OCTOBER 2016
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AN ALERT FROM THE BDO FEDERAL TAX PRACTICE

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SUBJECT

NEW FINAL REGULATIONS CLARIFY THE DEFINITION OF REAL PROPERTY FOR PURPOSES OF THE REAL ESTATE INVESTMENT TRUST PROVISIONS

SUMMARY

On August 30, 2016, Treasury issued final regulations (T.D. 9784) that clarify the definition of real property for purposes of the real estate investment trust ("REIT") provisions of the Internal Revenue Code ("Code"). The final regulations adopt the proposed regulations that were issued on May 14, 2014 (REG-150760-13), with some modifications, and replace the definition of real property in prior Reg. Section 1.856-3(d).

The rules in the new Treas. Reg. Section 1.856-10 are generally intended to be a clarification of current law rather than create new standards. Real property is defined as land and improvements to land. Improvements to land include inherently permanent structures and structural components of inherently permanent structures that have a passive function. In certain circumstances, intangible assets may also be defined as real property.

The final regulations list a number of safe harbor assets that will be treated as real property for purposes of Section 856. If a particular asset is not listed, the regulations provide factors that must be used to determine whether a distinct asset qualifies as real property based on all the facts and circumstances surrounding the asset. Examples are provided to illustrate how to apply the regulations.

The definition of real property contained in the new regulations is limited to Code Sections 856 through 859, and is not controlling for any other section of the Code unless there is a specific reference in another section of the Code or Regulations that directs application of the new regulations.

The regulations are effective for taxable years beginning after August 31, 2016. However, taxpayers are permitted to rely on the final regulations for periods beginning on or before the applicability date.

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DETAILS

Definition of Real Property - Background

In order for a taxpayer to qualify as a REIT, at least 75 percent of the value of its total assets has to represented by real estate assets, cash, and cash items (including receivables), and government securities at the close of each quarter of the taxable year. Real estate assets are defined by the Code to include real property, including interests in real property and interests in mortgages on real property. Interests in real property is defined to include fee interests and co-ownership of "land or improvements thereon."

Prior to the issuance of these final regulations, Treas. Reg. Section 1.856-3(d) promulgated in 1962 defined real property for purposes of the REIT provisions 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)." The prior regulation also stated that the local law definition of the term "real property" was not controlling for the REIT provisions.

The IRS issued a series of revenue rulings between 1969 and 1975 addressing whether certain assets qualify as real property for purposes of Section 856. The IRS has also issued various private letter rulings ("PLRs") to REITs that have invested in types of assets that are not directly addressed by the regulations or the published rulings. However, PLRs may not be relied on by taxpayers other than the taxpayer that received the ruling and are limited to their particular facts.

The limited published authority has created uncertainty around the definition of real property for purposes of the REIT tests. Therefore, Treasury and the IRS realized there was a need to provide updated guidance which ultimately resulted in the issuance of these final regulations.

The final regulations modify Reg. Section 1.856-3(d) by referencing new Reg. Section 1.856-10 for the definition of real property.

Real Property

New Treas. Reg. Section 1.856-10 (b) states that the term real property means land and improvements to land. As under the former definition, the local law definitions of real property are not controlling in determining the meaning of the term real property for the REIT provisions of the Code.

The regulations require that each distinct asset be analyzed separately to determine if the asset is real property. Therefore, it is necessary to first determine whether a property consists of one or more distinct assets prior to applying the rules in the regulation.

The determination of whether a particular separately identifiable item of property is a distinct asset is based on a facts and circumstances test. The following four factors must be taken into account in order to determine whether an asset is a distinct asset:

i. Whether the item is customarily sold or acquired as a single unit rather than as a component part of a larger asset;

ii. Whether the item can be separated from a larger asset, and if so, the cost of separating the item from the larger asset;

iii. Whether the item is commonly viewed as serving a useful function independent of a larger asset of which it is a part; and

iv. Whether separating the item from a larger asset of which it is a part impairs the functionality of the larger asset.

Once each distinct asset is identified, the other provisions of the final regulations are applied to determine whether the property qualifies as real property.

Land and Improvements To Land

Land is defined by the new regulations to include not only the land itself, but also the water and air space superjacent to land and natural products and deposits that are unsevered from the land. Once natural products and deposits (such as crops, water, ores, and minerals) are severed, extracted, or removed from the land, they cease to be real property. The mere storage of severed or extracted natural products or deposits in or on real property does not cause the stored property to be recharacterized as real property.

The regulations divide improvements to land into inherently permanent structures ("IPS") and their structural components.

Inherently Permanent Structures

An IPS is any permanently affixed building or other permanently affixed structure. The affixation is considered permanent if the affixation is reasonably expected to last indefinitely (based on all the facts and circumstances). Affixation may be to land or to another IPS, and may result by weight alone. The preamble to the regulations clarifies that the Treasury Department and the IRS do not intend the term "indefinitely" to mean forever.

