

Welcome Guidance on the Definition of Real Property for REITs Proposed by IRS

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On May 9, 2014, the Department of Treasury and the Internal Revenue Service (the "IRS") released proposed regulations (the "Proposed Regulations")^[1] revising and clarifying the definition of real property for the purposes of the real estate investment trust ("REIT") provisions of the Code.^[2] The preamble to the Proposed Regulations explains that no published guidance has been issued addressing whether certain assets qualify as real property for purposes of the REIT provisions of the Code since 1975; instead, taxpayers have asked for and received letter rulings from the IRS addressing certain of these assets. Because letter rulings are limited to their particular facts and may not be relied upon by taxpayers other than the taxpayer that received the ruling, letter rulings are not a substitute for published guidance. The Proposed Regulations are intended to provide a framework to analyze whether assets in which REITs seek to invest qualify as real property for purposes of Sections 856 through 859 of the Code. The Proposed Regulations generally are consistent with previously issued letter rulings and published guidance, and specifically list assets that will qualify as real property. In addition, the Proposed Regulations provide a welcome framework and standards to apply in determining whether assets not explicitly listed will qualify as real property.

Background

REITs are subject to various requirements relating to their organization, asset and income composition and distributions. One of these requirements is that at the close of each quarter of the REIT's taxable year, at least 75 percent of the value of its total assets is represented by real estate assets, cash and cash items (including receivables), and government securities.^[3] Real estate assets are defined as "real property (including interests in real property and interests in mortgages on real property) and shares (or transferable certificates of beneficial interest in other [REITs].)"^[4] Current regulations, promulgated in 1962, define real property as "land or improvements thereon, such as buildings or other inherently permanent structures thereon (including items which are structural components of such buildings or structures)." Local law is not controlling for purposes of the term "real property" under the regulations. The term includes "the wiring in a building, plumbing systems, central heating or central air-conditioning machinery, pipes or ducts, elevators or escalators installed in the building, or other items which are structural components of a building or other permanent structure," but does not include "assets accessory to the operation of a business, such as machinery, printing press, transportation equipment which is not a structural component of the building, office equipment, refrigerators, individual air-conditioning units, grocery counters, furnishings of a motel, hotel, or office building, etc. even though such items may be termed fixtures under local law."^[5]

The Proposed Regulations

The Proposed Regulations define real property as "land" and "improvements to land."^[6] Improvements to land is defined to include "inherently permanent structures" and their "structural components."^[7] As under the current regulations, local law is not controlling for purposes of determining the meaning of the term real property. Property is broken into "distinct assets," which are analyzed separately from any other assets to which the asset relates to determine if the asset is real property, whether as land, an inherently permanent structure, or a structural component of an inherently permanent structure.^[8]

Land

Land is defined to include water and air space superjacent to land and natural products and deposits that are unsevered from land.[\[9\]](#) Examples in the Proposed Regulations conclude that a lease of a marina, comprised of U-shaped boat slips and end ties, and a lease of fruit-bearing plants on a long-term triple net-basis qualify as leases of land within the meaning of the Proposed Regulations.[\[10\]](#)

Inherently Permanent Structures

The Proposed Regulations define the term inherently permanent structure as any permanently affixed building or other structure. Affixation may be to land or to another inherently permanent structure and may be by weight alone. If the affixation is reasonably expected to last indefinitely based on all the facts and circumstances, the affixation is considered permanent.

The concept of assets accessory to the operation of a business has been eliminated from the definition of real property in the Proposed Regulations. Instead, the Proposed Regulations clarify that a distinct asset that serves an "active function," such as an item of machinery or equipment, is not a building or other inherently permanent structure.

