



TaxNewsFlash

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PLR: Liability-waiver payments received from tenants, relating to self-storage facilities, deemed rents from real property for REIT income tests

The IRS today publicly released a private letter ruling* in which a real estate investment trust (REIT) leased self-storage space to tenants to store tenants' property and, under its standard-form lease, was shielded from any liability for damage to tenants' property even if the damage results from "the active or passive acts or omissions or negligence" of the landlord. In exchange for an additional monthly payment pursuant to an addendum, the REIT agrees to a limited waiver of this liability shield (described in greater detail below).

The IRS ruled that the additional monthly payment would be considered rents from real property for purposes of the REIT income tests.

Read [PLR 202211002](#) [PDF 83 KB] (release date of March 18, 2022, and dated November 17, 2021)

* Private letter rulings are taxpayer-specific rulings furnished by the IRS Office of Chief Counsel in response to requests made by taxpayers and can only be relied upon by the taxpayer to whom issued. Pursuant to section 6110(k)(3), written determinations such as private letter rulings are not intended to be relied upon by third parties and may not be cited as precedent. These written determinations may, however, offer an indication of the IRS's position on the issues addressed.

KPMG observation

Landlords often require tenants to provide proof of adequate insurance coverage in connection with rental of real property. In certain subsectors—such as multifamily and self-storage—landlords may present tenants with options for obtaining insurance, including potentially through a related party. Typically, to the extent that the landlords earn income from these arrangements, the amount has been treated as nonqualifying income and, in some cases, may raise tenant-services concerns. Therefore, this letter ruling is meaningful because the REIT was able to earn additional qualifying rental income in exchange for agreeing to expose itself, in certain circumstances, to liability for damages to a tenant's property.

Background

The REIT in this letter ruling owned, through a partnership, self-storage properties and leased space in those properties to tenants. Under a standard lease, neither the landlord nor its agents or employees had any liability for damage to the tenant's property located in the leased space, including for damages resulting from "the active or passive acts or omissions or negligence" of the landlord or its agents or employees (the "Liability Shield").

At the time of entering into a lease, a tenant was required to either present proof of adequate insurance coverage through a third-party insurer—e.g., an existing homeowner's policy that would provide the required coverage, (the "Insurance Option")—or alternatively, to obtain a limited waiver of the Liability Shield (the "Coverage Product").

Tenants that obtain the Coverage Product were required to enter into an addendum to the lease setting forth the terms of the Coverage Product, pursuant to which the landlord agreed to a limited waiver of the Liability Shield. Thus, a tenant could, in certain instances and subject to certain restrictions, bring a claim directly against the landlord for damages (up to a capped amount) that otherwise the tenant generally could not bring, absent being a party to the addendum because of the Liability Shield. The Coverage Product applied only to damages incurred by the tenant for which the landlord was liable under applicable law by virtue of the existence of the landlord-tenant relationship. These damages would result from: (1) a breach of duties otherwise owed by the landlord to the tenant that arise out of the landlord-tenant relationship under common or statutory law (including an intentional tort or negligence); or (2) an event for which the landlord otherwise had strict or vicarious liability to the tenant under local law as a result of the landlord-tenant relationship.

In exchange for obtaining the Coverage Product, the tenant had to make an additional monthly payment to the landlord, the amount of which varied if a waiver of a greater amount were obtained.

The REIT represented that the landlord required tenants either to obtain the Coverage Product or provide proof of adequate insurance primarily to provide protection from exposure associated with the operation of a facility—not merely exposure to monetary liability, but also direct costs (attorney's fees) and indirect costs (inefficient use of employee time, potential brand damage) associated with litigation, including nuisance and small-dollar litigation. The Coverage Product provided the tenant with a known potential source of, and regular process for, recovery for damages with respect to the type of claims that, in the absence either of insurance satisfying the Insurance Option or of the Coverage Product, would sometimes be the subject of lawsuits and other sub-litigation disputes with the relevant landlord. Likewise, the Coverage Product provided the landlord a regular process for resolving a potential claim made by a tenant. The addendum provided that the Coverage Product is not insurance.

Conclusion of the IRS

The IRS cited Rev. Rul. 75-226 that concludes that the receipt by a REIT of a payment for subordinating its fee interest in land leased to a tenant was rents from real property. In the revenue ruling, the tenant obtained a mortgage loan secured by its interest in improvements constructed on the leased land. The REIT, as landlord, subordinated its interest in the land to the mortgagee; the tenant was liable for the mortgage loan. In exchange for subordinating its fee interest in the land to the mortgagee, the REIT received a payment from the tenant in the form of a portion of the proceeds of the mortgage loan. The tenant's ability to mortgage its improvements was determined to be so closely connected with the tenant's occupation, possession, and enjoyment of the property that the additional consideration paid to the REIT for subordinating its interest in its land was determined to be rents from real property for purposes of section 856.

In the PLR, the IRS then reasoned:

As discussed above, the standard lease for the use of space in a Facility includes the Liability Shield that generally prevents a tenant from making a claim against the landlord for damages to its property stored in a Facility that would otherwise be payable under local landlord-tenant law.

However, a tenant that makes a Payment enters into a lease that includes a waiver of the Liability Shield, which is the ability to make a claim under local landlord-tenant law against the landlord for certain damage to its personal property located in the leased space. This ability to make a claim against a landlord for certain damage to personal property located in the leased space arises out of the landlord-tenant relationship (absent a Liability Shield) and the tenant's right to use the space in or upon the real property. In this case, paying a separate fee for this right does not change this analysis. Furthermore, as in Rev. Rul. 75-226, the Payment is additional consideration for a right that is so closely connected with the tenant's occupation, possession, and enjoyment of the real property that it constitutes rents from interests in real property within the meaning of section 856(d)(1)(A).

Based on these findings, the IRS ruled that additional monthly payments to obtain the Coverage Product would be considered rents from real property for purposes of section 856(c)(2) and (3).

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