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Proposed Regulations Clarify the Definition of “Real Property” Under the REIT Rules

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BACKGROUND

On May 14, 2014, the Treasury Department published proposed regulations (the “Proposed Regulations”) clarifying the definition of “real property” under the real estate investment trust (“REIT”) rules.¹ The issuance of the Proposed Regulations follows an Internal Revenue Service (“IRS”) moratorium on issuing private letter rulings (“PLRs”) with respect to REITs² during which time the IRS analyzed whether recent PLRs³ addressing types of assets that are not directly covered by the existing regulations regarding what constitutes “real property” (which were promulgated in 1962 (the “Existing Regulations”))⁴ and IRS published rulings issued between 1969 and 1975 (the “Early Guidance”) were consistent with the Existing Regulations and Early Guidance. In connection with that analysis, the IRS began a project to “modernize” the Existing Regulations to provide regulatory guidance for those less traditional types of property.

The Proposed Regulations expand the definition of “real property” in the Existing Regulations to include the types of property for which the IRS provided favorable rulings in the Early Guidance and the more recently issued PLRs. This guidance should be welcome for REITs seeking to invest in these types of property because a taxpayer cannot rely on a PLR received by another taxpayer. The Proposed Regulations also provide a framework for determining whether property that is not specified in the Proposed Regulations should be characterized as real property and include detailed examples illustrating the application of the framework.

Notably, the Proposed Regulations do not apply to definitions of “real property” outside of the REIT rules (*e.g.*, for purposes of FIRPTA or depreciation) given the different purposes for and interests involved in those definitions. In addition, the preamble to the Proposed Regulations expressly states they do not provide any guidance with respect to whether a particular item of income generated by these assets constitutes “good” REIT income for purposes of the REIT’s gross income test. The IRS and the Treasury Department view these Proposed Regulations as a clarification of the existing definition of real property and are proposed to be effective for calendar quarters beginning after these Proposed Regulations are finalized. We expect that the Proposed Regulations will be subject to significant comment and modification before promulgated in final form.

CLARIFIED DEFINITION OF REAL PROPERTY

The Proposed Regulations define “real property” to include land, inherently permanent structures and structural components, specify certain assets that are per se “real property” for purposes of the REIT rules and adopt a framework

¹ (REG-150760-13).

² For prior coverage, see <http://media.mofo.com/files/Uploads/Images/130722-MoFo-Tax-Talk.pdf>. The moratorium on issuing rulings ended in November 2013.

³ For example, the IRS had ruled favorable on REITs owning casinos, prisons, data centers, billboards, pipelines, cell-towers, and timber.

⁴ Treas. Reg. § 1.856-3(d).

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using a facts and circumstances approach to determine whether other assets are real property. The starting point is to determine whether an item is a “distinct asset” based on all of the facts and circumstances. Each distinct asset is analyzed separately from any other assets to determine if the asset qualifies as real property.

Land

Land is defined in the Proposed Regulations to include water and air space superjacent to land and natural products and deposits that are unsevered from the land.

Inherently Permanent Structures

The Proposed Regulations define an inherently permanent structure as any building or other structure permanently affixed to land. In general, inherently permanent structures must serve a passive function such as housing rather than an active function such as manufacturing. The Proposed Regulations provide a safe harbor list of inherently permanent structures which include microwave, cell, broadcast, and electrical transmission towers, telephone poles, parking facilities, bridges, tunnels, roadbeds, railroad tracks, transmission lines, pipelines, offshore drilling platforms, storage structures such as silos and oil and gas storage tanks, and outdoor advertising displays per election under §1033(g). If the distinct asset is not on the safe harbor list, then a facts and circumstances test is applied based on certain factors generally related to whether the asset is passive and whether the asset can be removed from the land or other real property to which it is affixed.

Structural Components

The proposed Regulations define structural components as any distinct asset that is a constituent part of and integrated into an inherently permanent structure, serves the inherently permanent structure in its passive function and, even if capable of producing income other than consideration for the use or occupancy of space, does not produce or contribute to the production of such income. A structural component is real property only if it is held by the taxpayer together with the taxpayer's interest in the inherently permanent structure to which the structural component is functionally related. The Proposed Regulations provide a safe harbor list of structural components which include wiring, plumbing systems, central heating and air conditioning systems, elevators or escalators, windows, doors, sprinkler systems and fire alarms, and integrated security systems. If the distinct asset is not on the safe harbor list, then, again, a facts and circumstances test is applied based on certain factors that are similar to those used in analyzing inherently permanent structures.

Intangible Assets

The Proposed Regulations clarify when an intangible asset should be treated as real property. In general, under the Proposed Regulations, an intangible asset is real property or an interest in real property if it derives its value from real property or an interest in real property, is inseparable from that real property or interest and does not produce or contribute to the production of income other than consideration for the use or occupancy of space. The Proposed Regulations provide that a license or permit for the use, enjoyment or occupation of land is an interest in real property but a license or permit to engage in or operate a business is not.

APPLICATION

The examples in the Proposed Regulations highlight the tax treatment of several fact patterns for which the REIT community had been seeking guidance in recent years:

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Example 1 of the Proposed Regulations involves a REIT that leases perennial fruit-bearing plants coupled with an easement (presumably to grant the tenant access to the plants). Among other things, the example concludes the plants themselves constitute land and are, therefore, real property (although the fruit, once severed, would not be).

Solar Property

In Example 8, the Proposed Regulations address the treatment of a solar energy site where the solar electricity is transmitted to an electrical power grid and sold to third parties. Although the land, the mounts, and the exit wires are treated as real property, the Proposed Regulations determine that photovoltaic modules should not be treated as real property because they actively generate electricity that is sold to third parties.

However, Example 9 of the Proposed Regulations treats photovoltaic modules as real property where they are mounted on land adjacent to an office building owned by a REIT, the solar electricity generated from the panels is used primarily to power that specific building and the tenant only occasionally transfers electricity to a utility company.

Although not necessarily favorable for taxpayers entertaining the idea of “solar REITs,” the Proposed Regulations do clarify the position of the IRS that photovoltaic panels used in commercial-scale solar facilities should not be “real property” for purposes of the REIT rules. It is interesting to note that the Examples only describe solar power. It is unclear what this means for other forms of renewable energy.

Pipeline Transmission System

In Example 10, the Proposed Regulations illustrate that in an oil pipeline transmission system comprised of underground pipelines, storage tanks, valves, vents, meters and compressors, the pipelines, storage tanks, vents, valves are real property but the meters and compressor are not.

Intangible Assets

Practitioners have speculated whether intangible assets such as a concession agreement to collect tolls would be considered real property. While the Proposed Regulations do not clearly address this particular example, they do provide some illustrative guidance. In Example 12, a special use permit to place a cell tower on federal government land is treated as an interest in real property because it is similar to a leasehold (*i.e.*, it provides a right to use property). This contrasts with Example 13 where a State license to operate a casino that applies only to one building and cannot be transferred to another location is treated as a license to engage in business and is not real property.

CONCLUSION

The Proposed Regulations are helpful in that they codify most of the favorable positions that the IRS has taken in PLRs as well as the framework that it generally has used in evaluating whether assets constitute real property. This should reduce the number of REIT PLRs being sought from the IRS. However, aside from the guidance on photovoltaic panels and certain other matters, the IRS has not used the Proposed Regulations to issue additional guidance in respect of many issues that are under discussion in the market place or could otherwise be expected to come up in the PLR program.

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