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

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BACKGROUND

On August 31, 2016, the Treasury Department published final regulations (the “Final Regulations”)¹ clarifying the definition of “real property” under the real estate investment trust (“REIT”) rules. The Final Regulations predominantly adopt the proposed regulations (the “Proposed Regulations”)² published on May 14, 2014, with only slight modifications despite numerous comments from various industry groups to broaden the definition of “real property” under the Final Regulations.

As did the Proposed Regulations, the Final Regulations flesh out the current definition of “real property” (contained in regulations promulgated in 1962 (the “Existing Regulations”)) to include expressly the types of property for which the IRS had previously provided favorable private letter rulings (“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. Adopting the approach in the Proposed Regulations, the Final Regulations continue to provide a framework for determining whether property that is not expressly addressed in the Final Regulations should be characterized as real property and include detailed examples illustrating the application of the framework.

Similar to the Proposed Regulations, the Final 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. Consistent with the Proposed Regulations, the preamble to the Final 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 gross income tests.³ The Final Regulations are effective for taxable years beginning after August 31, 2016. Because the IRS and the Treasury Department view these Final Regulations as a clarification of the existing definition of real property, taxpayers are permitted to rely on the Final Regulations for periods beginning on or before the applicability date. However, the preamble to the Final Regulations does note that PLRs inconsistent with the Final Regulations are revoked prospectively.

¹ 81 Fed. Reg. 59849 (2016). Available at <https://www.gpo.gov/fdsys/pkg/FR-2016-08-31/pdf/2016-20987.pdf>.

² 79 Fed. Reg. 27508 (2014).

³ Instead, the IRS and the Treasury Department have listed guidance clarifying the definition of REIT income on their 2016-2017 Priority Guidance Plan dated August 15, 2016.

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CLARIFIED DEFINITION OF REAL PROPERTY

As did the Proposed Regulations, the Final 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 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 Final Regulations to include water and air space superjacent to land and natural products and deposits that are unsevered from the land. The preamble to the Final Regulations clarifies that this applies even when the taxpayer owns only superjacent water or air space and does not own an interest in the underlying land.

Inherently Permanent Structures

The Final Regulations define an inherently permanent structure as any building or other structure permanently affixed to land. While the Final Regulations expanded the types of buildings that qualify as inherently permanent structures to include motels, enclosed stadiums and arenas and enclosed shopping malls, the Treasury Department refused to include other types of assets that may not always qualify as buildings, such as casinos that could be located on unaffixed barges or riverboats. In general, inherently permanent structures must serve a passive function such as housing rather than an active function such as manufacturing. The Proposed Regulations listed transport as a prohibited active function. In the preamble to the Final Regulations, the Treasury clarified that transport means to cause to move, and the Final Regulations retain transport as a prohibited active function. However, as additional clarification, the Final Regulations include providing a conduit (as in the case of a pipeline or electrical wire) or route (as in the case of a road or railroad track) as a permitted passive function. The Final Regulations retain the 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. 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 the degree to which the asset can be removed from the land or other real property to which it is affixed.

Structural Components

The Final Regulations continue to define a structural component 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. The Proposed Regulations provided that a structural component is not real property unless the interest held in the structural component is “included with an equivalent interest held by the taxpayer in the inherently permanent structure to which the structural component is functionally related.” This so-called equivalent interest requirement is modified in the Final Regulations to require

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that the REIT hold its interest in the structural component together with a real property interest with respect to the space in the inherently permanent structure that the structural component serves. Under this modified rule, a REIT may have a leasehold interest in real property and own a structural component that is installed as part of the real property. In addition, the Final Regulations add that a mortgage secured by a structural component is real property only if the mortgage is also secured by a real property interest in the inherently permanent structure served by the structural component. The Final Regulations retain the 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 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. In line with the modification to the equivalent interest requirement, the Final Regulations deleted one of the factors used in the facts and circumstances test that was included in the Proposed Regulations, that is, whether the owner of the real property is also the legal owner of the distinct asset.

