

## Internal Revenue Service

Department of the Treasury

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Person to Contact:  
Telephone Number:  
Refer Reply To:  
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### Legend:

Trust =  
Company A =  
Company B =  
Company C =  
a = 61.6

Operating Partnership =  
b = 99.99

LLC1 =  
LLC2 =  
Company D =

LLC3 =

Dear :

This is in reply to a letter dated June 8, 1999, and subsequent correspondence, requesting certain rulings on behalf of Trust. Specifically, you requested rulings that certain services performed by Companies B and C will not cause Trust's allocable share of otherwise qualifying income to be excluded from "rents from real property" under § 856(d)(2)(C) of the Internal Revenue Code. Additionally, you have requested a ruling that amounts collected under a reimbursement arrangement for shared overhead, personnel, and facilities will not be gross income to Trust for purposes of § 856(c).

### Facts:

Trust is organized as a real estate investment trust (REIT) under state law and is treated as a subchapter C corporation for federal income tax purposes. Trust was formed when Company A contributed its ambulatory care planning, property management, and development management business to Trust in exchange for stock and cash. Trust subsequently contributed the businesses to its wholly-owned subsidiaries, Company B and Company C. Company A owns approximately a percent of the common stock of Trust. An institutional investor owns all of Trust's Series A

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convertible preferred stock.

Trust intends to elect to be taxed as a REIT effective for its tax year ending December 31, 2000. After electing REIT status, Trust will recapitalize Company B and Company C into preferred stock subsidiaries. Trust intends to reduce its ownership of the voting stock of Company B and Company C to below 10-percent by converting substantially all of its ownership interest to non-voting preferred stock and issuing voting common stock to third parties. Trust also will contribute its non-voting preferred stock of Company B and Company C to Operating Partnership. Trust has a b percent general partnership interest in Operating Partnership. Operating Partnership is the sole member of two limited liability companies, LLC1 and LLC2. Operating Partnership and a wholly-owned subsidiary of Trust, Company D, are the majority owners of a third limited liability company, LLC3. All properties of Trust (the Properties) are, or will be owned by LLC1, LLC2, and LLC3 (collectively, the Property Partnerships). All references to services or activities performed by Trust for the Properties are intended to mean that the services or activities are conducted by Trust as a partner in Operating Partnership.

Trust intends to become a self-administered REIT focusing exclusively on owning, developing, managing, and leasing medical office buildings and outpatient real estate assets associated with hospitals and healthcare systems. Through the Property Partnerships, Trust will lease its properties to hospitals, healthcare systems, and physician practices under various arrangements, including: (1) leasing to a hospital or healthcare system and granting to the hospital or healthcare system the right to sublease; (2) leasing some space to a hospital or healthcare system, with the right to sublease, and leasing the remainder directly to individual tenants, such as doctors and their medical practices; (3) leasing to medical doctors whose physicians use the local hospital system; and (4) leasing to other medical service providers.

Following Trust's REIT election, Company B and Company C will provide the healthcare services provided by Company A and its predecessors. Company B and Company C will provide their services in the ordinary course of business at market rates to the tenants of the Properties and to non-tenant third parties. Company B will provide management and development services primarily to third parties. In some instances, however, Company B intends to provide non-tenant related services to the Properties.

### **Reimbursement Arrangement**

Company B and Company C will maintain their own books and records. They will maintain their own bank accounts, pay their own bills, and maintain separate corporate records and documents. Company C will bill its clients directly and will be paid directly for services performed. Separate budgets that must be approved by outside investors will be prepared for each entity.

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There will be some overlap of employee responsibilities among Operating Partnership, Trust, Company B, and Company C. For economic savings and administrative convenience and to maintain an incentive stock option plan in which all employees of Trust currently participate, Trust is nominally the employer of record for all individuals who have been hired to provide services to tenants or others on behalf of Trust, Company B, and Company C (the Employees). Several types of overhead costs are incurred that benefit all of the entities. These include office services (for example, rent and supplies), firm management, human resources, finance and accounting, administrative support staff, and marketing. Payroll expenses for executive and other employees that perform these services for all of the entities are allocated to each to the entities based on either 1) the estimated time spent on behalf of the various entities or 2) the number of employees sharing services.

Company B and Company C will reimburse Trust for expenses relating to the Employees, including payroll, payroll taxes, benefit costs, and administrative overhead including office space computers and telephones. Currently, with the exception of some key individual executives, many of the individuals spend 50 percent or more of their time working for either Company B or Company C, carry business cards representing themselves as employees of either Company B or Company C, and receive bonuses and promotions based, in part, on their performance for Company B or Company C. Invoices are issued to Company B and Company C for their expenses, and each reimburses Trust directly for its expenses.

