Closing the Gap Between Private Letter Rulings and Regulations

By Willard B. Taylor

Willard B. Taylor is an adjunct professor at New York University School of Law.

In this article, Taylor summarizes and comments on proposed regulations that would redefine real property for real estate investment trusts, and he argues that there should be more (and earlier) guidance on these and similar issues to close the gap between private letter rulings and published guidance affecting REITs and publicly traded partnerships in the natural resources sector.

The regulations that define real property for purposes of the real estate investment trust provisions were adopted in 1962,¹ and the last published guidance on the definition was in 1975.² Was it a surprise, then, that in May the IRS and Treasury issued proposed regulations that would significantly expand the definition of real property in the current regulations? And further, that the IRS and Treasury took the view that the proposed regulations are just “a clarification of the existing definition of real property and not ... a modification that will cause a significant reclassification of property”?

What the proposed regulations would do, if adopted, is close much of the gap between the guidance provided by private letter rulings to specific taxpayers over the course of the last 25-plus years and the few sentences on real property in the current regulations.

How did this gap come about? Was it simply an administrative lapse? Requests for rulings go to groups in the IRS that focus on specific entities — for example, on REITs, regulated investment companies, or publicly traded partnerships (PTPs). For REITs, one consequence of this siloed approach has been the growth of a significant body of rules that are not reflected in published guidance and are not always consistent with the interpretation of the same words in other contexts. There is a similar, if not larger, gap between published guidance and private rulings issued to PTPs in the oil and gas and other natural resources sector.³ Like the gap in the definition of real property for REITs, the gap in guidance for PTPs should be addressed by regulations. And if the IRS is focused on closing the gap between private and published guidance, shouldn’t there be more regulations on REIT issues — not only on what is real property but also on other REIT issues such as the definition of rent from real property, determining the value of a REIT’s assets, and the activities (and tax liabilities) of taxable REIT subsidiaries?⁴

A. Real Estate Investment Trusts

The REIT rules were enacted in 1960 to allow mutual funds for real estate — that is, to provide passthrough treatment for passive income from investments in real property that was leased or from mortgages secured by real property. The legislative history is clear that pass-through treatment was to be limited to passive income from real estate investments and that “any real estate trust engaging in active business operations should continue to be subject to the corporate tax in the same manner as ... similar operations carried on by other comparable enterprises.”⁵ As in the case of RICs, the

³Those that rely on section 7704(d)(1)(E) to avoid classification as corporations.
⁵See H.R. Rep. No. 86-2020 (1960) (“This bill restricts [the] pass through of the income ... to what is clearly passive income from real estate investments, as contrasted to income from the active operations of businesses involving real estate.”).
concept was parity of tax treatment between direct investments in real estate and mortgages by larger investors, and investments made by the pooled money of smaller investors.6

REITs were originally a small segment of the capital markets. In 1971, some 10 years after the 1960 enactment of the REIT provisions, there were only 34 publicly traded REITs, with an aggregate market capitalization of about $1.5 billion, of which equity (as opposed to mortgage and hybrid) REITs were the smallest segment.7 But there was a rapid growth in the number of REITs beginning in the 1980s and, in the last 20 years, a huge growth in the market capitalization of equity REITs. There were 138 REITs with an aggregate market capitalization of about $13 billion in 1991. Ten years later, in 2001, there were 182 with a market capitalization of $155 billion; and 12 years later, at the end of 2013, there were 202 REITs with an aggregate market capitalization of $670.3 billion. Of these, 161 were equity REITs with an aggregate market capitalization of $608.2 billion, and 41 were mortgage REITs with an aggregate market capitalization of $62 billion. Hybrids disappeared after 2009.8

Several tax factors have contributed significantly to the growth of REITs, including, for example, the emergence in the 1990s of UPREITs (and DownREITs);9 the ability to convert a C corporation into a REIT, whether by spinoff or otherwise, at an acceptable tax cost;10 the special rules for timber, healthcare, and lodging REITs; and, as discussed below, the enactment of the taxable REIT subsidiary rules in 1999 and the later interpretation of what such a subsidiary could do. But the growth — particularly the emergence of REITs that own and operate cellular communication towers, data storage facilities, and outdoor advertising — also reflects the IRS’s willingness to issue private rulings that expanded on what constitutes real property under the current regulations and on what constitutes rent from real property. On the basis of private rulings issued in the last 25-plus years, REITs now own and operate electric transmission towers, gas distribution systems, asphalt plants, cellular communication and broadcast towers, billboards and advertising signs, casinos, offshore drilling platforms,11 data and other sophisticated storage centers, boat slips, and private prisons.12 The law regarding what is real property and rent from real property has been made by private rulings, not by cases or regulations. Is this good tax policy?

