Internal Revenue Service

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Department of the Treasury
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Person To Contact:
, ID No.
Telephone Number:

Refer Reply To:
CC:FIP:B02
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Date:
June 17, 2008

Legend:

Taxpayer =

Subsidiary =

a =

b =

Month 1 =

c =

d =

e =

f =

g =

h =

Year 1 =

i =

j =

Dear :

This is in reply to a letter dated September 5, 2007, and subsequent submissions, requesting rulings on behalf of Taxpayer. You requested rulings that certain payments received from occupants of temporary housing, as described below, qualify as "rents from real property" within the meaning of section 856(d) of the Internal Revenue Code, and that Taxpayer may provide housekeeping functions and other noncustomary services at its temporary housing facilities though a taxable REIT subsidiary (TRS) of Taxpayer.

Facts:

Taxpayer is a domestic corporation that intends to elect to be treated as a real estate investment trust (REIT) under part II of subchapter M of the Code. Taxpayer or an affiliated entity owns all of the outstanding beneficial ownership interests of Subsidiary. Subsidiary is a domestic corporation that owns a large portfolio of temporary housing facilities (the Properties). Effective upon Taxpayer's REIT election, Subsidiary will become a qualified REIT subsidiary of Taxpayer.

Taxpayer currently owns a Properties, b of which were acquired in Month 1. Taxpayer leases the Properties to one or more third party lessees, who in turn lease the temporary housing to individual occupants. Taxpayer intends to terminate the leases with the third party lessees and lease temporary housing at the Properties directly to occupants.

The Properties provide temporary housing to individual occupants for lease periods lasting at least c days. Each occupant is required to execute an agreement that entitles the occupant to use a room for a c day period. An occupant that desires to stay longer than c days must renew the room agreement for each successive c day period. Occupants may sometimes be allowed to stay beyond the initial c day period on a day-to-day basis. Taxpayer represents that it currently does not allow occupants to enter into a room agreement for periods longer than c days for a number of business reasons, including but not limited to, the need to (i) standardize Taxpayer's business practice throughout its portfolio; (ii) reduce Taxpayer's financial exposure to occupants who fail to pay at the end of their term; and (iii) to provide Taxpayer an opportunity to verify the identity of occupants at the beginning and end of each lease period. Taxpayer also does not allow daily rentals. Taxpayer further represents that, except for the Properties acquired in Month 1, the average length of stay during Year 1 for each of the Properties ranged from d days to e days. Of the total Properties owned in Year 1, f each had an average length of stay in excess of g days.

The room agreement provides that occupants must pay a damage deposit that will be refunded only if (i) Taxpayer is given twenty-four hours written notice; (ii) the room is left in clean, rentable condition; and (iii) the keys are returned and the room vacated by 12:01 P.M. on the last day of the rental period. Taxpayer charges occupants a fee for a lost key or to have the door to a room opened. The room agreement also provides that the Taxpayer has a lien on the personal property of an occupant brought onto a Property to secure the performance of all of the occupant's obligations under the room agreement. Each property is staffed by a few full-time or part-time employees who function as general manager, cleaning staff, property maintenance, desk clerk, and security guard. Presently, at the end of the c day period of each rental agreement, the third party lessee provides some interior room cleaning services, including a change of bed linens and inspection of the facilities. Taxpayer intends that any noncustomary services, including housekeeping functions, that may be provided to occupants will be provided by either an independent contractor from whom Taxpayer does not derive any income or by a TRS within the meaning of section 856(l).

Taxpayer represents that amenities provided at the Properties, including kitchenettes, internet access, swimming pools, local phone service for a separate fee, cable TV and self-service coin operated laundry, are customarily furnished in connection with the rental of housing units similar to the Properties. Occupants are provided a small set of inexpensive towels at the beginning of the initial c day rental. Occupants are not required to return the towels, nor are the towels cleaned or replaced during any extension of the lease. Except for vending machines operated by third parties, no food or beverage service is provided.

Law and Analysis:

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

Section 856(d)(1) defines "rents from real property" to include rents from interests in real property, charges for services customarily rendered in connection with the rental of real property, and rent attributable to certain leased personal property. However, section 856(d)(2)(C) excludes "impermissible tenant service income" from the definition of rents from real property. Section 1.856-4(a) of the Income Tax Regulations provides that "rents from real property" means, generally, the gross amounts received for the use of, or the right to use, real property of the REIT.