Under the Proposed Regulations, a building "encloses a space within its walls and is covered by a roof."[\[11\]](#) The Proposed Regulations list the following types of permanently affixed distinct assets as buildings: "houses; apartments; hotels; factory and office buildings; warehouses; barns; enclosed garages; enclosed transportation stations and terminals; and stores."[\[12\]](#)

Other inherently permanent structures are defined as those that "serve a passive function, such as to contain, support, shelter, cover, or protect, and do not serve an active function such as to manufacture, create, produce, convert, or transport."[\[13\]](#)

Other inherently permanent structures include the following permanently affixed distinct assets: 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) of the Code.[\[14\]](#)

If a distinct asset is not otherwise specifically listed in the Proposed Regulations or in published guidance and the asset does not serve an active function, the determination of whether the asset is an inherently permanent structure is based on all the facts and circumstances. In particular, five factors must be taken into account: (A) the manner in which the distinct asset is affixed to real property; (B) whether the distinct asset is designed to be removed or to remain in place indefinitely; (C) the damage that removal of the distinct asset would cause to the item itself or to the real property to which it is affixed; (D) any circumstances that suggest the expected period of affixation is not indefinite (for example, a lease that requires or permits removal of the distinct asset upon the expiration of the lease); and (E) the time and expense required to move the distinct asset.^[15] The Proposed Regulations include examples analyzing the factors relevant to the determination that a distinct asset qualifies as an inherently permanent structure in a variety of circumstances. For instance, one example concludes that an indoor sculpture weighing five tons, constructed within a building, and which is permanently affixed to the building by supports embedded in the building's foundation is an inherently permanent structure.^[16] Another example concludes that prefabricated bus shelters, which can be moved in less than a day and whose removal does not significantly damage the bus shelters or the real property to which it was affixed, are not inherently permanent structures within the meaning of the Proposed Regulations.^[17]

Structural Component

The term structural component is defined 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.^[18] If interconnected assets work together to serve an inherently permanent structure with a utility-like function (for example, systems that provide a building with electricity, heat, or water), the assets are analyzed together as one distinct asset that may be a structural component. Structural components are real property only if the interest held therein is included with an equivalent interest held by the taxpayer in the inherently permanent structure to which the structural component is functionally related. If a distinct asset is customized in connection with the rental of space in or on an inherently permanent structure to which the asset relates, the customization does not affect whether the distinct asset is a structural component.

The Proposed Regulations list the following distinct assets and systems 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.

If a distinct asset is not otherwise specifically listed in the Proposed Regulations or in published guidance, the determination of whether the asset is a structural component is based on all the facts and circumstances.[\[19\]](#) The Proposed Regulations include examples analyzing the factors relevant to the determination that a distinct asset qualifies as a structural component in a variety of circumstances. One example concludes that an electrical system and telecommunication infrastructure system containing equipment used to ensure that a tenant is provided with uninterrupted, stable power and telecommunications services in a data center are structural components.[\[20\]](#)

Another example concludes that solar energy site assets mounted on land owned adjacent to an office building that were leased with the building and designed and constructed specifically for the building are structural components within the meaning of the Proposed Regulations.[\[21\]](#) However, meters (used to measure oil passing into or out of a pipeline transmission system) and compressors (required to add pressure to transport oil through the pipeline) comprising part of an oil pipeline transmission system are not structural components within the meaning of the Proposed Regulations.[\[22\]](#)

Intangible Assets

The Proposed Regulations also clarify that intangible assets, including intangible assets established under generally accepted accounting principles (GAAP) as a result of an acquisition of real property or an interest in real property, that derive value from real property or an interest in real property, are inseparable from that real property or interest in real property, and do not produce or contribute to the production of income other than consideration for the use or occupancy of space, are real property or interests in real property for the purposes of Section 856 through 859 of the Code.[\[23\]](#) An example in the Proposed Regulation concludes that goodwill acquired in connection with the purchase of the stock of a corporation whose sole asset is a hotel qualifies as real property for these purposes.[\[24\]](#)

A license, permit, or other similar right solely for the use, enjoyment, or occupation of land or an inherently permanent structure that is in the nature of a leasehold or easement generally is an interest in real property.[\[25\]](#) The Proposed Regulations include an example in which a special permit from the government to place a cell tower on federal government land qualifies as an interest in real property.[\[26\]](#) A license or permit to engage in or operate a business generally is not real property or an interest in real property because it produces or contributes to the production of income other than consideration for the use or occupancy of space.[\[27\]](#) In an example, the Proposed Regulations conclude that a license to operate a casino, even though the license applies only to a particular building and cannot be transferred to another location, is not real property within the meaning of the Proposed Regulations.[\[28\]](#)

Effective Date

The Proposed Regulations are proposed to be effective for calendar quarters beginning after the Proposed Regulations are published in final form. The IRS and the Treasury Department are soliciting comments regarding the proposed effective date as well all other aspects of the Proposed Regulations.

