

NEW RULINGS PRESENT OPPORTUNITIES, BUT NOT CARTE BLANCHE

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Background

The primary barrier to qualification as a real estate investment trust (“REIT”) is the requirement for REITs to meet certain income source requirements. At least 75% of a REIT’s income must consist of real-estate related items, and at least 95% must consist of passive income. Income classified as “rent from real property” within the meaning of Section 856(c)(2) is the primary component of income satisfying these income tests (other than for mortgage and hybrid REITs). Due to the fact-intensive nature of the determination of whether a given item of income qualifies as rent from real property, taxpayers often rely heavily on private letter rulings from the IRS in evaluating whether a given item of income will qualify. Over the years, the general trend has been towards more liberal rulings. 2012 was no exception to that trend.

REIT Conversion Opportunities and Investment Opportunities for Existing REITs

Although REITs were originally envisioned by Congress primarily as a vehicle for ordinary retail investors to passively invest in real estate, certain businesses with significant non-real estate activities that nevertheless possess substantial real estate holdings have identified REIT structures as attractive vehicles for reducing the tax

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liability of their enterprises.¹ Recent rulings and high-profile conversion announcements have sparked a flurry of interest in the potential for REIT conversions for businesses that previously might have had difficulty satisfying the REIT income tests. For example, SBA Communications' recently announced intention to convert to a REIT may have been inspired by a reaffirmation by the IRS that communications towers and antenna superstructures may be classified as real, as opposed to, personal property.² Likewise, the IRS recently granted several rulings allowing the leasing of billboards and other advertising structures to qualify as rent from real property, making way for Lamar Advertising's recent REIT conversion announcement.³

Structures analogous to those holding advertising or broadcasting equipment could conceivably qualify as real property. When a structure is substantial and permanent in nature, and does not serve any purpose other than to provide a mounting point for equipment, there exists a reasonable argument that the rental of such a structure will produce rents from real property. A mounting structure for a wind turbine or solar panel, for example, would likely qualify as "real property" so long as the structure itself is not related to energy production. Or, more conservatively, building rooftops may be rented for the purpose of installing energy-producing equipment under the same rationale allowing the rental of similar space for other equipment.

Caution

Despite the excitement, it is unlikely that the recent rulings portend an expansion of the definition of "real property" to include actual production equipment or the sale of

¹ Although Code Section 856(d) prevents related party rents from qualifying as rents from real property (other than for certain lodging and healthcare facilities), a public company may avoid this provision by spinning off its real estate assets into a separate publicly-held company.

² See Rev. Rul. 75-424, 1975-2 C.B. 269; Priv. Ltr. Rul. 201206001 (Feb. 10, 2012).

³ See Priv. Ltr. Rul. 201204006 (Jan. 27, 2012).

energy.⁴ The recent rulings generally rely on a representation that communications or advertising structures are “integral” to another edifice, such that they are not readily removable.⁵ Although stand-alone antenna towers have already been defined as real property, the “integral part” representation provides a distinguishing factor between permanent real estate and “equipment”, such as antennas themselves, which have been clearly identified as personal property.⁶ However, no consistent rule exists to parse the distinction between equipment and structures. Without such a rule, enterprises seeking to apply the real property definition to new and novel situations would be well advised to seek their own rulings rather than rely on opinion of counsel.

Even with a liberalized and better-defined definition of rents from real property, REIT status is not appropriate for all enterprises with significant real estate holdings. One significant impediment is cost. Section 857(a)(2)(B) requires the converting entity to distribute all its accumulated earnings and profits as a taxable dividend. For organizations with significant accumulated earnings and profits, lack of available cash may stymie a conversion to REIT status. Additionally, REIT status imposes significant administrative and legal costs, which, depending on the organization’s circumstances, could outweigh any tax benefits.

Particular caution should be exercised with respect to enterprises whose business activities must be carefully tailored or altered to satisfy the REIT income tests. For example, a wind energy company attempting to qualify as a REIT could be forced to

⁴ It has been reported that the IRS intends to issue a ruling on solar properties, but it is unlikely that such a ruling, at least in the context of a commercial production facility, would include photovoltaic cells themselves as “real property”, since such a ruling would far exceed the scope of prior rulings and the regulations under Section 856. See Tom Konrad, *IRS to Rule on Status of Solar PV Owned by REITs*, Forbes (Oct. 12, 2012), available at <http://www.forbes.com/sites/tomkonrad/2012/10/12/irs-to-rule-on-status-of-solar-pv-owned-by-reits/>.

⁵ See *supra* note 3.

⁶ Treas. Reg. 1.856-3(d) provides that assets used in the “operation of a business” are not considered real property.

forgo a potentially lucrative opportunity to invest in a new form of turbine. While it may be possible to successfully bifurcate qualifying and non-qualifying REIT income through the use of taxable REIT subsidiaries or independent contractors, such solutions may cause the REIT to forgo the economic benefit of the activity or incur significant administrative burdens.

Going Forward

Despite the caveats, qualification as a REIT carries with it very favorable tax benefits. Markets have rewarded businesses poised to convert to REIT status with healthy jumps in share price. Directors of potential REITs would be wise to examine the new possibilities for REIT creation or conversion.