LATHAM&WATKINS

Client Alert
Commentary

Latham & Watkins Real Estate Investment Trust Practice September 12, 2016 | Number 2007

Treasury Department Issues Final Regulations on Real Property Definition for REIT Purposes

Final regulations establish analytical framework for determining whether assets qualify as real property for purposes of the REIT rules.

On August 31, 2016, the Treasury Department and the Internal Revenue Service (IRS) published final regulations (Regulations) clarifying the definition of "real property" for purposes of the real estate investment trust (REIT) rules of the Internal Revenue Code (Code). The Regulations generally adopted the proposed regulations (Proposed Regulations) released on May 14, 2014, with some revisions in response to comments received from the public. Consistent with prior final REIT regulations, IRS-published guidance and the Proposed Regulations, the Regulations define real property to include land, inherently permanent structures and structural components. The Regulations provide safe harbors for determining whether certain assets are real property, as well as facts and circumstances tests for determining whether assets not listed under the safe harbors are real property. In addition, the Regulations identify certain types of intangible assets that are real property or interests in real property for REIT purposes.

Background

Prior to the Regulations, existing law provided only limited guidance on the meaning of real property for purposes of the REIT asset tests. Treasury regulations promulgated in 1962 under the REIT provisions of the Code defined 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)," but did not elaborate on the meaning of these terms. The IRS had issued a handful of revenue rulings between 1969 and 1975 addressing whether certain assets qualified as real property for REIT purposes. Since then, the IRS issued numerous private letter rulings addressing whether various other types of assets qualified as real property for REIT purposes. However, such private letter rulings were limited to their particular facts, and taxpayers other than the taxpayer that received the ruling could not rely on these rulings. Acknowledging the need to provide additional published guidance on the definition of real property for purposes of the REIT asset tests, the Treasury Department and the IRS published Proposed Regulations relating to such additional guidance on May 14, 2014. These Proposed Regulations were generally consistent with the positions the IRS had taken in prior rulings. The Regulations published on August 31, 2016 are generally consistent with the Proposed Regulations, with some modifications in response to comments received from the public. Taxpayers are likely to welcome the clarification of these rules.

Analytical Framework

In determining whether an item is real property for REIT purposes, the Regulations initially test whether the item is a distinct asset. If the item is a distinct asset, the Regulations then test whether it qualifies as land, an inherently permanent structure or a structural component (and, therefore, as real property). The Regulations include several examples (dealing with, among other assets, components of a cold storage warehouse, data center, solar energy site and natural gas pipeline transmission system) to illustrate the application of the adopted framework.

Land

The Regulations provide that land includes water and air space directly above the land, as well as natural products and deposits (such as crops, water, ores and minerals) that are not severed, extracted or removed from the land. The storage of severed or extracted natural products or deposits in or upon real property does not cause the stored property to qualify as real property.

Inherently Permanent Structures

Under the Regulations, inherently permanent structures are buildings and other structures that (1) are permanently affixed (including by weight alone) to land or to another inherently permanent structure and (2) serve a passive function, such as to contain, support, shelter, cover, protect, or provide a conduit or route. An asset that serves an active function, such as to manufacture, create, produce, convert or transport, is not an inherently permanent structure. The preamble to the Regulations explains that providing a conduit or route was added as a permitted passive function in response to public comments noting that certain assets, such as railroad tracks and tunnels, help transport a good or commodity but should be treated as inherently permanent structures. The preamble clarifies that, for purposes of the Regulations, the term “transport” is intended to mean to cause to move (for example, machines that push or pull items through or along a conduit), rather than to provide a conduit (such as in the case of a pipeline or electrical wire) or route (such as in the case of a road or railroad track).

Certain assets listed under a safe harbor are inherently permanent structures, including: houses and apartments; hotels and motels; enclosed stadiums and arenas; enclosed shopping malls; factory and office buildings; stores and warehouses; barns; enclosed garages; enclosed transportation stations and terminals; microwave transmission, cell, broadcast and electrical transmission towers; telephone poles; parking facilities; bridges, tunnels, roadbeds and 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 certain outdoor advertising displays. For other assets not listed under the safe harbor, a facts and circumstances test would determine whether the asset qualifies as an inherently permanent structure. The facts and circumstances test considers whether the distinct asset is designed to be removed or to remain in place “indefinitely” as a relevant factor. The preamble to the Regulations clarifies, in response to a public comment, that the term “indefinitely” is not intended to mean forever.

