The IRS recently issued the following guidance relating to the taxation of REITs:
• Revenue Procedure 2003-65—Loans secured by partnership interests;
• Revenue Procedure 2003-66—Rent paid by a partnership with a taxable REIT subsidiary (TRS) partner; and
• Revenue Ruling 2003-86—Services provided by a partnership with a TRS partner.

Historically, the IRS has limited itself to issuing private letter rulings with respect to REIT compliance issues of this kind, but such private letter rulings may only be relied upon by the particular taxpayers that requested them. Revenue Procedures and Revenue Rulings, on the other hand, may be relied upon by all taxpayers. This Client Alert summarizes the Revenue Procedures and Revenue Rulings listed above.

Safe Harbor for Loans Secured by a Partnership Interest
Many REITs invest in real estate by making loans that are secured by real property. In some cases, perhaps because of financing arrangements and restrictive loan covenants, instead of making a loan that is secured directly by real property, a REIT may make a loan to the owner of an entity that owns real property. Such a loan will often be secured by a pledge of the borrower’s ownership interest in the property-owning entity.

In order to maintain their privileged federal income tax status, REITs must meet certain income and asset tests under the Internal Revenue Code. For instance, at the close of each quarter, 75 percent of the value of a REIT’s assets must be comprised of real estate assets, cash and cash items and government securities (commonly known as the 75 percent asset test). Additionally, 75 percent of a REIT’s gross income must be derived from specified items including interest on obligations secured by mortgages on real property or on interests in real property (commonly known as the 75 percent income test). Revenue Procedure 2003-65 sets forth a safe harbor under which a loan made by a REIT and secured by a partnership interest or the sole membership interest in a disregarded entity, will be treated as a real estate asset for purposes of the 75 percent asset test and as producing qualifying interest income for purposes of the 75 percent income test.

To fit within the safe harbor, a loan must meet the following requirements:
1) The borrower must be either a partner in a partnership or the sole member of an eligible entity that is disregarded for federal income tax purposes (for example, a single member LLC that has not elected to be taxed as a corporation);
2) The loan must be non-recourse and secured only by the partner's interest in the partnership or the member's interest in the disregarded entity;
3) The lender must be granted a first priority security interest in the pledged ownership interest;
4) Upon default and foreclosure on the secured loan, the lender must replace the borrower as a partner in the partnership or as the sole member of the disregarded entity;
5) On the date the commitment by the lender to make the loan becomes binding on the lender, the partnership or disregarded entity must hold real property and, if all or part of the real property is subsequently sold or otherwise transferred, the loan must become due and payable upon the sale or transfer of the real property;
6) On specified testing dates, the value of the real property held by the partnership or disregarded entity must represent at least 85 percent of the value of all of the assets of the partnership or disregarded entity;
7) The loan value of the real property owned by the partnership or disregarded entity must equal or exceed the amount of the loan as determined under the applicable Treasury Regulations. For this purpose, the loan value is reduced by any liens encumbering the real property, as well as by any other liabilities of the partnership or disregarded entity on the date the commitment by the lender to make the loan becomes binding on the lender. Also, if the real property is owned by a partnership, only a proportionate share (based on the borrower's partnership interest) of the loan value may be used; and
8) Interest on the loan must include only an amount that constitutes compensation for the use or forbearance of money and the determination of the amount may not depend in whole or in part on the income or profits of any person.

A REIT that makes a loan secured by a partnership interest or an interest in a disregarded entity can be certain that it qualifies under the 75 percent asset test and produces qualifying income for purposes of the 75 percent income test, provided the loan satisfies the safe harbor requirements set forth in this Revenue Procedure.

Revenue Procedure 2003-65, however, leaves some questions unanswered. For example, the second requirement under the safe harbor is that the loan at issue be non-recourse. Lenders, however, often make loans secured by partnership or LLC interests on a recourse basis, particularly if the partners or members of the borrower need the loan to obtain an increase in the tax basis of their partnership or membership interests. Such an arrangement will fall outside of the present safe harbor.

Similarly, the fifth requirement listed above requires that the partnership or disregarded entity hold real property "on the date the commitment by the lender becomes binding." Read literally, this would prevent a REIT from making an advance commitment to provide purchase money financing. Moreover, if the entity that owns the real property holds multiple properties and sells some or all of them, the loan would have to become immediately payable to satisfy the safe harbor requirements. Some borrowers may object to this restriction, particularly in the case of a partial sale.

