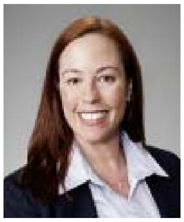
IRS Proposes Guidance on Real Property Definition for REIT Purposes, By Michael J. Brody, Esq., Ana G. O'Brien, Esq., and Eric Cho, Esq.…May 2014


Michael J. Brody, Esq.,Ana G. O'Brien, Esq.,Eric Cho, Esq.
Latham & Watkins, Los Angeles, CA

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

On May 14, 2014, the Internal Revenue Service (IRS) published in the Federal Register proposed regulations that clarify the definition of "real property" for purposes of the real estate investment trust (REIT) rules of the Internal Revenue Code (Code) (*see* REG-150760-13, RIN 1545-BM05, 79 Fed. Reg. 27508 (5/14/14)). Consistent with existing REIT rules and IRS published guidance, the proposed regulations define real property to include land, inherently permanent structures and structural components. The proposed 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 proposed regulations identify certain types of intangible assets that are real property or interests in real property for REIT purposes.

Background

Existing law provides only limited guidance on the meaning of real property for purposes of the REIT rules. Treasury regulations promulgated under the REIT provisions of the Code 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)," but do not elaborate on the meaning of these terms. As noted in the preamble to the proposed regulations, the IRS issued a handful of revenue rulings between 1969 and 1975 addressing whether certain assets qualify as real property for REIT purposes. Since then, the IRS has issued private letter rulings addressing whether various other types of assets qualify as real property for REIT purposes. However, such private letter rulings are limited to their particular facts and taxpayers other than the taxpayer that received the ruling may not rely on these rulings. Therefore, the IRS has acknowledged the need to provide additional published guidance on the definition of real property for REIT purposes. The proposed regulations are generally consistent with the positions the IRS has taken in prior rulings and taxpayers are likely to welcome the clarification of these rules.

Proposed Framework

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

Land

The proposed 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 proposed 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. An asset that serves an active function, such as producing goods, is not an inherently permanent structure.

Certain assets listed under a safe harbor are inherently permanent structures, including: houses, apartments and hotels; factory and office buildings; stores and warehouses; enclosed garages and parking facilities; microwave transmission, cell, broadcast and electrical transmission towers; transmission lines; pipelines; offshore drilling platforms; storage structures such as silos and oil and gas storage tanks; 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.

Structural Components

The proposed 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. A structural component is real property only if the taxpayer holds the interest in the structural component together with the taxpayer's interest in the inherently permanent structure to which the structural component is functionally related. 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.

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; fire escapes; central refrigeration systems; integrated 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 proposed 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 for REIT purposes if it:

- derives its value from real property or an interest in real property;
- is inseparable from that real property or interest in real property; and
- does not produce or contribute to the production of income other than consideration for the use or occupancy of space.

A license or permit 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 generally is not real property or an interest in real property.

Effective Date

The IRS proposes that the regulations be effective for calendar quarters beginning after the date the regulations are finalized. The proposed regulations are subject to further revision and significant public comment is expected, including at a public hearing scheduled for September 18, 2014.

For more information, in the Tax Management Portfolios, see Carnevale, de Bree, Schneider, Temkin & Witt, 742 T.M., Real Estate Investment Trusts, *and in Tax Practice Series, see ¶5180, Real Estate Investment Trusts (REITs).*

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