

REITS AND THE EXPANDING UNIVERSE OF “RENTS FROM REAL PROPERTY”

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A “Real Estate Investment Trust” (a “REIT”) is an entity that generally would be taxable as a corporation but that makes a special election to be taxable as a REIT. The benefit of REITs is that they generally are subject to only one level of tax. The downside to REITs is that they generally are subject to only one level of tax. The downside to REITs is that 75% of a REIT’s assets must consist of “real estate assets,” and at least 95% of a REIT’s income typically must consist of “rents from real property.” Treasury Regulations define “real property” to include “land or improvements thereon, such as buildings or other *inherently permanent structures*. . . .”¹ Recently, the IRS has issued several private letter rulings expanding this definition in the context of infrastructure assets.

In PLR 200725015, a REIT owned and leased a “system.” The REIT was not licensed to operate the system, and instead leased the system to an unrelated, licensed operator. The system consisted of “physically connected and functionally interdependent assets that serve as a conduit to allow [‘a’] created by a generation source to flow through the system to end-users.” The system was passive and did not include machinery that created or generated any ‘a’ or any other commodity. The system is understood to be an electricity transmission system.

The IRS found that the system was designed so that the components were physically and functionally interdependent, that it was not feasible to move all or any

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¹ Treas. Reg. § 1.856-3(d) (emphasis added).

substantial part of the system, and that each component of the system was intended to serve indefinitely and remain in place once affixed to other system parts or the underlying land. The IRS also found that the system was a passive conduit that allowed ‘a’ generated by another source to flow through the system to end-users. Thus, the IRS ruled that the system was an “inherently permanent structure” yielding rents from real property.

PLR 200937006 considered a similar system involving gas pipelines leased to an unrelated, licensed operator. The lessee owned all equipment to maintain and operate the system, and employed or contracted with all service and repair personnel necessary for maintenance and operation of the system. The system consisted of “physically connected and functionally interdependent assets designed for the distribution of Product within a local area.” No component of the system could be operated for its intended purpose without each of the other components of the system, and the system was designed and constructed to remain permanently in place. The system was passive and did not include any equipment that produced Product or any commodity. Generally, the system consisted of interests in land, pipes, pipelines, regulators, valves, meters, monitoring and control devices, and compressor stations.

The IRS found that the system was designed so that the components were physically and functionally interdependent, it was not feasible to move all or any substantial part of the system, each component of the system was intended to serve indefinitely and remain in place once affixed to other system parts, and the system was a passive conduit. Thus, the IRS concluded that the system was an inherently permanent structure and a real estate asset.

In PLR 201005018, “X”² leased a “Facility” to lessee, an unrelated entity. The Facility was a system of physically connected and functionally interdependent assets designed to receive, store, and distribute “Product.” No single component of the Facility could be effectively operated for its intended useful purpose without each of the other components of the Facility, and that the Facility was designed and constructed to remain permanently in place.

The major structural components of the Facility included (1) hoses, pipes, manifolds, valves, and an underground scale, (2) loading racks, (3) insulated heat traced pipes that were suspended above ground on a steel girder system affixed to the land, (4) pumps, valves, and vents affixed to the piping system, (5) storage tanks that were permanently affixed to the system and/or to the ground, (6) boilers that were permanently affixed to the system, (7) blending devices permanently affixed to the piping system, (8) buildings permanently affixed to the ground, (9) various interests in land, including easements, and (10) various driveways and roadways, docks, rail spurs, dikes, containment areas, and security fencing. The IRS ruled that the Facility was an inherently permanent structure and real property under Code Section 856(d).

In PLR 201129007, a REIT owned wireless and broadcast communication towers that it leased pursuant to long-term leases. The REIT’s interests in the tower sites were comprised of a variety of ownership interests, including fee interests, leaseholds, easements, licenses, and rights-of-way. Tower sites consisted of a compound enclosing the tower site, a tower structure, one or more equipment shelters that housed transmitting, receiving, and switching equipment, and possibly a backup generator permanently installed at the tower site, as well as certain fences and buildings. The base of the tower

² Although “X” was a publicly traded partnership (“PTP”) and not a REIT, the rents from real property test is the same for both.

was bolted and welded to a concrete base set upon pilings driven deep into the ground for anchoring. Most of the personal property at a tower site, such as antennas, wiring, power supply, and switching equipment was owned separately by the lessees.

The IRS found that the towers were “constructed to remain permanently in place, cannot be readily moved, are unlikely to be moved, and are not intended to be moved.” Because of the method of construction and permanency of the towers, the IRS ruled that the towers and their sites (including fencing, shelters, and permanently installed backup generators) were inherently permanent structures and real estate assets for purposes of Code Section 856(c).

In PLR 201250003, “X”³ leased an offshore platform and related machinery and equipment installed on the platform to an unrelated lessee. The facility consisted of an offshore oil platform located in deep water. It consisted of three sections: (a) a vertical hull, (b) a topside section attached to the hull, and (c) a mooring system to permanently attach the facility to the seabed. The three sections were constructed to be permanently connected and operated as a single structure. The structure was intended to remain in place indefinitely, and no similar off-shore platform had ever been moved. No portion of the platform extracted crude oil from undersea wells; instead, additional equipment installed on the platform and used by the lessee performed this function. The IRS ruled that the platform and structural components (but not the machinery and equipment) were inherently permanent structures giving rise to rents from real property.

The foregoing rulings generally share the following features:

1. The facilities are “passive,” do not create any of the material flowing through them, and are not used in a manufacturing or production process.

³ Also a PTP. *See id.*

2. It is not feasible to move all or any substantial part of the facility, and each component part is intended to serve indefinitely and remain in place once affixed to the underlying land or other parts of the facility.
3. The taxpayer is not licensed to operate the facility, and instead leases it to a licensed operator.
4. The lease is a triple net lease whereby the operator is responsible for operating and maintaining the system, hiring all employees, and paying all expenses associated with the facility.
5. The facility consists of physically connected and functionally interdependent assets that serve as a conduit.

Practitioners seeking to issue tax opinions or obtain rulings on behalf of clients regarding the status of infrastructure assets as “real property” should take appropriate steps to ensure that the foregoing factors are satisfied.