Conclusion

The Proposed Regulations provide welcome certainty and guidance on the definition of real property in the REIT context, and to the extent an asset is not specifically addressed in the guidance, create a workable framework for determining the asset's status as real property for the purposes of the REIT provisions of the Code. Please do not hesitate to contact any of the individuals listed herein with questions or for further detail.

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[1] All section references herein are to the Internal Revenue Code of 1986, as amended (the "Code").

[2] REG-150760-13, to be published in the Federal Register on May 14, 2014.

[3] Section 856(c)(4) of the Code.

[4] Section 856(c)(5)(B) of the Code. Treas. Reg. §1.856-3(b)(1).

[5] Treas. Reg. § 1.856-3(d).

[6] Prop. Treas. Reg. §1.856-10(b).

[7] Prop. Treas. Reg. §1.856-10(d)(1).

[8] Prop. Treas. Reg. §1.856-10(e)(1).

[9] Prop. Treas. Reg. §1.856-10(c).

[10] Prop. Treas. Reg. §1.856-3(g). *Ex. 1, Ex. 2.*

[11] Prop. Treas. Reg. §1.856-3(d)(2)(ii)(A).

[12] Prop. Treas. Reg. §1.856-3(d)(2)(ii)(B).

[13] Prop. Treas. Reg. §1.856-3(d)(2)(iii)(A).

[14] Prop. Treas. Reg. §1.856-3(d)(2)(iii)(B).

[15] Prop. Treas. Reg. §1.856-3(d)(2)(iv).

[16] Prop. Treas. Reg. §1.856-3(g) *Ex. 3.*

[17] Prop. Treas. Reg. §1.856-3(g) *Ex. 4.*

[18] Prop. Treas. Reg. §1.856-3(d)(3)(i).

[\[19\]](#) Prop. Treas. Reg. §1.856-3(d)(3)(iii). In particular, nine factors must be taken into account: (A) the manner, time, and expense of installing and removing the distinct asset; (B) whether the distinct asset is designed to be moved; (C) the damage that removal of the distinct asset would cause to the item itself or to the inherently permanent structure to which it is affixed; (D) whether the distinct asset serves a utility-like function with respect to the inherently permanent structure; (E) whether the distinct asset serves the inherently permanent structure in its passive function; (F) whether the distinct asset produces income from consideration for the use or occupancy of space in or upon the inherently permanent structure; (G) whether the distinct asset is installed during construction of the inherently permanent structure; (H) whether the distinct asset will remain if the tenant vacates the premises; and (I) whether the owner of the real property is also the legal owner of the distinct asset.

[\[20\]](#) Prop. Treas. Reg. §1.856-3(g) *Ex. 6*.

[\[21\]](#) Prop. Treas. Reg. §1.856-3(g) *Ex. 9*.

[\[22\]](#) Prop. Treas. Reg. §1.856-3(g) *Ex. 10*.

[\[23\]](#) Prop. Treas. Reg. §1.856-3(f).

[\[24\]](#) Prop. Treas. Reg. §1.856-3(g) *Ex. 11*.

[\[25\]](#) Prop. Treas. Reg. §1.856-3(f)(2).

[\[26\]](#) Prop. Treas. Reg. §1.856-3(g) *Ex. 12*.

[\[27\]](#) Prop. Treas. Reg. §1.856-3(f)(2).

[\[28\]](#) Prop. Treas. Reg. §1.856-3(g) *Ex. 13*.

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