### **Company B**

Company B employees will provide management and development services to Trust, Trust's tenants, or non-tenants. The management and development services will be provided both at the Properties and at other properties owned by Trust's tenants or non-tenants. At a client's expense, Company B will hire and supervise the people necessary to maintain and operate the property. Company B will perform general maintenance and repairs involving carpentry and plumbing. In connection with managing and operating the properties, Company B may also enter into contracts to provide for utilities, security, pest control, and elevator and boiler maintenance. Trust represents that all noncustomary services performed for tenants of the Properties will be provided by independent contractors within the meaning of § 856(d).

### **Lease Administration**

The Employees will perform lease administration such as soliciting prospective tenants, background and credit investigations of prospective tenants, drafting and negotiating leases, accounting, billing, bookkeeping, and rent collection for the client's properties.

The Employees will arrange for fire protection (sprinklers and alarms), landscape

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services and snow removal in common areas, common area background music, and for the collection of trash by an unrelated third-party waste management company for the Properties. Trust may charge tenants for air conditioning or heat after normal hours.

### **Leasing of Space for Telephones and Vending Machines**

Trust intends to permit local telephone companies to provide pay telephones to tenants and their customers. Space for the location of the telephones will be provided in exchange for a rental fee. In such case, the Employees will not be responsible for the installation, maintenance, and repair of the telephones. Trust also intends to rent space and supply utilities to third-party suppliers for vending machines. The third-party suppliers will be responsible for installing, maintaining, and repairing the vending machines. The Employees or independent service providers will provide routine general maintenance in the area surrounding the telephones or vending machines.

### **Telecommunications Services**

Trust intends to offer tenants of the Properties certain telecommunications services. Although there are currently no cable lease and easement agreements in place, Trust intends to enter into cable lease and easement agreements with third-party providers (Providers), either directly or through Company B, to provide certain telecommunication services for the Properties. Providers include internet service providers, broadcasters, long distance operators, and other similar telecommunication service providers. The agreements will permit the Providers to place antennas (including microwave antennas), cable, terminals, and other cable-related equipment on the Properties.

The Providers will also be granted an exclusive easement to enter the common areas to maintain the equipment. Trust will either receive an access fee from the Providers or will charge the Providers a percentage of gross sales for providing these services. The Providers will own the systems and will provide programming to tenants of the Properties. Trust will not directly solicit tenants with respect to the telecommunications services. However, the Providers may be permitted to advertise in a Property newsletter or make available informational brochures. Trust represents that (1) the telecommunications services described above are customarily offered to tenants in a similar class of buildings in the geographic area in which the Properties are located; (2) no Provider will offer services to tenants that it does not offer to non-tenants, and (3) no Provider will create a unique program of services tailored to the demands of a particular tenant.

### **Security**

In general, Trust does not contract to provide security at the Properties. Security is generally the responsibility of the tenant. Although Trust does not currently do so, it

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is considering providing security at certain of its Properties. If it does so, Trust will contract with third-party security companies to provide security or guards in the common areas of certain properties, either on a 24-hour basis or during normal business hours.

Trust intends for the Employees to change or repair locks for tenants of the Properties either in common areas, at the entrance to tenant space, or within a tenant's space. Tenants may be separately charged for this service at a reasonably competitive price. The charge would be based on the cost of having an unrelated third-party perform the service on an arm's length basis. Third-party contractors may also perform these services. Trust utilizes a master key system for locks at the Properties. All lock cores in a building, including tenant offices, are keyed off a master key. This system enables Trust to comply with the fire Code and regulations, as well as for security reasons.

### **Maintenance and Janitorial Services**

Trust intends for the Employees to provide various services in the common areas of the Properties and certain services within a tenant's space during a lease. The Employees may provide routine common area janitorial, maintenance, and engineering services for the Properties. These services include the cleaning of windows, public entrances, exits, stairwells, lobbies, and restrooms. The Employees may also perform emergency janitorial services (for example, repairing broken pipes or overflowing toilets), which tenants may not be equipped to handle or for which an independent contractor would be impracticable. Except for such emergency janitorial services, any janitorial services performed inside a tenant's leased space will be provided by independent contractors from whom Trust will not derive income. The Employees may also repair or replace light switches and outlets, electrical fuses, overhead lighting fixtures including light bulbs and ballasts, and speakers.

