

# ***Real Estate Tax Alert***



## ***Proposed regulations on the definition of real property for REITs***

On May 9, 2014, the IRS released proposed regulations (“Proposed Regulations”) which are intended to clarify the definition of “real property” for purposes of the asset tests applicable to real estate investment trusts (“REITs”).<sup>1</sup> The IRS’s expectation is that taxpayers will be able to utilize the additional guidance in the proposed regulations to analyze whether their assets qualify as real property in lieu of seeking private letter rulings.

The definition of real property is important to REITs for a variety of reasons. In particular, (i) real property and obligations secured by mortgages on real property are qualifying assets for purposes of the REIT asset tests and (ii) rents from real property and interest derived from obligations secured by mortgages on real property can be qualifying income for purposes of the REIT income tests. It should be noted that the Proposed Regulations do not purport to deal with the income tests. Thus, whether the use of a particular type of asset produces qualifying rents from real property or mortgage interest will remain an uncertain area.

Under the current regulations, “real property” includes land, improvements, such as buildings, and other inherently permanent structures such as structural components of buildings or structures. In addition, the term “real property” includes interests in real property. The current regulations include a list of specific items that are included in real property and note that the term 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, and furnishings of a motel, hotel, or office building, etc., even though such items may be termed fixtures under local law.<sup>2</sup>

The Proposed Regulations define real property to include the same three broad categories: (1) land, (2) inherently permanent structures and (3) structural components. In addition, unlike the current regulations, the Proposed Regulations identify certain types of intangible assets that are real property for purposes of the REIT asset tests.

The Proposed Regulations provide that each distinct asset (each unit of property) is tested individually to determine whether the distinct asset is real property (*i.e.*, land, inherently permanent structure, or structural component) or personal property. The Proposed Regulations provide a safe harbor list of assets that are inherently permanent structures or structural components and therefore are treated as real property for purposes of the REIT asset tests. If an asset is not specifically listed in the regulations as constituting real property, then the relevant facts and circumstances must be analyzed.

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<sup>1</sup> The proposed regulations are scheduled to be published in the Federal Register on May 14, 2014.

<sup>2</sup> Treas. Reg. §1.856-3(d).

The Proposed Regulations eliminate the concept of “assets accessory to the operation of a business” which is a source of uncertainty among practitioners. Under the current regulations, “assets accessory to the operation of a business” are not treated as real property regardless of whether they are affixed to real property. In contrast, the Proposed Regulation adopt an approach that considers whether the distinct asset in question either serves a passive function common to real property (in which case the distinct asset is considered real property) or an active function that produces or contributes to the production of income other than income from the use or occupancy of space (in which case the distinct asset is not real property).

Significantly, the Proposed Regulations contain 13 industry examples which illustrate the application of the definition of real property for REIT asset tests purposes. The IRS acknowledges that the Proposed Regulations are intended to be a clarification and not a modification of the existing definition of real property. Thus, it is expected that virtually every category of asset that the IRS has ruled is real property under the current regulations would be treated as real property under the Proposed Regulations.

The IRS recognizes that different Code provisions (*e.g.*, Section 168 or Section 897) may have different policies for real property vs. personal property delineations that create the need for different definitions than in the REIT context, and the IRS is requesting comments on the coordination of the common terms used in different provisions with the REIT provisions.

The following is a summary of the Proposed Regulations.

## *Land*

Land is treated as real property and includes water and air space superjacent to land. While air rights had previously been treated as real property in Rev. Rul. 71-286, water rights have only been treated as real property in a private letter ruling.<sup>3</sup> Therefore, the proposed regulations would provide comfort to owners of marinas that water rights are interests in real property and consequently, boat slips at the marina may qualify as real estate assets for REIT purposes.

The proposed regulations also provide that land includes natural products and deposits that are unsevered from the land. Once the crops or other natural products are detached or removed from the land, they cease to be real property.

## *Inherently permanent structures*

Inherently permanent structures are treated as real property and include structures, including buildings, that (1) are “inherently permanent” and (2) do not have an “active” function. Under the Proposed Regulations, a structure will be treated as inherently permanent if it is permanently affixed to a building or other structure. In addition to the method of attachment, an asset may be treated as affixed based on the weight of the structure alone.

