NATIONAL ASSOCIATION OF
REAL ESTATE INVESTMENT TRUSTS®

August 12, 2014

VIA ELECTRONIC SUBMISSION http://www.Regulations.gov
(IRS REG–150760–13)]

CC:PA:LPD:PR (REG-150760-13)
Room 5203
Internal Revenue Service
P.O. Box 7604
Ben Franklin Station
Washington, D.C. 20044

Re: Notice of Proposed Rulemaking: Definition of Real Estate Investment Trust Real Property

Dear Sir or Madam:

The National Association of Real Estate Investment Trusts® (NAREIT) appreciates the opportunity to comment on, and to offer our suggestions with respect to, the Treasury Department and Internal Revenue Service's proposed regulations (Proposed Regulations) that would clarify the definition of real property for purposes of certain of the real estate investment trust (REIT) provisions of the Internal Revenue Code of 1986 as amended.[1] In addition, NAREIT requests to speak at the September 18, 2014 public hearing. The outline of the topics to be addressed is set forth in Attachment B hereto, along with the expected time to be allocated to each topic.

NAREIT® is the worldwide representative voice for REITs and publicly traded real estate companies with an interest in U.S. real estate and capital markets. NAREIT's members are REITs and other businesses throughout the world that own, operate, and finance income-producing real estate, as well as those firms and individuals who advise, study, and service those businesses.

EXECUTIVE SUMMARY

NAREIT appreciates the issuance of the Proposed Regulations and urges the Treasury Department and IRS to finalize them as soon as possible, after taking into

[1] The Code. Unless otherwise provided, any reference to a "section" herein shall be to a section of the Code.

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account the recommendations set forth below and as further described in this letter. In particular, NAREIT commends the IRS and Treasury Department for attempting to codify (some would say "regify") existing guidance going back decades concerning the definition of real estate for REIT asset purposes and to clarify the applicable analysis relevant in determining whether a particular asset qualifies as a real estate asset for REIT purposes.

First, NAREIT recommends that the Proposed Regulations eliminate the use of the terms "active" or "passive" in connection with whether an asset is real property. REITs own and actively operate (or finance) income-producing properties, and since 1986, REITs have been authorized to actively manage their own properties and have been authorized to provide a range of services (including those detailed in Attachment A) relating to those properties. In addition, stock exchange-listed REITs actively manage their balance sheets and actively pursue capital market transactions.

Second, NAREIT recommends that the IRS and Treasury Department clarify (either in the preamble to the final regulations or in the final regulations themselves) that whether an asset is designed to be removed or to remain in place indefinitely (in connection with "inherently permanent structures") means whether it is expected to last into the foreseeable future and so long as the distinct asset's expected economic useful life (subject to early removal on account of condemnation, technical obsolescence, or ground lease expiration).

Third, NAREIT recommends deleting the requirement that a REIT have an equivalent interest in both a structural component and an inherently permanent structure, or, at a minimum, change "equivalent interest" to a "real property interest."

Fourth, to eliminate confusion and to avoid additional drain on the IRS' limited resources from repetitive ruling requests, NAREIT recommends that the IRS list the following as *per se* real property: a number of the "building systems" that have been considered real property by the IRS in private letter rulings; car charging stations (inherently permanent structures); storage facilities and health care facilities (buildings); and, timber (natural products of the land).

Fifth, NAREIT recommends that the test for whether an intangible is real property be modified from that stated in the Proposed Regulations to include whether the intangible alternatively is derived from the trade or business of earning revenues from consideration for the use or related services.

Sixth, NAREIT suggests that the Proposed Regulations include additional examples that would be useful for both taxpayers and the government.

Seventh, NAREIT recommends that the IRS clarify that taxpayers that received private letter rulings concluding that their particular assets were real property should be permitted to continue to rely on those rulings.

Eighth, NAREIT recommends that the final regulations apply to taxable years beginning after the date the final regulations are published in the Federal Register, with the option of taxpayers' electing to apply them to earlier taxable years and quarters within such years.

Finally, in response to the IRS and Treasury Department request on the extent to which the various meanings of real property that appear in regulations should be reconciled, NAREIT urges the IRS to defer to Congress to reconcile potentially differing definitions because reconciling such differences is more appropriately the role of Congress.

DISCUSSION

A. Background: REITs

Congress enacted REIT legislation more than 50 years ago to ensure that Americans from all walks of life could access the real estate asset class on a collective basis to secure greater investment diversification with the benefit of professional management.

REITs are entities that are taxed as corporations that operate under strict rules, including gross income and asset tests, designed to ensure that they are focused on long-term ownership and financing of real estate. These rules are based upon and are similar to the rules under which mutual funds are required to operate.

Equity securities in stock-exchanged listed REITs trade on established securities exchanges, mostly on the NYSE. As of June 30, 2014, 210 stock exchange-listed REITs represented an equity market capitalization of $816 billion. Additionally, the securities of public non-listed REITs are also registered with the Securities and Exchange Commission (SEC), thus subjecting them to the annual and periodic reporting requirements of the Securities and Exchange Act of 1934. Our estimate is that stock exchange-listed REITs together with public non-listed REITs held approximately $1.7 billion in commercial real estate gross assets as of June 30, 2014. Many other REITs are purely private.

