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Final Regulations Provide Guidance on Definition of “Real Property” for REIT Provisions

The IRS has issued final regulations (T.D. 9784, <https://www.federalregister.gov/articles/2016/08/31/2016-20987/definition-of-real-estate-investment-trust-real-property>) clarifying the definition of “real property” for REIT provisions of the Internal Revenue Code of 1986, as amended (the “Code”). The final regulations set out a number of safe harbors and provide facts and circumstances to consider in determining whether property that does not satisfy a safe harbor nonetheless qualifies as real property.

In May 2014, the IRS issued proposed regulations to clarify the definition of real property for purposes of Sections 856 through 859 (section references are to the Code, except where noted). In general, the proposed regulations provided an analytical framework and defined real property as including the following categories: land, inherently permanent structures and structural components. In determining whether an item fell into one of these categories, the proposed regulations first tested whether the item was a “distinct asset.”

The final regulations adopt the proposed regulations with certain modifications.

- **Distinct asset:** A distinct asset is the unit of property to which the definitions in the final regulations apply. Each distinct asset is tested individually to determine whether it is real or personal property. Items that are specifically listed in the final regulations as types of buildings and other inherently permanent structures (see below) are distinct assets. Assets and systems specifically listed in the final regulations as types of structural components (see below) also are treated as distinct assets.

Other distinct assets are identified using a series of factors, including whether the item is customarily sold or acquired as a single unit rather than as a component of a larger asset; whether the item can be separated from the larger asset and, if so, the cost of doing so; whether the item is commonly viewed as serving a useful function independent of the larger asset; and whether separating the item from the larger asset impairs the larger asset’s functionality.

- **Land:** Under the final regulations, land includes not only a parcel of ground, but the air and water space above ground, as well as crops and other natural products of the land until the crops or other natural products are detached or removed.
- **Improvements to land:** The final regulations define the term “improvements to land” to mean “inherently permanent structures and their structural components” (see “Inherently permanent structures” below). To the extent assets are distinct assets that have value apart from the land, a REIT must analyze these assets separately under the final regulations. For example, if landscaping includes shrubs planted in the ground, the shrubs are within the definition of land as unsevered natural products of the land, but if landscaping includes a bench that is a distinct asset, the bench must be analyzed under the factors in these regulations for an improvement to land to determine whether it is real property.

- **Inherently permanent structures:** Under the final regulations, inherently permanent structures are structures, including buildings, that have a passive function. Therefore, if a distinct asset has an active function, such as an item of machinery or equipment, the distinct asset is not an inherently permanent structure. In addition to serving a passive function, a distinct asset has to be inherently permanent, which is established not only by the method by which the structure is affixed but also by the weight of the structure alone.

The final regulations also provide a safe harbor list of assets that are buildings (which include houses, apartments, hotels, warehouses, enclosed garages, shopping malls, and arenas, among others), as well as a list of distinct assets that are other inherently permanent structures (e.g., parking facilities, electrical transmission towers, in-ground swimming pools, and railroad tracks, among others)). An inherently permanent structure also includes an outdoor advertising display subject to an election to be treated as real property under Section 1033(g)(3). Inclusion of a distinct asset on either list means that the distinct asset is real property for purposes of the REIT provisions.

- **Facts and circumstances:** If a distinct asset is not listed, then the final regulations provide facts and circumstances to consider in making that determination. These include the manner in which the distinct asset is affixed to real property; whether the distinct asset is designed to be removed or to remain in place indefinitely; the damage that removal of the distinct asset would cause to the item itself or to the real property to which it is affixed; any circumstances (i.e., a lease) that suggest the expected period of affixation is not permanent; and the time and

expense required to remove the distinct asset. The IRS notes that it does not intend the term “indefinitely” to mean forever.

- **Structural components:** The final regulations define a structural component as a distinct asset that is a constituent part of and integrated into an inherently permanent structure that serves the inherently permanent structure in its passive function and does not produce or contribute to the production of income other than consideration for the use or occupancy of space. An entire system is analyzed as a single distinct asset and, therefore, as a single structural component, if the components of the system work together to serve the inherently permanent structure with a utility-like function (i.e., heat or water).

For a structural component to be real property under the REIT provisions, the taxpayer’s interest in the structural component has to be held by the taxpayer together with the taxpayer’s interest in the inherently permanent structure to which the structural component is functionally related. For example, a central air-conditioning system is a machine that does not separately qualify as an inherently permanent structure, but a central air-conditioning system that is wholly owned by a REIT may 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 inherently permanent structure served by the central air-conditioning system. Additionally, if a distinct asset that is a structural component is customized in connection with the provision of rentable space in an inherently permanent structure, the customization of that distinct asset does not cause it to fail to be a structural component.

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The 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 inherently permanent structure that the structural component serves.