**Safe harbor list:** Buildings, which include houses, apartments, hotels, factory and office buildings, warehouses, barns, enclosed garages, enclosed transportation stations and terminals, and stores. Other inherently permanent structures, which include 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

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<sup>3</sup> See PLR 20130020 (December 5, 2012) (boat slips at a marina constituted real estate assets under Section 856(c)(4)).

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).<sup>4</sup>

**Facts and circumstances test:** If a distinct asset does not serve an active function or not otherwise listed in the safe harbor list, then the determination of whether such asset is an inherently permanent structure is based on the following factors: (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 (e.g., 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. These tests are substantially the same as the factors delineated in *Whiteco Industries, Inc. v. Commissioner*,<sup>5</sup> and are widely used to determine whether property is real or personal for federal income tax purposes.

## *Structural components*

A structural component is treated as real property and is generally a distinct asset that is a constituent part of, and integrated into, an inherently permanent structure that serves the 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. An entire system is analyzed as a single distinct asset and as a single structural component if the components of the system work together to serve the inherently permanent structure with a utility-like function (such as systems that provide a building with electricity, heat, or water).

Structural components are real property only if the REIT holds an equivalent interest in both the inherently permanent structure and the structural component to which it is functionally related. This section of the Proposed Regulations represents a major departure from the current regulations in that the active/passive rule for structural components essentially replaces the “assets accessory to the operation of a business” rule.

**Safe harbor list:** 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.

**Facts and circumstances test:** If a distinct asset is not otherwise listed in the safe harbor list above, then the determination of whether the asset is a structural component is based on the following factors: (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.

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<sup>4</sup> Section 1033(g)(3) contains an election to treat “outdoor advertising displays” as real property.

<sup>5</sup> 65 T.C. 664 (1975), *acq.* 1980-2 C.B.1. In *Whiteco*, the Tax Court concluded that certain outdoor advertising signs were tangible personal property for purposes of the investment tax credit. In previous private letter rulings, the IRS has used the *Whiteco* analysis in the REIT context. See PLR 199904019 (October 30, 1998).

## *Intangibles*

Under the Proposed Regulations, if an intangible asset, including an intangible asset established under GAAP rules as a result of an acquisition of real property or an interest in real property, (a) derives its value from real property or an interest in real property, (b) is inseparable from that real property or interest in real property, and (c) does not produce or contribute to the production of income other than consideration for the use or occupancy of space, then the intangible is real property or an interest in real property. For example, 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.” On the other hand, 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.

The current regulations do not cover intangibles, although the IRS had issued a number of private letter rulings covering various issues. The Proposed Regulations deviate from prior IRS guidance which looked to whether the intangibles were “inextricably and compulsorily tied” to the real property. It is unclear how whether the change in the standard will result in different conclusions.

The Proposed Regulations contain several examples to illustrate when certain intangibles are real property or interests in real property. In Example 11, goodwill which derives its value and is inseparable from the acquisition of hotel is treated as real property. In Example 12, a special use permit that a REIT receives from government to place a cell tower on federal government land is determined to be in the nature of a leasehold and therefore is an interest in real property. In Example 13, a REIT’s license to operate a casino in a building which it owns was determined to be a license to engage in the business of operating a casino and, thus, not real property.

## *Effective date*

The Proposed Regulations are proposed to be effective for calendar quarters beginning after they are published as final regulations in the Federal Register. Comments are due by August 12, 2014.

While the Proposed Regulations are pending, the IRS is expected to accept and process ruling requests, including ruling requests on the definition of real property for REIT purposes, in accordance with their current practice. However, future rulings are likely to be required by the IRS to be consistent with the Proposed Regulations.

## *Conclusion*

The Proposed Regulations are a welcome development for REITs. When finalized, they should reduce uncertainty regarding qualification of assets as real property and reduce the need for ruling requests, which can take many months and be costly to obtain. In particular, by specifically covering intangible assets, eliminating the “assets accessory to the operation of a business” rule in favor of an active/passive rule, providing the safe harbors for specific assets, and delineating the relevant facts and circumstances, the Proposed Regulations will make it easier for REITs and their advisors to conclude on the qualification of specific assets as real property.

It should be noted that the Proposed Regulations do not purport to deal with the income tests. Thus, whether the use of a particular type of asset produces qualifying rents from real property or mortgage interest will remain an uncertain area.

In the interim, REITs can take comfort that the IRS is not changing in a material way its current ruling policy in this area.

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