NATIONAL ASSOCIATION OF
REAL ESTATE INVESTMENT TRUSTS®

December 31, 2002

VIA HAND DELIVERY

Pamela F. Olson, Esq.
Assistant Secretary (Tax Policy)
Department of Treasury
1500 Pennsylvania Ave., N.W., Room 3120
Washington, D.C. 20220

Re: Tenant Improvements As Customary REIT Service

Dear Assistant Secretary Olson:

The National Association of Real Estate Investment Trusts® ("NAREIT") greatly appreciates the Treasury Department and the Internal Revenue Service's including in the 2002-03 Business Plan a project clarifying when certain services a real estate investment trust ("REIT") provides to its tenants are considered "customary" and therefore an integral part of the REIT's rental of real estate. NAREIT is the national trade association for real estate companies. Members are REITs and other public businesses that own, operate and finance income-producing real estate, as well as those firms and individuals who advise, study and service these businesses.

As you may recall, on November 5, 2002, we submitted a draft ruling in connection with a REIT's provision of parking to tenants and their employees, customers and guests visiting a REIT's property. Another area in the context of customary services that generates many questions concerns the provision of, and the payment for, tenant improvements. The attached draft revenue ruling concerning tenant improvements is based generally on private rulings and revenue rulings that considered a range of fact patterns. As in the case of the parking ruling, we believe that a public ruling would provide guidance on which REITs could rely without having to submit a separate ruling request and would simultaneously free IRS resources.

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Thank you again for increasing public guidance on a wide range of important tax issues. We would be glad to discuss any issue raised in the attached ruling.

Respectfully submitted,

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Senior Vice President & General Counsel

Enclosure

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[TENANT IMPROVEMENTS]

Rev. Rul. 2003-

ISSUE

If a real estate investment trust (REIT) constructs improvements for its tenants, either directly or through an independent contractor, what is the character of any amounts received by the REIT with respect to such activities, and will the construction activities prevent the rent paid by such tenants from qualifying as "rents from real property" under Section 856(d) of the Internal Revenue Code?

FACTS

X is a REIT that owns directly and indirectly, through partnerships and limited liability companies, a number of office buildings, residential buildings and shopping centers throughout the United States. X, directly and indirectly, constructs leasehold improvements and performs or supervises construction and related services in the situations described below.

Situation 1

In connection with entering into a lease or a lease renewal, or at the request of an existing tenant during the term of its lease, X agrees to have its employees construct capital improvements in space leased by the tenant, or to renovate the space, pursuant to the tenant's specifications. The construction work is performed before or during the period of the tenant's occupancy. The cost of the construction is paid for by X and is reflected in the rent negotiated or renegotiated with the tenant.

Situation 2

Leases entered into by X typically provide that any tenant improvements during the term of the lease will be constructed under the supervision of X. The construction will be performed by independent contractors engaged by the tenant or by X. In the latter case, X will collect from the tenant the amount to be paid over by X to the independent contractors. X's employees will supervise the independent contractors. X's construction, architectural and engineering employees will also review design proposals to ensure that improvements will not impair the value of leased space, are in compliance with building codes and zoning restrictions and are aesthetically pleasing. In addition, X's employees will make certain that the construction activities are performed in a manner that minimizes any noise or disturbance to other tenants of X. For this supervision, X is entitled to be paid a fee equal to a specified percentage of the construction costs.

LAW

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

Section 856(d)(1) provides, in relevant part, that rents from real property include rents from interests in real property and charges for services customarily furnished or rendered in connection with the rental of real property (whether or not such charges are separately stated).

Section 1.856-4(b)(1) of the regulations provides that services provided to tenants of a particular building will be considered customary if, in the geographic market in which the building is located, tenants in buildings which are of a similar class are customarily provided with the service. Such services include the furnishing of water, heat, light, air conditioning and telephone answering services.

