IRS Issues Proposed Regulations on the Definition of Real Property for Purposes of the Real Estate Investment Trust Provisions of the Code


SUMMARY

On May 9, 2014, the Internal Revenue Service ("IRS") issued proposed regulations (the “Proposed Regulations”) that provide guidance on what assets may qualify as real estate assets for purposes of determining whether a corporation qualifies as a real estate investment trust, or a “REIT,” for U.S. federal income tax purposes. The issuance of the Proposed Regulations is significant because the IRS recently ended a moratorium on issuing rulings relating to the qualification of certain assets as “real estate” for purposes of the REIT rules while the IRS conducted an internal review of the relevant issues. The moratorium and study apparently related to the qualification of certain types of assets not traditionally held by REITs such as billboards, data centers and secure storage facilities.

While the Proposed Regulations provide guidance for purposes of the REIT asset tests, the Proposed Regulations do not address whether certain types of income received in respect of the use of the assets would qualify as “good” income for purposes of the REIT qualification rules.

There are additional Code provisions for which the definition of real estate assets is relevant (for instance, for purposes of depreciation and the Foreign Investment in Real Property Tax Act of 1980 (“FIRPTA”)). The Proposed Regulations, however, are limited to the definition of real estate assets relating to the REIT
provisions (although the preamble requests comments on reconciling the various meanings of real property).

BACKGROUND

In order for a corporation to qualify as a REIT, the corporation must meet a number of detailed and technical requirements, including a quarterly asset test (the “Asset Test”) that generally requires at the close of each quarter of the entity’s taxable year at least 75% of the value of the entity’s total assets to be real estate assets, cash and cash items (including receivables), and Government securities.\(^1\) The Code defines “real estate assets” as including real property and interests in real property, which encompasses land and improvements thereon.\(^2\) In addition, to qualify as a REIT, the corporation must meet an income test that requires at least 75% of the corporation’s gross income each year be derived from qualifying rents, certain gains from the sale of real estate assets, interest on obligations secured by real estate mortgages, dividends on shares in other REITs and certain other real estate-related income.\(^3\)

Existing Treasury Regulations provide additional guidance on what improvements constitute real estate assets for purpose of the REIT provisions, distinguishing between inherently permanent structures such as buildings (including structural components of such inherently permanent structures)\(^4\) that are real estate assets for this purpose and assets accessory to the operation of a business that are not real estate assets for this purpose.\(^5\)

Furthermore, the IRS has issued a number of revenue rulings and released many private letter rulings that further clarify whether various assets are properly characterized as real estate assets for these purposes. For instance, the IRS issued revenue rulings holding that railroad assets, certain mobile homes, air rights and microwave transmission properties qualified as real estate assets for REITs.

---

1. Code Section 856(c)(4).
2. Code Section 856(c)(5)(B) also includes interests in mortgages on real property and shares (or transferable certificates of beneficial interest) in other real estate investment trusts in the definition of real estate assets. Code Section 856(c)(5)(C) defines interests in real property as including “fee ownership and co-ownership of land or improvements thereon, leaseholds of land or improvements thereon, options to acquire land or improvements thereon, and options to acquire leaseholds of land or improvements thereon, but does not include mineral, oil, or gas royalty interests.”
3. Code Section 856(c)(3).
4. Treasury Regulation Section 1.856-3(d) provides the following examples of items that would be considered real estate assets under this criteria: the wiring in a building, plumbing systems, central heating, or central air-conditioning machinery, pipes or ducts, elevators or escalators installed in the building.
5. Treasury Regulation Section 1.856-3(d) provides the following examples of items that would not be considered real estate assets under this criteria: 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.
purposes. Private letter rulings have held, on the facts set forth in the private letter rulings, that cellphone towers, billboards, self-storage facilities, cold storage facilities and data storage facilities also qualified as real estate assets for this purpose.

In June 2013, the IRS informed companies with pending ruling requests that involved the definition of real estate assets for REIT purposes that the IRS review of the ruling requests was on hold pending the outcome of an IRS working group that was formed to evaluate the consistency of the IRS’s approach on determining what assets should be real estate assets for purposes of the REIT provisions. In November 2013, the IRS completed its review and announced that it would resume ruling on the definition of real estate assets “consistent with existing law (section 856, underlying regulations and previously published guidance).”

