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PLRs: IRS acceptance of non-traditional real property (such as fiber optic cable) for REIT income tests

The IRS publicly released a pair of private letter rulings* concluding that amounts received by the taxpayer under certain arrangements for the right to the taxpayer's fiber optic cable would qualify as "rents from real property" for purposes of the income tests imposed on real estate investment trusts (REITs).

The IRS ruled that under any of the identified arrangements, the right to use a fiber optic cable may be exclusive to a user via designated or specified strands, dedicated wavelengths or capacity in one or more specified or unspecified strands over a specifically identified route, or a dedicated portion of the capacity of an identifiable fiber optic cable.

The IRS also ruled that for purposes of determining whether the "property" leased to taxpayer's "taxable REIT subsidiary" (TRS) is less than 10% of leased space of the "property" under the limited rental exception, it could be based on capacity over the taxpayer's continuously connected fiber optic cable within a specifically identified geographic region of its fiber network.

Read **PLR 202133003** [PDF 111 KB] (release date August 20, 2021, and dated February 5, 2021)

Read **PLR 202132002** [PDF 111 KB] (release date August 13, 2021, and dated February 5, 2021)

*Private letter rulings are taxpayer-specific rulings furnished by the IRS Office of Chief Counsel in response to requests made by taxpayers and can only be relied upon by the taxpayer to whom issued. Pursuant to section 6110(k)(3), written determinations such as private letter rulings are not intended to be relied upon by third parties and may not be cited as precedent. These written determinations may, however, offer an indication of the IRS's position on the issues addressed.

KPMG observation

These letter rulings evidence the IRS's continuing acceptance that when it comes to non-traditional "real property"—such as pipelines, transmission lines, and fiber optic cables, each of which is capable of being used by multiple users concurrently—exclusivity can be achieved via specified capacity. After all, similar to an office building (whose rentable area is limited) or a cold storage facility (whose storage capacity is limited), each of these other non-traditional assets also has a limited capacity that can be shared among concurrent users. Read also PLRs 202132002, 202035008, 201907001, 201901001, 201741002, and 201450017.

These letter rulings also confirm that for purposes of the limited rental exception, pursuant to which rents from a "related" TRS can be treated as qualifying if at least 90% of the leased "property" is rented to unrelated tenants, the "property" can be based on a geographic region of taxpayer's fiber network rather than specific cables or routes. This interpretation enables a REIT to utilize its TRS for potential arrangements with customers that may not clearly meet the "exclusivity" requirement. The benefit of this interpretation could even be more meaningful if proposals to increase the limited rental exception from 10% of the leased space of the property to 50% are enacted. For instance, refer the proposals in **H.R. 840** (introduced February 2021).

It is interesting to note that the conclusions in PLR 202133003 are substantially similar to those in PLR 202132002, with the seemingly minor exception that the taxpayer in PLR 202133003 was organized as a corporation while the taxpayer in PLR 202132002 was organized as a limited liability company. Both letter rulings were issued by the IRS to the taxpayers on the same date (February 5, 2021) and in response to ruling requests submitted on the same date (July 30, 2020).

Furthermore, both taxpayers are indirect subsidiaries of an existing REIT and intended to make an election to be taxed as REITs.

Also note that the conclusions in both recent letter rulings are very similar to the position that the IRS reached in PLR 201901001—except that in PLRs 202133003 and 202132002, the IRS addressed one additional "use" arrangement (i.e., the "bifurcated lease") and these requested that the IRS rule on the limited rental exception.

PLR 202133003

In PLR 202133003, the taxpayer is a corporate subsidiary of a REIT that intended also to elect the REIT status. The taxpayer leases systems composed of permanently affixed coaxial and fiber optic cable, and indoor and outdoor "distributed antenna systems" (DAS) or small cell systems to organizations, including wireless carriers and other telecommunication providers. The letter ruling included a taxpayer's representation that these assets are real property for purposes of the REIT rules and the following description:

> *A fiber optic cable is composed of ultra-thin strands of glass surrounded by layers of insulating materials, including cladding (together, "strands"). Many strands are aggregated into a single fiber optic cable. Multiple fiber optic cables are combined and contained in rigid conduit piping and are typically buried between two and four feet underground, or are permanently attached to above ground structures (e.g., utility poles).*
>
> *A single strand of fiber has two glass components – the core and the cladding, which together are about as thin as a typical human hair. An optical converter projects a beam of light down the glass core; the light reflects off the glass cladding as it travels down the fiber strand.* ***Since each strand can transport signals of different wavelengths simultaneously, multiple customers can use the same strand by having separately designated wavelengths.*** *[Emphasis added]*

The letter ruling then describes the following six contractual agreements, each of which allows a tenant to use its contracted capacity on its identified pathway during the term of an agreement:

- DAS Agreement: Under a DAS Agreement, the tenant has the exclusive right to use either a designated number of individual strands or a dedicated wavelength within the fiber optic pathway of a DAS installation.
- Indefeasible Rights of Use Agreements (IRUs): Under an IRU, the tenant has the exclusive right to use all of the wavelengths (or capacity) in one or more specified strands within a fiber optic cable over a specifically identified route for the term of the lease.