B. The Definition of Real Property

Qualification as a REIT requires that at least 75 percent by value of the entity’s gross assets consist of real estate assets, cash, cash items, and government securities. Real estate includes real property, which the current regulations define as land, buildings and other inherently permanent structures, and structural components of buildings and inherently permanent structures. In defining real property, the current regulations took, almost word for word, the definition of property that the existing section 179 regulations excluded from personal property eligible to be expensed. To the statutory definition of real property for REITs, which was “land or improvements thereon,” the current regulations thus added “other inherently permanent structures” and “structural components of buildings or structures.” They also excluded “assets

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6Id. (“H.R. 12559 extends this same type of tax treatment to real estate investment trusts specializing in investments in real estate equities and mortgages as distinct from the stock and security holdings of regulated investment companies”).


8The numbers on market capitalization underestimate the size of the REIT sector because they do not include shares of publicly traded REITs that would be issued in exchange for limited partnership interests in so-called UPREIT or DownREIT structures (which would significantly increase market capitalization), nor do they include private REITs or so-called public non-traded REITs. Public non-traded REITs are REITs whose shares are offered publicly but are not traded.

9UPREIT and DownREIT structures allow owners of real estate to defer tax by transferring the real estate to a partnership under the REIT in exchange for partnership interests that can later be converted into shares of the REIT or cash.


11The ruling on offshore drilling platforms, LTR 201250003, was issued to a PTP but relies on the definition of real property in section 856, which is incorporated in section 7704(d)(1)(C) and (D) and (d)(3).

12See, e.g., LTR 201423011 (information technology infrastructure provided to tenants); LTR 201334033 (communication infrastructure provided to tenants); LTR 201320007 (private correctional facility); LTR 201314002 (data centers); LTR 201301007 (wireless and broadcast communication infrastructure company); LTR 201206001 (broadcast antenna); LTR 201310020 (boat slips at a marina); LTR 201204006 (outdoor signs and sign superstructures); LTR 201143011 (outdoor steel billboard structures); LTR 201129007 (wireless and broadcast communication infrastructure company); LTR 201034010 (space designed to accommodate telecommunications, computing, and electronic data storage equipment including computer servers and personnel); LTR 201108009 (casino); LTR 200937006 (natural gas pipeline system); LTR 201005018 (terminating and storage services facility); LTR 200752012 (data centers, and buildings designed to accommodate computer servers and personnel); LTR 200725015 (electric transmission and distribution system); and LTR 199904019 (cold storage warehouses).
accessory to the operation of a business, such as machinery.\textsuperscript{13} The definition in the regulations was then interpreted in the five published rulings issued between 1969 and 1975, and that provided the basis for 25-plus years of private rulings.\textsuperscript{14}

The scope and number of the private rulings issued to REITs regarding what constitutes real property and rent from real property were significant and became controversial in mid-2013, largely because of publicly traded corporations in data storage, cellular communication, gaming casinos, and other businesses that converted, or planned to convert, to REITs.\textsuperscript{15} Concerned that it might not have been consistent in its definitions, the IRS suspended the issuance of private rulings in May 2013 to consider that issue. The moratorium ended in November 2013, without any apparent change in ruling policy, and was followed in May of this year by the proposed regulations on the definition of real property.

Private rulings continue to take an ever broader view of what is real property and what is rent from real property.\textsuperscript{16} To quote The Wall Street Journal, “In IRS Eyes, All The World’s a REIT.”\textsuperscript{17}

C. The Proposed Regulations

The regulations proposed in May,\textsuperscript{18} effective when adopted as final regulations, would define real property to include land, improvements, and other inherently permanent structures, and their structural components, as do the current regulations. They would, however, significantly elaborate on the meaning of those terms.