THE PROPOSED REGULATIONS
A. INTRODUCTION

The Proposed Regulations define real estate assets for purposes of the Asset Test as including three categories: (1) land (which includes water and air space, as well as crops and natural products attached to the land), (2) buildings and (3) other inherently permanent additions to land or buildings. In determining whether an inherently permanent structure or a structural component of a building qualifies as real estate, the Proposed Regulations first require that each such asset be tested to determine if the asset is a “distinct asset” that must be separately tested to determine if the asset qualifies as a real estate asset for these purposes. In addition to providing a list of factors to consider in analyzing whether various assets should be considered real estate assets for these purposes, the Proposed Regulations also provide a safe harbor list of assets that would be real estate for purposes of the Asset Test.

The Proposed Regulations also provide that certain intangible assets are real property for purposes of the Asset Test but that certain types of licenses are not real property for these purposes.

The Proposed Regulations only address the definition of real estate assets for the REIT assets test, and do not discuss other REIT qualification rules (such as the REIT income tests). The preamble to the

---

6 See, e.g., Rev. Rul. 69-94 (regarding railroad assets qualifying as real estate assets), Rev. Rul. 71-220 (regarding mobile homes qualifying as real estate assets), Rev. Rul. 71-286 (regarding air rights qualifying as real estate assets) and Rev. Rul. 75-424 (regarding microwave transmission properties qualifying as real estate assets).

7 See, e.g., PLR 201301007 (January 4, 2013) (regarding cellphone towers qualifying as real estate assets), PLR 201204006 (January 27, 2012) (regarding billboards qualifying as real estate assets), PLR 20008036 (February 25, 2000) (regarding self-storage facilities qualifying as real estate assets), PLR 200428019 (July 9, 2004) (regarding cold storage facilities qualifying as real estate assets) and PLR 201314002 (April 5, 2013) (regarding data storage facilities qualifying as real estate assets).

8 See Amy S. Elliot, IRS Resumes REIT Conversion Rulings, 2013 TNT 222-3, November 18, 2013.
Proposed Regulations states that the examples mentioned in the Proposed Regulations should not be used to infer whether various forms of income are acceptable for other REIT qualification requirements.

There are additional Code provisions in which the definition of real estate assets is relevant (for instance, for purposes of depreciation and the FIRPTA). However, the Proposed Regulations are limited to the definition of real estate assets relating to the REIT provisions.

The Proposed Regulations are expected to be effective for calendar quarters beginning after the Proposed Regulations are published in final form and existing REITs would not be grandfathered after the effective date.\(^9\)

**B. LAND**

The Proposed Regulations include water and air space in the definition of land.\(^10\) In addition, crops, deposits and other natural products would be considered part of the land so long as they remain attached to the land.\(^11\) However, crops, deposits and other natural products would no longer be considered part of the land once they have been harvested, extracted or severed from the land (even if subsequently stored on land).\(^12\)

**C. BUILDINGS**

The Proposed Regulations define a building as a permanently affixed enclosure containing walls and a roof.\(^13\) The Proposed Regulations provide a safe harbor list of assets that would qualify as buildings including houses, apartments, hotels, factory and office buildings, warehouses, barns, enclosed garages, enclosed transportation stations and terminals and stores.\(^14\)

**D. DISTINCT ASSETS**

In determining whether assets (other than land or buildings) are included within the definition of real estate assets for purposes of the Asset Test as inherently permanent structures or structural components, the Proposed Regulations first require that each such asset be tested to determine if it is a "distinct asset" that would be separately tested to determine if such asset qualifies as a real estate asset for these purposes.\(^15\)

\(^9\) Proposed Regulation Section 1.856-10(h).

\(^10\) Proposed Regulation Section 1.856-10(c).

\(^11\) Id.

\(^12\) Id.

\(^13\) Proposed Regulation Section 1.856-10(d)(2)(ii)(A).

\(^14\) Proposed Regulation Section 1.856-10(d)(2)(ii)(B).