- Capacity Lease: Under a Capacity Lease, the tenant has an exclusive right to use a specified subset of all the wavelengths (or capacity) within a strand located in a fiber optic cable over a specifically identified route for the term of the lease.
- Wave Lease: Under a Wave Lease, the tenant has an exclusive right to use a dedicated wavelength in a strand within the fiber optic cable over a specifically identified route for the term of the lease. The tenant under a Wave Lease, however, does not have a right to a specifically identified strand, or wavelength within a strand, in a fiber optic cable, unlike a tenant of an IRU or a Capacity Lease.
- Backhaul Lease: Under a Backhaul Lease, the tenant has an exclusive right to use all or a dedicated portion of the capacity of an identifiable fiber optic cable over a specifically identified route from a cell tower to a collection point for the term of the lease. Under certain Backhaul Leases, the tenant does not have an exclusive right to a specifically identified wavelength on a strand within the fiber optic cable; however, the tenant has the exclusive right to either all of the capacity of a particular number of unidentified strands or to a dedicated portion of the capacity within a strand of a fiber optic pathway. Signals of different tenants are not intermingled. The tenant will own and operate a mobile switching center and base station equipment for the generation of the initial digital signal, as well as the ultimate receipt of the signal.
- Bifurcated Lease: Under a Bifurcated Lease, the tenant has an exclusive right to use a dedicated portion of the capacity of fiber optic cable owned by the taxpayer over a set of specifically identified routes, with the taxpayer transferring the tenant's signals to a third party at the termination of the taxpayer's owned or leased interests. The tenant's signal will start at the tenant's premises and follow a dedicated fiber optic pathway owned by the taxpayer to equipment (which will be monitored, operated, managed, maintained and repaired by either a TRS or an "independent contractor" (IK) for an arm's length fee) that will direct the tenant's signal along one of up to seven dedicated fiber optic pathways owned by the taxpayer. Where the fiber optic pathway owned by the taxpayer terminates, for example at a data center owned by a third party, a TRS or an IK will transfer the tenant's signal to a server owned by an unrelated party. The taxpayer will compensate either the TRS or IK with an arm's length fee for performing this service. Signals of different tenants are not intermingled at any time.

Supporting its ruling that amounts under the above agreements would qualify as rents from real property, the IRS reasoned in part:

> *Agreements typically involves a term of a years to b years, and no Agreement is for less than c years. Each Agreement requires a fixed, recurring amount to be paid by the Tenant during the term of the Agreement. In addition, under DAS Agreements, as well as under certain IRUs and Capacity Leases, the Tenant generally pays an upfront amount in addition to a recurring amount. The Tenant is required to pay for the contracted usage, regardless of the Tenant's actual usage, and Taxpayer ensures that the Tenant has access to its contracted usage during the terms of an Agreement.*

The taxpayer in the ruling also intended in certain circumstances to lease capacity on its fiber optic cable to its TRS. The taxpayer represented that the TRS will lease less than 10% of the leased capacity as measured within an area, which is a specifically identified geographic region of taxpayer's fiber network. The taxpayer designated areas to facilitate the operation of its continuously connected fiber across the country. An area is comprised of a geographic footprint that allows an assigned team of field employees to focus on local customer and service needs. An area is generally designed so that every part of the area is within a reasonable driving distance, but is also limited by total fiber miles within the region so that the assigned team of field employees can effectively service the entire region. As a result, a more fiber-dense region would have an area covering fewer total square miles than one with more dispersed fiber strands.

With respect to the lease to the TRS, section 856(d)(8)(A) (or the limited rental exception) provides that amounts paid to a REIT by its TRS are not excluded from "rents from real property" by reason of the TRS being related to the REIT if, with respect to any property, at least 90% of the leased space of the property is rented to persons other than the REIT's TRSs and other than related persons. The taxpayer represented that the capacity leased to its TRS under an agreement will be the same type of capacity that is leased to unrelated third parties under the agreements. The taxpayer also represented that the capacity leased to the TRS and to unrelated persons under the agreements is measured within the applicable area, based on the above methodology.

The IRS ruled that, for purposes of the limited rental exception, the property with regard to taxpayer's fiber optic cable is the continuously connected fiber optic cable within the geographic boundaries of the applicable area.

For more information, contact a tax professional with KPMG's Washington National Tax:

Stephen Giordano | +1 (202) 533-3535 | stephengiordano@kpmg.com

David W. Lee | +1 (202) 533-4071 | dwlee@kpmg.com

kpmg.com/socialmedia

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