Similar to mutual funds, REITs are required to distribute at least 90% of their taxable income each year to their shareholders as dividends. SEC-registered REITs distributed $34 billion to shareholders in 2013. Market pressures tend to force most SEC-registered REITs to maintain relatively low leverage. For example, as of June 30, 2014, the debt ratio (total debt divided by total market capitalization) for all stock exchange-listed equity (or property-owning) REITs was 34.4% (and for all stock exchange-listed REITs, including mortgage REITs, was 46.7%).

REITs' required dividends have made them a key part of the investment landscape. Increasingly, REITs are used as a tool to help diversify investment portfolios. Since 1960, REITs have helped provide Americans with significant income through their mandatory dividends, with investment diversification through the requirement to focus on the real estate asset class and with competitive investment performance. Due to the success of the U.S. REIT industry, a number of other countries around the world have adopted their own REIT laws modeled after the U.S. approach. Today, about 30 countries have such laws, including all G-7 nations.

B. Summary of the Proposed Regulations

1. *Land, Inherently Permanent Structures and Structural Components*

The Proposed Regulations define real property to include the following items: 1) land (including not only a parcel of ground, but the air and water space directly above the parcel, as well as crops and other natural products of land until the crops or other natural products are detached or removed from the land); 2) inherently permanent structures (including buildings, which have a "passive" function); and, 3) structural components (a distinct asset that is a constituent part of and integrated into an inherently permanent structure that serves the inherently permanent structure in its "passive" function and does not produce or contribute to the production of income other than consideration for the use or occupancy of space). In determining whether an item is land, 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 the Proposed Regulations apply. Thereafter, each distinct asset is tested individually to determine whether it is real or personal property.

2. *Safe Harbor Lists*

In addition, the Proposed Regulations include a safe harbor list of types of buildings (houses; apartments; hotels; factory and office buildings; warehouses; barns; enclosed garages; enclosed transportation stations and terminals; and, stores) and inherently permanent structures (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, outdoor advertising displays for which an election has been properly made under section 1033(g)(3)), as well as a safe harbor list of structural components (wiring; plumbing systems; central heating and air conditioning systems; elevators or 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; integrated security systems; and, humidity control systems), that are considered real property for REIT purposes. If a distinct asset is not in one of the safe harbor lists, the Proposed Regulations provide facts and circumstances that must be considered in determining whether the distinct asset is a building, other inherently permanent structure, or a structural component.

3. *Examples*

Furthermore, the Proposed Regulations set forth a number of illustrative examples under which the following are considered real property: perennial fruit-bearing plants, water adjacent to land (*e.g.*, boat slips); a permanent sculpture, freezer walls and central refrigeration units in cold storage warehouse; a data center, including customized interior components and utility systems; conventional (but not modular) building partitions, solar mounts (but not photovoltaic modules); solar energy site assets that provide energy to an adjacent REIT-owned building; an oil pipeline transmission system (but not meters or compressors), goodwill associated with stock of

corporation that owns a landmark hotel; and, a permit to place a cell tower on government property (but not a permit to operate a casino).

4. *Intangible Assets*

Finally, the Proposed Regulations also provide that certain intangible assets are real property for purposes of the REIT rules. To be real property, the regulations would require that an intangible asset must derive its value from tangible real property and be inseparable from the tangible real property from which the value is derived.

5. *Effective Date*

The Proposed Regulations (as corrected on July 9, 2014) are proposed to be effective for calendar quarters beginning after they are published as final regulations in the Federal Register.

C. Because REITs May Be Active in the Business of Real Estate and Real Estate Investment, Differentiating Assets as Serving an Active or Passive Function is Inappropriate

The Proposed Regulations include a requirement in two areas that an asset be "passive" before the asset may be considered to be "real property." Specifically, Prop. Treas. Reg. § 1.856-10(d)(2)(iii)(A) proposes that, for structures other than buildings, the appropriate definition should be whether the asset "serve[s] a *passive* function, such as to contain, support, shelter, cover, or protect, and do[es] not serve an active function such as to manufacture, create, produce, convert, or transport." (Emphasis added). The preamble to the Proposed Regulations notes that:

> These [P]roposed [R]egulations do not retain the phrase ''assets accessory to the operation of a business,'' which the existing regulations use to describe an asset with an active function that is not real property for purposes of the regulations under sections 856 through 859. The IRS and the Treasury Department believe that the phrase ''assets accessory to the operation of a business'' has created uncertainty because the existing regulations are unclear whether certain assets that are permanent structures or components thereof nevertheless fail to be real property because they are used in the operation of a business.

Similarly, Prop. Treas. Reg. § 1.856-10(d)(3)(i) would define an asset as a structural component if it is a "constituent part of and integrated into an inherently permanent structure, serves the inherently permanent structure in its *passive* function, and, 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. (Emphasis added).

Since 1986 REITs have been permitted not only to own income-producing real property, but also to operate such property. Rev. Rul. 2001-29 specifically notes that a REIT may be engaged in "the active conduct of a trade or business within the meaning of section 355(b) solely by virtue of functions with respect to rental activity that produces income qualifying as rents from real

property within the meaning of section 856(d)." The IRS has appropriately issued scores of private letter rulings in which it has approved of a vast array of services that REITs may provide in connection with this active business of owning and operating real estate. A list of representative services is attached as Attachment A.