\(^15\) Proposed Regulation Section 1.856-10(e)(1).
Determining whether any asset is a distinct asset is based on a facts and circumstances test, and the Proposed Regulations provide the following factors to consider:

(i) Whether the item is customarily sold or acquired as a single unit rather than as a component part of a larger asset;
(ii) Whether the item can be separated from a larger asset, and if so, the cost of separating the item from the larger asset;
(iii) Whether the item is commonly viewed as serving a useful function independent of a larger asset of which it is a part; and
(iv) Whether separating the item from a larger asset of which it is a part impairs the functionality of the larger asset.\(^{16}\)

**Example**
The Proposed Regulations provide an example illustrating how to determine whether various components of a single system should be treated as distinct assets. The example describes a solar energy system which includes photovoltaic modules (that convert the sun’s energy into electricity), mounts (that support the photovoltaic modules) and exit wires (that are connected to the photovoltaic modules and transmit the electricity).\(^{17}\) Each of these components would be distinct assets because (i) each of these components are separately identifiable, (ii) separating the mounts from photovoltaic modules would not affect the ability of the photovoltaic modules to produce electricity (or the ability of the exit wires to transmit the electricity) and is not costly, (iii) disconnecting the exit wires from photovoltaic modules would not damage the photovoltaic modules and is not costly, and (iv) the photovoltaic modules and exit wires are customarily sold separately.\(^{18}\)

### E. INHERENTLY PERMANENT STRUCTURES

The Proposed Regulations define inherently permanent structures as any permanently affixed buildings (or other structures).\(^{19}\) Inherently permanent structures include structures that are reasonably expected to last indefinitely.\(^{20}\) However, the definition does not include any distinct assets that serve an active function (such as manufacturing, creating, producing, converting or transporting).\(^{21}\)

The Proposed Regulations provide a safe harbor list of assets that would qualify as inherently permanent structures (other than buildings) including microwave transmission, cell, broadcast and electrical transmission towers, telephone poles, parking facilities, bridges, tunnels, roadbeds, railroad tracks, microwave transmission, cell, broadcast and electrical transmission towers, telephone poles, parking facilities, bridges, tunnels, roadbeds, railroad tracks,

---

\(^{16}\) Proposed Regulation Section 1.856-10(e)(2).

\(^{17}\) Proposed Regulation Section 1.856-10(g), Example 8.

\(^{18}\) Id.

\(^{19}\) Proposed Regulation Section 1.856-10(d)(2).

\(^{20}\) Id.

\(^{21}\) Id.

IRS Issues Proposed Regulations on the Definition of Real Property for Purposes of the Real Estate Investment Trust Provisions of the Code
May 14, 2014
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 (so long as an election has been properly made under the Code to treat the displays as real property)).

Determining whether any distinct asset not listed in the safe harbor list is an inherently permanent structure is based on a facts and circumstances test. Provided that the distinct asset does not serve an active function (such as manufacturing, creating, producing, converting or transporting), the Proposed Regulations provide the following factors to consider:

(i) The manner in which the distinct asset is affixed to real property;
(ii) Whether the distinct asset is designed to be removed or to remain in place indefinitely;
(iii) The damage that removal of the distinct asset would cause to the item itself or to the real property to which it is affixed;
(iv) 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
(v) The time and expense required to move the distinct asset.

Examples
The Proposed Regulations provide two examples that demonstrate how to apply these factors. In one example, a large five-ton statue (that does not serve an active function) would be an inherently permanent structure because (i) the statue is permanently affixed to the building with supports embedded in the building’s foundation, (ii) the statue is not designed to be removed, (iii) the statue and the building would be damaged if the statue is removed, (iv) the statue is affixed indefinitely (regardless of whether the tenants vacate the building) and (v) removal of the statue would be time-consuming and expensive.

In another example, a bus shelter would not be an inherently permanent structure because (i) the bus shelter is not permanently affixed to the land, (ii) the bus shelter is designed to be removed when the bus route changes, (iii) neither the bus shelter nor the sidewalk would be damaged upon removal, (iv) the bus shelter is intended to be removed when the local transit authority no longer requires its use and (v) the removal of the shelter would not require a significant amount of time or expense.