Under the proposed regulations, what constitutes an inherently permanent structure or a structural component would be determined by first finding whether there is a distinct asset and then applying to that asset the facts and circumstances set out in the proposed regulations. However, the regulations list a significant number of assets that meet the inherently permanent structure or structural component definition and for which it is unnecessary to use the distinct asset analysis or evaluate the facts and circumstances to determine whether the asset is real property. These assets are considered real property without the need for further analysis. They include the items covered by five published rulings issued between 1969 and 1975, as well as items covered by later private rulings, such as (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; stationary wharves and docks; and outdoor advertising displays if an election has been made under section 1033(g)(3) to treat the display as real property for all purposes.\textsuperscript{19} Others are listed in examples (3), (5), (6), and (10) of prop. reg. section 1.856-10(g) — specifically, a large sculpture embedded in the atrium of a building that was designed to support the sculpture; a cold storage warehouse; a data center; and an underground pipeline for oil transmission, which includes storage tanks, valves, vent meters, and compressors. The term “buildings” includes houses, apartments, hotels, factory and office buildings, warehouses, barns, enclosed garages, enclosed transportation stations and terminals, and stores.

The proposed regulations would replace the current regulations’ exclusion for “assets accessory to
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the operation of a business” with an exclusion for “active function” assets and structural components that do not serve a utility-like function. That exclusion picks up what was excluded from real property by the “assets accessory to the operation of a business” rule in the current regulations and adds items, some of which are mentioned in private rulings: offshore drilling, testing, and other equipment; antennae; waveguides; transmitting, receiving, and multiplex equipment; pre-wired modular racks; display racks and shelves; gas pumps; and hydraulic car lifts.

D. Specific Definitions

The proposed regulations define land, inherently permanent structures, and structural components of inherently permanent structures as follows:

1. Land. Land includes air and water space directly above the land, and crops and other natural products and deposits such as minerals, when not severed or detached. Examples (1) and (2) in prop. reg. section 1.856-10(g) are a fruit orchard, and U-shaped boat slips and end ties in a marina, respectively. The definition of land is consistent with private rulings and, for air rights, with Rev. Rul. 71-286, although neither air rights nor water space is mentioned in the current regulations.

2. Inherently permanent structures. Inherently permanent structures are buildings that have a passive function and are inherently permanent, either because of the way they are affixed to land or another inherently permanent structure or simply because of the weight of the structure. Affixation is permanent if it is reasonably expected to last indefinitely.

If not listed in the regulations, as set out above, the determination of whether the asset is an inherently permanent structure is based on the facts and circumstances, including the manner in which it is affixed, whether it is designed to be removed, the damage resulting from its removal, and so on. Example (4) of prop. reg. section 1.856-10(g) concludes that bus shelters do not qualify because, although bolted to the sidewalk, they are moved when bus routes change and are not enclosed transportation stations (and thus not buildings).

An asset has an active function if it produces, manufactures, or creates a product and would be excluded unless it is a structural component that serves a utility-like function (such as providing a building with electricity, heat, or water) for the inherently permanent structure of which it is a part.

3. Structural components. Structural components are distinct assets that are a constituent part of, and are integrated into, an inherently permanent structure and that serve the structure in its passive function (and, even if capable of producing income other than as consideration for the use or occupancy of space, do not do so). A system is analyzed as a single distinct asset if the components work together to serve the structure with a utility-like function, such as providing heat, water, or electricity — for example, the total energy system considered in Rev. Rul. 73-425.

To be real property, the taxpayer’s interest in the structural component must be held by the taxpayer, together with its interest in the structure to which the component is functionally related, and hence the solar energy examples described below.22 If not listed in the regulations, the facts and circumstances relevant to whether an asset is a structural component include the time, manner, and expense of installation or removal, and whether it is designed to be moved. Example (7) of prop. reg. section 1.856-10(g) concludes that conventional drywall partitions are covered, as walls, but that a modular drywall partition system, which changes with the tenant and was not designed to remain permanently in place, is not.

4. Renewable energy. Before the proposed regulations were issued, one much-debated issue was renewable energy — that is, solar panels and windmills. The general understanding was that renewable energy assets by themselves are assets

21A footnote to the preamble says the IRS is considering guidance for cases in which excess energy is transferred to a utility.