In addition, the active nature of REITs has been acknowledged by the capital markets, as evidenced by Standard & Poor's (S&P) decision in 2001 to include REITs in its stock indexes. At present there are 82 REITs in the S&P indexes. Further, in 2012 the Commodity Futures Trading Commission based its conclusion that stock exchange-listed equity REITs are not "commodity pools" in part on the active nature of their businesses.

While NAREIT agrees with the IRS and Treasury Department's decision to eliminate the phrase "assets accessory to the operation of a business," the Proposed Regulations' inclusion of the active/passive dichotomy appears to prevent a REIT from owning and leasing any factory or similar type of building or asset, contrary to the 1960 legislative history behind the enactment of the REIT rule.[2] As a result, NAREIT suggests two potential alternatives. The first alternative would be to replace the requirement that an asset serve a passive function with a test that analyzes whether the particular asset primarily contributes to the production of income other than for the use, occupancy, or financing of space. If not, the asset can qualify as real property. If so, the asset cannot qualify as real property.

Other than with respect to the use of the term "transport," as described below, NAREIT does not object to the description of such assets as being real property. Thus, another formulation could be to rephrase Prop. Treas. Reg. § 1.856-10(d)(2)(iii)(A) to say, for example, for structures other than buildings, the appropriate definition should be whether the asset "serve[s] a function, such as to contain, support, shelter, cover, or protect, and do[es] not serve a function such as to manufacture, create, produce, or convert" (deleting the characterization of these functions as "active" or "passive", respectively).

Similarly, Prop. Treas. Reg. § 1.856-10(d)(3)(i) would require that with respect to whether an asset is a structural component if it is a "constituent part of and integrated into an inherently permanent structure, serves the inherently permanent structure in its real estate-related function to contain, support, shelter, cover, or protect, 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" (again, deleting the characterization of this function as "passive" and deleting the term "passive" with "real estate-related").[3]

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[2] H.R. Rep. No. 2022, 86th Cong. 2d Sess. 4 (1960): "In addition to providing equality of tax treatment between the trust beneficiaries and the investment company shareholders, your committee believes it is also desirable to remove taxation to the extent possible as a factor in determining the relative size of investments in stocks and securities on one hand, and real estate equities and mortgages on the other. This is particularly important at the present time because of the shortage of private capital and mortgage money for individual homes, apartment houses, office buildings, **factories**, and hotels." (Emphasis added).

[3] Conforming changes also should be made to the examples in the Proposed Regulations. For example, subparagraph (E) ("Serve the office building in its passive function of containing and protecting the tenants' assets") of Example 9 (solar asset sites mounted on REIT's adjacent building) should be modified by deleting the word "passive."

If the latter alternative is preferred, NAREIT also recommends deleting the term "transport" from the types of functions that lead to the conclusion that an asset is not real property.

NAREIT believes that the Proposed Regulations go too far by including "transport" among the examples of an active and, therefore, "bad" function of real property for a REIT. The other examples of "active" functions involve activity that changes the physical nature or character of a commodity permanently or actually generates or creates a commodity when one did not previously exist. On the contrary, the mere act of allowing a commodity to move along a pipeline or transmission line does not create, generate, convert, destroy or change the nature of the commodity itself.[4] The function of moving items such as gas and electricity along a gas pipeline or electric transmission line is still "passive" in nature. The Proposed Regulations do try to circumvent this distinction in Example 10 and preserve the characterization of gas pipelines themselves as real property by stating – not entirely correctly – that the purpose of a gas pipeline is to "contain" oil. The purpose of storage tanks is to contain oil. While pipelines do contain oil, the purpose of oil pipelines is to transport oil. No tenant would pay to use a gas pipeline to simply store oil. Similarly, the purpose of an electric transmission line is to provide a means for electricity to flow over wires.

In the case of water, gravity performs most of the work, like what may occur, for example, in storm sewer pipes. However, gas pipelines require compressors, pumps and valves to regulate the flow of oil across the pipelines. This distinction alone should not determine whether an asset is real property. By including transport as an active function, the result of the Proposed Regulations is to exclude structural components of gas pipelines as inherently permanent structures such as compressors and pumps because they aid in the active function of transporting oil. Instead, these items clearly serve the intended purpose of the pipeline and should be considered structural components of the pipeline and, therefore, real property. Moreover, including transport as an active function is inconsistent with one of the earliest examples of real property for a REIT: railroad-related real estate. The purpose of a railroad is to permit cars and their cargo to move across railroad tracks, not to contain cars. In Rev. Rul. 69-94, 1969-1 C.B. 189, the Service confirmed that railroad track, bedding and the switching stations to move the tracks as necessary were real property.

D. Modify Test for Inherently Permanent Structures from Remaining in Place "Indefinitely"

Prop. Treas. Reg. § 1.856-10(d)(2)(i) would define an "inherently permanent structure" as:

> any permanently affixed building or other structure. Affixation may be to land or to another inherently permanent structure and may be by weight alone. If the affixation is reasonably expected to last *indefinitely* based on all the facts and circumstances, the affixation is considered permanent. (Emphasis added).

