[PARKING SERVICES]

ISSUE

If a real estate investment trust (REIT) provides parking services at a property owned by the REIT, in what situations will the amounts received by the REIT with respect to the property continue to qualify as "rents from real property" under § 856(d) and how is the income from the parking services treated under § 856 of the Code?

FACTS

M, a corporation that has elected to be a REIT as defined in § 856 of the Code, owns commercial office, multi-family, and retail properties. Parking facilities generally are located in, adjacent to, or as part of the same complex as M's properties. M operates and manages its own properties, but generally is not involved in the management or operation of the parking facilities. M's properties are located either in markets where parking is usually and customarily available tenants and their employees, customers and guests without charge or in markets where parking is usually and customarily available to tenants and their employees, customers and guests only for a fee.

P is a parking management company that meets the requirements under § 856(d)(3) of the Code to be an independent contractor. In some cases, P contracts with property owners, including M, for the operation of parking garages pursuant to parking management contracts. In other cases, P enters into lease agreements with property owners, including M, whereby P leases a parking facility from the property owner and operates the parking facility.

Situation 1

At property X, M makes parking available to tenants and their employees, customers and guests on an unreserved basis, free of charge. In the geographic area where property X is located, parking is readily available to tenants and their employees, customers and guests without charge. As a general rule, no charge is imposed upon tenants of property X or their employees, customers and guests for parking at property X (although in some cases patrons may pay a fee for the rental of a specific number of reserved parking spaces). No services are provided with respect to parking at property X. Basic utilities and general parking facility maintenance are provided and overseen by M.

Situation 2

At property Y, P operates the parking garage, which is leased from M. The lease payments made by P to M are based on a fixed percentage of the gross revenues that P receives with respect to its parking operations at property Y. The lease between P and M requires that P reserve a fixed number of parking spaces for use, free of charge, by M or tenants of Property Y designated by M. In connection with its garage operations, P may provide various services to garage customers, including valet parking.

Situation 3

M owns a parking garage that is located within a reasonable walking distance of property Z. P operates this parking garage pursuant to a parking management contract with M that delegates day-to-day responsibility for the operation of the parking facilities to P. In the geographic area where property Z is located, parking is usually and customarily provided to tenants, their employees, customers and guests by building owners for a fee. P provides all services associated with the rental of parking spaces to tenants, their employees, customers and guests, and members of the general public. The services provided by P include the collection of parking fees and the daily maintenance of the parking garage.

P sometimes requires that customers leave the ignition key to the parked car in order to permit parking attendants to park the cars more densely than could be accomplished if the customers were to park their own cars. This activity is provided primarily as a means to achieve maximum occupancy of a parking garage.

P also provides additional services, such as valet parking at property Z. In the geographic area where property Z is located, valet parking is usually and customarily provided at properties that are similar to property Z.

Under the parking management agreement, P is paid a management fee by M. The parking management fee is comprised of both a fixed dollar amount and an incentive fee based either on a percentage of gross or a percentage of net revenues from the parking garage. Tenants of the property Z, their employees, customers and guests, as well as members of the general public, pay parking fees directly to P. P remits to M the receipts from the parking garage, net of P's management fee and operating expenses incurred by P. In some cases, M collects monthly parking fees from tenants as part of their lease arrangements. M retains these monthly parking fees, but these amounts are taken into account in determining the fee due to P. M does not receive any income from P with respect to the parking garage at property Z.

At property Z, car wash and maintenance services also are available to parking customers for a fee. The car wash and maintenance services are provided in the parking garage by S, a service provider that meets the requirements under §856(d)(3) of the Code to be an independent contractor. Parking customers arrange for these services directly with S. Neither P nor M receives any income from S. S does not make any payment to M with respect to use of the space or utilities in the parking garage. M does not bear any of the direct expenses of S in providing the car wash and maintenance services.

Situation 4

The facts are the same as in *Situation 3*, except that S pays P an arm's-length fee for the use of the space in the parking garage where the car wash and maintenance services are provided. P remits such fee to M together with other receipts from the parking garage. Other than the revenues related to the space used by S in the parking garage, neither P nor M receives any revenue from S. S charges all customers a fixed price for its services and does not offer any discount to tenants of property Z that is not available to other customers of S.

Situation 5

The facts are the same as in *Situation 3*, except that employees of P provide the car wash and maintenance services to parking customers. Revenues from such services provided by P are not remitted to M and such revenues are not taken into account in determining the fee payable to P under the parking management contract. Expenses related to P's employees that perform the car wash and maintenance services are not charged to M and are not taken into account in determining the fee payable to P under the parking management contract. P does not make any payment to M with respect to use of the space or utilities in the parking garage.