Structural Components

The Regulations provide that a structural component is an asset that constitutes part of an inherently permanent structure, serves the inherently permanent structure in its passive function, and does not produce or contribute to the production of income other than consideration for the use or occupancy of space. If the components of a system work together to serve the inherently permanent structure with a utility-like function (for example, systems that provide a building with electricity, heat or water), the entire system is analyzed as an asset that may be a structural component. If an asset serves an active function, such as producing goods, the asset may be real property if it is a structural component that serves a utility-like function with respect to the inherently permanent structure of which it is a constituent part.

The Proposed Regulations had stated that a structural component is real property only if the interest held therein is included with an “equivalent interest” which the taxpayer held in the inherently permanent structure to which the structural component is functionally related. Commenters suggested deleting or amending this “equivalent interest” requirement because, among other reasons, it appeared to preclude a structural component from qualifying as real property if a REIT owned the structural component but leased from another party the building served by the structural component. To address such concerns, the Regulations provide that a structural component may qualify as real property only if a REIT holds its interest in the structural component together with “a” (rather than an equivalent) real property interest (such as a leasehold interest) in the inherently permanent structure served by the structural component. In addition, the Regulations provide that a mortgage secured by a structural component is a real estate asset only if the mortgage is also secured by a real property interest in the inherently permanent structure served by the structural component.

Certain assets listed under a safe harbor are structural components, including: wiring; plumbing systems; central heating and air conditioning systems; elevators and escalators; walls, floors and ceilings; permanent coverings of walls, floors and ceilings; windows and doors; insulation; chimneys; fire suppression systems, such as sprinkler systems and fire alarms; fire escapes; central refrigeration systems; security systems; and humidity control systems. For other assets not listed under the safe harbor, a facts and circumstances test would determine whether the asset qualifies as a structural component.

Intangible Assets

The Regulations provide that an intangible asset, including an intangible asset established under generally accepted accounting principles (GAAP) as a result of an acquisition of real property or an interest in real property, qualifies as real property or an interest in real property for REIT purposes if it meets all of the following conditions:

- Derives its value from real property or an interest in real property
- Is inseparable from that real property or interest in real property
- 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 solely for the use, occupancy or enjoyment of real property in the nature of a leasehold or easement, generally qualifies as an interest in real property. However, a license or permit to engage in or operate a business is not real property or an interest in real property if the license or permit produces or contributes to the production of income other than consideration for the use or occupancy of space.

Effect on Prior Private Letter Rulings

The preamble to the Regulations notes that to the extent a previously issued private letter ruling is inconsistent with the Regulations, the private letter ruling is revoked prospectively from the effective date of the Regulations. This statement creates some uncertainty regarding a taxpayer’s ability to rely on its prior ruling, or other taxpayers’ ability to look to prior rulings for guidance.

Effective Date

The Regulations are effective for taxable years beginning after August 31, 2016. However, as the Regulations generally are intended as a clarification of current law, taxpayers may rely on them for quarters that end prior to the effective date. In addition, for purposes of applying a limited retesting rule under the asset tests (which retesting rule provides that if a REIT satisfied the asset tests at the close of any quarter, the REIT will not lose its status as a REIT in a subsequent quarter merely because of fluctuations in the value of its assets) to a quarter in a taxable year that begins after August 31, 2016, the Regulations apply in determining whether a REIT satisfied the asset tests at the close of prior quarters.

If you have questions about this *Client Alert*, please contact one of the authors listed below or the Latham lawyer with whom you normally consult:

Michael J. Brody
michael.brody@lw.com
+1.213.891.8724
Los Angeles

Ana G. O'Brien
ana.o'brien@lw.com
+1.213.891.8721
Los Angeles

Eric Cho
eric.cho@lw.com
+1.213.891.8238
Los Angeles

You Might Also Be Interested In

Treasury Targets Inversions and Related-Party Debt with Far-Reaching Regulations

Congress Enacts Significant Changes to the REIT and FIRPTA Rules

Court Decision Helps REITs Strategize for Successful Acquisitions in the Face of Shareholder Litigation

Secondary/Tertiary Market Debate: Why the 2016 Investment Opportunities Are Greatest (Here) (Webcast)