[4] Consistently with this point, Prop. Treas. Reg. § 1.856-10(d)(3)(ii) includes "elevators and escalators" as structural components, although the sole purpose of such components is to perform a transportation function.

NAREIT recognizes that, among other factors indicating that an asset is "inherently permanent" is the factor that the asset not be easily moved. NAREIT believes that the term "indefinitely" used throughout the Proposed Regulations with respect to both structures and structural components should not be viewed as meaning "forever." If it did, a REIT that that planned to remove and/or replace the asset at the end of the asset's economic useful life could never satisfy the "indefinitely" requirement. However, most assets cannot be expected to remain in place longer than their **finite** economic useful life.

In lieu of modifying the text in the Proposed Regulations, NAREIT recommends including a statement in the preamble to the final regulations that clarifies that "indefinitely" does not mean "forever." Instead, the term "indefinitely" means lasting into the foreseeable future until the end of the asset's useful life. With that said, removal of an asset may occur earlier for other reasons outside of the REIT's control (*e.g.,* condemnation or obsolescence). If preferred, this change could be made in the actual text of the final regulations, rather than in the preamble.

E. Structural Components – "Equivalent Interest" Should Not Be Required

Among other things, Prop. Treas. Reg. § 1.856-10(d)(3) would treat structural components as real property "only if the interest held therein is included with an equivalent interest held by the taxpayer in the inherently permanent structure to which the structural component is functionally related."

The reason for this qualification is unclear, and it is not explained in the Preamble. It appears to be derived from a 41-year-old revenue ruling, Rev. Rul. 73-425, 1973-2 C.B. 222, which addressed the qualification for REIT purposes of a loan secured by a mortgage on a "total energy system."[5] The ruling concluded (without explanation) that in order for such a loan to qualify as a real estate asset, the security interest must extend to the building that the energy system served. It appears as though the ruling's reasoning was based on the language in Treas. Reg. § 1.856-3(d) that "the term 'real property' means land or improvements thereon, such as building or other inherently permanent structures thereon (**including items which are structural components of such buildings** or structures." (Emphasis added). In other words, because the regulations require that there be a connection between a structural component and a building for the structural component to be considered real property, the REIT's loan must be secured by a mortgage on both. However, the regulation contains no such requirement. Instead, it merely notes that items that are structural components of buildings are themselves real property, just like the buildings are real property.

By way of background, the definition of "real property" in Treas. Reg. § 1.856-3(d) is virtually identical to the exclusion of property from "tangible personal property" under the former investment tax credit (ITC) of section 38 of the Internal Revenue Code of 1954. Section 38 allowed a credit for certain investments in depreciable property, which was defined in section 48

[5] Rev. Rul. 73-425 describes a total energy system as "a self-contained facility for the production of all the electricity, steam or hot water, and refrigeration needs of associated commercial or industrial building, building complexes, shopping centers, apartment complexes and community developments." The ruling notes that the system may be permanently installed within the building, attached to the building, or a separate structure nearby.

(as then in effect) as "tangible personal property" or "other tangible property (not including a building and its structural components)" used in production, manufacturing or furnishing certain services. Treas. Reg. § 1.48-1(c) defines "tangible personal property" as "any tangible property except land and improvements thereto, such as buildings or other inherently permanent structures (including items which are **structural components of such buildings** or structures)." (Emphasis added).

In *Samis v. Commissioner*,[6] the Tax Court addressed whether a taxpayer was entitled to claim the ITC with respect to an "on-site energy conversion plant and distribution system", apparently similar to that described in Rev. Rul. 73-425, which would furnish hot and chilled water for heating and air-conditioning and hot domestic water to an apartment complex owned by a third party. In other words, the Tax Court evaluated whether this energy plant and distribution system was tangible personal property entitled to the ITC or a structural component of a building not entitled to the ITC.

The Tax Court held that "despite the separate ownership of the energy plant and the apartment buildings, the energy plant must be classified as a structural component of a building under the regulations. Since the total energy plant is a structural component of a building, it therefore does not qualify as [eligible for the ITC]."[7] The Tax Court also noted that:

> **[t]he separate ownership of the energy plant should not obscure the essential matter under consideration**. Certainly, if [the apartment owner] has itself constructed and operated the plant, it would clearly have to be treated as an integral and structural component of the entire apartment complex and would not qualify for the investment credit. It can hardly be assumed that Congress intended to allow the credit in respect of the identical structure merely because [the apartment owner] arranged to have it installed and operated pursuant to contract by another entity which engaged in no other business.[8]

It should be emphasized that this is by no means just a theoretical issue. The requirement of an "equivalent interest" would lead to inappropriate results in many commonplace situations. For example, it is not unusual for a REIT to own a building outright, but to lease from third parties all or portions of particular structural components—electric generators, environmental monitoring equipment, or computer equipment used to operate structural components. Similarly, it is not unusual for a REIT to lease a building shell from a third party and then to outfit the building shell with structural components that the REIT itself owns in order to lease space to tenants. This situation frequently happens, for example, in the case of shopping centers and data centers. In these situations the REIT appears not to have an "equivalent interest" in the building and the structural components, but it is impossible to see why the structural components should for that reason be treated as anything other than structural components. If they are not structural

[6] 76 T.C. 609 (1981).
[7] *Id*. at 620-21.
[8] *Id*. at p. 621, footnote 6. (Emphasis added). *See also AmeriSouth XXXII, Ltd. v. Commissioner*, 2012 T.C. Memo 67, footnote 30 (2012) (citing *Samis* with approval).

components, are they personal property? If so, it seems odd that the REIT could be treated as leasing personal property as well as real property in these situations.

