



[4830-01-p]

DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[TD 9784]

RIN 1545-BM05

Definition of Real Estate Investment Trust Real Property

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations that clarify the definition of real property for purposes of the real estate investment trust provisions of the Internal Revenue Code (Code). These final regulations provide guidance to real estate investment trusts and their shareholders.

DATES: Effective date: These regulations are effective on **[INSERT DATE OF PUBLICATION IN THE FEDERAL REGISTER]**.

Applicability date: For dates of applicability, see §1.856-10(h).

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SUPPLEMENTARY INFORMATION:

**Background**

This document contains amendments to the Income Tax Regulations (26 CFR part 1) relating to real estate investment trusts (REITs). Section 856 of the Code

defines a REIT by setting forth various requirements. One of the requirements for a taxpayer to qualify as a REIT is that at the close of each quarter of the taxable year at least 75 percent of the value of its total assets is represented by real estate assets, cash and cash items (including receivables), and Government securities. See section 856(c)(4). Section 856(c)(5)(B) defines real estate assets to include real property (including interests in real property and interests in mortgages on real property). Section 856(c)(5)(C) defines interests in real property to include fee ownership and co-ownership of “land or improvements thereon.” Prior to these final regulations, §1.856-3(d) of the Income Tax Regulations, promulgated in 1962 in TD 6598 (the 1962 Regulations), defined real property for purposes of the regulations under sections 856 through 859. Under §1.856-3(d) of the 1962 Regulations, the term real property means land or improvements thereon, such as buildings or other inherently permanent structures thereon (including items which are structural components of such buildings or structures). In addition, the term “real property” includes interests in real property. Local law definitions will not be controlling for purposes of determining the meaning of the term “real property” as used in section 856 and the regulations thereunder. The term includes, for example, the wiring in a building, plumbing systems, central heating, or central air-conditioning machinery, pipes or ducts, elevators or escalators installed in the building, or other items which are structural components of a building or other permanent structure. The term does not include assets accessory to the operation of a business, such as machinery, printing press, transportation equipment which is not a structural component of the building, office equipment, refrigerators, individual air-conditioning units, grocery counters, furnishings of a motel,

hotel, or office building, etc., even though such items may be termed fixtures under local law.

The IRS issued revenue rulings between 1969 and 1975 addressing whether certain assets qualify as real property for purposes of section 856. Specifically, the published rulings address whether assets such as railroad properties,<sup>1</sup> mobile home units permanently installed in a planned community,<sup>2</sup> air rights over real property,<sup>3</sup> interests in mortgage loans secured by total energy systems,<sup>4</sup> and mortgage loans secured by microwave transmission property<sup>5</sup> qualify as either real property or interests in real property under section 856. After these published rulings were issued, REITs invested in various types of assets that are not directly addressed by the regulations or the published rulings, and some of these REITs received letter rulings from the IRS concluding that certain of these various assets qualified as real property. A letter ruling, however, may not be relied upon by taxpayers other than the taxpayer that received the letter ruling<sup>6</sup> and is limited to its particular facts. The Treasury Department and the IRS recognized the need to provide updated published guidance on the definition of real property under sections 856 through 859. On May 14, 2014, the Treasury Department and the IRS published in the **Federal Register** a notice of proposed rulemaking (REG-150760-13 at 79 FR 27508) (NPRM) to define “real property” solely for purposes of

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<sup>1</sup> Rev. Rul. 69-94 (1969-1 CB 189).

<sup>2</sup> Rev. Rul. 71-220 (1971-1 CB 210).

<sup>3</sup> Rev. Rul. 71-286 (1971-2 CB 263).

<sup>4</sup> Rev. Rul. 73-425 (1973-2 CB 222).

<sup>5</sup> Rev. Rul. 75-424 (1975-2 CB 269).

<sup>6</sup> Rev. Proc. 2016-1 (2016-1 IRB 1), section 11.02; see section 6110(k)(3) of the Code.

sections 856 through 859 and provisions that reference the definition of real property in section 856 and the regulations thereunder.

Written and electronic comments responding to the NPRM were received. The written comments are available for public inspection at <http://www.regulations.gov> or upon request. A public hearing was held on September 18, 2014.

After consideration of all the comments, these final regulations adopt the proposed regulations as revised by this Treasury decision.<sup>7</sup> The comments and revisions are discussed in this preamble.

## **Summary of Comments and Explanation of Revisions**

### **I. The Definition of Land**

The proposed regulations defined the term “land” to include water and air space superjacent to land and natural products and deposits that are unsevered from the land. A commenter requested clarification that land includes water space and air space above ground that the taxpayer does not own. For example, a taxpayer may own a building and purchase air rights superjacent to one or more neighboring buildings to enhance the value of the building the taxpayer owns, or a taxpayer may purchase air rights in anticipation of using those rights to facilitate the future acquisition or development of property. The Treasury Department and the IRS agree that air space or water space superjacent to land each qualify as land even if the taxpayer owns only the air space or

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<sup>7</sup> Under section 856(c)(2) and (3), in order for an entity to qualify as a REIT, certain prescribed percentages of that entity’s gross income must be derived from certain types of income (which include “rents from real property” and “interest on obligations secured by mortgages on real property or on interests in real property”). The definition of real property in these final regulations applies for purposes of section 856(c)(2) and (3), but these final regulations provide neither explicit nor implicit guidance regarding whether various types of income are described in section 856(c)(2) and (3).

water space and does not own an interest in the underlying land. The proposed regulations stated that superjacent water and air space qualify as land, and these final regulations retain the language of the proposed regulations.

## II. The Definition of Improvements to Land

The proposed regulations generally defined the term “improvements to land” to mean inherently permanent structures (IPs) and their structural components. A commenter recommended that these final regulations clarify that clearing, grading, landscaping, and earthen dams should be treated as improvements to land. The Treasury Department and the IRS believe that, to the extent these assets are distinct assets that have value apart from the land, the REIT must analyze these assets separately under these final regulations. For example, if landscaping includes shrubs planted in the ground, the shrubs are within the definition of land in these final regulations so long as the shrubs remain unsevered natural products of the land. If, however, landscaping includes a bench that is a distinct asset, the bench is analyzed under the factors for an IP in these final regulations to determine whether the bench is real property.

## III. The Definition of IP

### A. Passive function requirement and active function prohibition

#### 1. In General

Under the proposed regulations, IPs include buildings and other inherently permanent structures (OIPs). To qualify as an OIP under the proposed regulations, a structure must serve a passive function, such as contain, support, shelter, cover, or protect, and not serve an active function, such as manufacture, create, produce,

convert, or transport. Commenters suggested that use of the terms active and passive may cause confusion because, for example, REITs 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 produce income qualifying as rents from real property within the meaning of section 856(d).<sup>8</sup>

During the hearing, a commenter stated that REITs may perform certain services and that the requirement that an OIPS serve a passive function may be at odds with this permissible activity. This commenter suggested that the requirement be revised to: (1) State that OIPSS serve a real estate-related function; (2) require that the asset not primarily contribute to the production of income other than for the use, occupancy, or financing of space; or (3) not include the terms passive and active when describing permissible and prohibited functions. Other commenters suggested that the function of a distinct asset not be considered in determining whether the distinct asset is an OIPS. These commenters maintained that inherent permanence should be the only requirement for a distinct asset to qualify as an OIPS.

These final regulations do not adopt these suggestions. These final regulations address whether the asset itself has a passive function, not whether the asset is used in an active trade or business or whether income from the asset is income from an active trade or business. The requirement in the proposed regulations and in these final regulations that an asset serve a passive function is intended to be a more precise statement of the distinction previously set forth in §1.856-3(d) of the 1962 Regulations, which treated as real property certain passive assets but not assets accessory to the

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<sup>8</sup> See Rev. Rul. 2001-29 (2001-1 CB 1348).

operation of a business, including machinery. The Treasury Department and the IRS believe that the terms passive and active, when taken together with the examples in these final regulations, appropriately clarify and illustrate the permissible functions of an OIPS. The passive function requirement neither prohibits a tenant from using a passive asset, such as an office building, in the tenant's active business nor limits a REIT's ability to perform either the services excepted under section 856(d)(7)(C)(ii) or the trustee or director functions permitted by §1.856-4(b)(5)(ii).

The Treasury Department and the IRS believe that the commenters' suggested real estate-related standard is circular and might support real property treatment for assets that serve active functions. Further, the Treasury Department and the IRS do not agree that inherent permanence alone is a sufficient basis for a distinct asset to be treated as an IPS. For example, the Treasury Department and the IRS continue to believe that some inherently permanent assets, such as large, heavy machinery, do not qualify as real property for purposes of section 856.

A commenter suggested replacing the passive function requirement with a test that focuses on an asset's human factor, which the commenter defined as whether, and the extent to which, human involvement is needed for an asset to function. This commenter contended that human involvement is a characteristic of an active function and, therefore, should be taken into account in determining whether a particular asset is active or passive. The Treasury Department and the IRS disagree and continue to believe that machinery, including automated machinery that functions with little or no human involvement, does not qualify as real property for purposes of section 856.

## 2. Transport as a Prohibited Active Function

The proposed regulations listed transport as an active function. Commenters noted that this active function differs from the other four active functions (manufacture, create, produce, and convert) that involve changing the physical nature or character of a commodity or good. Commenters also suggested that some of the assets on the list of types of OIPs in the proposed regulations, such as railroad tracks and tunnels, help to transport a good or a commodity.<sup>9</sup>

The Treasury Department and the IRS agree that the term transport could be interpreted to describe functions of both passive conduits used for transportation and machines that push or pull items through or along a conduit. The Treasury Department and the IRS intend the term transport to mean to cause to move, and these final regulations retain transport as a prohibited active function of an OIP. To provide clarity, these final regulations include providing a conduit (such as in the case of a pipeline or electrical wire) or route (as in the case of a road or railroad track) as a permitted passive function of an OIP.

## 3. Assets with Both Active and Passive Functions

In addition to other requirements, §1.856-10(d)(2)(i) of the proposed regulations stated that a distinct asset that serves an active function, such as machinery or equipment, is not a building or OIP.

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<sup>9</sup> Commenters also noted that several assets listed as structural components, such as elevators and escalators, transport objects or occupants of a building. A structural component may have an active function if the structural component serves the passive function of the OIP of which it is constituent.

Commenters suggested that solar panels can perform dual functions, including a passive function (that is, to shelter) and an active function (that is, to convert (energy)). Commenters stated that solar panels may be used to protect pastures, parking lots, buildings, and other structures from the detrimental effects of solar radiation and to manage temperature through shading. The structures to which solar panels are attached—or even into which they are integrated—may qualify as IPSs under the proposed regulations.

The Treasury Department and the IRS note that the example given by the commenters presumes that the solar panel structure is a single distinct asset that serves a passive function of sheltering and an active function of converting energy for sale to third parties. If this were the case, the solar panel structure would fail to qualify as an IPS under §1.856-10(d)(2)(i) of the proposed regulations as a result of the structure's active function. If, however, a solar panel structure is composed of multiple distinct assets, then each of those distinct assets would be analyzed under the proposed regulations to determine whether it qualifies as an IPS or as a structural component of an IPS.<sup>10</sup> Because these final regulations retain the requirement that an IPS not serve an active function, machinery and equipment that may serve both passive and active functions are excluded from the definition of an IPS.

