Final Regulations Clarify Definition of "Real Property" for REIT Purposes

By Andrew Short & James Grace

On August 31, 2016, the Department of the Treasury ("Treasury") and the Internal Revenue Service (the "IRS") issued final regulations under section 856 of the Internal Revenue Code of 1986, as amended (the "Code"), which clarify the definition of real property for real estate investment trust ("REIT") purposes (the "Final Regulations").[1] While the Final Regulations generally adopt proposed regulations issued on May 14, 2014 (the "Proposed Regulations"),[2] the Final Regulations also reflect several important clarifications and changes made in response to extensive comments from industry groups on the Proposed Regulations.

Background

One requirement for qualifying as a REIT is that, as of the end of each quarter, at least 75% of the total gross value of the company's assets must be comprised of real estate assets, cash and cash items, and government securities.[3] Real estate assets include real property (including interests in real property and interests in mortgages on real property).[4] As REITs have pursued increasingly diverse investments over the years (*e.g.*, data centers), REITs have obtained private letter rulings ("PLRs") in order to provide comfort that such investments would be respected as real estate assets. The Proposed Regulations were issued to provide updated published guidance on the definition of real property and thereby give REITs greater certainty regarding the types of investments they may make.

The Proposed Regulations

The Proposed Regulations defined real property to include land and improvements to land, such as buildings and other inherently permanent structures ("OIPSs"), including their structural components. Under the preexisting regulations defining real property,[5] which were promulgated in 1962, the touchstone for distinguishing between real property and personal property was movability, or the lack thereof. The preexisting regulations also provided that "assets accessory to the operation of a business" would not be considered real property. The Proposed Regulations retained the emphasis on movability by requiring inherently permanently structures ("IPSs") to be "permanently affixed". In addition, the Proposed Regulations effectively replaced "assets accessory to the operation of a business" test with a new passive-active function test which requires that OIPSs must serve a passive function (*e.g.*, contain, support, shelter, cover, or protect) and must not serve an active function (*e.g.*, manufacture, create, produce, or convert). Under the framework established in the Proposed Regulations, each distinct asset is analyzed separately from any other assets to which the asset relates to determine if the asset is real property. In addition, the Proposed Regulations contain a list of specific assets which are deemed to be structural components or IPSs.
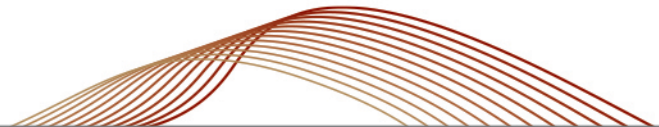
The Final Regulations

While retaining the basic framework for defining real property contained in the Proposed Regulations, the Final Regulations include several important changes and clarifications.

With respect to the definition of OIPS, Treasury and the IRS acknowledged the concern of commenters that the term "transport" could be interpreted broadly to describe functions of both passive conduits and machines that push or pull objects through or along a conduit. Reflecting the intent of Treasury and the IRS for the term transport to mean to cause to move, the Final Regulations clarify that assets which serve as a conduit (*e.g.*, pipeline or electrical wire) or route (*e.g.*, a road or railroad track) are deemed to serve a passive function for the purposes of assessing eligibility as an OIPS.

In order for an asset to be considered a structural component, the Proposed Regulations required that a REIT possess an "equivalent interest" in the IPS to which the structural component was functionally related. Under the Final Regulations, a REIT is no longer required to have an equivalent interest in the IPS; however, the REIT must still maintain a real property interest in the IPS. A REIT may possess differing interests in the structural component and the IPS (*e.g.*, full ownership of the structural component and a leasehold interest in IPS, or vice versa). For example, under the Final Regulations, a central air-conditioning system owned by a REIT may qualify as a structural component even if the REIT only holds a leasehold interest in the building served by the air-conditioning system.

The Final Regulations represent a mixed outcome for the renewable energy industry. An example within the Proposed Regulations provided that certain renewable energy assets, such as photovoltaic panels, would not qualify as IPSs because the conversion of solar energy to electricity is an active function. Treasury and the IRS rejected requests by commenters to deem certain solar energy assets to be real estate assets for public policy reasons, despite their active function. However, the Final Regulations were revised to permit REITs to own electricity generation systems for the limited purpose of offsetting their utility bills. Specifically, for REITs which own buildings that utilize rooftop photovoltaic panels or other electricity generation systems, the Final Regulations provide that the sale of excess electricity to a utility will not affect the qualification of such distinct assets as structural components, and such income generated will not be included in gross income for the purposes of REIT income tests or derived from a prohibited transaction, so long as such sales do not exceed the value of electricity purchased from the utility during the year.

The Final Regulations were modified to clarify that an intangible asset may be, in part, an interest in real property and, in part, an asset other than an interest in real property. To the extent there is value attributable to the portion of the lease that is an interest in real property, such portion is considered real property for REIT purposes. In response to industry comments, an example was added to the Final Regulations to illustrate the application of the Final Regulations to an in-place above-market lease that produces both income that qualifies as rents from real property under section 856(d)(1) and other income that does not so qualify.

Although the Final Regulations are intended to be a clarification of existing law, as opposed to a modification, the preamble provides that any PLRs which are inconsistent with the Final Regulations are revoked prospectively. Accordingly, REITs which have obtained PLRs concerning the status of assets as real property should consider whether the Final Regulations are consistent with such rulings.
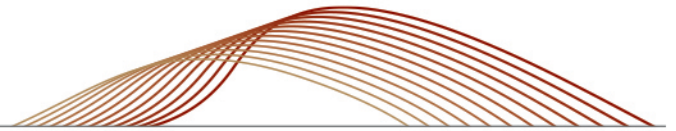
The Final Regulations are applicable for tax years that begin after August 31, 2016.

Taxpayers are permitted to rely on the Final Regulations for quarters ending prior to the applicability date.

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If you have any questions concerning these developing issues, please do not hesitate to contact any of the following Paul Hastings New York lawyers:

Andrew M. Short	James P. Grace
1.212.318.6018	1.212.318.6681
andrewshort@paulhastings.com	jamesgrace@paulhastings.com

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[1]   Treas. Reg. § 1.856-10 (T.D. 9784).

[2]   REG-150760-13, RIN 1545-BM05, 79 Fed. Reg. 27508 (5/14/14).

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

[4]   Code Section 856(c)(5)(B).

[5]   Treas. Reg. § 1.856-3(d).