REIT services – back to the future

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Why the resurgent interest in REIT services?

- REITs must use a fixed framework for evaluating a continually evolving universe of services
- REITs are seeking to increase revenues
  - In an increasingly competitive marketplace, REITs are seeking to identify ways to maximize revenues
- Rise of “non-traditional” REITs
  - There is minimal guidance regarding services for REITs operating in “non-traditional” REIT industries
- Taxable REIT subsidiary (TRS) size management
  - As TRS values increase, there is additional pressure on ability to use TRSs to perform services
Is it a service?

► When is an activity a service?
  ► Activity particular to a specific tenant or tenants
  ► Rendered in connection with lease of space

► What is a service versus a REIT’s management of its property?
  ► Trustees or directors are not required to delegate or contract out their fiduciary duty to manage the REIT
  ► Trustees may establish rental terms, choose tenants, enter into and renew leases; may also enter into construction contracts and supervise construction

► Service to tenants or separate non-qualifying income stream?
  ► Section 856 clearly contemplates non-qualifying income
  ► Older private letter rulings concluded that income from a “separate line of business” should not disqualify otherwise qualifying rental income
When is income from services qualifying income?

- Rents from real property include **charges for services customarily furnished or rendered in connection with the rental of real property, whether or not such charges are separately stated**, but exclude any impermissible tenant service income (856(d)(1)(B), 856(d)(2)(C)).
  - Services are considered customary if, in the geographic market in which a property is located, tenants of properties which are of a similar class are customarily provided the service (Treas. Reg. § 1.856-4(b)).

- “Impermissible tenant service income” includes “any amount received or accrued directly or indirectly by the real estate investment trust for (i) services furnished or rendered by the trust to tenants of such property or (ii) managing or operating the property”, but excludes amounts that would be treated as rent under the UBTI rules of section 512(b)(3).
  - Under section 512(b)(3), amounts received for the use of space qualify as rent so long as any services are not rendered primarily for the convenience of the tenant and are usually and customarily provided in connection with the rental of space (Treas. Reg. § 1.512(b)-1(c)(5)).
Two separate tests for services provided by a REIT

Two tests must be met for services to produce qualifying income:

- The service provided by the REIT must be usual and customary for properties of a similar type and class to the particular property and in the same geographic market
- The service provided by the REIT must not be “primarily for the convenience of a tenant”

If both tests satisfied, then all revenue from provision of services is qualified (whether separately stated or included in the overall rent, and whether provided at cost or at a mark-up)
Customary services determination

Determination of customary services depends on:

- Services provided in a similar class of property in a geographic market, and
  - E.g., services may be customary at a luxury apartment building but not at a moderate apartment building or neighboring commercial space
- Geographic market in which the property is located
  - E.g., services may be customary in California but not Hawaii
  - No clear guidance on the definition or scope of the term “geographic market”
Customary services rules of thumb

► If a service is supplied at several other properties of a similar class within an area, it should be usual and customary for a particular property

► It may be difficult for a REIT to become a market leader by providing new services in a local market because of the customary services test
  ► A TRS may, however, become a market leader in the provision of services to REIT tenants

► IRS private letter rulings continue to address what services are considered customary in various industries
Primarily for the convenience of tenants

► Maid and food services are often considered provided for the convenience of the tenant – but will depend on context (for example, cleaning of an office building may be customary)

► Heat, light and other utilities, and the cleaning of public areas, are considered rendered in connection with the rental of space for occupancy only and not primarily for the convenience of tenants

► A REIT may also take certain actions not for convenience of the tenants, but to protect itself
  ➤ E.g., extra property security or valet parking to protect against liability

► Certain activities – such as installing advertising copy on a billboard – may be customary in an industry, but perceived as being rendered for the convenience of the tenant
Examples of permitted REIT services

► In most geographic areas, a REIT may provide the following:
  ► Water, heat, light and air conditioning,
  ► Telecommunication services,
  ► Common area cleaning and security,
  ► Trash collection,
  ► Tenant improvement work for lease inducement, and
  ► Basic marketing for third party providers
Industry variations

► Billboards (PLR 201431018, PLR 201431020):
  ► Non-qualifying: installation, replacement and removal of advertisements, design and production services

► Data centers (PLR 201314002):
  ► Qualifying: controlled humidity, shipping and receiving, provision of telecommunications infrastructure, interconnection services, certain “remote hands” services

► Small cell systems (PLR 201450017):
  ► Qualifying: designing systems and overseeing construction, electricity, monitoring system status, periodic inspections, minor repairs

► Document storage (PLR 201503010):
  ► Non-qualifying: handling of records, courier operations, secure shredding, scanning and faxing of records
What if a service does not satisfy the two requirements?