#### **B. Definition of building**

Section 1.856-10(d)(2)(ii)(A) of the proposed regulations stated that a building encloses a space within its walls and is covered by a roof. Examples given in §1.856-

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<sup>10</sup> A similar analysis was applied to the solar energy site assets in §1.856-10(g), Example 8, of the proposed regulations.

10(d)(2)(ii)(B) of the proposed regulations were permanently affixed houses, apartments, hotels, factory and office buildings, warehouses, barns, enclosed garages, enclosed transportation stations and terminals, and stores.

During the hearing, a commenter stated that for appraisal purposes, buildings are considered to be buildings regardless of their permanence. This commenter suggested that these final regulations should adopt standards published by an appraisal organization to define real property.

Section 1.856-3(d) of the 1962 Regulations indicates that inherent permanence is important in determining whether a structure qualifies as real property. A tent, for example, may satisfy the portion of the definition of a building in the proposed regulations that referenced enclosing within its walls a space that is covered by a “roof,” but the impermanent nature of the tent would prevent it from qualifying as a building for purposes of section 856. The purposes of definitions used by appraisal organizations, which focus on valuation, differ from the purposes of definitions used for REIT qualification purposes. For example, although both permanent and impermanent property may be appraised, permanence is of crucial importance in defining real property for REIT qualification purposes. Therefore, these final regulations do not adopt standards published by an appraisal organization.

Another commenter urged the Treasury Department and the IRS to change the definition of building in these final regulations so that the definition does not depend on whether a space is completely enclosed by its walls and covered by a roof. The commenter stated that even an outdoor sports stadium or amphitheater and an

unenclosed parking garage that are permanently affixed to land or another IPS may fail to qualify as buildings under the proposed regulations.

The Treasury Department and the IRS agree that these structures may fail to meet the definition of building under the proposed regulations. The Treasury Department and the IRS believe, however, that many outdoor sports stadiums, amphitheatres, and unenclosed parking garages would satisfy the definition of an OIPS in §1.856-10(d)(2)(iii) of the proposed regulations and that this definition is more appropriate for these structures. Therefore, the definition of building in the proposed regulations is retained in these final regulations.

#### C. Clarification of the term indefinitely

The proposed regulations stated that, to qualify as an IPS, a distinct asset must be permanently affixed and that if the affixation is reasonably expected to last indefinitely based on all the facts and circumstances, the affixation is considered permanent.

Commenters indicated that the term indefinitely as used in determining whether an asset is an IPS was unclear. A commenter suggested using an asset's useful life as an alternate to indefinitely. The Treasury Department and the IRS have concluded that relying on the useful life of an asset as the measure for permanence would have the effect of treating certain impermanent assets as real property. For example, if an asset has a useful life of two years, it would be inappropriate for the asset to be treated as permanently affixed solely because the asset was reasonably expected to remain in place for two years.

Another commenter provided the example of a REIT that constructs a building on land on which the REIT holds a 99-year ground lease. Upon expiration of the lease, the building is subject to removal. In this case, the building may not be on the land in 100 years. Another commenter provided the example of a building that is subject to condemnation and that will be torn down in the future.

Another commenter suggested that whether an asset is inherently permanent should be based upon an objective analysis of the physical nature of the manner of affixation, rather than on a particular taxpayer's subjective intent. This commenter recommended that if the manner of affixation is of a permanent nature and is consistent with the distinct asset remaining in place indefinitely based on all the facts and circumstances, the affixation is considered permanent. Commenters also urged the Treasury Department and the IRS to provide a statement in the preamble to these final regulations that indefinitely does not mean forever but rather means for the foreseeable future.

The Treasury Department and the IRS do not intend the term indefinitely to mean forever. The proposed regulations stated that whether affixation is reasonably expected to last indefinitely is based on all the facts and circumstances. Section 1.856-10(d)(2)(iv) provides factors that must be taken into account to determine whether a distinct asset is an IPS if that distinct asset is not included in the lists of types of buildings in §1.856-10(d)(2)(ii)(B) or types of OIPs in §1.856-10(d)(2)(iii)(B). These factors provide additional guidance on the meaning of permanent affixation. The primary focus of these factors is on the nature of the distinct asset and the affixation, including the manner in which the distinct asset is affixed, whether the distinct asset is

designed to be removed, the damage that removal would cause, and the time and expense required to move the distinct asset. Although one factor includes any circumstances that suggest the expected period of affixation is not indefinite and provides as an example a lease that requires or permits removal of the distinct asset upon the expiration of the lease, the determination of whether a distinct asset is an IPS is based on all of the facts and circumstances.

These final regulations do not adopt these suggestions and, because the Treasury Department and the IRS do not believe additional guidance regarding inherent permanence is necessary, retain the definition of IPS as proposed.

D. Suggested presumption for structures with a certificate of occupancy or similar license

A commenter agreed that state or local definitions of property should not control for purposes of the definition of real property under section 856, but suggested that when a certificate of occupancy or similar license or certification is granted with respect to a structure, the structure be presumed to constitute real property for purposes of section 856 unless the facts and circumstances clearly indicate that the structure is not permanent.

Local law standards for a certificate of occupancy or similar license or certification might be inconsistent with the definition of real property for purposes of section 856. For example, local law might permit issuance of a certificate of occupancy for a tent that is not inherently permanent. In addition, this presumption might lead to inconsistent results. For example, two identical assets located in localities that use different standards for licensing might be treated differently for purposes of section 856 because a certificate of occupancy has been granted to one of the assets and not to the

other. For these reasons, we believe the suggested presumption would create confusion and administrative difficulty, and, therefore, these final regulations do not adopt this comment.

#### IV. The Definition of Structural Component

##### A. Income produced by a structural component

In generally defining the term structural component, §1.856-10(d)(3)(i) of the proposed regulations stated, in part, that a structural component is any distinct asset that is a constituent part of and integrated into an IPS, serves the IPS 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.

A commenter requested that the words “and related services” be added to the language of §1.856-10(d)(3)(i). If that request were adopted, structural components would include assets that serve the IPS and even if capable of producing income other than consideration for the use or occupancy of space and related services, do not produce or contribute to the production of such income (emphasis added to indicate commenter’s suggested language). The commenter stated that REITs use property such as the systems that supply utilities to a building to provide services to tenants. The commenter explained that a REIT may receive additional compensation to cover utilities that the REIT provides to the tenant when the tenant uses space in the building outside of specified business hours.

The Treasury Department and the IRS have concluded that the definition of structural component in the proposed regulations adequately accounts for the concerns

raised by the commenter, and accordingly these final regulations do not incorporate the commenter's suggested revision.

**B. Proposed utility safe harbor for structural components**

A commenter recommended that these final regulations adopt a safe harbor for distinct assets that provide utilities to IPSs. The commenter recognized that the utility-like function aspect of the definition in the proposed regulations underscores the importance of that type of structural component and suggested that a distinct asset that serves a utility-like function with respect to an IPS should be conclusively presumed to be a structural component of that IPS.

The Treasury Department and the IRS note that the list of types of structural components in the proposed regulations included several utility-like systems, such as plumbing systems, central heating and air-conditioning systems, fire suppression systems, central refrigeration systems, and humidity control systems. The Treasury Department and the IRS may add other systems that satisfy the factors in §1.856-10(d)(3)(iii) to the structural component list through future guidance published in the Internal Revenue Bulletin. The proposed regulations differentiated systems that perform utility-like functions from other distinct assets to permit analysis of these systems as a whole. Under the proposed regulations, once it has been determined that an asset or assets function as a utility-like system, the system is analyzed as a distinct asset basing the determination of whether the system is real property on all of the facts and circumstances and using the factors listed under §1.856-10(d)(3)(iii) for structural components. A system or asset that provides a utility but that does not qualify as a

structural component under the facts and circumstances test under §1.856-10(d)(3)(iii) (for example, a window air-conditioning unit) is not a structural component.

Because the Treasury Department and the IRS believe that the factors listed under §1.856-10(d)(3)(iii) for structural components are important to the analysis of systems that provide a utility-like function these final regulations decline to adopt the blanket rule suggested by the commenter.

### C. The equivalent interest requirement for structural components

Section 1.856-10(d)(3)(i) of the proposed regulations stated that a distinct asset is a structural component if the interest held therein is included with an equivalent interest held by the taxpayer in the IPS to which the structural component is functionally related. Commenters suggested that the equivalent interest requirement for structural components be deleted or amended because the requirement: (1) Is inconsistent with industry practices and an asset should qualify as a structural component even if the REIT owns the asset but leases from another party the building served by the structural component; (2) may negatively affect investment in energy efficient and renewable energy assets; (3) was not explained in the proposed regulations and seemingly serves no tax policy purpose; and (4) is contrary to congressional intent, case law, and the treatment of structural components by the IRS in other contexts.

The Treasury Department and the IRS intended that the equivalent interest requirement in the proposed regulations ensure that an asset did not qualify as a structural component unless that asset served real property in which the REIT also had an interest. The Treasury Department and the IRS set forth a similar requirement in Rev. Rul. 73-425, which addresses notes secured by a total energy system. Rev. Rul.

73-425 holds that obligations secured by a mortgage covering a total energy system and the building that the system served qualify as real estate assets. The revenue ruling also holds that an obligation secured only by the total energy system does not qualify as a real estate asset.

The Treasury Department and the IRS believe that, to treat an asset as a structural component, a REIT must hold its interest in the structural component together with a real property interest with respect to the space in the IPS that the structural component serves. For example, a central air-conditioning system is a machine that does not separately qualify as an IPS. A central air-conditioning system that is wholly owned by a REIT may, however, qualify as a structural component if the REIT also holds a real property interest, such as a leasehold interest, with respect to the space in the IPS served by the central air-conditioning system. Limiting the definition of structural component to assets that serve an IPS in which the REIT has a real property interest is consistent with the statutory requirement that REITs invest in real property or interests in real property.

For these reasons, these final regulations provide that a distinct asset qualifies as a structural component only if the REIT holds its interest in the distinct asset together with a real property interest with respect to the space in the IPS that the distinct asset serves. In addition, as illustrated by Rev. Rul. 73-425, for a mortgage that is secured by a structural component to qualify as a real estate asset under these final regulations, the mortgage also must be secured by the IPS served by the structural component.

#### D. Suggested standard for structural components

Section 1.856-10(3)(i) of the proposed regulations defined a structural component to include a distinct asset that serves the IPS 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.

Section 1.856-10(d)(3)(ii) of the proposed regulations furnished a list of distinct assets that are structural components. The proposed regulations also stated that a distinct asset that was not on this list might still be a structural component based on all of the facts and circumstances. In particular, the proposed regulations required the factors listed under §1.856-10(d)(3)(iii) to be taken into account.

A commenter suggested that the standard for a structural component should be revised so that a structural component is defined as a distinct asset that is intended to protect, preserve, secure, or support the safe operation of the IPS. The commenter suggested that satisfying this standard should be sufficient to determine if a distinct asset is a structural component and, therefore, the structural component factor test under §1.856-10(d)(3)(iii) of the proposed regulations is unnecessary.

These final regulations do not adopt the commenter's suggestion because the standard suggested would in some circumstances unduly limit the functions a structural component may serve and in other circumstances unduly expand the functions a structural component may serve. The Treasury Department and the IRS do not believe this modification is necessary given these final regulations' requirement that a structural component serve the IPS to which the structural component is constituent in the IPS's passive function. In addition, the Treasury Department and the IRS have concluded

that adopting a standard that takes into account a taxpayer's intent regarding an asset may lead to inconsistent results because different taxpayers may have different intentions regarding the same type of distinct asset.