A third-party contractor will perform maintenance and repair services, such as repairing and repainting buildings and other structures, repairing roofs, resurfacing and restriping parking lots, and repairing and replacing ducts, and conduits. Trust intends for the Employees to perform general maintenance and repair to heating, ventilation, and air conditioning equipment that is part of the central system owned by Trust either within a tenant's space or in common areas.

Trust intends for the Employees to perform regularly scheduled maintenance painting within tenant space as provided in the leases. Typically, maintenance painting will be done once during the usual 10-year lease. Trust represents that no design or decorative painting will be performed for tenants of the Properties. The Employees may repair and maintain ceilings, walls, doors, floors, floor coverings, hallways and stairs in the common areas of the Properties up to the perimeter of the tenant's leased space. The Employees may also install signage in the common areas and lobbies of the buildings of the Properties. Company B, as the management company of the

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Properties, intends to allow independent contractors from whom Company B or Trust derive no income to perform annual carpet cleaning within tenant space. Under the carpet contract, the independent contractor bills and collects amounts for the carpet cleaning directly from the tenants.

### **Parking**

Trust intends to provide parking for tenants in any of the following ways: (1) Trust may own the parking facility, lease it to a third-party operator under a master lease agreement, and collect rent from the third-party at arm's length; or (2) Trust may lease a parking facility from an unrelated property owner and subsequently sublease the space to tenants. In either situation, either Company B or a third-party garage operator will be hired, for a fee or a percentage of the parking revenues, to manage the parking garage, collect fees from parking patrons and remit the fees to Trust. Trust will not perform any services other than ordinary and necessary maintenance and repair such as snow removal in connection with the parking facilities.

### **Development Services**

Trust intends for the Employees to perform certain development services for the development of new properties. Trust will perform development services only to the extent that they are part of the upfront lease negotiation (including extensions and renewals) between Trust and prospective tenants. The development services to be performed by the Employees include feasibility studies, property design, hiring architects, general contractors, and managing general contractors, and overseeing the overall development process. Company B, in addition to performing development services for the Properties, may also perform some development services as a separate and independent business for other properties of tenant-clients and for non-tenant clients. Any construction activity for particular tenants that is not part of lease negotiations will be performed by an independent contractor from whom Trust will not derive income.

For construction activities performed by third-party contractors, Company B will charge clients an oversight or supervision fee based on a percentage of the third-party contractor's billed cost as is customarily provided to tenants by owners of rental properties of a similar class and located in the same geographical areas as the Properties. The fee may be a flat fee based on hours and/or construction costs or may be a flat fee based on estimated hours and/or construction costs.

### **Company C**

Company C provides a wide variety of real estate related strategic and management consulting services to non-tenant hospitals and healthcare systems nationwide. Company C operates as a separate business and does not currently have

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clients that are tenants of Trust. However, Company C intends to provide services to Trust's tenants. Company C's consulting services are operated and accounted for separately from the rental operation of Operating Partnership.

Company C and Trust represent that the services Company C will provide to tenant-clients and tenant affiliates will be independent from, and not directly related to, the client's tenancy in the Properties. Further, it is represented that Company C's healthcare consulting business is a separate viable business and is a separate and independent profit center. Because some non-tenant clients are in the same healthcare systems as tenant clients, Company C expects to provide consulting services to a tenant healthcare system (or its parent company). If Company C has a client that is also a Properties tenant, Company C will have a separate contract with the client. If the client ends its tenancy, Company C will continue to perform activities under its contract with that client. Additionally, if Trust disposes of a Property, Company C will continue to fulfill its obligations under contracts with clients at that Property. All consulting services performed by Company C for tenants of the Properties will be handled in the same manner and at the same rates as third-party engagements. Company C will not give preferential treatment or discounts to tenants of the Properties, and Trust will not give rental concessions to tenants who contract with Company C.

Company C intends to provide services to both third-party clients and clients who are tenants of the Properties. Among the services Company C provides are asset inventory, operations assessment, information system consulting, and strategic consulting for hospital ambulatory network expansion.

As part of an asset inventory, Company C will create a property abstract that includes all pertinent information on all properties owned or leased by clients. Company C will also assess the current staffing at properties, assess the condition of a property, establish property values, and develop financial forecasts relating to the property.

An operations assessment performed by Company C includes an analysis of the operating standards and procedures, current staffing, leasing procedures, marketing plans, tenant satisfaction, and overall profitability analysis for the property. Company C compiles all gathered information and creates operations and procedures manuals for the properties. Company C also makes recommendations for the acquisition or divestiture of properties or capital assets.