- The REIT may perform the service, provided not in excess of the *de minimis* amounts described below.
- An independent contractor (IK) from whom the REIT receives no income may perform the service (subject to certain limitations).
- A TRS of the REIT may perform the service (special rules for healthcare and lodging facilities apply).
- If a REIT performs the service and the *de minimis* threshold is exceeded for a particular property, then all rents from that property are tainted and are non-qualifying.
- Note that certain services, such as food service, must be provided by a TRS regardless of its customary nature.
<table>
<thead>
<tr>
<th>Service is (a) geographically customary and (b) not for convenience of tenant</th>
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De minimis services

► De minimis amounts of non-qualifying services by the REIT are permitted, so long as the value of such services does not exceed 1% of the gross income from the property
 ► For this purpose, the value is deemed to be not less than 150% of the direct costs for such services
 ► No guidance on what constitutes “direct costs”
 ► Requires a property by property calculation

► Even if the value of the non-qualifying service is less than the 1% de minimis threshold, that value is treated as nonqualifying
Independent contractors (IKs)

To qualify as an IK, a person or entity:

- may not be an employee of the REIT, and
- may not own more than 35% of the shares in the REIT, or have more than 35% common ownership with the REIT (for these purposes, complex rules of attribution and constructive ownership apply)
Performance of services by IKs

Services provided to tenants by IKs will not taint rents so long as the IK:

► bears the costs of such services,
► receives and retains a separate charge for such services,
► pays no income to the REIT (directly or indirectly), and
► receives adequate compensation from the tenant for such services

Note that these requirements technically apply only where service is not geographically customary

If these IK requirements are not met, then the services provided will be considered “furnished, rendered, or provided” by the REIT (and may taint all rents related to that property unless provided by a TRS)

Can REIT act as collecting agent for IK and satisfy separate charge requirement?
Performance of services by TRSs

► A TRS may provide any service that may be performed by an IK (special rules for healthcare and lodging facilities apply)

► The REIT must compensate the TRS for the value of the services (transfer pricing rules apply to arrangements)

► Rev. Rul. 2002-38: REIT pays TRS to perform non-qualifying services, for which there is no separately stated charge to the tenant; TRS employees perform the services, and TRS bears all costs of providing the services

  ► Services are considered rendered by the TRS, not the REIT and do not give rise to ITSI

  ► All revenues received are qualifying, including any markup over what is paid to TRS to perform services

  ► Portion of rent could be subject to 100% tax as re-determined rent if REIT failed to adequately compensate TRS
Performance of services by TRSs (cont.)

► What if a charge for a non-qualifying service is separately stated, and a TRS performs the service?
  ► Is the income for the service qualifying? Non-qualifying? Received by the REIT in an agency role? Is the amount of bad income the entire fee charged for the service, or just any markup retained by the REIT?
  ► See PLR 201334033, PLR 201503010

► Coordination with UBTI Rules
  ► If a non-qualifying service is performed by a TRS, REIT income is qualifying but may still taint rental income for UBTI purposes
Employee cost sharing and REIT services

► Rev. Rul. 84-138: Regulated investment company (RIC) and its wholly-owned subsidiary shared facilities and personnel; RIC paid all overhead expenses and personnel costs and subsidiary reimbursed RIC for its pro rata share of these expenses

► 3 requirements to exclude reimbursements from gross income:
  ► Neither RIC nor subsidiary are engaged in the business of providing services of the type that were reimbursed
  ► Neither RIC nor subsidiary profited from the reimbursement
  ► Party receiving reimbursement did not deduct advances

► Amounts do not result in gross income, treated as non-interest bearing loans
Employee cost sharing and REIT services (cont.)

► Employees at REIT, TRS reimburses REIT for TRS’s use of employees
  ► If REIT performs de minimis non-qualifying services for tenants and then hires TRS to perform similar non-qualifying services, is REIT considered in the business of providing these services for third parties?

► Employees are at TRS, REIT reimburses TRS for REIT’s use of TRS employees in providing customary services to tenants
  ► If TRS performs services for third parties (for example, TRS has cleaning business) and REIT then uses TRS employees to clean common areas, is TRS being reimbursed for services it provides to third parties? Does REIT need to pay TRS cost plus (as opposed to just cost)?