

Treasury Issues Proposed Regulations Defining 'Real Property' for REIT Purposes

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On May 9, 2014, the U.S. Department of the Treasury (Treasury) released proposed regulations defining the term “real property” for purposes of the REIT rules. The proposed regulations, which provide a framework for taxpayers, practitioners and the government to analyze the REIT classification of assets, generally confirm the IRS’s conclusions with respect to assets addressed in prior rulings (and thus should enable REITs to invest in those assets without the need to obtain a ruling) but nevertheless leave unresolved some of the uncertainty that exists under present law.¹

Safe Harbor List

The proposed regulations, if finalized in their current form, would represent a step forward by enumerating a safe harbor list of assets that will automatically qualify as real property for purposes of the REIT rules, many of which were previously the subject of published and private IRS rulings. The assets that automatically qualify as real property under the proposed regulations include:

- Microwave, cell, broadcast, and electrical transmission towers
- Telephone poles
- Parking facilities
- Bridges, tunnels, and roadbeds
- Transmission lines
- Pipelines
- Offshore drilling platforms
- Stationary docks
- Certain outdoor advertising displays
- Railroad tracks

Facts-and-Circumstances Analysis

If an asset does not fall within a safe harbor, its status as real estate will turn on a facts-and-circumstances analysis that focuses largely on the asset’s movability (or lack thereof) and passiveness (or activeness), as well as the nature of the income generated by the asset. The regulations provide a list of factors that must be analyzed to apply the facts-and-circumstances approach. If an asset is immovable and passive (e.g., merely supports or provides shelter for another asset but does not produce a product or convert one thing into another) and produces income solely in the form of consideration for the use of space, it will generally qualify as real property. By contrast, if an asset is easily movable or sufficiently active or produces income from the operation of a business, it will generally not be classified as real estate. We have long believed, based on previous PLRs and experience with the REIT PLR process, that this was the proper framework in which to analyze the REIT classification of an asset. Not surprisingly, however, the facts-and-circumstances test is difficult to apply in situations where an asset exhibits factors that are properly characterized in opposite categories. For these assets, much of the uncertainty that exists under current law is retained in the facts-and-circumstances test of the proposed regulations.

¹ For a further discussion on private letter rulings (PLRs) and REIT transactions, see “IRS Completes Review of REIT Ruling Standards and Resumes Issuing Rulings” (Nov. 15, 2013), available at <http://www.skadden.com/insights/irs-completes-review-reit-ruling-standards-and-resumes-issuing-rulings>.

To illustrate the application of the facts-and-circumstances test, the regulations contain a number of examples. In one pair of interesting examples, the Treasury addresses solar panels. The first of these examples addresses solar panels whose power is primarily sold to third parties, such as the panels that make up a typical solar farm. This example concludes that the panels are not real property because they perform an active function of converting sunlight into electrical energy and produce business income from the sale of energy to third parties. By contrast, the second of these examples addresses solar panels used primarily as a source of power for an adjacent office building, where both the panels and the office building are owned by the same REIT. This second concludes that the panels are real property because they were designed specifically to provide, and in fact primarily did provide, power to a rental building owned by the same REIT that owned the panels. The panels were thus viewed as a structural component of the building.

The solar panel examples highlight one curious feature of the proposed regulations: one of the factors that must be considered under the regulations when determining whether an asset is a structural component of another piece of real property such as a building is whether the same person is the legal owner of both the component and the related building. Thus, one of the factors cited by the Treasury for its conclusion in the second solar panel example was that the REIT owned both the panels and the office building that used the power produced by those panels. The focus on common ownership is new to the regulations. Although the ownership of an asset may be a factor that merits consideration in some cases, the character and use of an asset should receive greater weight in determining whether an asset is real property.

Another interesting example in the proposed regulations deals with an oil pipeline system. The example concludes that, based on the facts-and-circumstances, vents and valves located throughout the system are part of the real estate but meters and compressors are not, seemingly on the basis that the vents and valves serve a passive function of allowing the pipeline to store or contain oil, whereas the meters and compressors serve an active function of transporting oil.

Even though a pipeline and a building are both clearly real property under the proposed regulations, the above examples illustrate how the Treasury's analysis of a particular asset can depend on the type of real property (*i.e.*, building or non-building) to which that asset is related. In the case of assets attached to, or otherwise related to, a building (such as a solar panel dedicated to a particular building), the Treasury seems much more willing to treat those assets as real property, even though they may perform what the regulations describe as an "active" function of converting sunlight into electrical energy. If, however, an analogously active asset is part of a non-building piece of real property — such as a meter or compressor used in a pipeline — the regulations seem to require more scrutiny of the particular functions served by that particular asset (whether "passive" or "active"), with the result that these types of assets are less likely to be treated as real property.

Ancillary Issues Not Addressed by the Regulations

Although the regulations address the important question of what it means to be real property, they do not address certain ancillary issues that will be relevant to REITs that wish to invest in some of the assets that qualify as real property under the regulations. For example, the regulations are helpful to REITs that wish to invest in infrastructure — such as tunnels, bridges, roadbeds, transmission lines, pipelines, offshore drilling platforms, silos, and oil and gas storage tanks — insofar as the regulations clarify that these assets are real property. However, the regulations do not specify what types of income from the operation of these types of assets will constitute "rents from real property." In other words, while the regulations are helpful to a REIT that wishes to lend against these types of infrastructure assets or triple net lease them to a third-party operator, they do not provide guidance to a REIT that wants to operate the assets for its own account.

Conclusion

The proposed regulations represent a helpful step forward for the REIT industry. By providing certainty on the classification of a variety of assets, the regulations will simultaneously level the playing field among similarly situated real estate entities and should free up much needed resources inside the IRS. Perhaps more importantly, the regulations acknowledge that the REIT industry has become more specialized over time as the needs of tenants have evolved, and that specialization and evolution are not inconsistent with qualification as real property. Instead, the Treasury has responded to the trends of specialization and evolution by providing an articulable set of standards and rules that taxpayers and the government can analyze to determine whether an asset is or is not real estate. The regulations simultaneously embrace the past and lay the groundwork for the future development and evolution of the REIT industry. Although the facts-and-circumstances-standard leaves significant uncertainty as to how to weigh competing factors, the safe harbor lists and examples provide significant and generally applicable clarity for many industries in, and considering entering, the REIT space.