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REITs Expand Beyond Real Estate

Two recent decisions by the Internal Revenue Service and new regulations proposed by the IRS and the U.S. Treasury Department are generating much buzz within the real estate industry.

The first decision allows document storage and shredding company Iron Mountain Inc. to restructure as a real estate investment trust (REIT). The second allows telecom company Windstream Holdings Inc. to reclassify most of its copper and fiber-optic lines as real estate to be transferred to a REIT. These decisions enable each company to realize material tax savings under the real estate investment trust provisions of the Internal Revenue Code. On the surface, a document storage company and a telecom firm may not fall into most people's idea of "real property." Yet the rulings are in line with the IRS's revised and expanded definition of real property within the proposed new REIT regulations.

The new regulations represent a significant change to the current statutory definition of real property as it applies to REITs. To qualify as a REIT, among other things, an entity must generate at least 75 percent of its income from real property assets, either income-producing real property or interest from mortgages secured by real property assets. A REIT generally is not subject to federal income tax if it distributes at least 90 percent of its income to shareholders. Although the shareholder pays tax on this income, the REIT avoids the double taxation typically imposed on C corporations and their shareholders.

The proposed regulations expand the definition of real property applicable to REITs by removing what was essentially a one-paragraph definition of real property and replacing it with a considerably expanded definition. The proposed regulations clarify that, in addition to land, the following items also are considered real property:

- Air rights and water rights.
- Unharvested crops.
- Inherently permanent structures (those that have a passive rather than an active purpose and that are "permanently affixed" to the land or so heavy that they cannot be moved).
- Structural components (that is, distinct assets that are an essential part of an inherently permanent structure and that do not produce or contribute to the production of income, other than for use or occupancy).

The proposed regulations provide specific examples of assets that qualify as real property. The specific qualifying asset types set forth in the regulations may benefit telecom, utility, energy, logistics, infrastructure, storage and advertising companies. Some of the more noteworthy examples of qualifying assets include the following:

- A cold storage warehouse, including its built-in freezer walls and central refrigeration units.
- A data center and its customized leased space, including the electrical power, central air, redundant utility and integrated security systems.
- A leased solar field, including non-energy producing fixtures such as mounts and exit wires.
- An entire solar energy site, if it is constructed to serve a single office building owned and leased by a REIT.
- Pipeline assets that are not "used in connection with the production of income from the sale and transportation of oil."
- Intangible assets, such as a land use permit to use land for a cell tower — but not a license to operate a casino, which is not a right to use, enjoy or occupy real property.

The proposed regulations also describe factors that can be used to determine whether an unlisted asset qualifies as real property. For example, the factors for determining whether a structure is inherently permanent include the following:

- The manner in which the asset is affixed to real property.
- Whether the asset is designed to be removed or remain in place indefinitely.
- The damage that would be caused by its removal.
- Any circumstances that suggest the expected period of affixation is not indefinite.
- The time and expense required to move the asset.

Under the proposed regulations, the qualification of assets as real property is highly dependent upon the individual facts and circumstances of each company's assets. Nevertheless, the expanded guidance and the recent trend of non-real estate companies reclassifying assets into REITs are likely to encourage increasing numbers of companies to take advantage of the tax savings available to REITs and to encourage both conversions and investment in new, less traditional real property assets. ■

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