Practical Guidance

IRS Partially Revokes Previously Issued Private Letter Ruling on Percentage Rent

A Practical Guidance® Practice Note by Jesse A. Criz, Allen P. Ashley, Jeffrey P. Zanchelli, Shiukay Hung, Keith Stiggers, Allan Bowen, and Kevin Murphy, DLA Piper, LLP

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This practice note reviews (1) the rule relating to "percentage rent" under Code Section 856(d)(2)(A), (2) the history of PLR 202205001, (3) the holding of PLR 202205001, and (4) related prior PLRs from the IRS.

Where is the line between "adjusted revenue" and "income"? The Internal Revenue Service (IRS) recently shared its view with taxpayers and the real estate investment trust (REIT) industry in the context of percentage leases. On February 4, 2022, the IRS released Private Letter Ruling (PLR) 202205001 and reminded taxpayers that names do not matter-calling something "revenue" does not disguise the fact that it may be subject to recast by the IRS as "income" for purposes of the Internal Revenue Code of 1986, as amended (the Code) and the Treasury Regulations promulgated thereunder. 2021 PLR LEXIS 638 (I.R.S. November 4, 2021).

Overview

Congress enacted the REIT rules in 1960 as part of the Cigar Excise Tax Extension Act. 86 Pub. L. No. 779, 74 Stat. 998 (1960). The legislative history suggests that Congress wanted to provide all investors, especially smaller retail investors, with a tax-efficient vehicle to invest in professionally managed passive income-producing real estate.

Prior to the creation of the REIT vehicle, investment in commercial real estate was largely limited to financial institutions, big businesses, and wealthy individuals. Although the REIT rules have significantly evolved since 1960, the tax policy of limiting REITs to predominantly generating passive rental income from real estate continues to be a guiding principle today under modern REIT rules. Accordingly, REITs are limited in the commercial activities that they are permitted to conduct. A REIT is generally not permitted to directly operate active businesses.

To further the tax policy underlying the favorable tax treatment provided to REITs, the REIT rules under Code Sections 856(c)(2) and 856(c)(3) provide that a REIT is required to predominantly generate "rents from real property" in order to maintain its REIT status. 26 U.S.C. § 856(c)(2)-(c)(3). Code Section 856(d)(2)(A) further provides that "rents from real property" shall not include

> any amount received or accrued, directly or indirectly, with respect to any real or personal property, if the determination of such amounts depends *in whole or in part on the income or profits derived by any such person* from any such property (emphasis added).

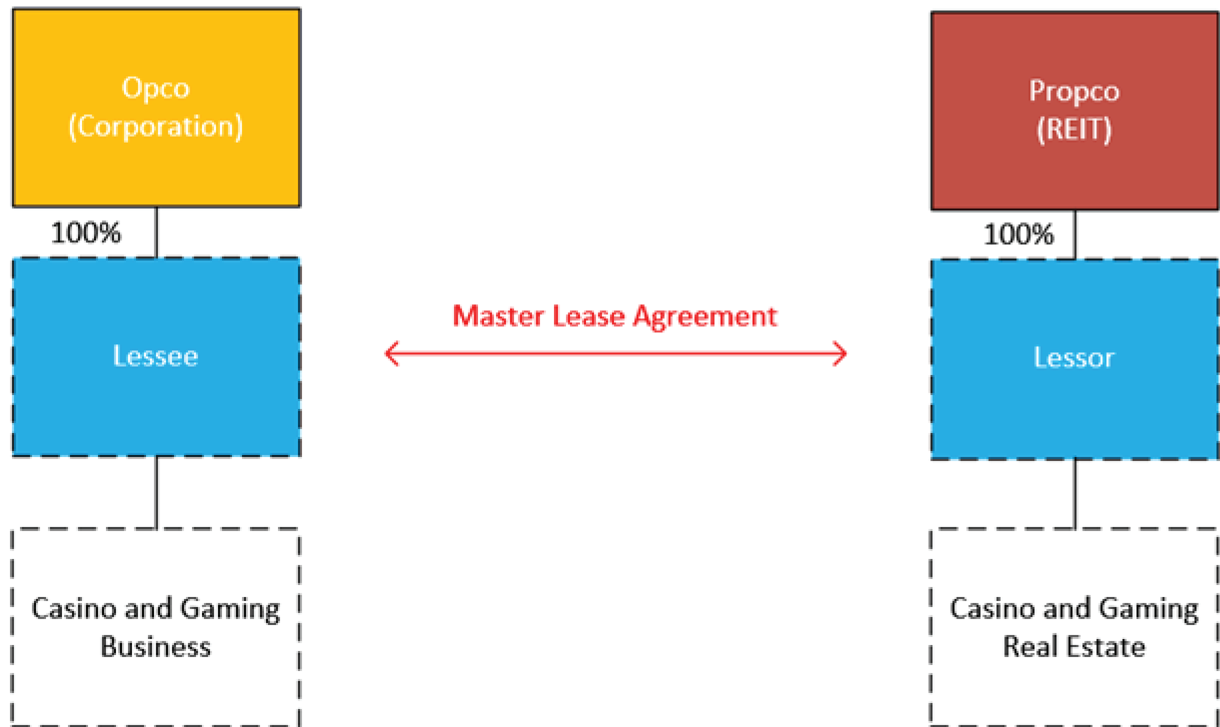
26 U.S.C. § 856(d)(2)(A). The term "income or profits" as used in Code Section 856(d)(2)(A) is broad and can be "in whole or in part." However, Code Section 856(d)(2)(A) continues to provide a carve-out for rents based on "fixed percentage or percentages of receipts or sales" that are permissible and treated as qualifying rents from real property.