## V. Requested Additions to the Lists of Qualifying Assets

### A. General suggestions

Sections 1.856-10(d)(2)(ii)(B), 1.856-10(d)(2)(iii)(B), and 1.856-10(d)(3)(ii) of the proposed regulations furnished lists of types of distinct assets that would qualify as buildings, OIPs, and structural components, respectively. A commenter requested that certain other distinct assets be included on these lists. These other distinct assets included car charging stations, healthcare facilities, storage facilities, timber, electrical distribution and redundancy systems, telecommunication systems, and equipment comprising a building management system.

The Treasury Department and the IRS have considered the proposed additions to the lists of qualifying assets and believe that the proposed regulations already addressed the tax treatment of certain of these assets, such as storage facilities and timber. In addition, the Treasury Department and the IRS are not persuaded that the other assets will in all cases satisfy the relevant definition. Therefore, these final regulations do not include these suggested additions to the lists of qualifying assets.

### B. Additions to the lists for types of IPSs

#### 1. Additions to the List for Types of Buildings

Commenters suggested adding motels, casinos, health care facilities, storage facilities, greenhouses, enclosed stadiums, enclosed shopping malls, museums, municipal buildings, other housing (such as assisted living), parking garages (whether

or not fully enclosed), and mixed-use properties combining one or more of the foregoing to the list for buildings under §1.856-10(d)(2)(ii)(B) of the proposed regulations.

These assets would not always qualify as buildings as defined under the proposed regulations and in these final regulations. For example, casinos may be on an unaffixed barge or riverboat, health care facilities may be in tents, storage facilities may include movable pods, and greenhouses may be structures that are not permanently affixed. Unenclosed parking garages were not within the definition of a building under the proposed regulations but were included in the list of types of OIPs in §1.856-10(d)(2)(iii)(B) of the proposed regulations (which included permanently affixed parking facilities). Museums may exist on unaffixed boats, in a room inside a building, or in the open air.

A mixed-use building would still qualify as a building because it encloses space within its walls and is covered by a roof. On the other hand, a mixed-use property comprised of several structures would require a separate analysis of each structure. The suggestions to include municipal buildings and assisted-living facilities focus on the use, rather than the type, of structure. In addition, office buildings, apartments, and houses were already included on the proposed regulations' list.

A distinct asset not on the list may nevertheless qualify as a building, because the list for types of buildings in the proposed regulations is not exclusive. Moreover, many of the requested assets are already included in that list. For these reasons, these final regulations do not include all the requested assets on the list for types of buildings. However, these final regulations include as types of buildings permanently affixed motels, enclosed stadiums and arenas, and enclosed shopping malls.

## 2. Additions to the List for Types of OIPSSs

Some commenters requested certain assets be added to the list under §1.856-10(d)(2)(iii)(B) of the proposed regulations for types of OIPSSs, including energy storage components, solar photovoltaic (PV) panels, related wiring and functionally related transformers, power conditioning equipment, and electrical power inverters and related wiring.

The Treasury Department and the IRS have determined that adding these assets to the list for types of OIPSSs is not warranted. Inclusion of these assets would be inconsistent with the requirements that OIPSSs serve a passive function and do not serve an active function.<sup>11</sup> Therefore, these final regulations do not include these assets on the list for types of OIPSSs.

### C. Additions to the list for types of structural components

One commenter suggested that the list under §1.856-10(d)(3)(ii) of the proposed regulations for types of structural components should include special flooring for data centers. The proposed regulations stated that customization of a distinct asset in connection with the rental of space in or on an IPS to which the distinct asset relates does not affect whether the distinct asset qualifies as a structural component. The list of types of structural components in §1.856-10(d)(3)(ii) of the proposed regulations included permanent coverings of floors. The commenter's suggestion of specifically including special flooring in a data center is an example of customization of a distinct asset in connection with the rental of space in an IPS. These final regulations, like the

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<sup>11</sup> Depending on all the facts and circumstances, however, some or all of these assets may qualify as structural components of an IPS.

proposed regulations, permit the customization of distinct assets in connection with the rental of space in or on an IPS, provided that the customized asset is integrated into the IPS and is held together with a real property interest in the space in the IPS that is served by the asset. Accordingly, these final regulations do not include special flooring in a data center on the list of types of structural components.

Another commenter recommended that the list for types of structural components be expanded to include solar energy generating and heating systems and related energy storage equipment. The Treasury Department and the IRS do not believe that solar energy generating and heating systems and related energy storage equipment necessarily satisfy the definition of structural components in §1.856-10(d)(3) of the proposed regulations but rather believe these assets should be analyzed using all the facts and circumstances and taking into account the factors provided in §1.856-10(d)(3)(iii) of these final regulations. For these reasons, these final regulations do not adopt the recommendation.

#### VI. Recommended Changes to the Factor Lists in §1.856-10(d)(2)(iii) and (3)(iv) of the Proposed Regulations

##### A. Recommended change to the factors used to determine whether a distinct asset is an IPS

The proposed regulations listed factors to be considered in determining whether a distinct asset (other than a type of building or type of OIPS listed in §1.856-10(d)(2)(ii)(B) of the proposed regulations or §1.856-10(d)(2)(iii)(B) of the proposed regulations, respectively) is an IPS. One factor is whether there are any circumstances that suggest the expected period of affixation is not indefinite (for example, a lease that requires or permits removal of the distinct asset upon the expiration of the lease).

One commenter stated that buildings constructed on land subject to a long-term ground lease arguably would not satisfy this factor. Another commenter stated that removal provisions are common in commercial leases and, as a practical matter, such provisions may not be determinative as to whether the asset is ultimately removed by the lessee at the expiration of the lease. This commenter recommended that the factor be changed to any circumstance that suggests the manner of affixation is temporary in nature rather than permanent.

As previously discussed in this preamble, for purposes of section 856, the Treasury Department and the IRS do not intend the term indefinitely to mean forever. Whether a distinct asset qualifies as an IPS depends on all the facts and circumstances including an analysis of the factors in §1.856-10(d)(2)(iv). For these reasons, this factor is not modified in these final regulations.

**B. Recommended change to the factors used to determine whether a distinct asset is a structural component**

For distinct assets other than those listed in §1.856-10(d)(3)(ii) of the proposed regulations as structural components, the proposed regulations listed factors under §1.856-10(d)(3)(iii) that must be taken into account in determining whether the distinct asset qualifies as a structural component of an IPS. One of those factors was whether the owner of the property was also the legal owner of the distinct asset. A commenter noted that a REIT may have a leasehold interest in real property and may own a structural component that it installs as part of the real property. An example provided by the commenter is a REIT that leases the shell of a building and then engages independent contractors to complete internal build-outs to customize the shell of the building into a shopping mall.

The Treasury Department and the IRS have considered this comment, along with the comments received regarding the equivalent interest requirement, as discussed in this preamble. Accordingly, these final regulations require that, for a distinct asset to be a structural component, a REIT must hold a legally enforceable real property interest in the space in the IPS that the structural component serves.

## VII. Intangible Assets

### A. Intangibles derived from the trade or business of earning revenues for the use of real property or related services

Under §1.856-10(f) of the proposed regulations, an intangible asset is real property or an interest in real property if the asset 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. Commenters requested inclusion of intangible assets derived from services that produce income other than consideration for the use or occupancy of space, which would include workforce-in-place and customer-based intangibles. The Treasury Department and the IRS believe that intangible assets that are separable from real property or an interest in real property should not qualify as real property. The final regulations clarify that intangible assets that are related to services and that are separable from the real property do not qualify as real property.

### B. In-place above and below-market leases

Commenters requested that intangible assets related to in-place above-market leases in which the REIT is the lessor and below-market leases in which the REIT is the lessee be treated as qualifying real property. Under section 856(c)(5)(C), a lease of

land or improvements thereon is an interest in real property and, therefore, a lease of land or improvements thereon is a real estate asset under section 856(c)(5)(B). A lease of real property that produces both rents from real property under section 856(d)(1) and other income that does not so qualify is, in part, an interest in real property under section 856(c)(5)(C) and, in part, an asset other than an interest in real property. To the extent the portion of the lease that is an interest in real property has value, that portion is a real estate asset under section 856(c)(5)(B). These final regulations have been modified to clarify that an intangible asset may be, in part, an interest in real property and, in part, an asset other than an interest in real property. In addition, these final regulations include an example illustrating the application of these final regulations to an in-place above-market lease that produces both income that qualifies as rents from real property under section 856(d)(1) and other income that does not so qualify.

C. Intangible assets that result from mergers, certain business combinations, and stock or asset acquisitions

Section 1.856-10(f)(1) of the proposed regulations generally defined an intangible asset to include certain intangible assets established under generally accepted accounting principles (GAAP) as a result of an acquisition of real property or an interest in real property. Commenters noted that intangible assets may result from mergers, certain business combinations, and stock or asset acquisitions. The commenters urged that the final regulations acknowledge that REITs may acquire intangible assets in both asset and stock transactions.

The proposed regulations used the acquisition of real property or an interest in real property as an example of a type of transaction in which an intangible asset may be established under GAAP. Under §1.856-2(d)(3), the term total assets means the gross

assets of the REIT determined in accordance with GAAP. Thus, an intangible asset that, in accordance with GAAP, results from a merger, business combination, or stock or asset acquisition may qualify as real property. Because the proposed regulations did not preclude real property treatment of intangible assets resulting from mergers, certain business combinations, or stock or asset acquisitions, the Treasury Department and the IRS have concluded that no change is necessary to the final regulations to accommodate the commenter's concern.

D. Use permits and leases requiring property to be operated for a specific use

Section 856(c)(5)(C) defines interests in real property to include leaseholds of land or improvements thereon. Section 1.856-10(f)(2) of the proposed regulations stated that, if a license, permit, or other similar right solely for the use, enjoyment, or occupation of land or an IPS is in the nature of a leasehold or easement, that right generally is an interest in real property. However, a license or permit to engage in or operate a business generally is not real property or an interest in real property because the license or permit produces or contributes to the production of income other than consideration for the use or occupancy of space.

Section 1.856-10(g), Example 12, of the proposed regulations concluded that a special use permit from a government that, under governmental regulations, was not a lease of the land but was a permit to use the land for a cell tower was an interest in real property. Section 1.856-10(g), Example 13, of the proposed regulations illustrated that a license from a government to operate a casino in a specific building is a license to engage in the business of operating a casino and is not real property.

A commenter noted that many leases require property to be operated for a specific use. A property owner has an interest in requiring its property to be operated for its intended purpose. The commenter suggested that a specific-purpose lease should not be excluded from the definition of real property as an operating license.

The Treasury Department and the IRS generally agree that a requirement in a lease agreement that property be operated for a specific use does not cause the lease to fail to be treated as an interest in real property. A specific use requirement in a lease is distinguishable from a license or permit to operate a business. Such a requirement is generally a term or condition of a lease requiring that real property be used in the manner permitted by the property owner or landlord and does not constitute a separate grant by a governmental entity of the right to operate a business. Example 12 concludes that a special use permit to use land for a specific purpose, a cell tower, is an interest in real property. Consistent with Example 13, if the special use permit in Example 12 included a governmental authorization required to conduct a business that would produce income other than consideration for the use or occupancy of space, that portion of the special use permit would not be real property for purposes of these rules. Therefore, the Treasury Department and the IRS do not believe that any change in the proposed regulations is needed to address the commenter's concern.