Company C intends to advise clients on the installation and use of a lease administration software program specifically tailored to the healthcare industry. Company C will sell and install the program, load information into the program, train client employees, and provide technical support.

Finally, Company C intends to assist clients in expanding their ambulatory care network. The assistance may include demographic studies, site location, feasibility

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studies, and brokerage services for the purchase or lease of property.

Trust and Company C represent that: (1) Company C does not, and will not, give preference in terms of accessibility or cost to Trust tenants; (2) Trust operates similar to a common paymaster and that Company C will reimburse Trust at cost for all costs associated with the Employees; (3) Company C will reimburse Trust at cost for the use of office space and components thereof; (4) Company C is responsible for hiring, firing, and promoting the employees performing services for Company C; (5) Company C maintains its own business licenses and has separate bank accounts and pays its own bills; (6) Company C bills its clients directly; and (7) Company C determines and approves its own annual budget.

**Law:**

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

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

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

Section 856(d)(1) provides that "rents from real property" include (subject to exclusions provided in § 856(d)(2)): (A) rents from interests in real property; (B) charges for services customarily furnished or rendered in connection with the rental of real property, whether or not such charges are separately stated; and (C) rent attributable to personal property leased under, or in connection with, a lease of real property, but only if the rent attributable to the personal property for the taxable year does not exceed 15 percent of the total rent for the tax year attributable to both the real and personal property leased under, or in connection with, the lease.

Section 1.856-4(b)(1) provides that, for purposes of §§ 856(c)(2) and 856(c)(3), the term "rents from real property" includes charges for services customarily furnished or rendered in connection with the rental of real property, whether or not the charges are separately stated. Services rendered to tenants of a particular building will be considered customary if, in the geographic market in which the building is located, tenants in buildings of a similar class are customarily provided with the service. In



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particular geographic areas where it is customary to furnish electricity or other utilities to tenants in buildings of a particular class, the submetering of those utilities to tenants in the buildings will be considered a customary service.

Section 1.856-4(b)(5)(ii) of the regulations provides that the trustees or directors of a REIT are not required to delegate or contract out their fiduciary duty to manage the trust itself, as distinguished from rendering or furnishing services to the tenants of its property or managing or operating the property. Thus, the trustees or directors may do all those things necessary, in their fiduciary capacities, to manage and conduct the affairs of the trust itself.

Section 856(d)(2)(C) provides that any impermissible tenant service income is excluded from the definition of "rents from real property". Section 856(d)(7)(A) defines "impermissible tenant service income" to mean, with respect to any real or personal property, any amount received or accrued directly or indirectly by the REIT for services furnished or rendered by the REIT to tenants at the property, or for managing or operating the property.

Section 856(d)(7)(B) provides that if the amount of impermissible tenant service income exceeds one percent of all amounts received or accrued during the tax year directly or indirectly by the REIT with respect to the property, the impermissible tenant service income of the REIT will include all of the amounts received or accrued with respect to the property. Section 856(d)(7)(D) provides that the amounts treated as received by a REIT for any impermissible tenant service shall not be less than 150 percent of the direct cost of the REIT in furnishing or rendering the service.

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

Section 512(b)(3) provides, in part, that there shall be excluded from the computation of unrelated business taxable income all rents from real property and all rents from personal property leased with such real property, if the rents attributable to such personal property are an incidental amount of the total rents received or accrued under the lease, determined at the time the personal property is placed in service.

Section 1.512(b)-1(c)(5) provides that payments for the use or occupancy of rooms and other space where services are also rendered to the occupant, such as for the use or occupancy of rooms or other quarters in hotels, boarding houses, or apartment houses furnishing hotel services, or in tourist camps or tourist homes, motor

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courts or motels, or for the use or occupancy of space in parking lots, warehouses, or storage garages, do not constitute rent from real property. Generally, services are considered rendered to the occupant if they are primarily for his convenience and are other than those usually or customarily rendered in connection with the rental of rooms or other space for occupancy only. The supplying of maid service, for example, constitutes such service; whereas the furnishing of heat and light, the cleaning of public entrances, exits, stairways and lobbies, and the collection of trash are not considered as services rendered to the occupant.