22Other structural components include wiring; plumbing systems; central heating and air conditioning systems; elevators or escalators; walls; floors; ceilings; permanent coverings of walls, floors, and ceilings; windows; doors; insulation chimneys; fire suppression systems, such as sprinkler systems and fire alarms; fire escapes; central refrigeration systems; integrated security systems; and humidity control systems.

23Prop. reg. section 1.856-10(d)(3)(i), which provides that an item will be real property “if the interest held therein is included with an equivalent interest held by the taxpayer in the inherently permanent structure to which the structural component is functionally related.” The equivalent interest standard in the proposed regulations may be more flexible than the identical interest standard used in Rev. Rul. 73-425, and this might be clarified.

24See, e.g., Kelly Kogan, “Can REITs Invest in Renewable Energy Projects?” 204 DTR J-1 (Oct. 23, 2012), arguing that the exclusion of assets accessory to the operation of a business should not exclude assets used in a business if those assets meet the inherently permanent structure requirement and thus

(footnote continued on next page.)
accessory to the operation of a business, not real property, and thus could not qualify if the REIT’s interest was severable from its interest in the building or other inherently permanent structure that they serviced. That view was consistent with Rev. Rul. 73-425, which ruled that a loan to construct a total energy system was not a real estate asset unless secured by both the system and the building that it serves, construing the current regulations as contemplating “that structural components will not be treated as real property unless they are included with land, buildings, or other inherently permanent structures.” It was also consistent with private rulings on renewable energy.25

To the disappointment of the energy industry, this is where the proposed regulations came out: Example (8) in prop. reg. section 1.856-10(g) concludes that photovoltaic modules, as opposed to their mounts and exit wires, are items of machinery or equipment that are not inherently permanent structures, and are therefore not real property. But Example (9) concludes that the modules will be real property if they are mounted on land adjacent to an office building, are designed to produce electricity for the office building (although there may be some excess), and are leased by the REIT together with the office building. The analysis would be the same for solar shingles, that is, roofing shingles.

5. Intangibles. Under the proposed regulations, an intangible is real property in two cases. First, if the intangible derives its value from tangible real property and is inseparable from that property, such as the historic significance of a building, and does not contribute to the production of income other than consideration for the use or occupancy of space, it is real property. Example (11) in prop. reg. section 1.856-10(g) treats as real property the goodwill of a hotel that is strategically located and is a historic structure that is viewed as a landmark. The reasoning is that the goodwill derives its value, and is inseparable, from the hotel.

The preamble also says that this may be the case when the intangible is created by generally accepted accounting principles as the result of the acquisition of real property, noting that under GAAP, goodwill is the excess of the value over the depreciated replacement cost.

The current regulations make no mention of intangibles, but this part of the proposed regulations is consistent with private rulings on locational reputation and the like.

Second, licenses or permits for the use, occupancy, or enjoyment of tangible real property may also be real property, but a license allowing a taxpayer to engage in or operate a particular business will not be. Examples (12) and (13) in prop. reg. section 1.856-10(g) conclude that a governmental license to place a cell tower on federal land is in the nature of a leasehold and thus an interest in real property, but that a state permit to operate a casino in a building is a license to engage in the casino business and is not real property.26

Again, the rule in this part of the proposed regulations is consistent with private letter rulings (which, for example, have treated federal permits to ski in a national forest, as well as building concessions and easements on land, as real property), although permits are not addressed by the current regulations. The proposed regulations likely indicate where the IRS will come out on the treatment of permits and licenses for purposes of the 1980 Foreign Investment in Real Property Tax Act.27

E. What’s Missing in the Proposed Regulations?

If the purpose of the proposed regulations is to close the gap between private rulings and regulations, there are at least four other, sometimes overlapping, issues that should be dealt with: the definition of rent from real property, the use of GAAP to determine the assets of a REIT, the treatment of goodwill and similar intangibles, and the use of taxable REIT subsidiaries. Some of these issues are closely related to the definition of real property and should be dealt with in revisions to the proposed regulations.

1. Income from real property. First, the proposed regulations are limited to the definition of real property and do not deal with (that is, according to

should not exclude photovoltaic cells or wind turbines, which generate electricity, or mirrors and boilers, which generate steam.

