues would have been excluded from the reach of section 857(b)(7) as not being section 856(d) rents from real property in the first place. That is, such a view of separately charged subject revenues would render former section 857(b)(7)(B)(v) a nullity and thus is incorrect.[78] Accordingly, former section 857(b)(7)(B)(v) illustrates that Congress intended separately charged subject revenues, and not just bundled subject revenues, to constitute section 856(d) rents from real property under the RMA.

In sum, without applying section 857(b)(7) and its 100 percent penalty tax to subject revenues (whether bundled or separately stated), there would have been no purpose for section 857(b)(7) redetermined rents after the RMA. Because section 857(b)(7)(B)(i) applies only to section 856(d) rents from real property, subject revenues must have been intended to constitute rents from real property. Further — and again, to avoid interpretations that render statutory terms as surplusage or nullities — the fact that only some separately charged subject revenues are specifically excluded from the reach of section 857(b)(7)(B)(i) means that Congress intended that separately charged subject revenues generally (as well as bundled subject revenues) constitute section 856(d) rents from real property.

C. Rev. Rul. 2002-38

Rev. Rul. 2002-38 confirms that subject revenues, including unbundled subject revenues, are treated as rents from real property. Rev. Rul. 2002-38 analyzes an apartment REIT that provides noncustomary housekeeping services to its tenants through a wholly owned TRS that administers and

---

[74]As the 2004 legislative history indicates, the deletion of former section 857(b)(7)(B)(ii) was intended to eliminate the "free pass" given to payments made by a REIT to its TRS for customary services and instead subject those payments to the rigor of section 857(b)(7). *See* H. Rep. No. 108-755, at 333 (Oct. 7, 2004).

[75]*See supra* Section III, particularly the figure.

[76]*See*, *e.g.*, *Duncan v. Walker*, 533 U.S. 167, 174 (2001) (refusing to adopt a construction of a statute that would leave a statutory term "insignificant, if not wholly superfluous"); *Williams v. Taylor*, 529 U.S. 362, 404 (2000) (describing this rule as a "cardinal principle of statutory construction"); *United States v. Menasche*, 348 U.S. 528, 538-539 (1955) ("It is our duty 'to give effect, if possible, to every clause and word of a statute'" (quoting *Montclair v. Ramsdell*, 107 U.S. 147, 152 (1883)).); *Market Co. v. Hoffman*, 101 U.S. 112, 115 (1879) ("As early as in Bacon's Abridgment, sec. 2, it was said that 'a statute ought, upon the whole, to be so construed that, if it can be prevented, no clause, sentence, or word shall be superfluous, void, or insignificant.'"); and *BLAK Investments v. Commissioner*, 133 T.C. 431 (2009) (quoting *Menasche*). The IRS has adopted this doctrine in its own interpretations. *See* TAM 9637008 (rejecting an interpretation of section 58(h) that would leave section 56(b) as "statutory deadwood"); and TAM 8940005 (rejecting an interpretation of reg. section 1.864-4(c)(2)(ii) that would make the word "otherwise" in reg. section 1.864-4(c)(2)(ii)(c) meaningless).

Moreover, because former section 857(b)(7)(B)(ii) was corrected in 2000 (see *supra* note 71), the very next year after it was added to the code by the RMA, section 857(b)(7) redetermined rents would most likely have been entirely deleted at that point, not revised, were it intended to be a nullity. Therefore, section 857(b)(7) redetermined rents must have been intended to apply to subject revenues.

[77]Although the 2004 amendment that deleted former clause (ii) commensurately expanded the scope of section 857(b)(7) redetermined rents, that amendment did not alter the RMA treatment of subject revenues. As Section IV.B clearly illustrates, subject revenues were originally intended by Congress to come within the ambit of redetermined rents, and to do so they had to have been section 856(d) rents from real property in the first place. *See supra* note 74.

[78]*See supra* note 76.

(C) Tax Analysts 2015. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

For more *Tax Notes* content, please visit www.taxnotes.com.

manages the services and bears all the related costs. The housekeeping services are bundled as part of the monthly rent charge to tenants, and the REIT pays the TRS for providing the services to the REIT's tenants. In Situation 1, the REIT pays the TRS 160 percent of the cost of the services. In Situation 2, the REIT pays the TRS only 125 percent of the cost of the services, which is stipulated to be less than the arm's-length transfer price under section 482. Rev. Rul. 2002-38 concludes that all the subject revenues in both situations — even when the TRS is undercompensated by the REIT in Situation 2 — constitute section 856(d) rents from real property.

