IRS Letter Rulings and TAMs (1954-1997), UIL No. 7704.03-00, Letter Ruling 9743006, (July 18, 1997), Internal Revenue Service, (Jul. 18, 1997)

Letter Ruling 9743006, July 18, 1997

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[Code Sec. 7704]

This letter responds to your submission of November 20, 1996, in which you requested rulings concerning the qualifying income exception to the publicly traded partnership rules under section 7704 of the Code.

Facts

Partnership was organized as a publicly traded partnership in State during 1986 to succeed to the business of Corporation. Partnership's assets include X, Y, and nearby dry storage facilities. In addition, Partnership owns and operates a parking garage (Garage) that is adjacent to X, and a parking lot (Lot I) that is adjacent to the Garage. Partnership leases a second parking lot (Lot II) in downtown City to a third-party operator.

A portion of the bottom floor of the building that houses X is leased to several retail tenants. The remainder of the floor and the upper 11 floors of the building (Facility I) include X and three floors used for hotel rooms for visiting guests of X.

Y includes a clubhouse and adjacent parking areas for Y members (Facility II). The dry storage area includes designated spaces on land for individual a storage. Partnership master leases the land for Facility II and the dry storage area from County under a long-term lease that has 26 years remaining. Partnership owns the building on the leased land.

Partnership currently subleases the dry storage spaces to individual tenants, who have the exclusive right to use the designated space. The sublease agreements are designated as licenses to comply with certain terms of the master lease. Partnership does not assume any liabilities typical in a bailment arrangement and generally does not have the right to use a tenant's designated space for its own purposes.

Partnership offers paid parking in the Garage and Lot I. The Garage building is immediately adjacent to the building housing X; the two buildings share a common wall. Moreover, several doorways allow free passage between X and the Garage. A small portion of the Garage was walled in years ago and converted to office space, which opens into X, that is leased to tenants. Lot I is situated immediately adjacent to the Garage on the opposite side of X and therefore functions as an "overflow" parking area when the Garage is filled.

Both the Garage and Lot I are open to members of the general public. However, approximately 86 percent of the Garage use is attributable to X members or to retail or office tenants of the X building. Approximately 40 percent of the use of Lot I is attributable to X members or to retail or office tenants of the X building. The Garage has 420 parking spaces; Lot I has 113 spaces. Both the Garage and Lot I have multiple payment options available. Motorists generally can pay an hourly rate, or rent a parking space on a monthly basis for a substantial discount. Members of X can obtain parking on an hourly basis at a substantial discount (approximately 75 percent).

Currently, Partnership's employees manage both the Garage and Lot I. Partnership does not assume liability for the parked automobiles and does not render any services other than maintaining lighting, collecting parking fees, and providing necessary accounting for insurance, taxes, and overhead.

Since 1987, Partnership has avoided corporate taxation as a publicly traded partnership (PTP) under "grandfather" provisions that expire on December 31, 1997. After the expiration of the grandfather provisions, Partnership must satisfy the qualifying passive income rules in section 7704(c) of the Code to continue being treated as a partnership for federal income tax purposes. Partnership's representative believes that except for the revenues generated by the X and Y operations and those that are the subject of this ruling request, Partnership would generate sufficient "real property rents" to satisfy the qualifying income exception.

Partnership will engage a qualified independent contractor (Independent Contractor) within the meaning of section 856(d)(2) and (3) of the Code to perform all management services for the Garage and Lot I. Employees of the Independent Contractor will be responsible for performing general maintenance, collecting parking fees, and remitting parking proceeds to Partnership.

Partnership has not yet selected an Independent Contractor or negotiated an operating agreement. Partnership, however, has represented that any such agreement will be negotiated at arms' length, the Independent Contractor will not be an employee of Partnership, the manner in which the Independent Contractor carries out its duties will not be subject to the control of Partnership (except under principles of agency), and the Independent Contractor will be adequately compensated. The Independent Contractor will be responsible as an agent of Partnership for collecting and remitting parking receipts from the Garage and Lot I to Partnership. Moreover, Partnership has represented that the Independent Contractor will be compensated for its services by the payment by Partnership of either a percentage of the gross receipts realized by the parking operation (in a manner that is reasonable when compared to similar services being performed for comparable properties in downtown City), or a fixed fee that is adequate and reasonable for the nature of the services performed. Generally, the Independent Contractor will not bear the cost of physical upkeep of the Garage and Lot I, but will bear the expense of its own employees who manage the two properties.

Partnership has asked for a ruling that gross income realized from the following two sources will qualify as "real property rents" under section 7704(d)(1)(C) of the Code:

(1) rental of parking spaces in the Garage and Lot I on a monthly or hourly basis, and

(2) rental of dry storage spaces.

Analysis

Section 7704(a) of the Code provides that a publicly traded partnership shall be treated as a corporation.

Section 7704(c)(1) provides that section 7704(a) shall not apply to any publicly traded partnership for any taxable year if such partnership met the gross income requirements of section 7704(c)(2) for such taxable year and each preceding taxable year beginning after December 31, 1987, during which the partnership (or any predecessor) was in existence.