Another example of a scenario with respect to which the "equivalent interest" standard could be problematic is when a structural component services a building whose ownership has been disaggregated, as when a REIT owns some, but not all, of the space in a building, and also owns the wiring, plumbing or heating system servicing the entire building. Since in this example the structural components owned by the REIT serve portions of the building that the REIT does not own, it is unclear under the Proposed Regulations whether the structural component would qualify as a real estate asset, though unquestionably they are permanently installed and would be classified as real estate for investment credit and other tax purposes. They would also meet all the other proposed criteria for inherently permanent structures. Similar questions would arise whenever a REIT holds a leasehold interest in a building into which it has installed tenant improvements that it owns. Note these scenarios are not at all uncommon; if the Proposed Regulations are adopted as proposed, the REIT qualification of such assets would be called into question.

This issue additionally can be illustrated by changing the facts slightly in Example 9 in the Proposed Regulations. Example 9 describes the situation of a REIT that owns a solar energy site, and the solar energy site assets (Solar Energy Site Assets) are mounted on land adjacent to an office building owned by the REIT. The REIT leases both the office building and the solar energy site to a single tenant. After analyzing the facts and circumstances that indicate that the Solar Energy Site Assets would be difficult to remove, are designed specifically for the office building, are intended to remain in place permanently, serve a "utility-like" function with respect to the office building and serve the building in its function of containing and protecting tenants' assets, will remain in place when the tenant vacates and (along with the adjacent building) are owned by the REIT, the Proposed Regulations treat the Solar Energy Site Assets as a structural component of the adjacent office building. We do not believe that there is a policy reason to come to a different result in this example if, for example, the REIT were leasing the adjacent building (as a tenant itself or as a tenant and then subleasing to a subtenant), and the REIT owned the associated solar assets, or the REIT were leasing the associated solar assets and owned the adjacent building.

We believe that the characterization of an asset as a structural component (and therefore real property) as opposed to not a structural component (and therefore not real property) should be the same regardless of whether, for example, a REIT that owns the asset also owns the associated building that the asset serves, or a REIT that owns the asset also leases from another party the building served by the asset.

As a result, NAREIT recommends that that the requirement of an "equivalent interest" held by the taxpayer in the inherently permanent structure be deleted entirely. Alternatively, if it is felt that some qualification needs to be added to address the fact pattern at issue in Rev. Rul. 73-425, we would suggest that the requirement be amended to require only *a* real property interest in both the building and the structural component. We note that neither Rev. Rul. 73-425 nor the

preamble to the Proposed Regulations uses the term "equivalent interest," which terminology appears only in the Proposed Regulations themselves.

F. List Additional Assets as *Per Se* Real Property to Limit Unnecessary Private Letter Ruling Requests

In order to provide greater certainty to taxpayers and to limit the unnecessary expenditure of IRS resources, NAREIT recommends including the following examples of real property in the Proposed Regulations: 1) car charging stations; 2) health care facilities (buildings);[9] 3) storage facilities (buildings); and, 4) timber (as a natural product of the land; *See* Prop. Treas. Reg. § 1.856-10(g), Example 1).

In addition, NAREIT recommends that the following types of systems be added to those listed as structural components in Prop. Treas. Reg. § 1.856-(d)(3)(ii). The IRS defined these systems as real property in several private letter rulings relating to data centers: 1) electrical distribution and redundancy system (the "electrical components"); and, 2) telecommunication infrastructure (the "telecommunication components").[10] Similarly, equipment comprising a building management system that is used to implement a sustainability system should be considered a structural component.

G. Clarify and Modify Test Applicable to Intangibles

NAREIT appreciates that the Proposed Regulations recognize, as did several earlier private letter rulings, that certain intangibles are so connected to a REIT's real property business that they themselves should be considered part of the REIT's real property. Prop. Treas. Reg. § 1.856-10(f)(1) would provide the following with respect to an intangible asset:

> If an intangible asset, including an intangible asset established under generally accepted accounting principles (GAAP) as a result of an acquisition of real property or an interest in real property, derives its value from real property or an interest in real property, is inseparable from that real property or interest in real property, and does not produce or contribute to the production of income other than consideration for the use or occupancy of space, then the intangible asset is real property or an interest in real property.

NAREIT suggests that this provision be modified to the following, which would be in line with PLR 201314002:

> If an intangible asset, including an intangible asset established under generally accepted accounting principles (GAAP) as a result of an acquisition of real

[9] Both healthcare and storage have long been recognized in REIT Indexes as distinct property sectors.
[10] *See, e.g.*, PLRs 200752012; 200921019; 201034010 (as modified by PLR 201334033), 201037005, and 201314002. The Proposed Regulations has identified each of the other systems identified in these rulings (the central heating and air conditioning (HVAC) system, the humidity control system, the fire suppression system, and the integrated security system) as a structural component. *See* Prop. Treas. Reg. § 1.856-10(g) Example 6.