In analyzing this extreme fact pattern of bundled charges,[79] Rev. Rul. 2002-38 concludes as an intermediate step that the non-customary housekeeping services performed by the TRS "do not give rise to impermissible tenant service income and thus do not cause any portion of the rents[80] received by [the REIT] to fail to qualify as rents from real property under section 856(d)."[81]

But the legal exposition and analysis do not end there. Rev. Rul. 2002-38 adds in the very next line: "As rents from real property, those rents[82] are subject to being treated as redetermined rents under section 857(b)(7)(B)(i)."[83] This is important because, by definition, redetermination under section 857(b)(7)(B)(i) can be performed only for amounts that first constitute section 856(d) rents from real property.[84] Thus, the remainder of the analysis and the conclusions in Rev. Rul. 2002-38 are predicated on a determination that all the amounts received by the REIT (which included both occupancy charges and services charges, bundled together as "rents") constitute section 856(d) rents from real property. That is, Rev. Rul. 2002-38 both explicitly and implicitly concluded that the appropriate treatment of the subject revenues was as section 856(d) rents from real property. In short, the genius of Rev. Rul. 2002-38 is that for subject revenues, it both creates a workable rule for REIT gross income testing[85] and imposes the discipline of the section 857(b)(7) 100 percent penalty tax,[86] all as Congress and the statutory structure intended.

Some have wondered whether Rev. Rul. 2002-38 might have come to a different conclusion if subject revenues had been separately stated as opposed to bundled with occupancy charges. For several reasons, that would not have been the case. First, nothing in the legislative history or structure of the RMA indicates that result. In fact, those authorities suggest the opposite: that all subject revenues, whether bundled or unbundled, constitute section 856(d) rents from real property.

Second, the scenarios considered in Rev. Rul. 2002-38 were meant to be the hardest, most extreme situations possible. The facts of the revenue ruling represent an explicit rejection of the older independent contractor requirements of reg. section 1.856-4(b)(5) for non-customary services and thus demonstrate the utility and flexibility of a TRS as a provider of non-customary services to REIT tenants.[87] Necessarily then, simpler and easier facts, including compliance with the old independent

[79] *See infra* text accompanying notes 87-88. The fact pattern in Rev. Rul. 2002-38 was "extreme" because of its intentional contrast to the six requirements of the prior independent contractor regime for non-customary services, one of those prior requirements being that service fees be separately stated. *See supra* text accompanying notes 39-43.

[80] Rev. Rul. 2002-38 used the word "rents" in this instance to include the service charges bundled therein in the facts of the revenue ruling (which states that "no service charges are separately stated from the tenants' rents"). 2002-2 C.B. 4, 5. As shown in Sections III and IV.A above, the legislative history is clear that all amounts received by the REIT, including amounts for services such as subject revenues, are also properly covered by the RMA.

[81] Rev. Rul. 2002-38, 2002-2 C.B. 4, 5.

[82] *See supra* note 80.

[83] *See supra* note 81.

[84] *See supra* Section IV.B.

[85] *See infra* Section IV.D.

[86] *See supra* Section IV.B.

[87] As discussed in Section II, before the creation of the TRS regime, the six independent contractor requirements represented the only way for a REIT to provide tenants services that could not meet the section 856(d)(1)(B) standard. That is, these six requirements applied to both halves of the outer ring in the figure of Section III. To demonstrate the utility and flexibility of TRSs as providers of non-customary services, Rev. Rul. 2002-38 recited extreme, expansive facts to reject each of the six independent contractor (IK) requirements as having any application to TRS arrangements:

Under the IK Regime:	Rev. Rul. 2002-38 Facts:
• The REIT and the independent contractor (IK) must have been less than 35 percent affiliated.	• The REIT and the TRS were 100 percent affiliated, well beyond the 35 percent threshold.
• The REIT could not earn interest, dividend, rental or other income from the IK.	• The REIT expected to earn dividends and rent from its TRS.
• The charges for the services had to be separately stated.	• There was no separate charge to tenants for the housekeeping services.
• The service revenues had to be collected by the IK.	• Revenues for the TRS services (which happened to be part of the bundled charge) were collected from the tenants by the REIT, and the existence and role of the TRS were opaque to the tenant.