Intangible Assets

The Final Regulations retain the clarification provided in the Proposed Regulations regarding when an intangible asset should be treated as real property. In general, under the Final 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. As in the Proposed Regulations, the Final 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 are largely adopted in the Final Regulations, with some clarification and changes reflecting certain comments. In response to comments that the term “triple-net lease” is undefined, references to a “triple-net lease” in many of the examples in the Proposed Regulations are revised to provide that the REIT neither operates the property nor provides services to the lessee.

Crops

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

Data Center

Example 6 of the Final Regulations illustrates the definition of structural component in the context of a data center. The example concludes that the central heating and air-conditioning system, integrated security system, fire suppression system and humidity control system are structural components of the building even though they have been customized for a data center. Additionally, the Final Regulations clarify that the electrical system and

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telecommunication infrastructure system are integrated into the building and would be difficult to remove, which are factors that support the conclusion that these systems are structural components under a facts and circumstances test.

Solar Property

For the renewable energy industry, the Final Regulations make some helpful clarifications but generally follow the Proposed Regulations' approach in limiting the circumstances in which renewable energy property is treated as a qualifying REIT asset.

In Example 8, the Final 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 Final Regulations determine that photovoltaic modules should not be treated as real property because they actively generate electricity that is sold to third parties. The preamble to the Final Regulations further clarifies that, similar to photovoltaic modules, inverters that are used to generate electricity that is sold to third parties also would not qualify as real property.

However, Example 9 of the Final 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. The preamble to the Final Regulations provides that the Treasury Department and the IRS are considering whether additional guidance is needed to address the circumstances where a distinct asset that serves as an inherently permanent structure may produce electricity that is also sold to third parties and qualify as a structural component of the inherently permanent structure for REIT purposes.

The preamble to the Final Regulations does provide that until additional guidance is published in the Internal Revenue Bulletin, if a REIT transfers excess energy to a utility that does not equal or exceed the energy it purchases from the utility company in a taxable year, the IRS will not treat the transfer as affecting the qualification of the energy asset as structural components of the inherently permanent structure. Further, the IRS will treat any income resulting from the transfer of energy to the utility as excluded from gross income for purposes of the REIT income tests and will not treat net income resulting from the transfer of energy as net income from a prohibited transaction.

Although not necessarily favorable for taxpayers entertaining the idea of "solar REITs," the Final 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. One commenter requested Example 9 to be modified to address wind facilities rather than solar facilities. However, the Final Regulations did not adopt this recommendation because the Treasury Department and the IRS believe that the components of wind facilities may be similarly analyzed under the Final Regulations. Significantly, recommendations from commenters to broaden the definition of "real property" to include renewable energy credits were not adopted because renewable energy credits may be sold separately from any real property to which they relate.

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Pipeline Transmission System

In Example 10, the Final Regulations demonstrate, in the context of a natural gas pipeline transmission system, that a distinct asset within a system may still qualify as an inherently permanent structure, or a structural component thereof, even though the system serves an active function. In this example, the pipelines serve the passive function of providing a conduit and are thus considered real property. Also, isolation valves and vents and pressure control and relief valves are real property but the meters and compressor are not under the facts and circumstances test.

Intangible Assets

The Final Regulations continue to provide illustrative guidance as to certain intangible assets that qualify as real property and provide updates to the examples provided in the Proposed Regulations. Example 11 in the Proposed Regulations concluded that goodwill established under GAAP as a result of the acquisition of stock of a corporation that owned a hotel qualified as real property and that goodwill was the difference between the purchase price and the depreciated replacement cost of the hotel. The preamble states that this example was deleted in the Final Regulations because depreciated replacement cost is no longer the standard under GAAP for valuing property such as a hotel. Instead, Example 11 in the Final Regulations illustrates the application of the Final Regulations to an above-market lease that produces both rent from real property and other income that does not qualify as rent from real property. 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 Final 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, taxpayer should take note that previously issued PLRs are revoked prospectively from August 31, 2016 to the extent they are inconsistent with the Final Regulations.

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