#### E. Treatment of intangible assets in another context

A commenter noted that goodwill is not considered real property for appraisal purposes. The commenter recommended that goodwill be characterized as something other than real property, but nevertheless be provided the same tax treatment as real property. The Treasury Department and the IRS do not agree with this

recommendation. Section 856 governs the determination of whether an asset is real property for REIT qualification purposes. Under §1.856-2(d)(3), the gross assets of the REIT are determined in accordance with GAAP. Therefore an asset determined in accordance with GAAP, such as GAAP goodwill, must for purposes of sections 856 through 859 be accounted for either as real property or as property that is not real property. Although section 856(c)(5)(J)(ii) permits the Secretary to determine that an item of income that is not otherwise qualifying REIT income is considered as gross income that is qualifying REIT income, section 856 does not include a similar provision to permit an asset that is not otherwise real property to be treated as real property.

#### VIII. Procedural and Administrative Matters

##### A. Previously issued letter rulings

A commenter requested that the final regulations provide that taxpayers may continue to rely on previously issued letter rulings. Section 11.04 of Rev. Proc. 2016-1<sup>12</sup> states that a letter ruling may be revoked or modified by the issuance of temporary or final regulations that are inconsistent with that letter ruling. Accordingly, to the extent a previously issued letter ruling is inconsistent with these final regulations, the letter ruling is revoked prospectively from the applicability date of these final regulations.

##### B. Revised applicability date and election to apply these final regulations to earlier quarters

The proposed regulations' applicability date was for calendar quarters beginning after the date that the proposed regulations are published as final regulations in the Federal Register. Commenters requested that the final regulations apply to taxable

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<sup>12</sup> Rev. Proc. 2016-1, 2016-1 I.R.B. at 59.

years beginning after the date that final regulations are published in the Federal Register and that taxpayers be permitted to apply the final regulations to earlier taxable years and quarters.

The Treasury Department and the IRS understand that an applicability date based on a calendar quarter may have unintended consequences in applying the gross income tests in section 856(c)(2) and (3) because those tests apply on an annual basis. For example, for rents to qualify as rents from interests in real property, the asset from which the rents are derived must qualify as real property. An asset that qualifies as real property before the applicability date, but not on or after the applicability date, would generate rents from real property only during quarters before the applicability date. These final regulations adopt this suggestion and apply to taxable years that begin after the date that the final regulations are published as final regulations in the Federal Register. In addition, because the Treasury Department and the IRS intend these final regulations generally to be a clarification of current law, taxpayers are permitted to rely on the final regulations for periods beginning on or before the applicability date. The applicability date for these final regulations is discussed further in this preamble in the “Applicability Date” section.

#### IX. Interaction of the Definition of Real Property for Purposes of Sections 856 through 859 with Other Code Provisions

##### A. Interaction of the final regulations with other provisions that cross-reference the definition of real property for REIT purposes

A commenter noted that §1.860G-2(a)(4) references the definition of real property found in §1.856-3(d) of the 1962 Regulations for purposes of determining whether an obligation is “principally secured by an interest in real property” for regulated

mortgage investment conduit qualification purposes. The proposed regulations were proposed to revise §1.856-3(d) to read as follows: “See §1.856-10 for the definition of real property.” To the extent other Treasury regulations reference the definition of real property in §1.856-3(d), §1.856-3(d), as proposed in the NPRM and as amended by these final regulations, directs taxpayers to apply the definition found in §1.856-10.

#### B. Reconciling definitions of real property

The preamble to the proposed regulations discussed various Code provisions in which the term real property appears. Noting the diverse contexts and varying legislative purposes of the Code provisions in which the term real property appears, the Treasury Department and the IRS requested comments on the extent to which the various meanings of real property that appear in the Treasury regulations should be reconciled.

Several commenters were concerned that the term real property has different meanings as the term is applied for purposes of different Code provisions, which could lead to confusion and inconsistent treatment of taxpayers. A commenter noted that there is no Federal definition of real property and suggested that another Code provision’s restrictions on the use of real property should not preclude a REIT from investing in or financing such real property so long as the property is otherwise inherently permanent. Another commenter noted that under section 197, certain intangible assets are amortized as separate assets not associated with another asset. A third commenter requested clarification that the final regulations apply only to the definition of real property for purposes of sections 856 through 859, so that there is no

conflict between the REIT provisions and other provisions of the Code that govern the investment tax credit and depreciation.

As discussed in the preamble to the proposed regulations, in drafting the proposed regulations, the Treasury Department and the IRS sought to balance (1) the general principle that common terms used in different provisions should have common meanings with (2) the particular policies underlying the definition used in the REIT provisions. These final regulations retain the language in §1.856-10(a) of the proposed regulations stating that §1.856-10 provides definitions for purposes of part II, subchapter M, chapter 1 of the Code. This language addresses the commenters' concerns by limiting the application of the definition of real property under these final regulations to sections 856 through 859.

#### X. Environmental Concerns

Some commenters suggested that the proposed regulations would encourage building in, on, or above water, which these commenters suggested is dangerous to water ecosystems and fish habitats. The commenters also suggested that the aftermath of hurricanes such as Katrina and Sandy should have demonstrated to the Government that development near or on water is dangerous to humans and extremely costly.

Neither section 856 nor the regulations thereunder override any environmental rules or regulations that may restrict development in these areas. In defining land, the Treasury Department and the IRS have concluded that it is important to include water space superjacent to land because rights to this water space are analytically

indistinguishable from rights to air space superjacent to land, which, as discussed in this preamble, are treated as real property. See Rev. Rul. 71-286.

## XI. Renewable Energy

### A. Consequence of net metering on an asset's qualification as real property

Under §1.856-10(d)(3)(i) of the proposed regulations, to qualify as real property, a structural component must serve an IPS and, even if capable of producing income other than consideration for the use or occupancy of space, must not produce or contribute to the production of such income. The preamble to the proposed regulations indicated that the Treasury Department and the IRS are considering guidance to address the treatment of any income earned when a system that provides electricity to an IPS held by a REIT also transfers excess electricity to a utility company.

Commenters questioned whether a structural component would maintain its qualification as real property if the structural component served an IPS in its passive function but also produced a product, such as electricity, that was provided to third parties. One commenter suggested that the relevant test should be whether or not the property has net sales of electricity to the grid. Another commenter noted that the amount of electricity a building may net meter is regulated by the marketplace because utility companies often limit the percentage or amount of electricity that a building may net meter.

The Treasury Department and the IRS are considering whether additional guidance is necessary to address the circumstances under which a distinct asset that serves an IPS may produce electricity that is also sold to third parties and qualify as a structural component of the IPS for REIT purposes. Until additional guidance is

published in the Internal Revenue Bulletin, in any taxable year in which (1) the quantity of excess electricity transferred to the utility company during the taxable year from such distinct assets does not exceed (2) the quantity of electricity purchased from the utility company during the taxable year to serve the IPS, the IRS (x) will not treat the transfer of such excess electricity as affecting the qualification of such distinct assets as structural components of the IPS for REIT purposes, (y) will exercise its authority under section 856(c)(5)(J)(i) to treat any income resulting from the transfer of such excess electricity as not constituting gross income for purposes of section 856(c)(2) and (3), and (z) will not treat any net income resulting from the transfer of such excess electricity as constituting net income derived from a prohibited transaction under section 857(b)(6).

B. Qualification of renewable energy credits as real property for purposes of sections 856 through 859

Commenters requested that the final regulations address the qualification of renewable energy credits (RECs) as real property. Renewable energy credits are credits issued to a provider of renewable energy and may be freely bought and sold. The owner of a system that produces renewable energy may sell RECs without selling the system or the electricity produced by the system.

Because RECs are intangible assets, the Treasury Department and the IRS have determined that RECs should be analyzed as such under §1.856-10(f) of these final regulations. Thus, RECs do not qualify as intangible real property assets under these final regulations because RECs may be sold separately from any real property to which they relate.

### C. Treatment of renewable energy assets as real property as a matter of public policy

Commenters urged the Treasury Department and the IRS to allow REITs to invest in solar energy sites as a means of furthering clean energy objectives. These commenters requested that investors in solar energy have the same access to REIT financing as investors in conventional energy sources such as natural gas, oil, and other fossil and electric energy property. Other commenters noted that private investment would be encouraged by treating certain electricity generating assets as real property.

Congress has not provided for solar energy assets to be treated differently from other assets for purposes of determining whether the assets qualify as real property under the REIT provisions. For this reason, the final regulations do not adopt this suggestion.

### D. Treatment of sunlight and wind rights as interests in land

Commenters suggested that sunlight used to power a solar energy site should be considered either real property or an interest in real property. One commenter analogized sunlight and wind to rights to air space, suggested that a REIT should be allowed to sell the rights to the sunlight or wind enjoyed on its property to third parties, and further suggested that a REIT should be able to treat income from the sale of such rights as qualifying income. This commenter posited that the process used to convert sunlight into electricity is analogous to the process inherent in fruit-bearing plants, which are discussed in §1.856-10(g), Example 1, of the proposed regulations, and that the sunlight, like the plants in Example 1, should be treated as real property. Another commenter characterized sunlight as a resource analogous to oil, gas, and mineral resources inherent in land.

The Treasury Department and the IRS agree that a REIT may lease the air space superjacent to its land, which is an interest in its land, and may allow its tenants access to sunlight and wind. The Treasury Department and the IRS, however, are not aware of an approach that could be used to enable a REIT to rent or grant an interest in sunlight or wind separate from its interest in the land or the air space superjacent to the land. Therefore, these final regulations do not adopt these suggestions.

#### E. Qualification of a concentrating solar power system and its associated assets as real property for purposes of sections 856 through 859

A commenter suggested that a concentrating solar power system uses assets that differ from PV panels to harvest solar energy. This commenter suggested that a concentrating solar power system, including, for example, a parabolic trough system, should be considered real property under these final regulations.

The Treasury Department and the IRS have concluded that this type of system is comprised of many distinct assets that may serve different functions. As illustrated in §1.856-10(g), Examples 8 and 9, these distinct assets may be analyzed using the standards provided in the final regulations for OIPs and structural components. Accordingly, concentrating solar power systems and their associated assets are not added to the lists of qualifying assets in these final regulations.

## XII. Examples

Section 1.856-10(g) of the proposed regulations provided thirteen examples illustrating the application of the proposed regulations in a variety of factual scenarios.

### A. References to net leases

Each of §1.856-10(g), Examples 1, 5, 6, 7, 8, and 10, of the proposed regulations stated that the REIT enters into a long term, triple-net lease of property. A commenter

noted that the term “net lease” is not defined for purposes of section 856 and, therefore, may encompass different economic arrangements, the variations in which are not relevant to whether property is real property. The commenter further contended that many REITs do not net lease their assets. The commenter suggested that if it is necessary to describe the underlying facts, the term “lease” is sufficient and avoids the implication that a REIT must net lease its asset.

Each of Examples 1, 5, 6, 7, 8, and 10 of the proposed regulations stated that the assets are net leased to avoid any potential implication that the REIT is operating the property. Examples 1, 5, 6, 7, 8, and 10 are revised in these final regulations to provide that the REIT neither operates the property nor provides services to the lessee.

