

# IRS Releases PLR 202012012 on Lease Rights and Percentage Rents from Billboard Site

**Executive Summary:** On March 20, 2020, the Internal Revenue Service (“IRS”) released a Private Letter Ruling (“PLR”) addressing the treatment of lease rights and concluded that such rights constitute real property and real estate assets for purposes of Real Estate Investment Trust (“REIT”) asset testing. Furthermore, the IRS ruled that the percentage rent from 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 for purposes of the REIT rules.

## Background

In order for an entity to qualify as a REIT, at least 75% of the value of the total assets of the REIT be represented by one or more of the following: (i) Real estate assets; (ii) Government securities; and (iii) Cash and cash items (including receivables)<sup>1</sup>.

Additionally, in order for an entity to qualify REIT, at least 75% of a REIT’s gross income must be derived from sources that include rents from real property, gain from the sale or other disposition of real property, dividends from REIT stock, and/or abatements and refunds on taxes on real property. At least 95% of its gross income must be derived from sources that include qualifying income from the 75% test, plus dividends,

interest, and gain on sale or other disposition of stock and securities<sup>2</sup>. Percentage rent, if based upon gross revenues or sales, is considered qualifying income for the 75% & 95% tests, however, if the percentage rent is based upon net income it will be considered non-qualifying for the above tests, respectively.

## Facts

The taxpayer, which operates as a REIT, earns revenue from leases of land, building rooftops, and other assets that constitute real property (collectively, the “sites”) to third parties.

The REIT acquired the right, title and interest in certain ground leases.

<sup>1</sup> §856(c)(4)(A)

<sup>2</sup> §856(c)(2) and §856(c)(3)

With respect to certain ground leases of sites used for billboards, third-party tenants pay a percentage rent that is equal to the specified percentage of a third-party tenant's gross revenue or receipts from the billboards reduced by agency fees and continuity discounts.

The agency fee is paid by the third-party tenant to an advertising agency for locating a billboard customer and is added to the rent charged by the third-party tenant to the billboard customer. In other cases, the third-party tenant receives rent from the billboard customer but pays a portion of the rent received back to the billboard customer in the form of a continuity discount for customer's committing to place advertisements on multiple billboards owned by the third-party tenant or for using a specific billboard for an extended period of time. Rather than reducing the rent charged, a third-party tenant will reimburse or rebate the continuity discount to the billboard customer once certain thresholds are met.

## Takeaway

In this PLR, the IRS provides beneficial rulings on lease intangibles and arrangements that provide flexibility with the percentage rent rules.

Reminder that PLRs are intended only for the taxpayer requesting the ruling and only apply to this specific set of facts. While PLRs are not intended to be relied upon by third parties, they do offer an indication of the IRS's position on the issues addressed.

The Real Estate Solutions tax advisory experts at FTI Consulting offer top notch support to public and private REITs, private equity funds, real estate operating companies, developers and investors. We assist in all transactions, including acquisitions, refinancing, debt and equity restructurings, and sales and other dispositions, providing best practice tax structuring, compliance and due diligence services.

## Ruling

**Ruling 1:** The IRS held that pursuant to Treasury regulation section 1.856-10(f)(1) the lease rights are intangible assets that derive their value from the underlying site or lease thereon, are not separable from the underlying site and lease, and only contribute to the production of rental income for use of the site, and thus do not contribute to the production of income other than consideration for the use or occupancy of space. Accordingly, the IRS ruled that the lease rights constitute real property under Treasury regulation section 1.856-10(f) and are real estate assets for purposes of section 856(c)(4).

- The IRS noted that no opinion has been expressed as to whether the REIT has qualifying rents from real property with respect to the lease rights. However, the IRS ruled in prior private letter rulings that income associated with lease rights constitutes rents from real property.

**Ruling 2:** With respect to agency fees, the IRS reasoned that these are transaction fees akin to sales taxes or credit card fees in a retail merchandise business and are specific to each transaction. For the continuity discount, the IRS reasoned if tenant's gross receipts were not reduced by the continuity discount, the gross receipts would overstate the amount of rent received by the tenant from its customer. The IRS ruled that adjusting for agency fees and continuity discounts more accurately reflects the third-party tenant's gross receipts and does not cause the rent received by the REIT to be based on the income or profits of any person.

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