(Footnote continued on next page.)

(C) Tax Analysts 2015. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

For more *Tax Notes* content, please visit www.taxnotes.com.

(C) Tax Analysts 2015. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

contractor rule of separately stated charges, are subsumed into the conclusion of Rev. Rul. 2002-38.[88] The IRS has apparently concluded in at least two private letter rulings that subject revenues are section 856(d) rents from real property.[89] Although both cases involved bundled subject revenues, the same conclusion would apply to unbundled subject revenues. To suggest that the liberation from separately stated charges in Rev. Rul. 2002-38 has somehow become a requirement to use bundled charges is to misread Rev. Rul. 2002-38 and get its intent backwards.

D. Industry Practice

As shown below, the treatment of subject revenues as section 856(d) rents from real property faithfully and fairly applies the REIT gross income tests, and treating subject revenues in this fashion is critical to many traditional public REITs. Consistent with the critical commentary regarding the 1960 standard, REITs today use their TRSs as a control point for property access and the provision of services to REIT tenants. Many activities that require widespread access through the landlord's property (including over and under the rented space of other REIT tenants) are now performed by TRSs for the orderly leasing and maintenance of the property, not primarily for the convenience of the tenant.[90] Otherwise, giving an independent party that access would create safety and security vulnerabilities for the other tenants of the property.[91] Also, the performance of non-customary services by a TRS of a REIT landlord increases the tenants' clout and comfort regarding the quality and reliability of service. This occurs because the REIT (unlike an

---

Under the IK Regime:	Rev. Rul. 2002-38 Facts:
• The service revenues had to be retained by the IK.	• Revenues for the TRS services collected by the REIT from the tenants (which happened to be part of the bundled charge) were not paid over to the TRS, but instead the REIT hired the TRS under a subcontract and paid the TRS for its services based on an intercompany contractual arrangement.
• The IK had to be adequately compensated.	• In the first of the two situations, the TRS may not have been adequately compensated by the REIT, and in the second of the two situations, the TRS definitely was not adequately compensated by the REIT.

As this comparison demonstrates, the facts of Rev. Rul. 2002-38 are consciously liberated from the six independent contractor requirements, creating a system in which the separate existence of the TRS could remain opaque to REIT tenants, as the existence and use of subsidiaries already could be for non-REIT landlords. In the RMA, Congress intended its new TRS legislation to produce those benefits for REITs. *See supra* Sections III and IV.A, and in particular text accompanying notes 60, 67, and 69.

[88]This reading of Rev. Rul. 2002-38 is confirmed by the following passage from the text of the published ruling, which shows that the bundled charges were intended to make the underlying facts harder, not easier:

> 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.

2002-2, C.B. 4, 5. From this passage, it is clear that Rev. Rul. 2002-38 is focused on the substance of the arrangement (*viz.*, that the rents therein included fees for services) rather than the form of the arrangement (*viz.*, that somehow the mere act of bundling service fees with rents transmutes service fees into rents).

[89]*See* LTR 201317001 and LTR 201320007. These two private letter rulings indicate that some of the services provided by prison REITs under their tenant contracts and through their TRSs are outside the section 856(d)(1)(B) standard (*e.g.*, in LTR 201317001's description of halfway houses: "A few of the halfway houses employ a psychologist, but generally no other medical care is available onsite. One halfway house employs a nurse who provides basic medical services"). Despite that, all subject revenues in these private letter rulings are held to be section 856(d) rents from real property (to quote, each of the rulings states that "the *entire contract fee* will be treated as 'rents from real property' within the meaning of section 856(d)" (emphasis added)). *See also* LTR 201503010 (storage REIT's "related services"). By contrast, to our knowledge, there is not a single published or private letter ruling that concludes that subject revenues do not qualify as section 856(d) rents from real property. If there were, that would be expressly contrary to the structure of the statute, the legislative intent of the RMA, and Rev. Rul. 2002-38.