Section 7704(c)(2) explains that a partnership meets the gross income requirements of this section for any taxable year if 90 percent or more of the gross income of such partnership for such taxable year is qualifying income.

Section 7704(d)(1) provides that the term "qualifying income" includes, among other things, real property rents. Section 7704(d)(3) provides that the term "real property rent" means amounts which would qualify as "rent from real property" under section 856(d) if such section were applied without regard to paragraph (2)(C)

thereof (relating to independent contractor requirements).

Section 856(d)(1) of the Code defines the term “rents from real property” to include (subject to the exclusion in section 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 which is leased under, or in connection with, a lease of real property, but only if the rent attributable to such personal property for the taxable year does not exceed 15 percent of the total rent for the taxable year attributable to both the real and personal property leased under, or in connection with, such lease.

Section 1.856-4(b)(1) of the regulations provides that services furnished to tenants 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. The regulations further provide that in many geographic areas examples of customary services include the furnishings of water, heat, light, and air-conditioning, the cleaning of windows, public entrances, exits, and lobbies, the performance of general maintenance and of janitorial and cleaning services, the collection of trash, and the furnishing of parking facilities.

Section 856(d)(2)(C) of the Code, however, excludes from the term “rents from real property” any amount received or accrued, directly or indirectly, with respect to any real or personal property if the REIT furnishes or renders services to the tenants of such property, or manages such property, other than through an independent contractor from whom the trust itself does not derive or receive any income. The flush language of section 856(d)(2)(C) qualifies this rule and provides that a REIT may perform services if providing such services would not cause amounts received from a tenant to be excluded from unrelated business taxable income under section 512(b)(3) if received by an organization described in section 511(a)(2) .

Section 512(b)(3) of the Code provides, in part, that all rents from real property are excluded from the computation of unrelated business taxable income. Section 1.512(b)-1(c)(5) of the regulations provides that:

[P]ayments 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 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 [or her] 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, the collection of trash, etc., are not considered as services rendered to the occupant.

The Report of the Conference Committee on the Tax Reform Act of 1986, H. Rep. No. 841, 99th Cong., 2d Sess. 1 (1986), 1986-3 (Vol. 4) C.B. 1, 220, in discussing Section 856(d)(2)(C) of the Code provides that:

The conferees wish to make certain clarifications regarding the 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 one hand, section 1.512(b)-1(c)(5) of the regulations holds that income from the direct operation of a parking lot by an exempt organization does not constitute “rent” because it conclusively deems the operator

to be performing services for the convenience of the occupant. On the other hand, the receipt of income from the lease of a parking lot by an exempt organization to a third-party operator may constitute “rent” if the exempt organization provides no services for the convenience of the occupant in connection with the lease. The legislative history of the Revenue Act of 1950 distinguishes between the rental of real property and the operation of unrelated trades or businesses, such as parking lots.

Your committee believes that such ‘passive’ income [including rents] should not be taxed where it is used for exempt purposes because investments producing incomes of these types have long been recognized as proper for educational and charitable organizations. The term ‘rents from real property’ does not include income from the operation of a hotel but does include rents derived from a lease of the hotel itself. Similarly, income derived from the operation of a parking lot is not considered ‘rents from real property.’

H. Rep. No. 2319, 81st Cong., 2d Sess. 38, 110, 1950-2 C.B. 409, 459.

Conclusion

Partnership will engage an Independent Contractor to operate the Garage and Lot I for the benefit of the tenants and members of X. The Independent Contractor will perform all management activities and render all services. Employees of the Independent Contractor will be responsible for performing general maintenance, collecting parking fees, and remitting parking proceeds to Partnership. Since Partnership provides no services, income from the Garage and Lot I constitutes “rent” that is excludable from UBTI under section 512 (b)(3) of the Code, and thus qualifies as “rent from real property” under section 856(d) .

The dry storage areas are designated spaces on land for individual a storage. Although Tenants may use either of two a cranes on a self-service basis without charge, Partnership provides no services relating to the dry storage areas. Consequently, income from the rental of dry storage spaces qualifies as “rent from real property” under section 856(d) of the Code.

In conclusion, because the income realized by Partnership from the rental of parking spaces in the Garage and Lot I on a monthly or hourly basis, and the rental of dry storage spaces qualifies as “rent from real property” under section 856(d) , such income will also qualify as “real property rents” under section 7704(d)(1)(C) .

Except as specifically ruled upon above, no opinion is expressed or implied as to the federal tax consequences of the transaction described above under any other provision of the Internal Revenue Code. In particular, no opinion is expressed whether Partnership meets the 90 percent gross income requirement of section 7704(c)(1) .

This ruling is directed only to the taxpayer who requested it. Section 6110(j)(3) of the Code provides that it may not be used or cited as precedent.

In accordance with the Power of Attorney on file with this office, we are sending copies of this letter to your authorized representatives.

Sincerely yours, William P. O’Shea, Chief, Branch 3 Office of the Assistant Chief Counsel (Passthroughs and Special Industries).