In addition, Treasury Regulations Section 1.856-4(b)(3) provides that adjustments for returned merchandise, or federal, state, or local sales taxes are permissible. 26 C.F.R. § 1.856-4(b)(3). Adjustments for certain escalation receipts are also permissible. Furthermore, the percentage rent formula must be fixed at the time of entering into the lease and cannot be renegotiated during the term of the lease.

Therefore, the distinction between revenue (with permitted adjustments) and income is a key distinction between qualifying and non-qualifying rents from real property in typical percentage rent leases.

A Brief History of PLR 202205001

In 2012, the IRS issued PLR 201337007, which related to a tax-free spinoff of real estate assets into a REIT by an operating business that was structured as a "C" corporation ("Opco/Propco REIT Spinoff") (as shown in the diagram immediately below). 2012 PLR LEXIS 1810 (I.R.S. September 28, 2012). The taxpayer formed a controlled corporation ("Propco") to primarily hold casino real estate assets that would be leased back to the distributing business ("Opco"). Immediately following the distribution, Propco, holding only real estate assets, would elect REIT status. Subsequently, Propco would lease back the real estate assets to Opco in exchange for rent payments. The rent paid by Opco was presumably tax deductible. In PLR 201337007, the IRS provided the taxpayer with a tax-efficient method to split off its real estate holdings from the operational side of its business and a tax-efficient holding structure for the spun off real estate assets.



Against this backdrop, in PLR 201337007 the IRS asked whether the percentage rent master lease between Opco and Propco was qualifying rent from real property. The master lease was calculated based on a percentage of "Net Revenues," defined in the master lease as the amount received by Opco from patrons plus gross receipts of Opco generated through goods and services minus the retail value of services.

Taxes and expenses were specifically not deducted in the calculation of Net Revenue. In addition, the rental payments under the master lease were subject to certain escalation and other adjustments ("Escalation and Other Adjustments"). Without providing a detailed discussion of Escalation and Other Adjustments, the IRS held in PLR 201337007 that the amounts under the master lease were qualifying rents from real property.

Summary of PLR 202205001

PLR 202205001 reconsidered a portion of the percentage rent ruling from PLR 201337007. 2021 PLR LEXIS 638 (I.R.S. November 4, 2021). Specifically, in PLR 202205001, the IRS reviewed the Escalation and Other Adjustments provisions in the master lease. The Escalation and Other Adjustments were calculated based on "Adjusted Revenue," which was calculated based on the net revenue of the lessee minus interest expense, income tax expense, depreciation and amortization expense, rent expense, and certain other expenses or EBITDAR. This is to be distinguished from the definition of Net Revenues discussed above in PLR 201337007, which did not deduct taxes and expenses from its definition. 2012 PLR LEXIS 1810 (I.R.S. September 28, 2012). The IRS held that rents calculated based on Adjusted Revenue was a measure of income and profits of the lessee and therefore not treated as qualifying rents from real property.