[90]*Cf.* reg. section 1.512(b)-1(c)(5) (first prong), *supra* text accompanying notes 49-51.

[91]Given the heightened security demands that tenants have placed on landlords (particularly after September 11, 2001, and in general when permitting access to confidential business-critical systems), REITs would prefer to use their own TRSs to provide any services that do not meet the section 856(d)(1)(B) standard, rather than rely on independent contractors to perform these sensitive roles. *Cf.* LTR 9014022 and LTR 8914048, *supra* note 50.

For more *Tax Notes* content, please visit www.taxnotes.com.

independent contractor) has an extensive lease relationship with the tenant, which it wants to protect. That gives the tenant significant commercial leverage if problems arise.

The correct interpretation of Rev. Rul. 2002-38 — namely, that subject revenues are section 856(d) rents from real property — is heavily relied on by many public REITs across a variety of real estate property sectors. The following is a non-exhaustive list of common situations in which public REITs treat subject revenues as rents from real property and might otherwise fail the 95 percent REIT gross income qualification test of section 856(c)(2):

- office REITs with separate charges for building amenities such as fitness center memberships and personal trainers, conference center and reception area catering, carwashes, shuttle services, daycare services, and subsidized cafeterias;
- apartment REITs with separate charges for amenities such as housekeeping services, pet care services, daycare services, dry cleaning services, and concierge services;
- shopping mall REITs with separate charges for advertising services and promotional services; and
- self-storage REITs with separate charges for pickup, packing, and delivery services, and for inspection and disposal services.

Further, the above interpretation of Rev. Rul. 2002-38 is not being abused by public REITs to "hype" their qualifying gross income and therefore more easily pass the REIT gross income tests. That interpretation is being used because it is the correct interpretation. This point is best illustrated by a realistic example. Suppose a public REIT has the following items of gross income under section 61 and reg. section 1.856-2(c)(1):

- $98 million of qualifying rent from occupancy charges and from charges such as utilities that are clearly covered by section 856(d)(1)(B);
- $2 million of revenue that is definitely nonqualifying because it is outside section 856(c)(2) altogether — for example, third-party management fees or the like; and
- at most $7 million of subject revenues.

If the subject revenues were merely excluded from REIT gross income testing altogether (say, under section 856(c)(5)(J)(i)), the REIT's gross income test percentage would be equal to 98 percent (98/(98+2)), and it would pass the 95 percent REIT gross income qualification test of section 856(c)(2). By contrast, if the subject revenues are properly included as rents from real property under Rev. Rul. 2002-38,[92] the REIT's gross income percentage would be equal to 98.13 percent ((98+7)/(98+2+7)), which is only immaterially higher.[93] The truly unfair outcome here would be to treat the subject revenues as section 61 nonqualifying income, whereby the REIT's gross income test percentage would equal only 91.6 percent (98/(98+2+7)), and the REIT would not pass the 95 percent REIT gross income qualification test of section 856(c)(2). That interpretation would reduce or even block the use of TRSs, which would contradict the express intent of Congress when it created the TRS structure in the RMA.

E. Section 856(c)(5)(J)(ii)

The lack of an explicit rule of inclusion for subject revenues in the RMA was offset by the later addition of section 856(c)(5)(J)(ii), which grants the IRS authority to designate otherwise nonqualifying items of income or gain as qualifying income under section 856(c)(2) or (3). When section 856(d) was reformulated under TRA 1976, section 856(d)(1) and (2) then served a clear purpose, as noted in their titles: "Amounts included" for section 856(d)(1) and "Amounts excluded" for section 856(d)(2).[94]

It is true but irrelevant that an explicit inclusion for subject revenues was not drafted into section 856(d)(1) as part of the RMA.[95] What is relevant is that Rev. Rul. 2002-38 incorporates the intended

---

[92]The correct interpretation of Rev. Rul. 2002-38 is tantamount to a rule of inclusion for subject revenues under section 856(c)(5)(J)(ii). Given that there is already a prescribed treatment for subject revenues under Rev. Rul. 2002-38, it would be inappropriate and confusing to fashion a new exclusion rule for the same under section 856(c)(5)(J)(i). Moreover, a ruling under section 856(c)(5)(J)(i) would remove subject revenues from the ambit of section 856(d) rents from real property and thus from the reach of the section 857(b)(7) 100 percent penalty tax. As explained in Sections IV.A-C, that was not the intent of Congress or the IRS and would result in inappropriate and incorrect conclusions.

