



TaxNewsFlash

United States

No. 2016-387
August 30, 2016

Final regulations: Definitions of “real property” for REITs

The Treasury Department and IRS today released for publication in the Federal Register final regulations (T.D. 9784) that clarify the definition of real property for purposes of real estate investment trusts—REITs.

The [final regulations](#) [PDF 382 KB] adopt regulations as proposed in May 2014 with revisions being made in response to comments received concerning the proposed regulations.

Background

The IRS issued revenue rulings between 1969 and 1975 addressing whether certain assets qualify as real property for purposes of section 856—e.g., assets such as railroad properties, mobile home units permanently installed in a planned community, air rights over real property, interests in mortgage loans secured by total energy systems, and mortgage loans secured by microwave transmission property. The revenue rulings addressed whether the assets qualify as either real property or interests in real property under section 856.

Subsequently, REITs sought to invest in various types of assets that were not directly addressed by the regulations or the published revenue rulings, and asked for and received private letter rulings from the IRS addressing certain of these assets. Because private rulings are limited to their particular facts and may not be relied upon by taxpayers other than the taxpayer that received the letter ruling, these were not substitutes for published guidance.

The IRS and Treasury recognized the need to provide additional published guidance on the definition of real property under sections 856 through 859. Therefore, regulations were proposed in May 2014 to define real property for purposes of sections 856 through 859 by providing a framework to analyze the types of assets in which REITs seek to invest. The proposed regulations defined “real property” to

include land and improvements to land (i.e., inherently permanent structures and their structural components).

In determining whether an item is an inherently permanent structure, or a structural component, the proposed regulations first test whether the item is a distinct asset (which is the unit of property to which the definitions in these proposed regulations apply).

In addition, the proposed regulations:

- Identified certain types of intangible assets that are real property or interests in real property for purposes of sections 856 through 859
- Included examples to illustrate the application of the principles of these proposed regulations to determine whether certain distinct assets are real property for purposes of sections 856 through 859

Final regulations

The preamble to the final regulations explains the comments received by the IRS and Treasury about the proposed regulations and whether the comments were adopted or rejected. The final regulations provide or clarify:

- The definition of land to include air space or water space superjacent to land as qualifying as land even if the taxpayer owns only the air space or water space and not an interest in the underlying land.
- Improvements to land, like landscaping or shrubs planted in the ground, are within the definition of land as long as the shrubs remain unsevered natural products of the land (whereas a bench that is a distinct asset would be analyzed under the factors for an “inherently permanent structure”).
- In determining whether an “inherently permanent structure” (IPS) or “other inherently permanent structure” (OIPS) satisfies the passive function requirement (to contain, support, shelter, cover or protect and not an active function such as manufacture, create, produce, convert or transport), the final regulations retain the standard from the proposed regulations. Yet, in response to comments the final regulations clarify that the term “transport” could be interpreted to be both passive conduits used for transportation and machines that push or pull items through a conduit, and thus provide that a conduit (e.g., a pipeline or electrical wire) or route (like a road or railroad track) could be a permitted passive function.
- The definition of “building” in the proposed regulations is retained, and the preamble notes that outdoor sports stadiums, amphitheatres, and unenclosed parking garages would satisfy the definition of an OIPS. The final regulations add motels, enclosed stadiums and arenas, and enclosed shopping malls as examples of buildings.
- The term “indefinitely”—that is, to qualify as an IPS, an asset must be permanently affixed and expected to last indefinitely—does not mean forever,

but is based on all the facts and circumstances with a primary focus on the nature of the distinct asset and the affixation.

- A safe harbor or blanket rule for distinct assets that provide utilities to IPSs was not adopted in the final regulations. Rather, the factors listed in Reg. section 1.856-10(d)(3)(iii) for structural components are deemed important to the analysis of systems that provide a utility-like function.
- The final regulations provide that a distinct asset qualifies as a structural component if the REIT hold its interest in the structural component together with a real property interest with respect to the space in the IPS that the structural component serves. For example, a central air-conditioning system is a machine that does not separately qualify as an IPS.
- The final regulations did not adopt suggestions from commenters to add to the list of types of distinct assets that would qualify as buildings, OIPs, and structural components. As the preamble explains, these suggested assets were either already included or would not in all cases satisfy the definition. For example, the preamble notes that energy storage components, solar photovoltaic (PV) panels, related wiring and functionally related transformers, power conditioning equipment, and electrical power inverters and related wiring do not serve a passive function and thus are not considered OIPs.
- With respect to factors for determining whether the owner of property was also the legal owner of the distinct asset, the final regulations require that for a distinct asset to be a structural component, a REIT must hold a legally enforceable real property interest in the space in the IPS that the structural component serves.
- The final regulations clarify that intangible assets that are related to services (commenters had suggested the inclusion of workforce-in-place and customer-based intangibles) and that are separable from the real property do not qualify as real property.
- The final regulations have been 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. An example is provided illustrating the application of this rule 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 qualify.
- Renewable energy credits do not qualify as intangible real property assets under the final regulations because they may be sold separately from any real property to which they relate.
- Concentrating solar power systems and associated assets are not added to the list of qualifying assets in the final regulations.

The final regulations also reflect changes to certain examples provided in the proposed regulations. For instance:

- Examples provide in the proposed regulations concerning a REIT that enters into a long-term, triple-net lease of property (the assets were net leased to avoid any potential implications that the REIT is operating the property) are

revised to clarify that the REIT neither operates the property nor provides services to the lessee.

- Example 10 has been revised to illustrate a pipeline may serve the passive function of providing a conduit, may have assets (e.g., vents, valves, pressure regulation stations) that may be identified as structural components.
- Example 11 of the proposed regulations concerning goodwill established under GAAP due to acquisition of stock of a corporation that owned a hotel has been removed because depreciation replacement cost is no longer the standard under GAAP for valuing property such as the hotel.
- Other suggested changes to the 13 examples were not adopted in the final regulations.

The preamble to the final regulations notes that the IRS and Treasury are considering whether additional guidance is needed to address the circumstances under which a distinct asset that serves as an IPS may produce electricity that is also sold to third parties (i.e., net metering) and qualify as a structural component of the IPS for REIT purposes. The final regulations provide guidance in such instances until the IRS issues other guidance in the Internal Revenue Bulletin.

Effective date

The final regulations apply to tax years that begin after the date of publication in the Federal Register (i.e., August 31, 2016). Also, taxpayers are permitted to rely on the final regulations for periods beginning on or before the applicability date because according to the preamble these regulations are generally “a clarification of current law.” Further, today’s release clarifies that a previously issued letter ruling that is inconsistent with these regulations is revoked prospectively from the applicable date of the final regulations.

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