> property or an interest in real property (or as a result of a merger or combination transaction when the acquired entities own real property or an interest in real property), derives its value from one or more of: A) real property, B) an interest in real property, or, C) the trade or business of earning revenues from consideration for the use or occupancy of space or related services, is inseparable from one or more of the foregoing, and does not produce or contribute to the production of income other than consideration for the use or occupancy of space or related services, then the intangible asset is real property or an interest in real property.

By modifying the definition along these lines, the regulations would acknowledge that an intangible is real property for REIT asset test purposes not only if derived from real property, but also if derived from the business of renting real property. For example, in PLR 201314002, the IRS concluded that certain taxpayer-described "real estate intangibles" were real estate assets because "[a]lthough the real estate intangibles are separate assets for those purposes, they may be characterized for purposes of the REIT income and asset tests based upon the characterization of the [REIT's operating partnership's] activities in its underlying trade or business. Since the real estate intangibles relate solely to the [operating partnership]'s *business of leasing and providing customary services to tenants in their data centers*, they qualify as real estate assets and interests in real property for purposes of section 856." (Emphasis added).

FAS 141R (later codified as ASC 805-20-55-31) requires acquirers of rental real estate to amortize for financial statement purposes all in-place above and below market leases, thereby creating intangible assets under GAAP. Because this rule applies to such a large portion of real estate acquisitions, we recommend that a new example be added to Prop. Treas. Reg. § 1.856-10(g) concluding that such an intangible is considered real property.

In addition, NAREIT also requests that the IRS clarify specifically that the definition of intangibles in the Proposed Regulations applies to the goodwill that results in a merger or acquisition when the purchase price of stock exceeds the fair market value of the company's underlying assets, resulting in goodwill being included as an asset on the REIT's balance sheet. Doing so would recognize the reality that REITs may acquire intangible assets both in "asset" and "stock" transactions.

H. Delete or Modify Examples; Add Additional Examples

NAREIT recommends that the final regulation delete Example 4 (relating to removable bus shelters) and delete or modify Example 13 (relating to a license to operate a casino). NAREIT does not disagree with the conclusions in these examples, but we do not believe that the facts sufficiently describe realistic scenarios. We think the inclusion of these examples increases the risk that they could be misapplied in context of a REIT that actually owns bus shelters for advertising purposes or leases casino facilities.

The facts in Example 4 describe a REIT that owns bus shelters that it leases to the local transit authority. The facts state that the shelters may be disassembled and moved to different locations, without damaging the shelter or the real property to which they are affixed. NAREIT has been

informed that a REIT is most likely to own bus shelters in context of making an election under section 1033(g) for purposes of leasing the shelter to an unrelated party as an outdoor advertising display. We are not aware of any REIT that leases or intends to lease bus shelters to a transit authority. NAREIT has also been advised that such shelters are rarely re-located and any attempt to disassemble and re-locate a bus shelter would result in damage to the sidewalk and potentially the shelter itself. Accordingly, NAREIT believes the facts described in Example 4 are unrealistic. Because the result in this example could be misapplied in the context of a REIT that owns bus shelters to be used as outdoor advertising displays, NAREIT recommends deleting this example.

The facts and conclusion described in Example 13 are also vulnerable to being misapplied in the case of a REIT that owns a gaming facility. This example describes a situation in which a gaming license is issued to conduct gaming in a specific location, which license is not transferable for use in another location. While the example correctly concludes that a license to conduct a gaming business should not, by itself, be classified as a real estate asset, the fact that the facility may be used for gaming purposes will likely enhance its value as real estate, apart from the value of the gaming license itself. Enabling laws for gaming activities frequently apply to restricted geographical areas or even to specific locations. The effect of such laws on the valuation of real estate is the same as that of favorable zoning rules.

Compare, for example, the zoning and licensing requirements that apply to liquor stores. Many jurisdictions strictly limit the number and locations of liquor stores through zoning restrictions. In certain cities, a zoning right to locate a liquor store in a given area might substantially increase the real property value of that location. That value is distinct from the license required to be held by a liquor store operator. In either case, the fact that a particular area, or even a specific location, is approved for use in a particular business may cause the value of the affected property to increase. That value, however, is part of the real property and is separate and distinct from the value of the license to conduct such business.

Accordingly, NAREIT recommends either deleting example 13, or clarifying it to demonstrate that although a gaming operating license is not real property, such conclusion does not apply to any value that may inure to the real property itself, as a result of a favorable enabling law or zoning rule related to gaming. NAREIT also recommends supplementing the Proposed Regulations with additional examples. Doing so would provide greater certainty for taxpayers, which would mitigate the potential burden on IRS resources from additional private ruling requests.

I. Confirm Taxpayers Can Rely On Private Letter Rulings Issued to Them

There has been some uncertainty in the REIT community regarding whether the Proposed Regulations may affect the continuing vitality of rulings that specific taxpayers have received from the IRS. NAREIT requests that the IRS clarify that taxpayers may continue to rely on private letter rulings issued to them regarding the treatment of their assets as real property.

J. Modify Effective Date

NAREIT recommends that the final regulations apply to taxable years beginning after the date the final regulations are published in the Federal Register, rather than calendar quarters after final regulations are published, with taxpayers' having the option to elect to apply them to calendar quarters within earlier taxable years.