The IPS must have a passive function. A distinct asset that serves an active function, such as an item of machinery or equipment, is not a building or other IPS for purposes of the regulations, even if it is permanently affixed.

Buildings

A building is defined as a structure that encloses a space within its walls and is covered by a roof. The regulations provide the following safe harbor list of assets that (if permanently affixed) will qualify as buildings: houses. apartments, hotels, motels, enclosed stadiums and arenas, enclosed shopping malls, factory and office buildings, warehouses, barns, enclosed garages, enclosed transportation stations and terminals, and stores.

If a structure fails to qualify as a building, then it may still meet the definition of an other inherently permanent structure ("OIPS"). For example, a structure that is not completely enclosed or that does not have a roof, such as an outdoor sports stadium or an unenclosed parking garage, do not qualify as buildings, but they may still qualify as an OIPS and, therefore, would still be real property under the final regulations.

Other Inherently Permanent Structures

An OIPS is a permanently affixed structure that does not meet the definition of a building, and serves a passive function. Examples of passive functions are to contain, support, shelter, cover, protect, or provide a conduit or a route. An OIPS cannot serve an active function, such as to manufacture, create, produce, convert, or transport.

The regulations provide the following safe harbor list of distinct assets which (if permanently affixed) are considered OIPSs: 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 and oil and gas storage tanks; and stationary wharves and docks. OIPSs also include outdoor advertising displays for which an election has been properly made under section 1033(g)(3).

If a distinct asset does not serve an active function and is not listed in the regulations (or in guidance published in the Internal Revenue Bulletin) as one of the safe harbor buildings or OIPSs, then the determination of whether that asset is an IPS is based on a facts and circumstances test. In making that determination, the following factors must be taken into account:

(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 (for example, 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.

Structural Components

The term structural component is defined by the regulations as any distinct asset that is a constituent part of and integrated into an IPS and serves the IPS in its passive function. Additionally, a structural component cannot produce or contribute to the production of income other than consideration for the use or occupancy of space, even if capable of producing such income. If interconnected assets work together as a system to serve an IPS (for example, electricity, heat, or water systems), the assets are analyzed together as one distinct asset to determine if it is a structural component.

A structural component will only qualify as real property if the REIT holds its interest in the structural component together with the real property served by the structural component. For example, under the final regulations, the heating, ventilation, and air conditioning ("HVAC") system of a building will only qualify as real property if the REIT also owns a real property interest in the IPS served by the HVAC system. Likewise, 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 IPS served by the structural component. Additionally, if a distinct asset is customized in connection with the rental of space in an IPS, the customization does not affect whether the distinct asset is a structural component.

The regulations provide a safe harbor list of structural components, which includes the following distinct assets and systems (if integrated into the IPS and held together with the real property): 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; security systems; and humidity control systems.

If an interest in a distinct asset is not listed as a safe harbor structural component in the regulations (or in guidance published in the Internal Revenue Bulletin), the determination of whether that asset is a structural component is based on a facts and circumstances test. The following factors must be taken into account in that determination:

(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 IPS to which it is affixed;

(D) Whether the distinct asset serves a utility-like function with respect to the IPS;

(E) Whether the distinct asset serves the IPS in its passive function;

(F) Whether the distinct asset produces income from consideration for the use or occupancy of space in or upon the IPS;

(G) Whether the distinct asset is installed during construction of the IPS; and

(H) Whether the distinct asset will remain if the tenant vacates the premises.

Intangible Assets

The final regulations provide that an intangible asset is real property or an interest in real property to the extent the intangible asset (1) derives its value from real property or an interest in real property, (2) is inseparable from that real property or interest in real property, and (3) 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 that is solely for the use, enjoyment, or occupation of land or an IPS and that is in the nature of a leasehold or easement generally is 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.

Effective Date

The final regulations apply for taxable years beginning after August 31, 2016**.** Taxpayers may rely on the final regulations for quarters that end before the applicability date.

BDO INSIGHTS

- The final regulations will likely not affect REITs that own traditional types of rental properties which generally include office, retail, industrial, multifamily and hotel properties.
- REITs that own more non-traditional assets, such as infrastructure assets, should analyze the property they own to confirm property it owns will continue to qualify as real property under the final regulations. Examples provided in the regulations illustrate a number of assets that may be treated as real property in certain situations. Such property includes:
  - Fruit-bearing plants
  - Boat slips and end ties
  - Indoor sculptures
  - Cold storage warehouse assets
  - Certain data center assets
  - Certain solar energy assets
  - Certain pipeline transmission assets
  - Land use permit
- If a REIT has received a PLR on whether particular items qualify as real property, the REIT needs to review the final regulations to determine whether the PLR is consistent with the final regulations. To the extent that the PLR is inconsistent with the final regulations, the PLR is revoked prospectively from the effective date of the final regulations.
- To the extent that any REIT asset does not qualify as real property, the REIT will need to determine whether it is necessary to dispose of the property prior to the effective date of the regulations in order to comply with the REIT's quarterly asset tests.