#### B. Example 4

Section 1.856-10(g), Example 4, of the proposed regulations analyzed whether a bus shelter is an IPS. One commenter suggested that Example 4 be deleted because it was uncertain if a REIT would make a section 1033(g)<sup>13</sup> election with respect to the bus shelter. Additionally, the commenter was not aware of any REIT that leases or intends to lease bus shelters to a transit authority and believed that such shelters are rarely relocated. For these reasons, the commenter recommended that the example be stricken. No commenters, however, disagreed with the conclusion in the example.

The Treasury Department and the IRS believe that Example 4 is helpful because it describes a structure that is not permanently affixed and thus does not qualify as an

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<sup>13</sup> Section 1033(g)(3) provides that a taxpayer may elect to treat property that constitutes an outdoor advertising display as real property for purposes of chapter 1 of the Code.

IPS under the standards provided in the regulations. Therefore, these final regulations do not adopt this suggestion.

### C. Example 6

Section 1.856-10(g), Example 6, of the proposed regulations illustrated the definition of structural component in the context of a data center. One commenter suggested changes to Example 6 including clarification that the electrical system and telecommunication infrastructure systems are (1) embedded in significant part within the walls and floors of the building, (2) would be difficult to remove, and (3) are intended to remain in place indefinitely. Although suggestions (1) and (2) would clarify the example and would not affect the analysis or conclusion of the example, suggestion (3) is not relevant because the structural component factors in §1.856-10(d)(3)(ii)(B) of the proposed regulations do not include the intent of the owner of the asset. Accordingly, these final regulations revise Example 6 to accurately reflect the integration of these assets into the data center building.<sup>14</sup>

Another commenter suggested that cross-connects used in a data center should not be considered real property because the cross-connects produce income that is not for the use or occupancy of space and this income is significant in comparison to the income produced by other assets in a data center. Example 6 did not, and was not intended to, address every distinct asset that may be part of a data center. Distinct assets that are not addressed in the example may be analyzed by applying the

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<sup>14</sup> For consistency and clarity, similar revisions have been made to other examples illustrating the definition of structural component.

standards set forth in the proposed regulations. Accordingly, no change was made to the final regulation in response to this comment.

E. Example 8

Section 1.856-10(g), Example 8, of the proposed regulations analyzed a solar energy site that includes land, photovoltaic modules (PV modules), mounts and an exit wire. The solar energy site was triple-net leased to an operator who uses the assets to produce and transmit energy to an electrical power grid for sale to third parties. The example concluded that the land, mounts, and exit wire qualify as real property and that the PV modules do not qualify as IPSs because they convert solar energy into electricity, which is an active function.

One commenter requested that the Treasury Department and the IRS update Example 8 to include an analysis of inverters, which the commenter contended serve an active function compared to PV modules, which the commenter contended are relatively passive. Another commenter elaborated on the function of the PV modules, above ground wiring, and inverters. The commenter proposed adding language to Example 8 to state that these assets have no moving parts and are therefore passive.

The Treasury Department and the IRS have concluded that PV modules and inverters that are used in the generation of energy for sale to third parties do not qualify as IPSs under the proposed regulations. The Treasury Department and the IRS do not believe the inclusion of above ground wiring in Example 8, which already analyzes an exit wire, is necessary to illustrate the application of the rules in §1.856-10 to above ground wiring. For these reasons, the final regulations do not adopt these suggestions.

## F. Example 9

Section 1.856-10(g), Example 9, of the proposed regulations described a solar energy site similar to the solar energy site in Example 8, except that the solar energy site in Example 9 is mounted on land adjacent to an office building owned by the REIT. Other than occasional transfers of electricity to the grid, the solar energy site in Example 9 serves only the REIT's office building to which it is constituent. The solar energy site in Example 9 of the proposed regulations qualifies as a structural component.

A commenter recommended revisions to the statements in Example 9 that the solar energy site was (1) designed specifically for the particular office building of which it is a part and (2) expensive and time consuming to install and remove. The commenter stated that most materials used for solar rooftop and other smaller-scale installations are mass-produced and standardized and can be removed and reinstalled without major complications or damage. These final regulations revise Example 9 to state that the size and other specifications of the solar energy system were established to serve the needs of the office building and that no facts indicate that the solar energy system will not remain in place indefinitely.

Another commenter requested clarification of the term "occasionally transfers." This commenter recommended changing "occasionally transfers" to "regularly transfers" in describing the transfer of energy from the solar energy site to a utility company. As discussed in section XI.A. of this preamble, the Treasury Department and the IRS are considering whether additional guidance is necessary to address this commenter's concern. Until the issuance of such additional guidance, the Treasury Department and

the IRS (1) will not treat the transfer of the excess electricity as affecting the qualification of the distinct assets as structural components of the IPS for REIT purposes, (2) will exercise its authority under section 856(c)(5)(J)(i) to treat any income resulting from the transfer of the excess electricity as not constituting gross income for purposes of section 856(c)(2) and (3), and (3) will not treat any net income resulting from the transfer of the excess electricity as constituting net income derived from a prohibited transaction under section 857(b)(6).

A commenter noted that even when a building uses all of the solar electricity produced by a solar energy site, such as the one in Example 9, the tenant of the building may earn income through the sale of RECs awarded under a local renewable portfolio standard. The Treasury Department and the IRS believe that income earned by a tenant from RECs in this situation would not affect the qualification of the solar energy site as a structural component. The tax consequences of income earned by a REIT from RECs are beyond the scope of this guidance.

Another commenter requested that Example 9 be modified to address wind facilities rather than solar facilities. The Treasury Department and the IRS believe that the components of wind facilities may similarly be analyzed using the standards provided in §1.856-10(d)(3) of the proposed regulations. For these reasons, the final regulations do not adopt these recommendations.

#### G. Example 10

Section 1.856-10(g), Example 10, of the proposed regulations addressed application of the proposed regulations to a pipeline transmission system. Distinct assets of the pipeline transmission system include underground pipelines, storage

tanks, valves, vents, meters, and compressors. The example stated that the pipeline transmission system serves a passive function, containing oil, and an active function, transporting oil. The example further stated that, even though the pipeline transmission system serves an active function, a distinct asset within the system may nevertheless be an IPS if that asset does not perform an active function.

One commenter noted that whether the entire system performs an active function is not relevant because the system is composed of distinct assets, each of which must be separately analyzed. The Treasury Department and the IRS believe that Example 10 is helpful because it demonstrates that a distinct asset within a system may still qualify as an IPS, or a structural component thereof, even though the system serves an active function.

As discussed in section III.A.2. of this preamble, these final regulations include providing a conduit or route as a permitted passive function and retain transport, which has been clarified to mean cause to move, as a prohibited active function. The Treasury Department and the IRS have revised Example 10 to illustrate that the pipelines in Example 10 serve the passive function of providing a conduit.

Another commenter suggested revising Example 10 so that the pipeline transmission system transports natural gas rather than oil and suggested changing the vents and valves to isolation valves and vents, pressure control valves, relief valves, and pressure regulating stations. The commenter also suggested that Example 10 be revised to apply the factors set forth in the regulations to determine whether these assets are structural components. These final regulations incorporate this commenter's suggestions.

In addition, commenters argued that the compressors within a pipeline transmission system are analogous to elevators and escalators within a building, with the function of moving things or people within an IPS. One commenter noted that compressors may be viewed as performing a propelling function. Another commenter suggested that elevators and escalators serve a building by enabling access to taller buildings, higher levels of occupancy, and more efficient usage. Another commenter suggested that compressors enable the efficient use of space within a pipeline.

To qualify as a structural component, a distinct asset must serve an IPS in its passive function. The compressors that transport natural gas through the pipeline transmission system in Example 10 do not serve the underground pipelines in their passive function of providing a conduit but rather cause the natural gas to move through the conduit, which is an active function. For this reason, these final regulations do not adopt these suggestions.

#### H. Example 11

Section 1.856-10(g), Example 11, of the proposed regulations addressed whether goodwill established under GAAP as a result of the acquisition of stock of a corporation that owned a hotel qualifies as real property for purposes of sections 856 through 859. This example stated that the amount of the acquisition cost allocated to the hotel was limited to the hotel's depreciated replacement cost. The example also stated that the difference between the amount paid for the acquired corporation's stock and the depreciated replacement cost of the hotel was treated as goodwill attributable to the acquired hotel. The Treasury Department and the IRS have been advised that depreciated replacement cost is no longer the standard under GAAP for valuing

property such as the hotel. The Treasury Department and the IRS have therefore removed this example.

#### I. Example 13

Section 1.856-10(g), Example 13, of the proposed regulations addressed whether a license to operate a casino is real property. Example 13 concluded that because the license permits the holder to engage in the business of operating a casino the license is not real property even though the license applies only to the REIT's building and cannot be transferred to another location.

One commenter stated that in some foreign jurisdictions, a casino license may be more in the nature of a zoning permit that may be transferred to a subsequent buyer. This commenter suggested that a license that runs with the land is more in the nature of a zoning permit. The commenter recommended either deleting Example 13 or revising it to distinguish transferable zoning-based or similar real estate-based licenses.

Another commenter noted that the permitted use of a facility for gaming purposes may enhance its value as real estate, apart from the value of the gaming license itself. The commenter also remarked that zoning laws frequently restrict gaming activities or liquor sales to particular geographical areas or locations, which restrictions, in general, favorably affect the value of real estate in these areas or locations.

These final regulations do not adopt these recommendations. Under §1.856-10(f) of the proposed regulations, whether a license runs with the land is not dispositive in determining whether the license is real property for purposes of sections 856 through 859. The valuation of real property, including any effect that zoning may have on the value of real property, are beyond the scope of these final regulations.

## J. Additional examples

The Treasury Department and the IRS received requests to add additional examples to the final regulations.

Section VII.B. of this preamble describes comments received requesting clarification that intangible assets related to in-place above-market leases in which the REIT is the lessor and below-market leases in which the REIT is the lessee be treated as qualifying real property. As discussed in section VII.B., these final regulations include §1.856-10(g), Example 11, which illustrates the application of these final regulations to an in-place above-market lease that produces both rents from real property under section 856(d)(1) and other income that does not qualify as rents from real property under section 856(d)(1).

A commenter suggested adding an example applying these final regulations to an electric transmission and distribution system. The Treasury Department and the IRS believe that the distinct assets of an electric transmission and distribution system are similar in many respects to the distinct assets of the solar energy site addressed by §1.856-10(g), Example 8 of the proposed regulations, and may be analyzed using the standards provided in §1.856-10(d)(2) and (3) of the proposed regulations. Accordingly, these final regulations adequately address the distinct assets that may be part of an electrical transmission and distribution system.

Another commenter suggested that the final regulations include an example illustrating the components of an in-ground swimming pool. (The proposed regulations listed the pool itself as an OIPS.) The Treasury Department and the IRS are not aware that there have been significant questions concerning whether the various components

qualify as real property. Therefore, these final regulations do not include an example addressing whether these components qualify as real property for purposes of sections 856 through 859.

### XIII. Additional Comments

#### A. Potential tax inequality among taxpayers

Three commenters viewed the proposed regulations as a substantial expansion of the definition of real property. The Treasury Department and the IRS believe that the proposed regulations and these final regulations generally clarify existing law. These commenters also called for equal application of the tax laws and appear to believe that REITs are a vehicle that some corporations use to avoid taxes. The REIT structure was established by Congress in 1960, and it is not within the scope of these final regulations to change the REIT structure as these commenters suggest.