25LTR 201323016, apparently issued to Hannon Armstrong Sustainable Infrastructure Capital Inc., which went public in April 2013. The entity is listed on the New York Stock Exchange and invests in and finances renewable energy projects (solar and wind farms, and geothermal) that generate clean energy and the installation of heating, ventilation, and air conditioning equipment. When it lends, its liens cover both the energy project and the related real property. It “will in each case have a valid security interest that, in the case of default by the owner, provides the holder with . . . the right to bring a foreclosure action with respect to the Structural Improvements and the real property into which the Structural Improvements have been installed.”

26On the casino example, see Sheppard, “Gambling on REIT Status,” Tax Notes, June 30, 2014, p. 1463.

27In Announcement 2008-115, 2008-2 C.B. 1228, the IRS said that it was contemplating proposed regulations that would “address certain rights granted by a governmental unit that are related to the lease, ownership, or use of toll roads, toll bridges, and certain other physical infrastructure” and would amend the section 897 regulations.
the preamble, “provide neither explicit nor implicit guidance regarding”) what is income from real property.

Qualification as a REIT requires that at least 75 percent of the entity’s gross income consist of rents from real property or other specific items of real property income. Whether income from services provided by REITs to tenants or from the management and operation of properties is rent for this purpose has evolved significantly. Originally, only rent was good income under a provision to the effect that amounts, if not separately charged, for customary services to tenants were rent, but another rule said that any customary services had to be provided by an independent contractor from which the REIT derived no income. Income from separately charged services or services not provided by an independent contractor did not qualify as rent. In 1976 this was changed so that amounts paid for services could be separately charged and qualify as rent, but the customary services still had to be provided by an independent contractor from whom the REIT received no income. Then, in 1986 this was changed further, so that a REIT could henceforth, without using an independent contractor, charge for services — either separately stated or not, if the services were customary — and treat the income as rent.

Services are customary “if, in the geographic market in which the building is located, tenants in buildings which are of a similar class (such as luxury apartment buildings) are customarily provided with the service.” The 1986 change in the REIT rules borrowed the rule that defined “good” rent for tax-exempt organizations (that is, rent that was excluded from the organization’s unrelated business income).

The definition of customary services in the regulations was originally directed at relatively incidental services provided to tenants of apartment buildings and the like (for example, maid service and parking garage attendants), but over time the definition has expanded significantly, and it now seems to be the IRS’s view that any payment for services by a tenant of real property qualifies, as long as the REIT is satisfied that the services are customary in its industry. The IRS thus allows corporations with significant real property to become REITs and operate fully integrated businesses in which much of the value is derived from the services provided to tenants.

Is the IRS’s view consistent with the legislative purpose of the customary services rule? Another, narrower approach would be to limit the services that are treated as customarily furnished, and thus included in rent for purposes of the 90 percent of gross income test that applies to REITs, by comparing the value of the services to the value of the space that is rented. If the consideration paid for the customary services is, say, three or four times the rent that would otherwise be paid for the space, should the payment be treated in its entirety as rent for real property? And although rents based on profits (as opposed to gross receipts) are excluded from rent, the IRS has not always read this rule as strictly as it might. It has also interpreted the exclusion of mineral royalties from the definition of real property as not covering payments for surface rights that are dependent on the production of minerals below the surface (since the owner of the surface rights has no “economic interest” in the minerals). Why should that be the answer if the

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29H.R. Rep. No. 86-2020 (1960). This was “intended to limit the definition of rents from real property to those of a passive nature.” The rule is now in section 856(d)(7)(C)(ii).
30Reg. section 1.856-4(b).
31Reg. section 1.856-4(b).
32E.g., LTR 201423001 (server services and cross-connect services for tenants’ telecommunications carriers; and services provided by a telecommunications infrastructure and data storage company); LTR 201334035 (telecommunications cross-connectivity services using wires, cables, and other transmission equipment to provide connectivity to carriers, to tenants’ own servers, and directly with each other); LTR 201334033 (cross-connectivity services provided by a telecommunications infrastructure company); LTR 201033022 (facilities and amenities provided by a lodging facility); and LTR 200052031 (dealing comprehensively with manufactured home communities that provide for trash collection; walk-on golf courses and putting greens; boat docks and ramps on internal waterways; exercise rooms; whirlpool spas; libraries; car wash areas; vending and ATM machines; and voice, video, and data communication systems).
33See Glanz, supra note 15. The article refers to Equinix and Digital Realty Trust, which was apparently the first data center to become a REIT, and questions whether the payments it receives are rent because they are four times those for midtown Manhattan office space. The author argues that this is because “data centers provide huge banks of remote computer storage, and the enormous amounts of electric power and ultrafast fiber optic links that they demand.” The industry, Glanz says, “has evolved from a purveyor of space to an energy broker” — a “kind of wildcat power utility.”
34LTR 201108009, ruling that “based on the unique nature of the gaming business,” rents for a casino that are based on net gaming revenues are not excluded by the profit-based rent rule in section 856(d)(2)(A).
purpose of the exclusion is to eliminate income that depends on the extraction and sale of minerals.