Finally, with respect to the seventh requirement, the Revenue Procedure does not indicate whether the loan-to-value test is reapplied when the entity that owns the real property incurs subsequent secured indebtedness to a third party.

Despite these open issues and questions, Revenue Procedure 2003-65 provides helpful guidance to REITs in addressing their compliance obligations in this area.

**Safe Harbor for Treating Rent Paid by a TRS Partnership as Qualifying Rent**

Revenue Procedure 2003-66 describes conditions under which rental payments...
to a REIT from a joint venture or partnership between a TRS of a REIT and a third party not related to the REIT will be treated as qualifying “rents from real property.” The Revenue Procedure is effective for leases in effect or entered into on or after January 1, 2001.

A REIT must meet two percentage tests relating to the sources of its income on an annual basis (commonly known as the REIT income tests). One source of qualifying income for purposes of both REIT income tests is “rents from real property.” In general, rent received from tenants that are related to the REIT, applying a 10 percent direct or indirect ownership test, do not qualify as rents from real property. However, a REIT’s ownership of more than 10 percent of the stock of a TRS will not disqualify the rent paid by the TRS if (1) the rent paid by the TRS is substantially comparable to the rent paid by the other tenants for comparable space; and (2) at least 90 percent of the leased space at the property is leased to tenants other than TRSs of the REIT and other related party tenants. Rent from a TRS will also qualify as rents from real property if the property is a “qualified lodging facility” that is operated by an “eligible independent contractor.”

In Revenue Procedure 2003-66, the IRS states that rent from a joint venture between a TRS and third party that is unrelated to the TRS or the REIT will be treated as rents from real property if (1) the rent paid by the TRS joint venture is substantially comparable to the rent paid by the other tenants of the property for comparable space; and (2) at least 90 percent of the leased space at the property is rented to persons other than TRSs of the REIT and other related parties (including the TRS partnership). The IRS did not address the treatment of a TRS joint venture that leases a qualified lodging facility.

**Partnership Owned by a TRS and an Independent Contractor May Provide Non-Custonmary Services to REIT Tenants**

On July 16, 2003, the IRS issued Revenue Ruling 2003-86, which holds that a partnership between a TRS and an entity qualifying as an independent contractor of the REIT may provide non-customary services to tenants of the REIT without causing the rent paid by such tenants to fail to qualify as rents from real property.

In the Revenue Ruling, a REIT formed a TRS to provide services to tenants of its properties. The services provided to tenants by the TRS were services that were not customarily provided to tenants of rental apartment properties in the metropolitan areas in which the REIT’s properties were located. X was a corporation unrelated to either the REIT or the TRS and thus, X qualified as an independent contractor from which the REIT derived no revenue. X provided various services to the REIT’s tenants and the tenants of other rental apartments in the areas where the REIT’s properties were located. The services provided by X were primarily for the convenience of the tenants and were not customary in the areas where the REIT’s properties were located.

The TRS and X formed a joint venture, treated as a partnership for federal income tax purposes, to provide the non-customary services that formerly were separately provided to the REIT’s tenants by either the TRS or X. The REIT’s tenants contracted directly with the partnership for the services, and the REIT did not receive any payments related to the services from the partnership, X or the tenants. The REIT received quarterly dividends from the TRS.

For purposes of the REIT income tests, rents from real property do not include
“impermissible tenant service income” which includes any amount received or accrued directly or indirectly by the REIT for services furnished or rendered by the REIT to the tenants of the property. If a REIT receives more than a de minimis amount of impermissible tenant service income from a property, all amounts received from that property will fail to qualify as rents from real property. However, services furnished or rendered through a TRS or an independent contractor from which the REIT does not derive or receive any income are not treated as furnished or provided by the REIT, and thus, do not result in the REIT receiving impermissible tenant service income.

In this case, the REIT indirectly derived income from the partnership which provided the tenant services (i.e., the quarterly dividends from the TRS). However, the IRS held that the services provided by the partnership would be treated as provided by the TRS to the extent of the TRS’s interest in the partnership. The “no income” requirement is not applicable to a TRS service provider. The remaining partnership interests were held by an independent contractor from which the REIT derived no revenue. Accordingly, the IRS ruled that the partnership’s performance of services for the REIT’s tenants did not cause the rent paid by the tenants to fail to qualify under the REIT income tests.