K. Defer to Congress to Reconcile Conflicting Definitions

In the preamble to the Proposed Regulations, the IRS and Treasury Department request comments on the extent to which the various meanings of real property should be reconciled, whether through modifications to the Proposed Regulations or through modifications to the regulations under other Code provisions.

NAREIT believes that the reconciliation of the various definitions of real property in the Code would be best left to Congress as Congress is best suited to evaluate the various policy considerations for the various definitions.

Over the years, there have been a number of situations involving potentially differing definitions in the Code with respect to which Congress either has elected successfully to reconcile or Congress has decided not to reconcile. For example, as part of the Working Families Tax Relief Act of 2004, Congress provided a uniform definition of "child" relevant for several Code sections (the child care credit under Section 21, the child tax credit under Section 24, the earned income credit under Code Section 32, and the dependent exemption under Section 151). In 2001, the Joint Committee on Taxation published the *Study of the Overall State of the Federal Tax System and Recommendations for Simplification, Pursuant to Section 8022(3)(B) of the Internal Revenue Code of 1986* (JCS-3-01), April 2001 (JCT 2001 Recommendations), in which it recommended that Congress address, among other things, the following:

> a) for purposes of ordinary loss treatment under sections 1242 and 1244, the definition of small business should be conformed to the definition of small business under section 1202, regardless of the date of issuance of the stock;
>
> b) a uniform definition of qualifying higher education expenses should be adopted . . [to] eliminate the need for taxpayers to understand multiple definitions if they use more than one education tax incentive and reduce inadvertent taxpayer errors resulting from confusion with respect to the different definitions;
>
> c) uniform definitions of highly compensated employee and owner should be used for all qualified retirement plan and employee benefit purposes… [to] eliminate multiple definitions of highly compensated employee and owner for various purposes, thereby allowing employers to make a single determination of highly compensated employees and owners;

> d) 1) a single definition of compensation should be used for all qualified retirement plan purposes, including determining plan benefits, and, 2) compensation should be defined as the total amount that the employer is required to show on a written statement to the employee, plus elective deferrals and contributions for the calendar year… [to] eliminate the need to determine different amounts of compensation for various purposes or periods.

It would be appropriate to defer to Congress to balance the various policy considerations that may be implicated by reconciling different definitions.

* * *

Thank you again for the opportunity to submit these comments. Feel free to contact me at tedwards@nareit.com or Dara Bernstein, NAREIT's Senior Tax Counsel, at dbernstein@nareit.com if you would like to discuss these issues in greater detail.

Respectfully submitted,

Tony M. Edwards
Executive Vice President & General Counsel

Attachments: Attachment A (List of Services)
Attachment B (Request to Speak and Outline of Topics for September 18, 2014 Hearing)

Attachment A: List of Services Conducted by REITs

Equity REITs own and operate income producing real estate, such as shopping malls, office buildings, hotels, industrial facilities, and apartment homes. Operation of income producing real estate involves the physical, administrative, operational and fiscal management of a real estate asset. Though very important, collecting rents – and the related fiscal activities – constitutes only one part of the real estate related services that REITs perform in connection with ownership and rental of property.

Professional real estate management encompasses the overall management of a real property asset and may include, without limitation, the following activities, many of which are inter-related.

A. PHYSICAL PROPERTY OPERATIONS

1. Furnish electricity (including sub-metering of electricity), water, heat, light, and air conditioning, elevator services, telephone answering services, incidental storage space, laundry equipment, parking facilities and swimming pool facilities, all if such services are customarily provided to tenants in that geographic market

2. Perform general property maintenance and related services such as routine engineering and janitorial services, general cleaning services (including cleaning of windows, public entrances, exits and lobbies as well as the cleaning of a tenant's interior space), trash collection, snow removal, pest control, landscaping services, and fire protection, life/safety system and sprinkler system maintenance

3. Perform regular property inspections

4. Provide routine security guard services if necessary to maintain safety

B. ADMINISTRATIVE & OPERATIONAL ACTIVITIES

1. Establish rental terms, select tenants, enter into, negotiate and renew leases, arrange for payment of taxes with respect to the property

2. Routinely communicate with the occupants of the property concerning the delivery of services and other management matters

3. Design, implement, or approve and administer a tenant retention program

4. Enforce tenant compliance with lease terms

5. Pursue legal action against any tenants that are delinquent in payment, or in violation of the lease terms

6. Prepare, approve, or execute marketing plans for attracting potential tenants to the property,

7. Provide personnel to staff a shopping mall's information center and furnish courtesy wheelchairs and strollers

8. Recruit, train and supervise on-site personnel, off-site management staff, or sub-contracted management firms

9. Select vendors and decide which items or services for the property are to be purchased, determine the quantity and quality of purchases, and negotiate or approve contracts for services

10. Supervise employees or direct contractors who perform routine maintenance and repair work, and confirm the vendors' compliance with purchasing and insurance criteria