[93]This numerical example shows that in practical terms and real-world cases, there is very little difference between the Rev. Rul. 2002-38 approach to subject revenues and an alternative approach under section 856(c)(5)(J)(i). "Hyping" qualifying revenue is not a concern: Mathematically, compliance with the 95 percent REIT gross income qualification test is anchored by the $2 million of nonqualifying revenue, and it matters little whether the denominator is $100 million or $107 million; that is, the REIT's so-called 5 percent bad basket (which is the mathematical complement of the 95 percent REIT gross income qualification test of section 856(c)(2)) has everything to do with the $2 million and very little to do with the $100 million or $107 million, which is as it should be.

[94]*See* TRA 1976.

[95]Because the RMA did so much and had so little legislative history, some rough patches were inevitable. To see another example of rough patches in the RMA concerning the TRS provisions, see Paul W. Decker, Ponda, and Jonathan Stein, "Toward a Workable Definition of REIT Healthcare Facility," *Tax Notes*, Dec. 5, 2011, p. 1231.

(C) Tax Analysts 2015. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

For more *Tax Notes* content, please visit www.taxnotes.com.

inclusion rule from the legislative history: Subject revenues are in fact intended to be section 856(d) rents from real property — both to assist in compliance with the 95 percent REIT gross income qualification test of section 856(c)(2) and to make sense of the 100 percent penalty tax of section 857(b)(7), all in accordance with the legislative intent of the RMA — and in fact Rev. Rul. 2002-38 accomplishes this despite the lack of an explicit inclusion in section 856(d)(1). Perhaps Rev. Rul. 2002-38 was purposefully subtle in its reasoning and conclusions because of the lack of an explicit inclusion for subject revenues in section 856(d)(1).

Today, however, because of the 2008 addition of the IRS's clear authority to include those amounts as qualifying income under section 856(c)(5)(J)(ii), the published conclusion of Rev. Rul. 2002-38 rests on unquestionably solid ground.

F. No Contrary Authority

There is no contrary published authority that would indicate or compel a different conclusion. Although the absence of negative authority is not definitive proof of the positive, it shows that no authority in over a decade has interpreted any of the primary legal authorities — the structure of the statute, the legislative history of the RMA, or Rev. Rul. 2002-38 — in a way that reaches a conclusion different from the one presented in this report. As noted above, both bundled and separately stated subject revenues are common among public REITs, which interpret this provision in the same manner as discussed in this report.

For example, LTR 201334033 involves a situation in which the REIT "expects to collect all, or nearly all, of the amounts owing from tenants," including amounts for TRS-provided services that "may not be customary services within the meaning of [reg. section] 1.856-4(b)(1)," and some services provided by the TRSs to tenants "may be listed as separate line items on invoices to tenants."[96] There is no published authority that indicates or compels a conclusion that subject revenues *are not* section 856(d) rents from real property, and the reasons presented in this report compel a conclusion that subject revenues *are* section 856(d) rents from real property.[97]

[96]That is, for the taxpayer in LTR 201334033, the TRS-provided services may be outside the section 856(d)(1)(B) standard and may be separately itemized and thus give rise to separately stated subject revenues.

[97]As we discuss in *supra* note 12, we recommend that these conclusions, which are consistent with the code and with prior guidance, be preserved in any future regulations.

V. Conclusion

As this report illustrates, subject revenues, whether separately stated or bundled, constitute section 856(d) rents from real property for the following reasons:

1. according to the legislative history of the RMA, Congress intended that all subject revenues be treated as rents from real property;
2. the statutory structure of the section 857(b)(7) 100 percent penalty tax is predicated on, and consistent only with, treating all subject revenues as rents from real property;
3. Rev. Rul. 2002-38 confirms that subject revenues are treated as rents from real property, and that conclusion applies equally to separately stated subject revenues;
4. the treatment of all subject revenues as rents from real property faithfully and fairly applies the REIT gross income tests, and treating subject revenues this way is critical to many traditional public REITs;
5. the lack of an explicit rule of inclusion for subject revenues in the RMA is offset by the later addition of section 856(c)(5)(J)(ii); and
6. we are unaware of any contrary authority that would indicate or compel a different conclusion.