2. Determining ‘gross assets.’ For an entity to qualify as a REIT, at least 75 percent in value of its assets at the close of each quarter must consist of real estate assets, cash, cash items (including receivables), and government securities; and no more than 25 percent in value of its assets can consist of securities of taxable REIT subsidiaries. Value is fair value as determined by the trustees in good faith (or market value for securities for which quotations are available).

The statutory rules for testing dates and value are thus essentially the same as for RICs — quarterly testing and the ability under some circumstances to correct following the close of a quarter. When the current REIT regulations were proposed in 1961, they followed the statute and rules that apply to RICs, but the final regulations, adopted in 1962, added (under “determination of investment status” in reg. section 1.856-2(d)(3)) that ‘The term ‘total assets’ means the gross assets of the trust determined in accordance with generally accepted accounting principles.”

What is the incorporation of the GAAP rules intended to accomplish? The purpose may have been to exclude intangibles from total assets. It does not have that effect, however, when (as the proposed regulations now acknowledge) there is an acquisition or other transaction that triggers the creation of intangibles under GAAP. If there has been such an acquisition or other transaction, private rulings have invariably taken the view that the intangible assets created by GAAP are a function of the REIT’s real property and so are real property for purposes of the asset test, despite the GAAP rule and the 1986 enactment of section 1060 concerning asset acquisitions.35 One private ruling, for example, concludes that intangibles that resulted from a REIT’s acquisition of a cellular tower business “consisting of the value of network location, the customer base, the customer relationships, goodwill and other intangibles” were a function of the real property acquired and thus were real property.36 The same issue arises when a REIT sells assets and some of the gain is allocated under section 1060 to intangibles. Again, private rulings have treated the gain allocable to intangibles as good income from real property.37

The GAAP rule in the current regulations makes no sense. It allows a REIT to exclude non-GAAP assets, despite the distortive effect on the proportionate value of its other assets; it overrides the statutory rules in section 856(c)(4)(A) and (c)(5)(A), as well as section 1060 in cases in which there has been an acquisition or disposition; it does not always eliminate intangibles from total assets, if that was its purpose; and how it applies is unclear — for example, its relationship to the rule that allows the trustees to determine the fair market value of a REIT’s assets38 or in a case in which the REIT has subsidiaries that would be consolidated under GAAP. Wouldn’t it be better to eliminate the part of the current regulations that uses GAAP to determine assets and address the treatment of intangibles in a straightforward and comprehensive way?

The GAAP rule is in substance part of the definition of real property and should be addressed in revisions to the proposed regulations.

F. Other Intangibles

Do the proposed regulations address intangibles in a straightforward and comprehensive manner? What about trademarks, goodwill, customer relationships, workforce in place, and going concern

35 See LTR 201314002 (“tenant relationships, trademarks, and favorable land leases” and goodwill related to data centers); LTR 201129007 (GAAP intangibles of a wireless and broadcast communication infrastructure company, consisting of network location, customer base, customer relationships, and other intangibles, but the REIT “holds only real property, so all of the intangibles derived from the GAAP rule must be treated as a function of that real estate”); LTR 200823014 (amounts realized by a REIT from the sale of real property that was treated by section 1060 as goodwill were income from real property); and LTR 200813009 (“renaming and value of the brand or franchise name of” each of a number of acquired properties).

36 See LTR 201129007, allowing a REIT to treat the intangibles that resulted from the acquisition of a cellular tower business in a reorganization (consisting of the value of network location, the customer base, the customer relationships, goodwill, and other intangibles as “a function of” the real estate that it owned and thus as real property). See also LTR 200813009 (reaching the same conclusion regarding “the renaming and value of the brand or franchise name of” each of several acquired properties that for GAAP purposes were recorded at replacement cost).