- **Safe harbor structural components:** The final regulations provide a safe harbor list of assets that are structural components (including plumbing systems, central heating, elevators, and fire escapes, among other things), and if an asset is not listed, it is subject to the provided list of facts and circumstances to consider in making that determination. The factors include whether the distinct asset is designed to be removed; the manner, time, and expense of doing so; whether the asset will remain if the tenant vacates the premises; and whether the owner of the real property is also the owner of the distinct asset.
- **Intangible assets:** Certain intangible assets are also real property for purposes of the REIT provisions if the asset derives its value from tangible real property and is inseparable from the tangible real property from which the value is derived. The assets of a REIT are its gross assets determined in accordance with GAAP. Intangibles established under GAAP when a taxpayer acquires tangible real property may meet the definition of real property intangibles.

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.

A license or permit solely for the use, occupancy, or enjoyment of tangible real property can also be an interest in real property under the final regulations because it is in the nature of an interest in real property (similar to a lease or easement). However, if an intangible asset produces, or contributes to the production of, income other than consideration for the use or occupancy of space, then the asset is not real property or an interest in real property.

The final regulations 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 (e.g., a lease of real property that produces both rents from real property under Section 856(c)(5)(B) 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).

- **Effective/applicability date:** The final regulations apply to tax years that begin after Aug. 31.



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Final Regulations Issued Redefining Marriage-related Terms

Due to the Supreme Court's decisions on same-sex marriage in Windsor and Obergefell, the IRS has issued final regulations (T.D. 9785, https://www.federalregister.gov/articles/2016/09/02/2016-21096/definition-of-terms-relating-to-marital-status?utm_campaign=pi+subscription+mailing+list&utm_medium=email&utm_source=federalregister.gov) that amend the current income, estate, gift, generation-skipping, employment, and procedure regulations under Section 7701 to provide that for federal tax purposes, the terms "spouse," "husband" and "wife" mean an individual lawfully married to another individual, and the term "husband and wife" means two individuals lawfully married to each other. These definitions apply regardless of sex.

IRS Releases Guidance on Depreciation Changes Under PATH Act

The IRS released Revenue Procedure 2016-48, 2016-37 IRB (<https://www.irs.gov/pub/irs-drop/rp-16-48.pdf>), which provides guidance on changes made last year by the Protecting Americans from Tax Hikes Act of 2015 (PATH Act, P.L. 114-113) to provisions dealing with Section 168(k) bonus depreciation, the Section 168(k)(4) election to forgo bonus depreciation and increase the alternative minimum tax credit, and the Section 179 expensing election for real property, effective Aug. 26.

IRS Resumes Issuing Rulings on Device and Business Purpose in Divisions

The IRS released Revenue Procedure 2016-45, 2016-37 IRB (<https://www.irs.gov/pub/irs-drop/rp-16-45.pdf>) modifying

the list of areas in which it will not issue letter rulings or determination letters by removing two no-rule areas relating to distributions of stock of controlled corporations under Section 355. The issues concern the requirements that a transaction not be used principally as a device for the distribution of earnings and profits and that the distribution be carried out for a business purpose.

IRS Rules on Treatment of Employees of Disregarded LLC Under Sole Member's 403(b) and 457 Plans

In Chief Counsel Advice 201634021 (https://www.irs.gov/pub/irs-wd/201634021.pdf?_ga=1.238926599.665444381.1445536580), the IRS has concluded that employees of a disregarded single-member limited liability company are treated as employees of the member for purposes of Section 403(b) plan and Section 457 plan rules where the member is an entity that is qualified to establish those plans.

Additional Groups Call for Delay in Implementing Dividend Equivalent Withholding

The International Capital Market Services Association (<http://www.stradley.com/~media/Files/Publications/2016/>

ICMSA_871m_comments.pdf) and the Options Clearing Corporation (see [http://www.optionsclearing.com/components/docs/about/newsroom/comment-letters/August-16-OCC-Request-for-Postponement-871\(m\)-2016.pdf](http://www.optionsclearing.com/components/docs/about/newsroom/comment-letters/August-16-OCC-Request-for-Postponement-871(m)-2016.pdf)), on behalf of the U.S. Securities Markets Coalition, has asked that the effective date of dividend equivalent regulations be delayed one year to Jan. 1, 2018, raising concerns that there is insufficient time to implement the required Section 871(m) withholding.

Iowa Adopts Regulations Relating to ABLE Savings Accounts

The Iowa Department of Revenue has adopted Iowa Admin. Code Section 701–40.81 to reflect the recent legislative enactment of the Iowa ABLE savings plan trust, which allows individuals to contribute funds to qualified ABLE accounts on behalf of eligible individuals with disabilities. The Department has also adopted Iowa Admin. Code Section 701–86.5(16) on how to calculate the gross estate for Iowa inheritance tax purposes, and to specify that the decedent's interest in a qualified ABLE account is not included in the gross estate. The regulations are effective Oct. 5.

Stradley Ronon's tax practice group reaches into every sphere of international, federal, state and local taxation, working with tax laws that are numerous, complex and frequently changing. The group's lawyers regularly undertake tax planning for C corporations, S corporations, partnerships, business trusts, limited liability companies, individuals, estates and trusts, tax-exempt organizations, and regulated businesses such as mutual funds and banks.