Accordingly, subject revenues constitute section 856(d) rents from real property, regardless of whether they are billed to tenants separately or as part of a bundled charge.

VI. Appendix

Section 857(b) (2001)

(7) Income from redetermined rents, redetermined deductions, and excess interest.

(A) Imposition of tax. There is hereby imposed for each taxable year of the real estate investment trust a tax equal to 100 percent of redetermined rents, redetermined deductions, and excess interest.

(B) Redetermined rents.

(i) In general. The term "redetermined rents" means rents from real property (as defined in section 856(d)) the amount of which would (but for subparagraph (E)) be reduced on distribution, apportionment, or allocation under section 482 to clearly reflect income as a result of services furnished or rendered by a taxable REIT subsidiary of the real estate investment trust to a tenant of such trust.

(ii) Exception for certain amounts. Clause (i) shall not apply to amounts

For more *Tax Notes* content, please visit www.taxnotes.com.

(C) Tax Analysts 2015. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

received directly or indirectly by a real estate investment trust —

(I) for services furnished or rendered by a taxable REIT subsidiary that are described in paragraph (1)(B) of section 856(d), or

(II) from a taxable REIT subsidiary that are described in paragraph (7)(C)(ii) of such section.

(iii) Exception for de minimis amounts. Clause (i) shall not apply to amounts described in section 856(d)(7)(A) with respect to a property to the extent such amounts do not exceed the one percent threshold described in section 856(d)(7)(B) with respect to such property.

(iv) Exception for comparably priced services. Clause (i) shall not apply to any service rendered by a taxable REIT subsidiary of a real estate investment trust to a tenant of such trust if —

(I) such subsidiary renders a significant amount of similar services to persons other than such trust and tenants of such trust who are unrelated (within the meaning of section 856(d)(8)(F)) to such subsidiary, trust, and tenants, but

(II) only to the extent the charge for such service so rendered is substantially comparable to the charge for the similar services rendered to persons referred to in subclause (I).

(v) Exception for certain separately charged services. Clause (i) shall not apply to any service rendered by a taxable REIT subsidiary of a real estate investment trust to a tenant of such trust if —

(I) the rents paid to the trust by tenants (leasing at least 25 percent of the net leasable space in the trust's property) who are not receiving such service from such subsidiary are substantially comparable to the rents paid by tenants leasing comparable space who are receiving such service from such subsidiary, and

(II) the charge for such service from such subsidiary is separately stated.

(vi) Exception for certain services based on subsidiary's income from the services. Clause (i) shall not apply to any service rendered by a taxable REIT subsidiary of a real estate investment trust to a tenant of such trust if the gross income of such subsidiary from such service is not less than 150 percent of such subsidiary's direct cost in furnishing or rendering the service.

(vii) Exceptions granted by Secretary. The Secretary may waive the tax otherwise imposed by subparagraph (A) if the trust establishes to the satisfaction of the Secretary that rents charged to tenants were established on an arms' length basis even though a taxable REIT subsidiary of the trust provided services to such tenants.

(C) Redetermined deductions. The term ''redetermined deductions'' means deductions (other than redetermined rents) of a taxable REIT subsidiary of a real estate investment trust if the amount of such deductions would (but for subparagraph (E)) be decreased on distribution, apportionment, or allocation under section 482 to clearly reflect income as between such subsidiary and such trust.

(D) Excess interest. The term ''excess interest'' means any deductions for interest payments by a taxable REIT subsidiary of a real estate investment trust to such trust to the extent that the interest payments are in excess of a rate that is commercially reasonable.

(E) Coordination with section 482. The imposition of tax under subparagraph (A) shall be in lieu of any distribution, apportionment, or allocation under section 482.

(F) Regulatory authority. The Secretary shall prescribe such regulations as may be necessary or appropriate to carry out the purposes of this paragraph. Until the Secretary prescribes such regulations, real estate investment trusts and their taxable REIT subsidiaries may base their allocations on any reasonable method.

(C) Tax Analysts 2015. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

For more *Tax Notes* content, please visit www.taxnotes.com.