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Proposed Regulations Provide Greater Certainty on the REIT Classification of Solar and Other Non-Traditional Assets

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The Internal Revenue Service (the "IRS") and Treasury Department have proposed regulations (the "Proposed Regulations") under Section 856 of the Internal Revenue Code providing guidance for analyzing whether non-traditional real estate assets qualify as real estate assets to a real estate investment trust ("REIT"). The Proposed Regulations are a good development for businesses with non-traditional assets that are considering converting into REITs or considering spinning off assets through REITs. There had been some question in 2013 regarding whether the IRS was considering contracting the categories of non-traditional assets that are qualifying real estate assets. The Proposed Regulations provide welcome guidance on the categories of assets that are qualifying real estate assets and provide factors for analyzing other types of assets. The Proposed Regulations also address the REIT classification of solar assets.

Background on REITs

A REIT is an entity with special tax status under Sections 856 through 860 of the Internal Revenue Code. The REIT tax rules were enacted to promote and facilitate widely-held investment in portfolios of real estate. A REIT has a hybrid tax treatment. From an investor's tax perspective, a REIT is a separate taxable entity. An investor in a REIT generally only is taxed on dividends paid by the REIT and on gains on the disposition of shares in the REIT. Tax-exempt and non-US investors also are not directly taxed on the REIT's underlying income. From the entity's tax perspective, the REIT is allowed a "dividends paid deduction" so that it generally does not pay US corporate tax, provided that each year it distributes to its shareholders an amount at least equal to its annual taxable income.

In order to qualify as a REIT, among other requirements, (i) at least 75 percent of the REIT's assets must be "real estate assets" (the "asset test"), (ii) at least 75 percent of the REIT's gross income must be from items related to real estate, such as "rents from real property," and (iii) at least 95 percent of the REIT's gross income must be from items related to real estate or certain passive investments.

For purposes of the asset test, "real estate assets" include interests in real property, which in turn includes land or improvements thereon, such as buildings or other "inherently permanent structures." The existing regulations generally provide that assets that are affixed to a building or other inherently permanent structures may also qualify as real estate assets, provided they are deemed "structural components" of a building or other inherently permanent structures and are not assets "accessory to the operation of a business." Until now, the qualification of non-traditional assets has been dependent on interpretation of this general standard or IRS published rulings and private letter rulings. However, because much of such authority was private letter rulings, there was some uncertainty as to the proper classification of certain types of non-traditional assets.

Proposed Regulations

The Proposed Regulations, in essence, incorporate into the regulations the body of law that has developed interpreting the existing regulations. The Proposed Regulations follow the same general definitional approach as the existing regulations but provide a step-by-step analysis. Each improvement to land is a distinct asset tested individually to determine whether the asset is a qualifying real estate asset. The Proposed Regulations also replace the concept that an asset can be "accessory to the operation of a business" with a new standard that the asset must serve a "passive function" common to real property rather than an "active function" such as producing, manufacturing or transporting goods or income.

Inherently Permanent Structures. Improvements to land are qualifying real estate assets if they are "inherently permanent structures" or "structural components of inherently permanent structures." The Proposed Regulations list the following as inherently permanent structures: microwave transmission, cell, broadcast, and electrical transmission towers, telephone poles, parking facilities, bridges, tunnels, roadbeds, railroad tracks, transmission lines, pipelines, fences, in-ground swimming pools, offshore drilling platforms, storage structures such as silos and oil and gas storage tanks, stationary wharves and docks, and outdoor advertising displays for which an election has been properly made under Section 1033(g)(3) (electing to treat such displays as real property). The Proposed Regulations also provide a general facts and circumstances test (with applicable factors) for analyzing whether other assets that do not serve an active function should be considered to be inherently permanent structures.

Structural Components. Structural components are distinct assets that are a constituent part of, and integrated into, an inherently permanent structure. The Proposed Regulations list the following as structural components: wiring, plumbing systems, central heating and air conditioning systems, elevators or escalators, walls, floors, ceilings, permanent coverings of walls, floors and ceilings, windows, doors, insulation, chimneys, fire suppression systems such as sprinkler systems and fire alarms, fire escapes, central refrigeration systems, integrated security systems, and humidity control systems. The Proposed Regulations also provide a general facts and circumstances test (with applicable factors) for analyzing whether other assets that do not serve an active function should be considered to be structural components.

Intangible Assets. The Proposed Regulations also make clear that intangible assets can be real property if the intangible asset derives its value from real property or an interest in real property, is inseparable from that real property or interest in real property, and does not produce or contribute to the production of income other than consideration for the use or occupancy of space. A license, permit, or other similar right to use loan or an inherently permanent structure also may be an interest in real property.

Specific Examples of Qualifying Assets

The Proposed Regulations contain a list of examples, applying the general facts and circumstances test, that conclude that the following types of distinct non-traditional assets, many of which had already been addressed in IRS published rulings and private letter rulings, are qualifying real estate assets:

- Perennial fruit-bearing plants qualify as land;
- Boat slips and end ties qualify as land;
- An indoor sculpture that is essentially permanently affixed and would be costly to remove should be considered an inherently permanent structure under the applicable facts and circumstances test;
- Custom freezer walls and a centralized refrigeration system of a cold storage warehouse are structural components of inherently permanent structures;
- Electrical system and telecommunication infrastructure system in a data center are structural components of inherently permanent structures;
- Pipelines, storage tanks and pipeline transmission systems are inherently permanent structures and structural components of inherently permanent structures.

Solar Assets

The Proposed Regulations also resolve open questions that were not directly addressed in IRS published rulings and private letter rulings. Examples 8 and 9 address the treatment of certain portions of solar energy assets, the classification of which was not entirely certain. Example 8 concludes that the foundations, mounts for photovoltaic ("PV") modules and exit wiring are inherently permanent structures. However, if the power is produced and sold on the grid, the PV modules themselves are not inherently permanent structures or structural components in part because they serve an active function of producing electricity. Example 9, on the other hand, concludes that, if the same solar assets are adjacent to a building and primarily provide power to such building, the assets including the PV modules are structural components of inherently permanent structures.

The Proposed Regulations are not effective until finalized. However, in the meantime they provide welcome guidance on the IRS's view as to the qualification of certain non-traditional assets.

If you wish to receive more information on REITs generally or the REIT transaction structures that may be available to your business, you may contact your regular Shearman & Sterling contact person or any contact person listed in this publication.

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