37 LTR 200726002 (“It follows, therefore, that a REIT such as Taxpayer that is engaged in the trade or business of renting real property... will generate goodwill that increases the value of the REIT. Goodwill is inseparable from the business from which it arose. In this case, the goodwill generated by Taxpayer’s trade or business is integrally related to the rental of real property. Although goodwill is treated as a separate asset for purposes of section 1060, it may be characterized for purposes of the REIT income tests based upon the characterization of the income produced by Taxpayer’s activities in its trade or business. To the extent that Taxpayer’s trade or business that generates goodwill produces qualifying income [for REIT purposes], gain from goodwill related to the trade or business will be treated as qualifying income for purposes of the REIT income tests.”).

38 See LTR 201236006, allowing a REIT’s board of directors to determine that “deferred offering costs” shown as an asset on its GAAP balance sheet had no value.
value? In the words of the proposed regulations that define when intangibles are real property, (1) do they “derive . . . [their] value from real property or an interest in real property”; (2) are they “inseparable from that real property or interest in real property”; and (3) do they “not produce or contribute to the production of income other than consideration for the use or occupancy of space”? These are three separate requirements, each of which must be satisfied for an intangible (other than a permit) to be treated as real property.

If there is an asset acquisition, whether direct or because of a section 338 election, intangibles such as goodwill are treated by section 1060 as assets separate from real estate (and defined in general as deriving their value from the trade or business that is carried on, not any particular asset). Moreover, they are not necessarily inseparable from the real estate of a business — certainly trademarks and taxable REIT subsidiaries that perform non-customary services and have intangible value are severable as a legal matter. Nor do the intangibles necessarily derive their value from the real estate as opposed to the value of the services rendered directly or by taxable REIT subsidiaries. A number of the REITs that have resulted from the evolving definition of real property have many thousands of employees. Treating intangibles such as trademarks, goodwill, going concern value, workforce in place, and customer relationships as part of the real property seems also to be inconsistent with the rules that apply to the amortization of intangibles under section 197. That section’s premise is that these intangibles are separate assets, not part of something else, and should be so treated.

Like the GAAP rule, the treatment of goodwill, going concern value, and other intangibles that are separate from real property and not covered by the rule in the proposed regulations should be addressed by revisions to the proposed regulations.

And if goodwill and like intangibles are separate assets, there should also be guidance on where services provided to lessees are located — that is, on the allocation of the value between the parent REIT and any taxable REIT subsidiaries, at least in cases in which the subsidiary is economically significant.

G. Taxable REIT Subsidiaries

The REIT rules were amended in 1999 to allow a REIT to manage or operate properties and provide non-customary services to tenants through taxable REIT subsidiaries, as well as through independent contractors. This was a big expansion of permitted activities, allowing for the management and operation of properties as well as the provision of services, albeit through taxable REIT subsidiaries.

The purpose was to permit a REIT, through a taxable REIT subsidiary, to provide non-customary services to tenants, and possibly to others, but the rule as written imposes no constraints on what a taxable REIT subsidiary may do. On the basis of the legislative history, regulations might have so restricted the activities of a taxable REIT subsidiary, but they did not. REITs soon began to use taxable REIT subsidiaries for a wide variety of activities that do not necessarily involve providing services to tenants. Timber REITs, for example, use taxable REIT subsidiaries to mill timber and sell the resulting products, such as cellulose fibers.

While taxable REIT subsidiaries are, of course, taxed on their taxable income, it is an open question
whether they are adequately taxed on what they should earn from their activities. There are two Treasury reports on taxable REIT subsidiaries that while difficult to parse, indicate that in the studied years, taxable REIT subsidiaries were highly leveraged, often because of third-party debt; sometimes had negative debt-to-equity ratios; and in the aggregate, had negative net income.\(^{46}\) Most of the taxable REIT subsidiaries studied in the reports paid little or no tax.