The Report of the Conference Committee on the Tax Reform Act of 1986, H.R. Rep. No. 99-841, 99th Cong., 2d Sess. 1 (1986), 1986-3 (Vol. 4) C.B. 1, 220, in discussing the application of § 512(b)(3) to REITs provides that:

The conferees wish to make certain clarifications regarding those services that a REIT may provide under the conference agreement without using an independent contractor, which services would not cause the rents derived from the property in connection with which the services were rendered to fail to qualify as rents from real property (within the meaning of section 856(d)). The conferees intend, for example, that a REIT may provide customary services in connection with the operation of parking facilities for the convenience of tenants of an office or apartment building, or shopping center, provided that the parking facilities are made available on an unreserved basis without charge to the tenants and their guests or customers. On the other hand, the conferees intend that income derived from the rental of parking spaces on a reserved basis to tenants, or income derived from the rental of parking spaces to the general public, would not be considered to be rents from real property unless all services are performed by an independent contractor. Nevertheless, the conferees intend that the income from the rental of parking facilities properly would be considered to be rents from real property (and not merely income from services) in such circumstances if services are performed by an independent contractor.

Rev. Rul. 69-178, 1969-1 C.B. 158, holds that amounts received by an exempt organization for the occasional use by others of its meeting hall are "rents from real property" within the meaning of section 512(b)(3) of the Code. The only services provided by that exempt organization consisted of the provision of utilities and janitorial services. Rev. Rul. 80-297, 1980-2 C.B. 196, holds that the leasing of tennis facilities to a third party without services and for a fixed fee is excluded from unrelated business taxable income as rent from real property under section 512(b)(3) and the regulations thereunder. Rev. Rul. 80-298, 1980-2 C.B. 197, holds that income from the lease of a football stadium by an exempt university to a professional football team is not excluded from unrelated business taxable income as rent from real property under section 512(b)(3) and the regulations thereunder because the university provided substantial services for the convenience of the team.

### **Analysis and Conclusions:**

In this case, Company B intends to provide management and development services both to tenants and non-tenants of the Properties, as well as to Operating Partnership. Company B is a separate entity from Trust or Operating Partnership. It maintains separate books, records, and bank accounts from Trust and Operating Partnership and reimburses Trust at arms length for expenses related to shared employees. Accordingly, the services Company B directly provides to tenants of the Properties both within the Properties and outside the Properties and to non-tenants of the Properties will not cause Trust's allocable share of rents from the Properties to be treated as other than rents from real property for purposes of § 856(d). The services to be provided by Company B with respect to the Properties are either customary services that are not for the convenience of tenants, or, if non-customary, will be provided through a third-party independent contractor. Consequently, the property management and development services provided by Company B to the Properties will not cause Trust's allocable share of income that otherwise qualifies as rents from real property under § 856(c) to be excluded under § 856(d)(2)(C).

Like Company B, Company C will maintain its own books, records, and bank accounts. Company C will bill its clients directly and will be paid directly for services performed. All consulting services performed by Company C for tenants of the Properties will be handled at the same rates and on the same terms as services performed for non-tenants. The services provided by Company C will be separately contracted and will not be part of any rental agreement between Trust or Operating Partnership and tenants of the Properties. Trust will not give rental concessions or other preferences to tenants of the Properties contracting with Company C. Trust will be reimbursed at arms-length for shared employees and other expenses. Accordingly, the strategic and management consulting services that will be provided by Company C to tenants of the Properties will constitute a separate and independent business and will not cause Trust's allocable share of income that otherwise qualifies as rents from real property under § 856(c) to be excluded under § 856(d)(2)(C).

In Rev. Rul. 84-138, 1984-2 C.B. 123, a regulated investment company (RIC) and its wholly-owned subsidiary shared facilities and some of the same personnel. It was agreed that the RIC would pay all of the expenses for general and administrative overhead, including personnel costs. The subsidiary agreed to reimburse the RIC for its pro rata share of the expenses on an arms-length basis. The revenue ruling holds, in relevant part, that the reimbursements are not subject to the gross income requirement of § 851(b)(2). See also Rev. Rul. 92-56, 1992-2 C.B.153.

The facts of the present case are analogous to those in Rev. Rul. 84-138. Accordingly, amounts collected by Trust under the reimbursement arrangement for general and administrative overhead, shared personnel, and facilities including amounts for employee expenses on behalf of Company B and Company C, will not constitute gross income for purposes of § 856(c).

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**Other Information:**

Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any aspect of the transaction discussed in this letter. No opinion is expressed concerning whether Trust will otherwise qualify as a REIT under § 856 following the reorganization discussed above.

Additionally, no opinion is expressed whether Trust satisfies the 10 percent voting securities requirement of § 856(c)(4)(B) with respect to Company B and Company C, as a result of Trust's interest in Operating Partnership.

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

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

Enclosure:  
Copy of this letter  
Copy for 6110 purposes