How Does PLR 202205001 Fit In with Older PLRs?

This distinction between gross revenue and net income has been the subject of many REIT PLRs. Compiled below is a sample of past PLRs on point. As illustrated below, ultimately, this is a facts and circumstances analysis. While PLRs are indicative of administrative practice, only the taxpayer that requested the specific PLR from the IRS is entitled to rely on such guidance.

PLR	SUMMARY
PLR 202012012	The IRS ruled that the percentage rent paid by tenants of billboard sites as adjusted for agency fees and continuity discounts does not depend in whole or in part on the income or profits derived by any person at the billboard site. 2019 PLR LEXIS 794 (I.R.S. December 17, 2019).
PLR 201848013	The IRS ruled that amounts received by a REIT from tenants based on electricity cost savings from systems installed by the REIT's operating partnership at rental properties do not depend in whole or in part on the income or profits derived by any person from the leased property. 2018 PLR LEXIS 685 (I.R.S. August 30, 2018).
PLR 9719018	The IRS ruled that gross receipts could be adjusted for returns of merchandise to the tenant, refunds, sales of fixtures used by the tenant, and taxes payable out of gross receipts. 1997 PLR LEXIS 177 (I.R.S. February 4, 1997).
PLR 9308013	The IRS ruled that reimbursement of attorneys' fees, costs of litigation, punitive damages, and recovery of previously deducted expenses constitute gross income. 1992 PLR LEXIS 2502 (I.R.S. November 24, 1992).
PLR 8313037	The IRS ruled that rent based on a fixed percentage of a prime tenant's gross income from subtenants, as reduced by escalation receipts received from the subtenants (i.e., amounts intended to cover increases in certain property operating expenses incurred by the prime tenant, such as property taxes, insurance, etc.) will qualify as rents from real property. 1982 PLR LEXIS 170 (I.R.S. December 27, 1982).
PLR 7836030	The IRS ruled that certain tenant expenses such as cash or credit refund, allowance, discount or rebate, and sales tax can be subtracted from gross receipts. 1978 PLR LEXIS 1980 (I.R.S. June 8, 1978).

These PLRs demonstrate the IRS's willingness to modernize the archaic 1960 rules and to evolve the REIT rules while adhering to the basic policy of not allowing REITs to participate in earning active business income. To a certain degree, basing rent on a percentage of gross receipts with certain permitted deductions may economically approximate income. These PLRs illustrate that there is a fine line between subtracting permitted deductions from the definition of gross receipts that should be respected as adjusted revenue versus building in too many deductions that might be recast by the IRS as income. PLR 202205001 illustrates that percentage rent based on EBITDAR is too far over the line. Overall, we do not view PLR 202205001 as a marked departure from prior IRS guidance on point.

Conclusion

A lot has changed since 1960, when REITs were first created under the Cigar Excise Tax Extension Act.

Since 1960, both Congress and the IRS have generally shown a willingness to expand their interpretation of "rents from real property" and to liberalize the REIT rules. For example, in order to allow REITs to provide substantial tenant services, Congress created the TRS regime in 1999 under the REIT Modernization Act. In addition, in recent years, the IRS issued a series of PLRs to allow REITs to enter into new asset classes such as cold storage and to allow REITs to provide best in class physical amenities to tenants.

Nevertheless, PLR 202205001 serves as a reminder that the views of the IRS are constantly evolving. PLR 202205001 was rendered because the IRS had determined that a portion of one of its 50 rulings in PLR 201337007 was no longer in accord with its current views. REIT taxpayers are encouraged to consult with their REIT tax advisors to review percentage rent leases, including the defined terms in such leases.

Learn more about the implications of PLR 202205001 by contacting any of the authors.