11. Design and implement and schedule preventive maintenance programs for the property

12. Obtain and maintain property licenses and permits

13. Design, implement, or approve a life-safety and emergency preparedness program for the property

14. Establish or monitor and enforce the property's operating policies and procedures

15. Establish, approve, or monitor adherence to the record-keeping system

16. Establish management and internal controls and monitor property performance

17. Identify the property's insurable risks and choose and monitor coverage's

18. Undertake or oversee a physical and financial risk management program

19. Analyze market conditions and approve rental rates, and other lease terms for the property

20. Identify and analyze alternate uses of the property, and implement a plan to change the property's use or approve such a plan

21. Monitor property value and assess the implications that estimates of value have; determine the reasonableness of assessed value and insurable value

22. Prepare annual budgets, including capital expenditure and reserve/impound budgets, or review and authorize such budgets prepared by

23. Identify, analyze, and implement, or approve, major capital expenditure programs, including, but not limited to, maintenance or remodeling projects, and major tenant improvements

24. Participate in legal proceedings regarding the property, including undertaking or overseeing valuation appeals with respect to assessed property valuation

25. Monitor and administer the property's compliance with government and environmental regulations and consult legal or other counsel when appropriate

26. Develop, review and or approve business plans for each property

27. Identify properties for acquisition or disposition

28. Provide other types of ancillary services such as: nine hole walk on golf courses, boat docks, exercise rooms, whirlpool spas, libraries, car wash areas, automatic cash machines, playgrounds, picnic areas, boat docks; organize tenant social events; lease conference rooms, maintain exercise rooms, lease space for vending machines (provided by independent third parties); and provide telecommunications services (by negotiating cable lease and easement agreements with internet service providers, broadcasters, long distance operators, and other service providers that provide telephone and other communications, cable, e-mail, video communications, electronic research, internet access, networking, safety and security systems, and environmental control systems and similar types of systems and services or in some cases setting up cable service at a property)

29. Provide "courtesy" services like facsimile and copy machine services, vacuum cleaners, the holding of mail, etc.

C. CONSTRUCTION AND DEVELOPMENT ACTIVITIES

1. Plan, design, supervise, and administer the development of properties and the construction and rehabilitation work and remodeling of interior tenant space, perform pricing estimates and cost analysis, negotiate and contract for engineering and feasibility studies, arrange for zoning and building permits, employ and supervise architects and contractors, assist in the layout and design of tenant space, approve and process invoices and disburse funds, order building materials and supplies and inspect and approve plans and work performed for aesthetic factors, effect on property value and compliance with laws and regulation

2. Work with engineers, consultants, contractors and governmental agencies to prevent, detect, and remedy environmental contamination

D. FISCAL ACTIVITIES

1. Supervise property revenue collections, including the handling of property receipts, journal entries, records of account, bank deposits, and delinquent accounts

2. Administer the payroll, directly or through others, for on-site personnel, off-site management staff, or sub-contracted management firms

3. Make principal and interest, insurance, tax and utility payments

4. Prepare periodic property operating statements, together with any required explanatory text Analyze and review the property's financial requirements and evaluate available options for property financing

Attachment B: Request to Speak, Outline of Topics for September 18, 2014 Hearing, and Time to be Allocated to Each Topic

NAREIT requests the opportunity to speak at the September 18, 2014 hearing concerning the Proposed Regulations. Dara F. Bernstein, NAREIT's senior tax counsel, will speak on behalf of NAREIT.

The outline of topics to be discussed at the public hearing is set forth below:

1. In particular, NAREIT will commend the IRS and Treasury Department for attempting to codify (some would say "regify") existing guidance. NAREIT will suggest that the Proposed Regulations include additional examples. (1 minute)

2. NAREIT will recommend that the Proposed Regulations eliminate the use of the terms "active" or "passive" in connection with whether an asset is real property. (1 minute)

3. NAREIT will recommend that one of the factors applicable to determining whether an asset is an inherently permanent structure be modified from "[w]hether the distinct asset is designed to be removed or to remain in place indefinitely" to a more realistic test. (1 minute)

4. NAREIT will recommend that the IRS eliminate the requirement with respect to structural components that a REIT have an equivalent interest in an inherently permanent structure. In the alternative, NAREIT will recommend that this metric be changed to "a real estate interest." (1 minute)

5. In order to eliminate confusion and avoid additional drain on IRS' limited resources from ruling requests, NAREIT will recommend that the IRS list the following as *per se* real property: a number of the "building systems" that have been considered real property by the IRS in private letter rulings; car charging stations (inherently permanent structures); storage facilities and health care facilities (buildings); and, timber (natural products of the land). (1 minute)

6. NAREIT will recommend that the test for whether an intangible is real property be modified from that stated in the regulations to include whether the intangible alternatively is derived from the trade or business of earning revenues from consideration for the use or occupancy of real estate or related services. (1 minute)

7. NAREIT will recommend that the IRS clarify that taxpayers who received private letter rulings concluding that their particular assets were real property should be permitted to continue to rely on those rulings. Further, NAREIT will recommend that the regulations be applicable to taxable years beginning after regulations are finalized with possibility to elect to apply the regulations to earlier time periods. (1 minute)

8. Finally, in response to the IRS and Treasury Department request on the extent to which the various meanings of real property that appear in the Treasury regulations should be reconciled, whether through modifications to the Proposed Regulations or through modifications

to the regulations under other Code provisions, NAREIT will urge the IRS to defer to Congress to reconcile potentially conflicting definitions as doing so is more appropriately the role of Congress. (1 minute).