#### B. Clarification that buildings can be on or inside of other buildings or IPSs

A commenter requested that the final regulations clarify that buildings can be on or inside of other buildings or IPSs. The Treasury Department and the IRS believe that this comment was adequately addressed by the proposed regulations, which provided that the affixation of an IPS (which may be a building) may be to land or to another IPS. In addition, §1.856-10(g), Example 3, concludes that a large sculpture inside an office building qualifies as an IPS. A building inside another building is not analytically different from the sculpture inside the building in Example 3. Accordingly, the proposed regulations, as finalized by this Treasury decision, adequately address this commenter's concern.

### C. Qualification of appurtenances and zoning and similar rights

A commenter suggested that appurtenances should be included in the definition of land. The commenter suggested that real estate law provides that an appurtenance encompasses easements and rights of way over another's land to access one's own land. In addition, this commenter suggested that zoning and similar rights should be included in the definition of real property.

Taxpayers should apply §1.856-10(f)(2) of these final regulations, which addresses the treatment of rights for the use, enjoyment, or occupation of land, to determine whether an appurtenance qualifies as real property for purposes of sections 856 through 859. Zoning rights may increase the value of real property. Consistent with §1.856-2(d)(3), if a zoning right is considered a separate asset under GAAP, then the zoning right should be analyzed as an intangible asset under section 1.856-10(f) of these final regulations.

### D. Additional comments

A commenter suggested that the final regulations address the definition of rents from real property, eliminate the standard requiring that total assets be based on GAAP, and regulate the type of services that a taxable REIT subsidiary may provide. These issues are beyond the scope of these final regulations.

### **Effective/Applicability Date**

These final regulations apply to taxable years that begin after **[INSERT DATE OF PUBLICATION IN THE FEDERAL REGISTER]**. Under section 856(c)(4), whether a taxpayer loses status as a REIT in one quarter may depend on whether the taxpayer satisfied section 856(c)(4) at the close of one or more prior quarters. For purposes of applying the first sentence of the flush language in section 856(c)(4) to a quarter in a

taxable year that begins after **[INSERT DATE OF PUBLICATION IN THE FEDERAL REGISTER]**, these final regulations apply in determining whether the taxpayer met the requirements of section 856(c)(4) at the close of prior quarters. Taxpayers may rely on these final regulations for quarters that end before the applicability date.

### **Special Analyses**

Certain IRS regulations, including this one, are exempt from the requirements of Executive Order 12866, as supplemented and reaffirmed by Executive Order 13563. Therefore, a regulatory impact assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations, and because the regulations do not impose a collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Pursuant to section 7805(f) of the Internal Revenue Code, the proposed regulations preceding these final regulations were submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on their impact on small business. No comments were received.

### **Drafting Information**

The principal author of these regulations is Julanne Allen, Office of Associate Chief Council (Financial Institutions and Products). However, other personnel from the Treasury Department and the IRS participated in their development.

### **Statement of Availability of IRS Documents**

The IRS revenue rulings and revenue procedure cited in this preamble are published in the Internal Revenue Bulletin (or Cumulative Bulletin) and are available from the Superintendent of Documents, U.S. Government Publishing Office, Washington, DC 20402, or by visiting the IRS website at [www.irs.gov](http://www.irs.gov).

### **List of Subjects in 26 CFR Part 1**

Income taxes, Reporting and recordkeeping requirements.

## Adoption of Amendments to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

### PART 1--INCOME TAXES

Paragraph 1. The authority citation for part 1 continues to read in part as follows:

Authority: 26 U.S.C. 7805 \* \* \*

Par. 2. Section 1.856-3(d) is revised to read as follows:

#### §1.856-3 Definitions.

\* \* \* \* \*

(d) Real property. See §1.856-10 for the definition of real property. A regulation that adopts the definition of real property in this paragraph is to be interpreted as if it had referred to §1.856-10.

\* \* \* \* \*

Par. 3. Section 1.856-10 is added to read as follows:

#### §1.856-10 Definition of real property.

(a) In general. This section provides definitions for purposes of part II, subchapter M, chapter 1 of the Internal Revenue Code. Paragraph (b) of this section defines real property, which includes land as defined under paragraph (c) of this section and improvements to land as defined under paragraph (d) of this section. Improvements to land include inherently permanent structures as defined under paragraph (d)(2) of this section and structural components of inherently permanent structures as defined under paragraph (d)(3) of this section. Paragraph (e) of this section provides rules for determining whether an item is a distinct asset for purposes of applying the definitions in paragraphs (b), (c), and (d) of this section. Paragraph (f) of this section identifies intangible assets that are real property or interests in real property. Paragraph (g) of this section provides examples illustrating the rules of paragraphs (b) through (f) of this section. Paragraph (h) of this section provides the effective/applicability date for this section.

(b) Real property. The term real property means land and improvements to land. Local law definitions are not controlling for purposes of determining the meaning of the term real property.

(c) Land. Land includes water and air space superjacent to land and natural products and deposits that are unsevered from the land. Natural products and deposits, such as crops, water, ores, and minerals, cease to be real property when they are severed, extracted, or removed from the land. The storage of severed or extracted natural products or deposits, such as crops, water, ores, and minerals, in or upon real property does not cause the stored property to be recharacterized as real property.

(d) Improvements to land--(1) In general. The term improvements to land means inherently permanent structures and their structural components.

(2) Inherently permanent structure--(i) In general. The term inherently permanent structure means any permanently affixed building or other permanently affixed 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. A distinct asset that serves an active function, such as an item of machinery or equipment, is not a building or other inherently permanent structure.

(ii) Building--(A) In general. A building encloses a space within its walls and is covered by a roof.

(B) Types of buildings. Buildings include the following distinct assets if permanently affixed: houses; apartments; hotels; motels; enclosed stadiums and arenas; enclosed shopping malls; factory and office buildings; warehouses; barns; enclosed garages; enclosed transportation stations and terminals; and stores.

(iii) Other inherently permanent structures--(A) In general. Other inherently permanent structures serve a passive function, such as to contain, support, shelter,

cover, protect, or provide a conduit or a route, and do not serve an active function, such as to manufacture, create, produce, convert, or transport.

(B) Types of other inherently permanent structures. Other inherently permanent structures include the following distinct assets if permanently affixed: 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; and stationary wharves and docks. Other inherently permanent structures also include outdoor advertising displays for which an election has been properly made under section 1033(g)(3).

(iv) Facts and circumstances determination. If a distinct asset (within the meaning of paragraph (e) of this section) does not serve an active function as described in paragraph (d)(2)(iii)(A) of this section and is not otherwise listed in paragraph (d)(2)(ii)(B) or (d)(2)(iii)(B) of this section or in guidance published in the Internal Revenue Bulletin (see §601.601(d)(2)(ii) of this chapter), the determination of whether that asset is an inherently permanent structure is based on all the facts and circumstances. In particular, the following factors must be taken into account:

(A) The manner in which the distinct asset is affixed to real property;

(B) Whether the distinct asset is designed to be removed or to remain in place indefinitely;

(C) The damage that removal of the distinct asset would cause to the item itself or to the real property to which it is affixed;

(D) Any circumstances that suggest the expected period of affixation is not indefinite (for example, a lease that requires or permits removal of the distinct asset upon the expiration of the lease); and

(E) The time and expense required to move the distinct asset.

(3) Structural components--(i) In general. The term structural component means any distinct asset (within the meaning of paragraph (e) of this section) that 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. If interconnected assets work together to serve an inherently permanent structure with a utility-like function (for example, systems that provide a building with electricity, heat, or water), the assets are analyzed together as one distinct asset that may be a structural component. A structural component may qualify as real property only if the real estate investment trust (REIT) holds its interest in the structural component together with a real property interest in the space in the inherently permanent structure served by the structural component. A mortgage secured by a structural component is a real estate asset only if the mortgage is also secured by a real property interest in the inherently permanent structure served by the structural component. If a distinct asset is customized in connection with the rental of space in or on an inherently permanent structure to which the asset relates, the customization does not affect whether the distinct asset is a structural component.

(ii) Types of structural components. Structural components include the following distinct assets and systems if integrated into the inherently permanent structure and held together with a real property interest in the space in the inherently permanent structure served by that distinct asset or system: 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; security systems; and humidity control systems.

(iii) Facts and circumstances determination. If an interest in a distinct asset (within the meaning of paragraph (e) of this section) is held together with a real property

interest in the space in the inherently permanent structure served by that distinct asset and that asset is not otherwise listed in paragraph (d)(3)(ii) of this section or in guidance published in the Internal Revenue Bulletin (see §601.601(d)(2)(ii) of this chapter), the determination of whether that asset is a structural component is based on all the facts and circumstances. In particular, the following factors must be taken into account:

(A) The manner, time, and expense of installing and removing the distinct asset;

(B) Whether the distinct asset is designed to be moved;

(C) The damage that removal of the distinct asset would cause to the item itself or to the inherently permanent structure to which it is affixed;

(D) Whether the distinct asset serves a utility-like function with respect to the inherently permanent structure;

(E) Whether the distinct asset serves the inherently permanent structure in its passive function;

(F) Whether the distinct asset produces income from consideration for the use or occupancy of space in or upon the inherently permanent structure;

(G) Whether the distinct asset is installed during construction of the inherently permanent structure; and

(H) Whether the distinct asset will remain if the tenant vacates the premises.

(e) Distinct asset--(1) In general. A distinct asset is analyzed separately from any other assets to which the asset relates to determine if the asset is real property, whether as land, an inherently permanent structure, or a structural component of an inherently permanent structure.

(2) Facts and circumstances. The determination of whether a particular separately identifiable item of property is a distinct asset is based on all the facts and circumstances. In particular, the following factors must be taken into account:

(i) Whether the item is customarily sold or acquired as a single unit rather than as a component part of a larger asset;

(ii) Whether the item can be separated from a larger asset, and if so, the cost of separating the item from the larger asset;

(iii) Whether the item is commonly viewed as serving a useful function independent of a larger asset of which it is a part; and

(iv) Whether separating the item from a larger asset of which it is a part impairs the functionality of the larger asset.

(f) Intangible assets--(1) In general. To the extent that 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, the intangible asset is real property or an interest in real property.

(2) Licenses and permits. A license, permit, or other similar right that is solely for the use, enjoyment, or occupation of land or an inherently permanent structure and that is in the nature of a leasehold or easement generally is an interest in real property. A license or permit to engage in or operate a business is not real property or an interest in real property if the license or permit produces or contributes to the production of income other than consideration for the use or occupancy of space.

(g) Examples. The following examples demonstrate the rules of this section. Examples 1 and 2 illustrate the definition of land as provided in paragraph (c) of this section. Examples 3 through 10 illustrate the definition of improvements to land as provided in paragraph (d) of this section. Finally, Examples 11 through 13 illustrate whether certain intangible assets are real property or interests in real property as provided in paragraph (f) of this section.

Example 1. Natural products of land. A is a REIT. REIT A owns land with perennial fruit-bearing plants. REIT A leases the fruit-bearing plants to a tenant and

grants the tenant an easement to enter the land to cultivate the plants and to harvest the fruit. The lease and easement are long-term and REIT A provides no services to the tenant. The unsevered plants are natural products of the land and are land within the meaning of paragraph (c) of this section. The tenant annually harvests fruit from the plants. Upon severance from the land, the harvested fruit ceases to qualify as land. Storage of the harvested fruit upon or within real property does not cause the harvested fruit to be real property.