Section 856(d)(2)(C) excludes from the definition of rents from real property any "impermissible tenant service income," as defined in section 856(d)(7). Section 856(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 services furnished or rendered to the tenants of the property or managing or operating such property. Section 856(d)(7)(B) provides that if the amount of impermissible tenant service income received by a REIT with respect to a property exceeds one percent of all amounts received or accrued by the REIT with respect to such property during the taxable year, then all amounts, including rent, received by the REIT with respect to such property for such taxable year will be treated as impermissible tenant services income.

Rev. Rul. 98-60, 1998-2 C.B. 749, holds that if a REIT receives impermissible tenant service income with respect to a building that exceeds one percent of all of the rental income received by the REIT from the building, then all of such rental income is treated as impermissible tenant services income.

Section 856(d)(7)(C) excludes from the definition of impermissible tenant service income amounts received for services furnished or rendered, or management or operation provided, through an independent contractor from which the trust itself does not derive or receive any income or through a taxable REIT subsidiary of such trust. Similarly, subparagraph (C) excludes amounts that would be excluded from unrelated business taxable income (UBTI) under section 512(b)(3) of the Code if received by an organization described in section 511(a)(2) of the Code. Section 512(b)(3)(A)(i) excludes rents from real property from UBTI. Section 1.512(b)-1(c)(5) of the regulations provides, however, that payments for the occupancy of space where services are also rendered to the occupant are not rents from real property. Generally, services are considered rendered to the occupant if they are primarily for the occupant's convenience and are other than those usually or customarily rendered in connection with the rental of space for occupancy only. Section 1.512(b)-1(c)(5) taints payments received under a lease as other than rents from real property if impermissible services are provided to the tenant. Rev. Rul. 98-60,

however, holds that for purposes of section 856(d)(7)(C)(ii), only the amount attributable to the impermissible service will be treated as impermissible tenant service income (unless section 856(d)(7)(B) applies).

Section 1.856-4(b)(5)(ii) of the regulations provides that trustees or directors of the 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 operating the property. Thus, the trustees or directors may make capital expenditures with respect to the REIT's property and may make decisions as to repairs of the property the cost of which may be borne by the REIT.

Rev. Rul. 67-353, 1967-2 C.B. 252, holds that a REIT is permitted to contract for construction of an office building on land owned by the REIT to be held by the REIT for the production of rental income without adversely affecting its qualification as a real estate investment trust. That ruling concluded, in part, that the trustees of the REIT are not required to delegate or contract out the authority to make decisions or negotiate contracts in connection with such construction, since the construction of the office building is for the REIT's own benefit and does not constitute a service to tenants of the REIT.

ANALYSIS

In *Situation 1*, X is paying for the cost of the improvements and is recovering the cost through the rent to be paid by the tenant. Accordingly, X will be treated as the owner of the improvements for federal income tax purposes. Therefore, under Rev. Rul. 67-353, X should be viewed as constructing the improvements for its own benefit and should not be viewed as providing a service to the tenant. This conclusion should be the same regardless of when the construction is agreed to or the activities occur. Accordingly, the amounts paid by the tenant to the REIT should be viewed as rent, which qualifies as rents from real property for purposes of section 856(d).

In *Situation 2*, the tenant is paying for the cost of the improvements and will be treated as the owner of the improvements for federal income tax purposes. The supervisory activities performed by X in connection with tenant construction activities are of a type customarily performed by landlords and are intended for the protection of the landlord's interests. In addition, the construction activity is performed by an independent contractor. Accordingly, the activities performed by X should not be viewed as a service provided by X to its tenants. Thus, no impermissible tenant service income would result therefrom under section 856(d)(7)(C), and the fees would qualify as rents from real property. In addition, where X engages the independent contractor, since the sole activity of X with respect to the construction is arranging for and supervising the construction, X should be viewed as a conduit with respect to the amounts collected by X which are paid over by X to the independent contractor, and such amounts should not be included in X's gross income for purposes of Code section 856.

CONCLUSIONS

In *Situation 1*, all amounts paid by the tenant to X will be treated as rents from real property for purposes of section 856(d).

In *Situation 2*, the fees received by X with respect to supervising and arranging the construction activities will qualify as rents from real property for purposes of section 856(d). The amounts collected by X to be paid over to the independent contractor will not be includible in X's gross income.