Section 856.—Definition of Real Estate Investment Trust

If a taxable REIT subsidiary of a REIT and an independent contractor from whom the REIT does not derive income from a joint venture to provide noncustomary services to tenants of the REIT, will rents paid to the REIT by tenants fail to qualify as "rents from real property" under section 856 of the Code. See Rev. Rul. 2003-86, page 290.

Noncustomary services provided to REIT tenants by a joint venture between a taxable REIT subsidiary and an independent contractor. This ruling provides that a joint venture between a taxable REIT subsidiary and an independent contractor to provide noncustomary services to REIT tenants will not cause rents paid by tenants to fail to qualify as "rents from real property" under section 856 of the Code.

Rev. Rul. 2003–86

ISSUE

If a joint venture partnership between a taxable REIT subsidiary (TRS) of a real estate investment trust (REIT) and a corporation that qualifies as an independent contractor of the REIT under § 856(d)(3)(B) of the Internal Revenue Code provides noncustomary services to tenants of the REIT in the situation described below, will rents paid by the tenants to the REIT fail to qualify as rents from real property under § 856(d)?

FACTS

R is a corporation that has elected and qualifies to be treated as a REIT under subchapter M of Chapter 1 of the Code. *R* owns and operates rental apartment properties in several major metropolitan areas. In 2002, *R* formed a wholly owned corporation, *T*, to provide services to tenants of its properties. *R* and *T* filed Form 8875 to jointly elect for *T* to be treated as a TRS of *R* effective as of the date of *T*'s formation. The services provided to tenants by *T* are services that are not customarily provided to tenants of rental apartment properties in the metropolitan areas in which *R*'s properties are located.

X is a corporation unrelated, either directly or indirectly, to either *R* or *T*. *X* qualifies as an independent contractor under § 856(d)(3)(B). *X* provides various services to *R*'s tenants and tenants of other rental apartments in the areas where *R*'s properties are located. The services provided by *X* are noncustomary in the areas where *R*'s properties are located and are primarily for the convenience of tenants.

X and *T* formed *P*, which is treated as a partnership for federal income tax purposes, to provide the noncustomary services that formerly were separately provided to *R*'s tenants by either *X* or *T*. *X* and *T* made equal capital contributions to *P*. *X* and *T* share in all items of *P*'s income, gain, loss, and deduction in proportion to their capital contributions. *R*'s tenants contract directly with *P* for services. *R* does not receive any payments related to the services from *P*, *X* or tenants. *R* receives quarterly dividends from T.

LAW AND ANALYSIS

To qualify as a REIT, an entity must derive at least 95 percent of its gross income from sources listed in § 856(c)(2) and at least 75 percent of its gross income from sources listed in § 856(c)(3). "Rents from real property" are among the sources listed in both of those sections. Section 856(d)(1) defines rents from real property to include rents from interests in real property, charges for services customarily rendered in connection with the rental of real property, and rent attributable to certain leased personal property. However, § 856(d)(2)(C) excludes "impermissible tenant service income" from the definition of rents from real property.

Section 856(d)(7)(A) defines "impermissible tenant service income" to include, with respect to any real or personal property, any amount received or accrued directly or indirectly by a REIT for services furnished or rendered by the REIT to tenants of the property. Section 856(d)(7)(B) provides that if impermissible tenant service income from a property for any tax year exceeds 1 percent of all amounts received or accrued directly or indirectly by the REIT during the tax year from the property, the impermissible tenant service income from the property shall include all amounts received or accrued from the property for the tax year.

Section 856(d)(7)(C)(i) provides that services furnished or rendered through a TRS or an independent contractor from whom the REIT does not derive or receive any income are not treated as furnished, rendered, or provided by the REIT for purposes of § 856(d)(7)(A). Thus, services rendered by a TRS do not give rise to impermissible tenant service income, and services rendered by an independent contractor do not give rise to impermissible tenant service income if the REIT does not receive or derive income from the independent contractor.

R's tenants contract directly with *P* to perform noncustomary services. Thus, *R* does not receive directly any payments related to the services from *P*. Also, *R* does not directly or indirectly receive income from *X*, an independent contractor. *T* is entitled to its share of income from the performance of services in proportion to its interest in *P*, and *R* may indirectly receive this income in the form of dividends from *T*. Under § 856(d)(7)(A), amounts received directly or indirectly by a REIT for services furnished or rendered to tenants constitute impermissible tenant service income. However, § 856(d)(7)(C)(i) provides an exception for services furnished or rendered through a TRS. *R*'s only interest in *P* is through *T*, which is a TRS. Accordingly, the services provided by *P* are treated as provided by *T* to the extent of *T*'s interest in *P*. Therefore, *R* will not be treated as providing impermissible tenant services to its tenants.

HOLDING

Under the circumstances described above, a joint venture partnership between a TRS of a REIT and a corporation that qualifies as an independent contractor of the REIT under § 856(d)(3)(B) may provide noncustomary services to tenants of the REIT without causing the rents paid by the tenants to the REIT to fail to qualify as rents from real property under § 856(d).

DRAFTING INFORMATION

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