Situation 6

The facts are the same as in *Situation 3*, except that the car wash and maintenance services are scheduled on behalf of tenants and their employees, customers and guests by an employee of M who is the property manager at property Z. On behalf of S, M collects all revenues from the car wash and management services directly from the parking customers and deducts and retains a service fee of $20x before remitting the revenues to S. The direct expenses of M incurred with respect to the car wash and maintenance services are not in excess of $5x. The total revenues received by M from property Z are $5000x.

LAW AND ANALYSIS

To qualify as a REIT, an entity must derive at least 95 percent of its gross income from sources described in §856(c)(2) and at least 75 percent from sources described in §856(c)(3). "Rents from real property" are among the sources described in both of those sections.

Section 856(d)(1) provides that rents from real property include, subject to the exclusions in §856(d)(2): (i) rents from interests in real property, (ii) charges for services customarily furnished or rendered in connection with the rental of real property (whether or not the charges are separately stated), and (iii) rent attributable to personal property that is 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 year attributable to both the real and the personal property leased under, or in connection with, the lease.

Section 856(d)(2)(C) excludes from the definition of rents from real property any "impermissible tenant service income" as defined in §856(d)(7). Section 857(d)(7)(A) provides, in relevant part, that impermissible tenant service income means, with respect to any real or personal property, any amount received or accrued directly or indirectly by a REIT for furnishing or rendering services to the tenants of the property or managing or operating the property.

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

Section 1.856-4(b)(1) of the Income Tax Regulations provides that services furnished to tenants are 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 many geographic areas, customary services include the furnishing of water, light, and air-conditioning, the cleaning of windows, public entrances, exits, and lobbies, the performance of general maintenance and janitorial and cleaning services, the collection of trash and the furnishing of parking facilities.

The report of the Conference Committee on the Tax Reform Act of 1986, H.R. Conf. Rep. No. 841, 99th Cong., 2d Sess. 1 (1986), 1986-3 (Vol.4) C.B. 1, 220, in discussing the independent contractor requirement provides that:

> The conferees wish to make certain clarifications regarding those services that a REIT may provide 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 § 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.

Section 856(d)(7)(B) provides that, if the amount of impermissible tenant service income with respect to a property for any taxable year exceeds one percent of all amounts

received or accrued during such taxable year directly or indirectly by the REIT with respect to the property, the impermissible tenant service income of the REIT with respect to the property includes all such amounts. Section 856(d)(7)(D) provides that the amount treated as received for any service (or management or operation) must not be less than 150 percent of the direct cost of the REIT in furnishing or rendering the service (or providing the management or operation).

In *Situation 1*, the general utility and basic facility maintenance services provided by M to tenants of property X, as described in the conference report above, are not services that are required to be performed by an independent contractor. No other services are performed. The availability of parking is not itself a service to tenants. Fees paid for the rental of parking spaces on a reserved basis therefore qualify as rents from real property for purposes of § 856(d).

In *Situation 2*, all activities and services relating to the parking garage operations are performed by P, an independent third party that leases the parking facility from M. The lease payment made by P for the parking garage is arm's-length and is not considered to result in the participation by M in the operation of the parking garage. Accordingly, M is not deemed to have furnished or rendered any parking services at property Y within the meaning of § 856(d)(7)(A)(i).

In S*ituation 3*, all of the parking services, whether provided to tenants of property Z, their guests, customers and employees, or to members of the general public, are performed by P or S, both independent contractors. The general parking services are provided by P, an independent contractor. P collects and remits parking revenues to M, net of P's fee and operating expenses. Under this arrangement, the independent contractor, P, is merely acting as a conduit for delivering revenues to M. Based on these economic arrangements, M is not treated as receiving any income from P with respect to the parking garage at property Z. Accordingly, the parking services performed by P do not give rise to impermissible tenant service income under the exception provided in § 856(d)(7)(C)(i) and no amounts received by M with respect to property Z are treated as other than rents from real property under § 856(d) as a result of such services. In addition, the parking revenues that M receives qualify as rents from real property for purposes of § 856(d).

The car wash and maintenance services are provided by S, an independent contractor. M does not receive any income from S or receive, directly or indirectly, any revenues from services provided by S. Accordingly, the car wash and maintenance services performed by S do not give rise to impermissible tenant service income due to the exception provided in § 856(d)(7)(C)(i) and no amounts received by M with respect to property Z are treated as other than rents from real property under § 856(d) as a result of such services.

In *Situation 4*, the car wash and maintenance services are provided by S, an independent third party. S has contracted with P for use of space in the parking garage where the car wash and maintenance services are performed. The car wash and maintenance business operated by S is a separate business operation, independent of and unrelated to the property leasing business of M. Despite overlapping clientele, M and S operate separate and independent businesses and S does not give preferential treatment to customers that are tenants of property Z, their employees, guests or customers. The fee paid by S for use of space in the parking garage is

arm's-length and is not the result of any participation by M in the car wash and maintenance services. Accordingly, M is not deemed to have furnished or rendered the car wash and maintenance services within the meaning of § 856(d)(7)(A)(i).