Example 2. Water space superjacent to land. REIT B leases a marina from a governmental entity. The marina is comprised of U-shaped boat slips and end ties. The U-shaped boat slips are spaces on the water that are surrounded by a dock on three sides. The end ties are spaces on the water at the end of a slip or on a long, straight dock. REIT B rents the boat slips and end ties to boat owners. The boat slips and end ties are water space superjacent to land that is land within the meaning of paragraph (c) of this section and, therefore, are real property.

Example 3. Indoor sculpture. (i) REIT C owns an office building and a large sculpture in the atrium of the building. The sculpture measures 30 feet tall by 18 feet wide and weighs five tons. The building was specifically designed to support the sculpture, which is permanently affixed to the building by supports embedded in the building's foundation. The sculpture was constructed within the building. Removal would be costly and time consuming and would destroy the sculpture. The sculpture is reasonably expected to remain in the building indefinitely. The sculpture does not manufacture, create, produce, convert, transport, or serve any similar active function.

(ii) The sculpture is not an asset listed in paragraph (d)(2)(iii)(B) of this section, and, therefore, the sculpture is an asset that must be analyzed to determine whether it is an inherently permanent structure using the factors provided in paragraph (d)(2)(iv) of this section. The sculpture--

(A) Is permanently affixed to the building by supports embedded in the building's foundation;

(B) Is not designed to be removed and is designed to remain in place indefinitely;

(C) Would be damaged if removed and would damage the building to which it is affixed;

(D) Will remain affixed to the building after any tenant vacates the premises and will remain affixed to the building indefinitely; and

(E) Would require significant time and expense to move.

(iii) The factors described in this paragraph (g) Example 3 (ii)(A) through (E) all support the conclusion that the sculpture is an inherently permanent structure within the meaning of paragraph (d)(2) of this section and, therefore, is real property.

Example 4. Bus shelters. (i) REIT D owns 400 bus shelters, each of which consists of four posts, a roof, and panels enclosing two or three sides. REIT D enters into a long-term lease with a local transit authority for use of the bus shelters. Each bus shelter is prefabricated from steel and is bolted to the sidewalk. Bus shelters are disassembled and moved when bus routes change. Moving a bus shelter takes less than a day and does not significantly damage either the bus shelter or the real property to which it was affixed.

(ii) The bus shelters are not permanently affixed enclosed transportation stations or terminals and do not otherwise meet the definition of a building in paragraph (d)(2)(ii) of this section nor are they listed as types of other inherently permanent structures in paragraph (d)(2)(iii)(B) of this section. Therefore, the bus shelters must be analyzed to determine whether they are inherently permanent structures using the factors provided in paragraph (d)(2)(iv) of this section. The bus shelters--

(A) Are not permanently affixed to the land or an inherently permanent structure;

(B) Are designed to be removed and are not designed to remain in place indefinitely;

(C) Would not be damaged if removed and would not damage the sidewalks to which they are affixed;

(D) Will not remain affixed after the local transit authority vacates the site and will not remain affixed indefinitely; and

(E) Would not require significant time and expense to move.

(iii) The factors described in this paragraph (g) Example 4 (ii)(A) through (E) all support the conclusion that the bus shelters are not inherently permanent structures within the meaning of paragraph (d)(2) of this section. Although the bus shelters serve a passive function of sheltering, the bus shelters are not permanently affixed, which means the bus shelters are not inherently permanent structures within the meaning of paragraph (d)(2) of this section and, therefore, are not real property.

Example 5. Cold storage warehouse. (i) REIT E owns a refrigerated warehouse (Cold Storage Warehouse). REIT E enters into a long-term lease with a tenant. REIT E neither operates the Cold Storage Warehouse nor provides services to its tenant. The tenant uses the Cold Storage Warehouse to store perishable products. Certain components and utility systems that are integrated into the Cold Storage Warehouse have been customized to accommodate the tenant's need for refrigerated storage space. For example, the Cold Storage Warehouse has customized freezer walls and a central refrigeration system. Freezer walls within the Cold Storage Warehouse are specifically designed to maintain the desired temperature within the Cold Storage Warehouse. The freezer walls and central refrigeration system comprise a series of

interconnected assets that work together to serve a utility-like function within the Cold Storage Warehouse, were installed during construction of the building, and will remain in place when the tenant vacates the premises. The freezer walls and central refrigeration system were designed to remain permanently in place.

(ii) Walls and central refrigeration systems are listed as structural components in paragraph (d)(3)(ii) of this section and, therefore, are real property. The customization of the freezer walls does not affect their qualification as structural components of REIT E's Cold Storage Warehouse within the meaning of paragraph (d)(3) of this section. Therefore, the freezer walls and central refrigeration system are structural components of REIT E's Cold Storage Warehouse.

Example 6. Data center. (i) REIT F owns a building that it leases to a tenant under a long-term lease. REIT F neither operates the building nor provides services to its tenant. To accommodate the particular requirements for housing computer servers, certain interior components and utility systems within the building have been customized to provide a higher level of functionality than a conventional office building. These customized systems are owned by REIT F and include an electrical distribution and redundancy system (Electrical System), a central heating and air-conditioning system, a telecommunication infrastructure system, an integrated security system, a fire suppression system, and a humidity control system (each, a System). In addition, the space for computer servers in REIT F's building has been constructed with raised flooring that is integrated into the building to accommodate the Systems. Each System is comprised of a series of interconnected assets that work together to serve a utility-like function within the building. The Systems are integrated into the office building, were installed during construction of the building, and will remain in place when the tenant vacates the premises. Each of the Systems was customized to enhance the capacity of the System in connection with the rental of space within the building.

(ii) The central heating and air-conditioning system, integrated security system, fire suppression system, and humidity control system are listed as structural components in paragraph (d)(3)(ii) of this section and, therefore, are real property. The customization of these Systems does not affect the qualification of these Systems as structural components of REIT F's building within the meaning of paragraph (d)(3) of this section. Therefore, these Systems are structural components of REIT F's building.

(iii) In addition to wiring and flooring, which are listed as structural components in paragraph (d)(3)(ii) of this section and, therefore, are real property, the Electrical System and telecommunication infrastructure system include equipment used to ensure that the tenant is provided with uninterrupted, stable power and telecommunication services. The Electrical System and telecommunication infrastructure system are not listed in paragraph (d)(3)(ii) of this section, and, therefore, they must be analyzed to determine whether they are structural components of the building using the factors provided in paragraph (d)(3)(iii) of this section. The Electrical System and telecommunication infrastructure system--

(A) Are embedded within the walls and floors of the building and would be costly to remove;

(B) Are not designed to be moved and are designed specifically for the particular building of which they are a part;

(C) Would not be significantly damaged upon removal and, although removing them would damage the walls and floors in which they are embedded, their removal would not significantly damage the building;

(D) Serve a utility-like function with respect to the building;

(E) Serve the building in its passive functions of containing, sheltering, and protecting computer servers;

(F) Produce income as consideration for the use or occupancy of space within the building;

(G) Were installed during construction of the building; and

(H) Will remain in place when the tenant vacates the premises.

(iv) The factors described in this paragraph (g) Example 6 (iii)(A), (B), and (D) through (H) all support the conclusion that the Electrical System and telecommunication infrastructure system are structural components of REIT F's building within the meaning of paragraph (d)(3) of this section and, therefore, are real property. The factor described in this paragraph (g) Example 6 (iii)(C) would support a conclusion that the Electrical System and telecommunication infrastructure system are not structural components. However this factor does not outweigh the factors supporting the conclusion that the Electric System and telecommunication infrastructure system are structural components.

Example 7. Partitions. (i) REIT G owns an office building that it leases to tenants under long-term leases. REIT G neither operates the office building nor provides services to its tenants. Partitions are owned by REIT G and are used to delineate space between tenants and within each tenant's space. The office building has two types of interior, non-load-bearing drywall partition systems: a conventional drywall partition system (Conventional Partition System) and a modular drywall partition system (Modular Partition System). Neither the Conventional Partition System nor the Modular Partition System was installed during construction of the office building. Conventional Partition Systems are comprised of fully integrated gypsum board partitions, studs, joint tape, and covering joint compound. Modular Partition Systems are comprised of assembled panels, studs, tracks, and exposed joints. Both the Conventional Partition System and the Modular Partition System reach from the floor to the ceiling.

(ii) Depending on the needs of a new tenant, the Conventional Partition System may remain in place when a tenant vacates the premises. The Conventional Partition System is integrated into the office building and is designed and constructed to remain in areas not subject to reconfiguration or expansion. The Conventional Partition System can be removed only by demolition, and, once removed, neither the Conventional Partition System nor its components can be reused. Removal of the Conventional Partition System causes substantial damage to the Conventional Partition System itself but does not cause substantial damage to the building.

(iii) Modular Partition Systems are typically removed when a tenant vacates the premises. Modular Partition Systems are not designed or constructed to remain permanently in place. Modular Partition Systems are designed and constructed to be movable. Each Modular Partition System can be readily removed, remains in substantially the same condition as before, and can be reused. Removal of a Modular Partition System does not cause any substantial damage to the Modular Partition System itself or to the building. The Modular Partition System may be moved to accommodate the reconfigurations of the interior space within the office building for various tenants that occupy the building.

(iv) The Conventional Partition System is comprised of walls that are integrated into an inherently permanent structure, and thus are listed as structural components in paragraph (d)(3)(ii) of this section. The Conventional Partition System, therefore, is real property.

(v) The Modular Partition System is not integrated into the building and, therefore, is not listed in paragraph (d)(3)(ii) of this section. Thus, the Modular Partition System must be analyzed to determine whether it is a structural component using the factors provided in paragraph (d)(3)(iii) of this section. The Modular Partition System--

- (A) Is installed and removed quickly and with little expense;
- (B) Is designed to be moved and is not designed specifically for the particular building of which it is a part;
- (C) Is not damaged, and the building is not damaged, upon its removal;
- (D) Does not serve a utility-like function with respect to the building;
- (E) Serves the building in its passive functions of containing and protecting the tenants' assets;
- (F) Produces income only as consideration for the use or occupancy of space within the building;
- (G) Was not installed during construction of the building; and

(H) Will not remain in place when a tenant vacates the premises.

(vi) The factors described in this paragraph (g) Example 7 (v)(A) through (D), (G) and (H) all support the conclusion that the Modular Partition System is not a structural component of REIT G's building within the meaning of paragraph (d)(3) of this section and, therefore, is not real property. The factors described in this paragraph (g) Example 7 (v)(E) and (F) would support a conclusion that the Modular Partition System is a structural component. These factors, however, do not outweigh the factors supporting the conclusion that the Modular Partition System is not a structural component.

Example 8. Solar energy site. (i) REIT H owns a solar energy site, among the components of which are land, photovoltaic modules (PV Modules), mounts and an exit wire. REIT H enters into a long-term lease with a tenant for the solar energy site. REIT H neither operates the solar energy site nor provides services to its tenant. The mounts support the PV Modules. The racks are affixed to the land through foundations made from poured concrete. The mounts will remain in place when the tenant vacates the solar energy site. The PV Modules convert solar photons into electric energy (electricity). The exit wire is buried underground, is connected to equipment that is in turn connected to the PV Modules, and transmits the electricity produced by the PV Modules to an electrical power grid, through which the electricity is distributed for sale to third parties.

