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Definition of Real Property for REIT Qualification

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Qualification as a real estate investment trust ("REIT") requires that at least 75 percent of an entity's assets consist of real estate assets, one of the components of which is real property. Consolidating decades of published and private rulings, the Treasury and IRS issued final regulations on April 16, 2016, defining real property for purposes of REIT qualification. As local law definitions are not controlling for this purpose (i.e., real property with respect to REITs is defined solely in the regulations), the regulations are extremely important in determining whether an entity qualifies to be taxed as a REIT. The regulations provide both safe harbors for certain types of property and a framework for analyzing whether other types of property qualify as real property.

The regulations divide real property into three broad categories – (i) land, (ii) inherently permanent structures, which includes buildings and "other" inherently permanent structures, and (iii) structural components. The regulations also address the treatment of certain intangibles as real property or an interest in real property.

Land

Land includes water and air space "superjacent" to land (such as boat slips), and natural products and deposits that are unsevered from the land (e.g., fruit bearing plants). However, such natural products and deposits, such as crops, water, ores, and minerals cease to be real property when they are severed, extracted or removed from the land.

Buildings

A building is a structure with walls and a roof. Types of buildings that qualify as real property (in addition to residence type structures, such as houses and hotels/motels), include enclosed stadiums and arenas, enclosed shopping malls, factory and office buildings, warehouses, barns, enclosed garages, enclosed transportation stations and terminals, and stores. Under a facts and circumstances test, a 5-ton indoor sculpture in the atrium of a building is an inherently permanent structure and therefore real property. However, bus shelters that are bolted to the sidewalk can be disassembled in less than a day and moved, are not permanently affixed and are thus not inherently permanent structures and not real property.

"Notably, a structural component qualifies as real property only if the REIT holds its interest in the structural component together with a real property interest in the space in the inherently permanent structure served by the structural component."

Other inherently permanent structures

Types of other inherently permanent structures ("safe harbor inherently permanent structures") that qualify as real property include 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, stationary wharves and docks and certain outdoor advertising displays. An "other" inherently permanent structure must serve a "passive" function, such as to contain, support or cover and not an "active" function, such as to manufacture, create, produce, convert or transport; a conduit or route qualifies as passive. If an asset is not a safe harbor inherently permanent structure, and does not serve an active function, it must be analyzed under a facts and circumstances test as a "distinct asset." The main factor to be considered is the permanency of the asset and whether it is designed to be removed or remain in place "indefinitely" (but not forever). Some examples of other inherently permanent structures include cold storage warehouses and data centers. Specific factors must be taken into account to determine whether the asset qualifies as an inherently permanent structure: (A) the manner in which the distinct asset is affixed to real property; (B) whether the asset is designed to be removed or remain in place indefinitely; (C) the damage that removal of the asset would cause to the asset itself or the real property to which it is affixed; (D) circumstances that might suggest the expected period of affixation is not indefinite (e.g., a lease that requires or permits removal of the asset upon expiration of the lease); and (E) the time and expense required to move the asset. Satisfaction of all the factors is not required; a balancing of the factors is necessary.

Structural components

A structural component is any distinct asset that (i) is a constituent part of and integrated into an inherently permanent structure, (ii) serves the inherently permanent structure in its passive function, and, (iii) even if capable of producing income other than consideration for the use or occupancy of space, does not produce or contribute to the production of such income. Interconnected assets that work together to serve an inherently permanent structure in a utility-like function (such as systems that provide a building with electricity, heat or water) are analyzed together as one distinct asset that may be considered a structural component. Notably, a structural component qualifies as real property only if the REIT holds its interest in the structural component together with a real property interest in the space in the inherently permanent structure served by the structural component. Types of structural components ("safe harbor structural components") include wiring, plumbing systems, HVAC systems, elevators and 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.

A mortgage secured by a structural component qualifies as a real estate asset only if the mortgage is also secured by a real property interest in the inherently permanent structure served by the structural component. The customization of a distinct asset in connection with the rental of space in or on an inherently permanent structure to which the asset relates does not affect whether the distinct asset is a structural component. If an interest in a distinct asset is held together with a real property interest in the inherently permanent structure served by the distinct asset and is not a safe harbor structural component, a facts and circumstances test is applicable. The following factors must be taken into account: (A) the manner, time and expense of installing and removing the distinct asset; (B) whether the distinct asset is designed to be removed; (C) the damage that removal of the asset would cause to the asset itself or the inherently permanent structure to which it is affixed; (D) whether the distinct asset serves a utility-like function with respect to the inherently permanent structure; (E) whether the distinct asset serves the inherently permanent structure in its passive function; (F) whether the distinct asset produces income from consideration for the use of occupancy of space in or upon the inherently permanent structure; (G) whether the distinct asset is installed during construction of the inherently permanent structure; and (H) whether the distinct asset will remain if the tenant vacates the premises. Some examples of structural components are conventional, but not modular (movable) partitions, isolation valves and vents and pressure control and relief valves (but not meters and compressors) in a natural gas pipeline transmission system, and the electrical system and telecommunication system in a data center. Similar to the analysis under inherently permanent structures, a balancing of the factors is required.

Intangible Assets

In general, an intangible asset can qualify as real property (or as an interest in real property) if it derives its value from real property, is inseparable from that real property and does not produce or contribute to the production of income other than consideration for the use or occupancy of space. This includes an intangible asset under GAAP principles as a result of an acquisition of real property or an interest therein. An intangible such as a license or permit can qualify as an interest in real property if it is solely for the use, enjoyment or occupation of land or an inherently permanent structure and is in the nature of a leasehold or easement. On the other hand, 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. Thus, a special use permit (which is not a lease) from the government to place a cell tower on government land that allows the REIT permittee to lease space to various cell service providers, is an interest in real property, as the permit does not produce or contribute to the production of any income other than the REIT's receipt of rental payments. However, a license to operate a casino, which cannot be transferred to another location, is not a right for the use, enjoyment or occupation of the REIT's building but a license to engage in the business of operating a casino in the building. As such, it is not real property. An above-market lease can also qualify as real property to the extent of the value attributable to rents from real property. Thus, where 70 percent of the value of an above-market lease was attributable to income that qualified as rents from real property for the 75 percent and 95 percent gross income tests, and the remaining 30 percent of the value was attributable to income that did not qualify as rents from real property, the 70 percent portion of the value was an interest in real property, while the 30 percent portion was not (i.e., the 70 percent portion derives its value from real property, is inseparable from the real property and does not produce or contribute to the production of income other than consideration for the use or occupancy of space).

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