In addition, for the reasons described above with respect to *Situation 3*, no amounts received by M with respect to property Z are treated as other than rents from real property under § 856(d) as a result of the parking services performed by P and the parking revenues that M receives qualify as rents from real property for purposes of § 856(d).

In *Situation 5*, all of the parking and car wash and maintenance services are provided by P. P is an independent contractor from which M derives no income with respect to the activities at property Z. Although P collects and remits revenues related to the general parking operation, no revenues from the car wash and maintenance services are remitted to M. In addition, M does not bear any portion of the direct expenses of P that are attributable to the car wash and maintenance services. Accordingly, the car wash and maintenance services performed by P do not give rise to impermissible tenant service income due to the exception provided in § 856(d)(7)(C)(i) and no amounts received by M with respect to property Z are treated as other than rents from real property under § 856(d) as a result of such services.

In addition, for the reasons described above with respect to *Situation 3*, no amounts received by M with respect to property Z are treated as other than rents from real property under § 856(d) as a result of the parking services performed by P and the parking revenues that M receives qualify as rents from real property for purposes of § 856(d).

In *Situation 6*, the parking services are provided by P, an independent contractor, but the car wash and maintenance services are provided in part by M and in part by S. The scheduling and collection activities performed directly by M are not of a type that may be performed directly by M without giving rise to impermissible tenant service income. The $20x fee retained by M is greater than 150% of the $5x of direct expenses incurred by M in providing the services. Accordingly, the $20x fee retained by M for scheduling the car wash and maintenance services and collecting the fees from such services is impermissible tenant services income to M with respect to property Z. Assuming that M does not have any other impermissible tenant service income from property Z, the one-percent "de minimis" limit set forth in § 856(d)(7)(B) is not exceeded and only the $20x of the total amounts received by M with respect to property Z fail to qualify as rents from real property for purposes of § 856(d).

For the reasons described above with respect to *Situation 3*, no amounts received by M with respect to property Z are treated as other than rents from real property under § 856(d) as a result of the parking services performed by P and the parking revenues that M receives qualify as rents from real property for purposes of § 856(d).

HOLDINGS

(1) In *Situation 1*, the activities of M with respect to the parking provided at property X do not cause any portion of the rents received by M from property X to fail to qualify as rents

from real property under § 856(d). In addition, revenues received by M from parking services provided at property X qualify as rents from real property for purposes of § 856(d).

(2) In *Situation 2*, the parking garage services provided by P are not services "furnished or rendered by" M to its tenants within the meaning of § 856(d)(7). Accordingly, the parking garage services do not give rise to impermissible tenant service income and, thus, such services do not cause any portion of the rents received by M to fail to qualify as rents from real property under § 856(d).

(3) In S*ituation 3*, neither the parking services nor the car wash and maintenance services give rise to impermissible tenant service income due to the exception provided in § 856(d)(7)(C)(i). Thus, such services do not cause any portion of the rents received by M to fail to qualify as rents from real property under § 856(d). In addition, the parking revenues that are remitted to M by P qualify as rents from real property for purposes of § 856(d).

(4) In *Situation 4*, the car wash and maintenance services are not services "furnished or rendered by" M to its tenants within the meaning of § 856(d)(7). Accordingly, the car wash and maintenance services do not give rise to impermissible tenant service income and, thus, such services do not cause any portion of the rents received by M to fail to qualify as rents from real property under § 856(d).

The parking services provided by P do not give rise to impermissible tenant service income. Thus, such services do not cause any portion of the rents received by M to fail to qualify as rents from real property under § 856(d). In addition, the parking revenues that are remitted to M by P qualify as rents from real property for purposes of § 856(d).

(5) In *Situation 5*, neither the parking services nor the car wash and maintenance services give rise to impermissible tenant service income due to the exception provided in § 856(d)(7)(C)(i). Thus, such services do not cause any portion of the rents received by M to fail to qualify as rents from real property under § 856(d). In addition, the parking revenues that are remitted to M by P qualify as rents from real property for purposes of § 856(d).

(6) In *Situation 6*, only the $20x attributable to M's direct activities with respect to the car wash and maintenance services is treated as impermissible tenant service income under §§ 856(d)(7)(A) and 856(d)(7)(D) and, accordingly, such amount does not qualify as rents from real property under § 856(d).

The parking services provided by P do not give rise to impermissible tenant service income due to the exception provided in § 856(d)(7)(C)(i). Thus, such services do not cause any portion of the rents received by M to fail to qualify as rents from real property under § 856(d). In addition, the parking revenues that are remitted to M by P qualify as rents from real property for purposes of § 856(d).