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## Proposed Regulations Expand Definition of Real Estate for REITS to Include Solar Sites

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On May 9, 2014, the Internal Revenue Service issued Proposed Treasury Regulation Section 1.856-10 under Section 856(c)(5)(C) of the Code relating to the definition of real property for purposes of the REIT provisions of the Code.

Proposed Treasury Regulation Section 1.856-10 (the "Proposed Regulation") defines real estate as consisting of 3 different types of assets: land, improvements to land, and intangible assets. As under the current Treasury Regulations, improvements to land include inherently permanent structures and structural components of inherently permanent structures. Each distinct asset to be classified as real estate is either listed as an inherently permanent structure or structural component or must satisfy a facts and circumstances test. In addition, it must be passive and not perform an active function.

### Solar Sites

A key conclusion of the Proposed Regulation is that solar and other renewable projects may qualify as real estate, except to the extent that distinct assets are not inherently permanent structures or structural components and do not serve a passive function. However, a solar project dedicated to a single building may qualify in its entirety as a structural component of the building.

### The Proposed Regulations

The approach of the current Treasury Regulations, revenue rulings and



private letter rulings are adopted by the Proposed Regulation which specifically includes as inherently permanent structures, among other things, towers, telephone poles, parking facilities, pipelines, drilling platforms, storage structures, wharves and docks and outdoor advertising displays. As noted, the Proposed Regulation recognizes that a solar energy site qualifies as real property, except for the PV Modules themselves since they perform an active function and are not inherently permanent structures. However, where the solar energy site is maintained on land adjacent to an office building owned by the REIT and the REIT leases the building and the solar energy site to a single tenant, the entire energy site qualifies as real property. This is because the energy site serves a passive function and produces income from the use of space in the office building.

The Proposed Regulation lists specific types of land, buildings, inherently permanent structures and components thereof which qualify as real estate. Those assets not listed as inherently permanent structures or components thereof must qualify under a facts and circumstances test.

### Intangible Assets

The Proposed Regulation specifically confirms that intangible assets, such as goodwill, land use permits or other permits for the use, enjoyment of land, qualify as real estate. However, a permit to operate a business, such as the right to operate a casino in a building would not qualify as real property.

### Distinct Assets

The new distinct asset approach is designed to remove the uncertainty in the current Treasury Regulations whether certain assets that are permanent structures or components thereof are not real estate because they are used in the operation of a business. Accordingly, the Proposed Regulation, as discussed below, deletes the “operation in connection with a business” rule and adds a new analytical tool based on the distinct asset concept which must either be an inherently permanent structure or component thereof and serve a passive as opposed to an active function.

Distinct assets require a separate analysis to determine whether the distinct asset is real property as either land, an inherently permanent structure or a structural component thereof. Thus, the Proposed Regulation retains the basic conceptual approach of the current Treasury Regulations but requires that the distinct asset must serve a passive function related to real property or inherently permanent structure or as a component of that structure’s passive function. Thus, if an asset has an active function, such as an asset that produces or manufactures a product, or contributes to the production of income other than consideration of its use or occupancy of space, it will not be classified as real property.

### Examples in the Proposed Regulations

The best way to understand the Proposed Regulation is through its examples. The Proposed Regulation contains 13 examples illustrating its provisions.

Under Example 1, natural products of land such as unsevered plants are real estate and cease to be real estate when they are severed. Boat slips and end ties in a marina qualify as land under Example 2. Indoor sculpture qualifies as an inherently permanent structure in Example 3 since the building was specifically designed to support the sculpture and removal of the sculpture would destroy it, and the sculpture does not serve any active function by producing any revenue. Example 4 concludes that bus shelters are not inherently permanent structures because they can be unbolted from the sidewalk, and do not meet the definition of buildings.





In Example 5, customized freezer walls and a central refrigeration system qualify as structural components of the warehouse building. Example 6 analyzes a data center and concludes that the customized central heating and air conditioning system, the electrical system and telecommunications infrastructure system are structural components of the building since they are designed to remain permanently in place. In example 7, modular partitions designed to delineate space between tenants are not structural components since they can be easily moved. In Example 8, the components of a solar site including the racks, mounts, exit wiring are distinct assets which qualify as inherently permanent structures, but the PV modules are not structural components since they can be moved and serve an active function by converting sun into electricity which produces revenue. Example 9 analyzes a solar powered building and concludes that the entire energy site designed to power an adjacent building including the PV modules qualifies as a structural component since it serves a passive function for the building and is limited to that building. In Example 10, a pipeline transmission system consisting of pipelines and storage tanks are listed as inherently permanent structures as

are the valves to control oil flow, but meters and compressors to measure the oil flow are not structural components. Example 11 concludes that goodwill related to a hotel building owned by a corporation is real property because it would be included in the basis of the hotel for Federal income tax purposes if the REIT had purchased the assets of the corporation. In Example 12, a special use permit from the government to use the land as a cell tower is treated as a leasehold interest and is therefore an interest in real property. A license to operate a casino as part of a hotel is not real property in Example 13 because it is a license to operate a business.

### Effective Date

The effective dates of the Proposed Regulation are the calendar quarters beginning on or before the date published in Federal Regulations as Final Regulations. Due to the favorable guidelines in the Proposed Regulations, taxpayers are anticipated to begin relying on them immediately as indicating IRS acquiescence in the expanded definition of real estate for REITs.

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## For More Information



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- Entity Formation
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\*Law360, March 2014

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