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Jesse A. Criz heads DLA Piper's Investment Management and Real Estate Capital Markets practice. He also co-manages the firm's Chicago office. For more than 20 years, Jesse has guided clients through their most critical transactions and advised them on strategic decisions in all aspects of their businesses, creating true partnerships with his clients.

Throughout his career, Jesse has practiced in the areas of taxation, corporate and vehicle formation. Today, he focuses on advising investment management firms in all aspects of their businesses, primarily regarding the structuring and formation of private investment vehicles and all of their investment activities, both in the United States and globally.

Jesse is formally trained as a tax attorney and has extensive experience representing real estate investment trusts (REITs). He regularly advises firms on structuring all types of funds, co-investments and separate accounts. In addition, he has experience in M&A transactions in the investment management sector. He has led numerous highly complicated domestic and international real estate, corporate, and partnership transactions, including going private transactions, public and private REIT formations and securities offerings, REIT mergers and acquisitions, partnership rollups and UPREIT transactions.

Jesse has also structured and advised global investment management firms on cross-border real estate investments and the formation of foreign real estate funds, most recently in Europe and Canada.

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Allen represents publicly-traded and privately-held multinational corporations and privately-held real estate funds. He is experienced in a broad range of business-related US federal income tax matters, including advising clients with respect to the tax aspects of domestic and international corporate acquisitions, dispositions and other reorganizations (including those involving publicly-traded corporations and REITs); capital market transactions; joint ventures; acquisition, ownership and disposition of real estate; intercompany transfer pricing and general tax planning.

Allen advises clients with respect to the formation of private real estate funds (including those established as REITs) and real estate-related joint ventures. His experience includes representing such funds in negotiations with prospective and existing investors, joint venture partners and providing guidance with respect to investments in general.

Allen's experience also includes advising clients with respect to a variety of matters related to intercompany transfer pricing, including establishing and restructuring of intercompany transfer pricing policies, preparing intercompany transfer pricing studies and representing clients with respect to controversies with tax authorities related to intercompany transfer pricing.

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Jeffrey P. Zanchelli represents real estate fund sponsors and other real estate owners and operators in a variety of corporate transactions, including the formation and structuring of real estate private equity funds, management entities and joint ventures. Jeff also concentrates his practice in the areas of corporate, finance and partnership law and US federal taxation, with an emphasis in real estate capital markets.

Jeff represents clients on a wide range of transactional matters, including the formation of domestic and international real estate private equity funds, structuring of real estate related joint venture acquisitions, private and public REIT transactions, and other corporate and capital market transactions. Jeff also represents clients in negotiations with existing and prospective investors, joint venture partners and service providers.

Jeff has worked with various property types, including industrial, office, senior housing, multi-family and student housing. He has represented non-US clients with respect to inbound real estate investments throughout the United States, and US clients focused on real estate investment opportunities throughout Canada, Europe and the United Kingdom.

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Shiukay Hung is a partner in DLA Piper's Investment Management and Real Estate Capital Markets practice. He advises on the structuring of transactions particularly the US tax aspects of real estate, REITs, M&A, private equity, corporate finance and capital markets transactions. He is experienced in the acquisition, disposition and operation of real estate assets through fund, REIT and joint venture vehicles.

With 15 years of experience, both as an in-house attorney and in private practice, Shiukay provides clients with practical advice on complex transactions that draws on his deep industry knowledge. He is also actively involved in bar associations and industry groups and is a frequent legal commentator. He has spoken before various audiences and media outlets including *Bloomberg*, *Law360*, the American Bar Association, *Tax Notes*, the American Institute of CPAs, the Harvard Law School Association of New York City, Strafford, and the Tax Executives Institute. He has also written for *LexisNexis* and the *Real Estate Finance Journal* on topics of REIT taxation.

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Keith Stiggers is an associate in the Chicago office. As a member of the firm's Investment Management practice, Keith advises and represents investment managers and fund sponsors with respect to the structuring, establishment, and operation of private investment funds across a broad range of asset classes, with a focus on real estate and private equity. Keith assists these clients in drafting and negotiating fund documents, including limited partnership agreements, subscription agreements, side letters and private placement memoranda. Trained as a tax attorney, Keith also advises clients on investment transactions including co-investments and joint ventures.

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