**H. Different Meanings in Different Contexts**

Acknowledging that real property has different meanings in different contexts (that it is used in “Code provisions that have diverse contexts and varying legislative purposes”), the preamble to the proposed regulations says that while the use of the same term would imply that Congress intended the same meaning, “both the regulatory process and decades of litigation have led to different definitions of these terms, in part because taxpayers have advocated for broader or narrower definitions in different contexts.”\(^{47}\)

Is this a fair assessment of the divergence between real property for REIT purposes and real property in other contexts? There has been litigation involving the eligibility of billboards and other items for the now-repealed investment tax credit\(^{48}\) but none on the meaning of real property for REIT purposes. Another possibility is that the divergence, not only in what is real property (including the treatment of intangibles) but what is rent from real property, results from the IRS’s siloed approach of issuing rulings to different industries.

**I. Publicly Traded Partnerships**

A PTP is taxed as a corporation unless at least 90 percent of its gross income is from specified sources, including income derived from specific activities concerning minerals and other natural resources — the exploration, development, mining or production, processing, refining, transportation, or marketing of the specified minerals or natural resources.\(^{49}\) This was one exception to the 1987 amendment that would otherwise have treated a PTP as a corporation.\(^ {50}\)

As with REITs, there has been a huge growth in PTPs in the natural resources sector. There are now more than 100 PTPs in that sector with a market capitalization at the end of 2013 of more than $445 billion (an increase of more than $200 billion since the end of 2010).\(^ {51}\)

The good income exception for income from natural resources raises the same issue as the definition of income from real property for REITs. While there is legislative history on what the natural resources exception means, there are no regulations or published rulings, and the law has been made by an ever-increasing number of private rulings. The numbers are remarkable — less than two a year from 1989 to 2006 but now about 100, most of which were issued in the last five years (more than 30 in 2013). Early rulings went beyond the words of the statute (for example, to include storage and byproducts of the primary products listed in the statute) and then adopted the view that good income is produced by anything that is integral to qualifying activities, permitting pretty much any service to qualify, including the licensing of seismic data, supplying water for fracking, well stimulation services, the construction of pipelines, marine services at terminals — indeed, any activity directed at exploration, production, or development.\(^ {52}\)

A pause on new rulings was announced in March so the IRS could determine whether it was being consistent. It is, of course, possible that this will, as with REITs, be followed by regulations that spell out what is good income based on the private rulings. Certainly, something should be done to

\(^{46}\)Thornton Matheson, “The Development of Taxable REIT Subsidiaries, 2001-2004,” 27 SOI Bull. 196 (Spring 2008) (stating that taxable REIT subsidiaries “are highly leveraged as a group, with about 30 percent of firms showing negative equity”); and Matheson, “Taxable REIT Subsidiaries: Analysis of the First Year Returns, Tax Year 2001,” 24 SOI Bull. 114 (Spring 2005) (concluding that only 42 of the 404 subsidiaries that were analyzed had positive net income).

\(^{47}\)It goes on to say that in issuing the proposed regulations, Treasury and the IRS “have sought to balance the general principle that common terms used in different provisions should have common meanings with the particular policies underlying the REIT provisions.”

\(^{48}\)E.g., Whiteco Industries Inc. v. Commissioner, 65 T.C. 664 (1975).

\(^{49}\)Section 7704(d)(1)(E).

\(^{50}\)There are also exceptions (in section 7704(d)(1)(C) and (D) and (d)(3)) for income from real property, which pick up the REIT definitions, investment income, and income from commodities.

\(^{51}\)See Wells Fargo Securities, “MLP Primer Fifth Edition” (Oct. 31, 2013). For additional information on PTPs, see the website of the National Association of Publicly Traded Partnerships, available at https://www.naptpt.org.

\(^{52}\)See, e.g., LTR 201416003 (gross income from supplying water for fracking and from transporting fluids and flowback); LTR 201412007 (gross income from a “full suite of services to customers” engaged in producing, processing, and transporting oil and natural gas); and LTR 201227002 (gross income from handling fracturing flowback, produced water, and other residual waste products generated by oil and gas wells during the fracturing process, earned by providing services to customers engaged in exploration for and development and production of oil and natural gas). See also Todd D. Keator, “Current Trends in ‘Qualifying Income’ for Master Limited Partnerships,” BNA Bloomberg (June 2013).
close the gap between private rulings and published guidance for PTPs in the natural resources sector. Absent published guidance, the volume of rulings will no doubt continue.