Section 856(d)(7)(A) defines "impermissible tenant service income" to include, with respect to any real or personal property, any amount received or accrued directly or indirectly by a REIT for services furnished or rendered by the REIT to tenants of the property. Section 856(d)(7)(B) provides that if impermissible tenant service income

from a property for any tax year exceeds 1 percent of all amounts received or accrued directly or indirectly by the REIT during the tax year from the property, the impermissible tenant service income from the property shall include all amounts received or accrued from the property for the tax year. Section 856(d)(7)(C)(i) provides that services furnished or rendered through a TRS or an independent contractor from whom the REIT does not derive or receive any income are not treated as furnished, rendered, or provided by the REIT for purposes of section 856(d)(7)(A).

Section 1.856-3(d) provides that "real property" includes land or improvements thereon, such as buildings or other inherently permanent structures thereon (including items which are structural components of such buildings or structures). Local law definitions will not be controlling for purposes of determining the meaning of "real property" for purposes of section 856 and the regulations thereunder. Under this regulation, "real property" includes, for example, the wiring in a building, plumbing systems, central heating or central air-conditioning machinery, pipes or ducts, elevators or escalators installed in a building, or other items which are structural components of a building or other permanent structure. The term does not include assets accessory to the operation of a business, such as machinery, printing press, transportation equipment which is not a structural component of the building, office equipment, refrigerators, individual air-conditioning units, grocery counters, furnishings of a motel, hotel, or office building, etc. even though such items may be termed fixtures under local law.

Section 856(l) provides that a REIT and a corporation (other than a REIT) may jointly elect to treat such corporation as a TRS. To be eligible for treatment as a TRS, section 856(l)(1) provides that the REIT must directly or indirectly own stock in the corporation, and the REIT and the corporation must jointly elect such treatment. The election is irrevocable once made, unless both the REIT and the subsidiary consent to its revocation. In addition, the election and the revocation may be made without the consent of the Secretary.

Section 856(l)(2) provides that any corporation in which a TRS owns directly or indirectly more than 35 percent of the total voting power or value of the outstanding securities shall be treated as a TRS. Section 856(l)(3)(A) provides that a TRS cannot directly or indirectly operate or manage a lodging facility or a health care facility.

"Lodging facility" is defined in section 856(d)(9)(D)(ii) as a (I) hotel, (II) motel, or (III) other establishment more than one-half of the dwelling units in which are used on a transient basis. The term "transient" is not defined in section 856 or the regulations thereunder. However, for other purposes of the Code, a renter has generally been treated as "transient" if the rental period is less than 30 days. See section 1.48-1(h)(2)(ii) (which concerned definitions under old section 48 for purposes of the investment credit under former section 38); Shirley v. Commissioner, T.C. Memo 2004-188.

Whether an arrangement is a lease that produces rents from real property for purposes of section 856(d) or a license or other contract right associated with lodging is determined by examining the substance of the arrangement in its entirety. The form or the name given to the arrangement is not controlling for federal income tax purposes. *See* Rev. Rul. 68-590, 1968-2 C.B. 66.

Rev. Rul. 69-69, 1969-1 C.B. 159, holds that income from an exempt organization's leasing of studio apartments and the operation of a dining hall for tenants does not qualify as rents within the meaning of section 1.512(b)-1(c)(5) because substantial services were rendered to the tenants. In addition to the dining services, the exempt organization provided maid services like that provided to occupants of rooms in hotels. Although this ruling does not involve rentals by a REIT, it is instructive in determining whether payments are rents from real property or income from lodging.

In this case, h percent of the Properties each have an average length of stay in excess of e days, and i percent of the Properties each have an average length of stay in excess of j days. Taxpayer represents that the amenities provided at the Properties are customarily furnished in connection with the rental of housing units similar to the Properties. The services provided at the end of each c day period under the rental agreement are minimal, and provide Taxpayer with a means for inspecting the premises. Those services do not rise to the level generally associated with lodging facilities.

Based upon the information submitted and representations made, to the extent that the average length of stay at a Property exceeds j days, we conclude that the payments received by Taxpayer for the use and occupancy of rooms at the Property will qualify as "rents from real property" under section 856(d). Therefore, Taxpayer may provide housekeeping functions and other noncustomary services at those Properties through its TRS.

Except as specifically ruled upon above, no opinion is expressed concerning any federal income tax consequences relating to the facts herein under any other provision of the Code, including whether use of the Properties is considered transient for purposes of either sections 42 or 142(d) of the Code. Also, we do not rule whether Taxpayer otherwise qualifies as a REIT under part II of subchapter M of Chapter 1 of the Code.

This ruling is directed only to the taxpayer who requested it. Section 6110(k)(3) provides that it may not be used or cited as precedent. In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to your authorized representatives.

Sincerely yours,

David B. Silber
David B. Silber
Chief, Branch 2
Office of Associate Chief Counsel
(Financial Institutions & Products)