(ii) REIT H's PV Modules, mounts, and exit wire are each separately identifiable items. Separation from a mount does not affect the ability of a PV Module to convert photons to electricity. Separation from the equipment to which it is attached does not affect the ability of the exit wire to transmit electricity to the electrical power grid. The types of PV Modules and exit wire that REIT H owns are each customarily sold or acquired as single units. Removal of the PV Modules from the mounts that support them does not damage the function of the mounts as support structures and removal is not costly. The PV Modules serve the active function of converting photons to electricity. Disconnecting the exit wire from the equipment to which it is attached does not damage the function of that equipment, and the disconnection is not costly. The PV Modules, mounts, and exit wire are each distinct assets within the meaning of paragraph (e) of this section.

(iii) The land is real property as defined in paragraph (c) of this section.

(iv) The mounts are designed and constructed to remain in place indefinitely, and they have a passive function of supporting the PV Modules. The mounts are not listed in paragraph (d)(2)(iii)(B) of this section, and, therefore, the mounts are assets that must be analyzed to determine whether they are inherently permanent structures using the factors provided in paragraph (d)(2)(iv) of this section. The mounts--

(A) Are permanently affixed to the land through the concrete foundations or molded concrete anchors (which are part of the mounts);

(B) Are not designed to be removed and are designed to remain in place indefinitely;

(C) Would be damaged if removed;

(D) Will remain affixed to the land after the tenant vacates the premises and will remain affixed to the land indefinitely; and

(E) Would require significant time and expense to move.

(v) The factors described in this paragraph (g) Example 8 (iv)(A) through (E) all support the conclusion that the mounts are inherently permanent structures within the meaning of paragraph (d)(2) of this section and, therefore, are real property.

(vi) The PV Modules convert solar photons into electricity that is transmitted through an electrical power grid for sale to third parties. The conversion is an active function. Thus, the PV Modules are items of machinery or equipment and therefore are not inherently permanent structures within the meaning of paragraph (d)(2) of this section and, so, are not real property. The PV Modules do not serve the mounts in their passive function of providing support; instead, the PV Modules produce electricity for sale to third parties, which is income other than consideration for the use or occupancy of space. Thus, the PV Modules are not structural components of REIT H's mounts within the meaning of paragraph (d)(3) of this section and, therefore, are not real property.

(vii) The exit wire is buried under the ground and transmits the electricity produced by the PV Modules to the electrical power grid. The exit wire was installed during construction of the solar energy site and is designed to remain permanently in place. The exit wire is permanently affixed and is a transmission line, which is listed as an inherently permanent structure in paragraph (d)(2)(iii)(B) of this section. Therefore, the exit wire is real property.

Example 9. Solar-powered building. (i) REIT I owns a solar energy site similar to that described in Example 8, except that REIT I's solar energy site assets (Solar Energy Site Assets) are mounted on land adjacent to an office building owned by REIT I. REIT I leases the office building and the solar energy site to a single tenant. REIT I does not operate the office building or the solar energy site and does not provide services to its tenant. Although the tenant occasionally transfers excess electricity produced by the Solar Energy Site Assets to a utility company, the Solar Energy Site Assets are designed and intended to produce electricity only to serve the office building. The size and specifications of the Solar Energy Site Assets were designed to be appropriate to serve only the electricity needs of the office building. Although the Solar Energy Site Assets were not installed during construction of the office building, no facts indicate either that the Solar Energy Site Assets will not remain in place indefinitely or that they may be removed if the tenant vacates the premises.

(ii) With the exception of the occasional transfers of excess electricity to a utility company, the Solar Energy Site Assets serve the office building to which they are adjacent, and, therefore, the Solar Energy Site Assets are analyzed to determine whether they are a structural component using the factors provided in paragraph (d)(3)(iii) of this section. The Solar Energy Site Assets--

(A) Are expensive and time consuming to install and remove;

(B) Were designed with the size and specifications needed to serve only the office building;

(C) Will be damaged, but will not cause damage to the office building, upon removal;

(D) Serve a utility-like function with respect to the office building;

(E) Serve the office building in its passive functions of containing, sheltering, and protecting the tenant and the tenant's assets;

(F) Produce income from consideration for the use or occupancy of space within the office building;

(G) Were not installed during construction of the office building; and

(H) Will remain in place when the tenant vacates the premises.

(iii) The factors described in this paragraph (g) Example 9 (ii)(A) through (C) (in part), (ii)(D) through (F), and (ii)(H) all support the conclusion that the Solar Energy Site Assets are a structural component of REIT I's office building within the meaning of paragraph (d)(3) of this section and, therefore, are real property. The factors described in this paragraph (g) Example 9 (ii)(C) (in part) and (ii)(G) would support a conclusion that the Solar Energy Site Assets are not a structural component, but these factors do not outweigh the factors supporting the conclusion that the Solar Energy Site Assets are a structural component.

(iv) The result in this Example 9 would not change if, instead of the Solar Energy Site Assets, solar shingles were used as the roof of REIT I's office building. Solar shingles are roofing shingles like those commonly used for residential housing, except that they contain built-in PV modules. The solar shingle installation was specifically designed and constructed to serve only the needs of REIT I's office building, and the solar shingles were installed as a structural component to provide solar energy to REIT I's office building (although REIT I's tenant occasionally transfers excess electricity produced by the solar shingles to a utility company). The analysis of the application of the factors provided in paragraph (d)(3)(ii) of this section would be similar to the analysis of the application of the factors to the Solar Energy Site Assets in this paragraph (g) Example 9 (ii) and (iii).

Example 10. Pipeline transmission system. (i) REIT J owns a natural gas pipeline transmission system that provides a conduit to transport natural gas from unrelated third-party producers and gathering facilities to unrelated third-party distributors and end users. REIT J enters into a long-term lease with a tenant for the pipeline transmission system. REIT J neither operates the pipeline transmission system nor provides services to its tenant. The pipeline transmission system is comprised of underground pipelines, isolation valves and vents, pressure control and relief valves, meters, and compressors. Although the pipeline transmission system as a whole serves an active function (transporting natural gas), one or more distinct assets within the system may nevertheless be inherently permanent structures that do not themselves perform active functions. Each of these distinct assets was installed during construction of the pipeline transmission system and will remain in place when the tenant vacates the pipeline transmission system. Each of these assets was designed to remain permanently in place.

(ii) The pipelines are permanently affixed and are listed as other inherently permanent structures in paragraph (d)(2)(iii)(B) of this section. Therefore, the pipelines are real property.

(iii) Isolation valves and vents are placed at regular intervals along the pipelines to isolate and evacuate sections of the pipelines in case there is need for a shut-down or maintenance of the pipelines. Pressure control and relief valves are installed at regular intervals along the pipelines to provide overpressure protection. The isolation valves and vents and pressure control and relief valves are not listed in paragraph (d)(3)(ii) and, therefore, must be analyzed to determine whether they are structural components using the factors provided in paragraph (d)(3)(iii) of this section. The isolation valves and vents and pressure control and relief valves--

- (A) Are time consuming and expensive to install and remove from the pipelines;
- (B) Are designed specifically for the particular pipelines for which they are a part;
- (C) Will sustain damage and will damage the pipelines if removed;
- (D) Do not serve a utility-like function with respect to the pipelines;
- (E) Serve the pipelines in their passive function of providing a conduit for natural gas;
- (F) Produce income only from consideration for the use or occupancy of space within the pipelines;
- (G) Were installed during construction of the pipelines; and
- (H) Will remain in place when the tenant vacates the premises.

(iv) The factors described in this paragraph (g) Example 10 (iii)(A) through (C) and (iii)(E) through (H) support the conclusion that the isolation valves and vents and pressure control and relief valves are structural components of REIT J's tanks or pipelines within the meaning of paragraph (d)(3) of this section and, therefore, are real property. The factor described in this paragraph (g) Example 10 (iii)(D) would support a conclusion that the isolation valves and vents and pressure control and relief valves are not structural components, but this factor does not outweigh the factors that support the conclusion that the isolation valves and vents and pressure control and relief valves are structural components.

(v) Meters are used to measure the natural gas passing into or out of the pipeline transmission system for purposes of determining the end users' consumption. Over long distances, pressure is lost due to friction in the pipeline transmission system. Compressors are required to add pressure to transport natural gas through the entirety of the pipeline transmission system. The meters and compressors do not serve the tanks or pipelines in their passive function of providing a conduit for the natural gas, and are used in connection with the production of income from the sale and transportation of natural gas, rather than as consideration for the use or occupancy of space within the pipelines. The meters and compressors are not structural components within the meaning of paragraph (d)(3) of this section and, therefore, are not real property.

Example 11. Above-market lease. REIT K acquires an office building from an unrelated third party subject to a long-term lease with a single tenant under which the tenant pays above-market rents. The above-market lease is an intangible asset under GAAP. Seventy percent of the value of the above-market lease asset is attributable to income from the long-term lease that qualifies as rents from real property, as defined in section 856(d)(1). The remaining thirty percent of the value of the above-market lease asset is attributable to income from the long-term lease that does not qualify as rents from real property. The portion of the value of the above-market lease asset that is attributable to rents from real property (here, seventy percent) derives its value from real property, is inseparable from that real property, does not produce or contribute to the production of income other than consideration for the use or occupancy of space, and, therefore, is an interest in real property under section 856(c)(5)(C) and a real estate asset under section 856(c)(5)(B). The remaining portion of the above-market lease asset does not derive its value from real property and, therefore, is not a real estate asset.

Example 12. Land use permit. REIT L receives a special use permit from the government to place a cell tower on Federal Government land that abuts a federal highway. Government regulations provide that the permit is not a lease of the land, but is a permit to use the land for a cell tower. Under the permit, the government reserves the right to cancel the permit and compensate REIT L if the site is needed for a higher public purpose. REIT L leases space on the tower to various cell service providers. Each cell service provider installs its equipment on a designated space on REIT L's cell tower. The permit does not produce, or contribute to the production of,

any income other than REIT L's receipt of payments from the cell service providers in consideration for their being allowed to use space on the tower. The permit is in the nature of a leasehold that allows REIT L to place a cell tower in a specific location on government land. Therefore, the permit is an interest in real property.

Example 13. License to operate a business. REIT M owns a building and receives a license from State to operate a casino in the building. The license applies only to REIT M's building and cannot be transferred to another location. REIT M's building is an inherently permanent structure under paragraph (d)(2)(i) of this section and, therefore, is real property. However, REIT M's license to operate a casino is not a right for the use, enjoyment, or occupation of REIT M's building but is rather a license to engage in the business of operating a casino in the building. Therefore, the casino license is not real property.

(h) Effective/applicability date. The rules of this section apply for taxable years beginning after **[INSERT DATE OF PUBLICATION IN THE FEDERAL REGISTER]**. For purposes of applying the first sentence of the flush language of section 856(c)(4) to a quarter in a taxable year that begins after **[INSERT DATE OF PUBLICATION IN THE FEDERAL REGISTER]**, the rules of this section apply in determining whether the taxpayer met the requirements of section 856(c)(4) at the close of prior quarters. Taxpayers may rely on this section for quarters that end before the applicability date.

John Dalrymple

Deputy Commissioner for Services and Enforcement.

Approved: August 8, 2016

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[FR Doc. 2016-20987 Filed: 8/30/2016 8:45 am; Publication Date: 8/31/2016]