---

22 Proposed Regulation Sections 1.856-10(d)(2)(ii)(B) and 1.856-10(d)(2)(iii)(B).
23 Proposed Regulation Section 1.856-10(d)(2)(iv).
24 Id.
25 Proposed Regulation Section 1.856-10(g), Example 3.
26 Proposed Regulation Section 1.856-10(g), Example 4.
F. STRUCTURAL COMPONENTS

The Proposed Regulations define structural components as distinct assets that are constituent parts of (and integrated into) inherently permanent structures and that serve the inherently permanent structures in their passive function (and do not contribute to nor produce income other than for the use of space).²⁷

The Proposed Regulations provide the following safe harbor list of assets that would qualify as structural components including 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.²⁸

Determining whether any distinct asset not listed in the safe harbor list is an inherently permanent structure is based on a facts and circumstances test, and the Proposed Regulations provide the following factors to consider:

(i) The manner, time, and expense of installing and removing the distinct asset;
(ii) Whether the distinct asset is designed to be moved;
(iii) 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;
(iv) Whether the distinct asset serves a utility-like function with respect to the inherently permanent structure;
(v) Whether the distinct asset serves the inherently permanent structure in its passive function;
(vi) Whether the distinct asset produces income from consideration for the use or occupancy of space in or upon the inherently permanent structure;
(vii) Whether the distinct asset is installed during construction of the inherently permanent structure;
(viii) Whether the distinct asset will remain if the tenant vacates the premises; and
(ix) Whether the owner of the real property is also the legal owner of the distinct asset.²⁹

Examples

The Proposed Regulations provide several examples that illustrate this facts and circumstances test. One example involves a data center, and provides that the electrical and telecommunications systems would be structural components because (i) the systems are embedded in the walls and floors and would be costly to remove, (ii) the systems are not designed to be moved, (iii) removal of the systems would damage the floors and walls (although removal would not damage the building itself), (iv) the systems

²⁷ Proposed Regulation Section 1.856-10(d)(3)(i).
²⁸ Proposed Regulation Section 1.856-10(d)(3)(ii).
²⁹ Proposed Regulation Section 1.856-10(d)(3)(iii).
serve a utility-like function, (v) the systems serve a passive function (of containing, sheltering and protecting the servers), (vi) the systems produce income as consideration for the use of space, (vii) the systems were installed during construction of the building, (viii) the systems would not be removed if the tenant vacates the building and (ix) the systems are owned by the owner of the real property.\(^{30}\)

Conversely, another example provides that a modular partition system would not be considered a structural component because the modular partition system (i) is easily installed and removed with little expense, (ii) is not intended to remain permanently in place and is not specially designed for any particular building, (iii) is not damaged upon removal and does not damage the building, (iv) does not serve a utility-like function, (v) however, serves a passive function, (vi) however, produces income only as consideration for the use or occupancy of the building, (vii) is not installed during construction of the building, (viii) may be removed when the tenant vacates and (ix) is owned by the owner of the real property.\(^{31}\)

Yet another example involves a solar energy site that sells the electricity generated to third parties and determines that the photovoltaic modules (that produce the electricity) are not structural components because the photovoltaic modules serve an active function (converting solar photons into electricity).\(^{32}\) However, where the solar energy site is leased to the tenant of a building and the solar energy is produced for the use of the tenant in the building (even if the excess electricity is occasionally sold to a utility company), the photovoltaic modules would be structural components qualifying as real property for purposes of the Asset Test.\(^{33}\)

Finally, an example dealing with an oil pipeline transmission system distinguishes between (i) the valves and vents that serve a passive function and are structural components of tanks and pipelines (which are inherently permanent structures) and therefore qualify as real estate and (ii) the meters (that measure the oil for purposes of determining the amount of the consumer’s consumption) and compressors (that are

\(^{30}\) Proposed Regulation Section 1.856-10(g), Example 6 (the example also notes that the central heating and air conditioning system, fire suppression system and humidity control system are listed on the safe harbor lists).

\(^{31}\) Proposed Regulation Section 1.856-10(g), Example 7 (the example notes that conventional drywall partitions are walls and therefore, inherently permanent structures).

\(^{32}\) Proposed Regulation Section 1.856-10(g), Example 8 (the example notes that (i) the mounts (that support the photovoltaic modules) are inherently permanent structures because they (a) are permanently affixed to the land, (b) are not designed to be removed, (c) would be damaged if removed, (d) would remain even after the tenant vacates and (e) would be expensive and time-consuming to remove and (ii) the exit wire (that transmits the electricity) is a transmission line, which is listed in the safe harbor list of inherently permanent structures.).

\(^{33}\) Proposed Regulation Section 1.856-10(g), Example 9.
G. INTANGIBLES

The Proposed Regulations provide that an intangible asset is a real estate asset for purposes of the Asset Test if (i) the intangible derives its value from real property or an interest in real property, (ii) the intangible is inseparable from that real property or interest in real property, and (iii) the intangible 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 while licenses or permits solely for the use and enjoyment of land or inherently permanent structures in the nature of a lease are interests in real property, licenses or permits to operate a business (such as a license to run a casino) are not interests in real property.

* * *

---

34 Proposed Regulation Section 1.856-10(g), Example 10.
35 Proposed Regulation Section 1.856-10(f)(1).
36 Proposed Regulation Sections 1.856-10(f)(2); 1.856-10(g), Example 13.

Copyright © Sullivan & Cromwell LLP 2014
SULLIVAN & CROMWELL LLP

ABOUT SULLIVAN & CROMWELL LLP

Sullivan & Cromwell LLP is a global law firm that advises on major domestic and cross-border M&A, finance, corporate and real estate transactions, significant litigation and corporate investigations, and complex restructuring, regulatory, tax and estate planning matters. Founded in 1879, Sullivan & Cromwell LLP has more than 800 lawyers on four continents, with four offices in the United States, including its headquarters in New York, three offices in Europe, two in Australia and three in Asia.

CONTACTING SULLIVAN & CROMWELL LLP

This publication is provided by Sullivan & Cromwell LLP as a service to clients and colleagues. The information contained in this publication should not be construed as legal advice. Questions regarding the matters discussed in this publication may be directed to any of our lawyers listed below, or to any other Sullivan & Cromwell LLP lawyer with whom you have consulted in the past on similar matters. If you have not received this publication directly from us, you may obtain a copy of any past or future related publications from Stefanie S. Trilling (+1-212-558-4752; trillings@sullcrom.com) in our New York office.

CONTACTS

<table>
<thead>
<tr>
<th>New York</th>
<th>+1-212-558-3645</th>
<th><a href="mailto:jacobsone@sullcrom.com">jacobsone@sullcrom.com</a></th>
</tr>
</thead>
<tbody>
<tr>
<td>Eli D. Jacobson</td>
<td>+1-212-558-3759</td>
<td><a href="mailto:masona@sullcrom.com">masona@sullcrom.com</a></td>
</tr>
<tr>
<td>Andrew S. Mason</td>
<td>+1-212-558-4376</td>
<td><a href="mailto:spitzerd@sullcrom.com">spitzerd@sullcrom.com</a></td>
</tr>
<tr>
<td>David C. Spitzer</td>
<td>+1-212-558-3113</td>
<td><a href="mailto:wangd@sullcrom.com">wangd@sullcrom.com</a></td>
</tr>
<tr>
<td>Davis J. Wang</td>
<td>+1-212-558-4354</td>
<td><a href="mailto:holtt@sullcrom.com">holtt@sullcrom.com</a></td>
</tr>
<tr>
<td>Theodore D. Holt</td>
<td>+1-212-558-4771</td>
<td><a href="mailto:pollockt@sullcrom.com">pollockt@sullcrom.com</a></td>
</tr>
<tr>
<td>Todd I. Pollock</td>
<td>+1-202-956-7675</td>
<td><a href="mailto:korbd@sullcrom.com">korbd@sullcrom.com</a></td>
</tr>
</tbody>
</table>

Washington, D.C.

-10-

IRS Issues Proposed Regulations on the Definition of Real Property for Purposes of the Real Estate Investment Trust Provisions of the Code
May 14, 2014
SC1:3642883.3C