DEFINING REAL PROPERTY AND ITS
CONSEQUENCES

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In recent years, the definition of real property under Section 856 has been
expanded to include assets in a number of industries that previously might not have been
considered qualifying REIT assets. These have included data storage centers, cold
storage facilities, electricity transmission and distribution property, natural gas pipelines
and associated assets such as liquefied natural gas converters, cell towers, offshore oil
platforms, and electronic billboards on buildings. Also, it has been reported that a ruling
request has been filed seeking confirmation that solar panels meet the real property
definition.¹

This definitional process has occurred exclusively through the private ruling
process whereby the IRS has interpreted “real property” under Section 856 and the
applicable regulation, Section 1.856-3(d). The Code itself does not define “real property,”
but rather the working definition is found in the regulations, which include two
components: (i) the asset must be deemed permanent (either as a structure or a structural
component of such structure) and (ii) it must not be an accessory to the operation of a
business. An initial question is the relationship between these two tests. For example,
could an asset meeting the permanency requirement fail to qualify as real property since
it was deemed to be an accessory to the operation of a business? In a series of GCM’s in
the 1960’s and 1970’s, the IRS considered this issue and concluded at one point that such
a result could not occur because the tests were “mutually exclusive.” However,

¹ Managing Director, Global Renewable Solutions.
² In the interest of full disclosure, the author recently has argued the case that renewable energy assets should
qualify for inclusion as REIT assets.
subsequent declarations have not been consistent with that position. Moreover, the IRS apparently has lost interest in the issue in that the recent rulings have failed to discuss it. Rather, decisions frequently have been made by the IRS on the basis of such considerations as whether the assets in question resemble railroad beds and trackage rather than microwave transmitters and receivers.

While discernible standards have been lacking during this process, what has been clear is that through this highly technical, and at times, strained analysis, the IRS has been setting economic policy by providing a number of industries with the highly favorable tax regime and capital cost afforded by REIT qualification. Not surprisingly, there is anecdotal evidence that other industries have been reviewing these rulings to determine if they similarly can reap these advantages. This trend does raise a number of questions: (1) would the IRS benefit from incorporating into its analyses tests that have been employed in discerning the meaning of real property under other sections of the Code; (2) should the IRS consider other factors in making these determinations, such as equitable treatment of competing industries; and (3) should Congress step into the breach and provide specific statutory categories of activities that qualify for REIT treatment.

Having a consistent definition of real property under the Code at first impression is an attractive proposition. The specter of an asset being treated variously as real property and personal property suggests a set of tax rules without coherency or logic. However, a review of the various definitions of real property under the Code may lead to the conclusions that the attainment of such a goal is illusory and that the goal itself in fact may not be desirable. To illustrate, the following provisions will be considered: Sections 48/168, 263A, 897 and 1031.
Under Section 48, the investment tax credit (when in effect) has been available principally to personal property, and the provisions of Section 168 have piggy-backed on its rules where the personal property definition is relevant, e.g., in the case of defining 5-year property. The distinction between personal and real property for purposes of these provisions has proven to be a fertile ground for activity by the courts and the IRS, spawning numerous cases and rulings, some of which extend to considerable length. In general, the analyses found in those cases and rulings have focused on the concept of permanency as delineated through the application of the six-factor test set forth in Whiteco Industries, Inc. v. Commissioner. Those tests consist of six questions that probe such matters as the nature of affixation, the removability of the asset after fixation and the intent of permanency when installed.

Interestingly, the Whiteco tests have been cited rarely in the IRS’s determinations under the REIT provisions although their influence can be detected in some of the rulings. While the tests do provide an analytically attractive framework to differentiate between the real and the personal, there is good reason not to import the specific analyses to the REIT provisions—namely, by specific intent there is a bias towards personal property characterization. The ITC and MACRS provisions represented efforts by Congress to encourage investment in personal property assets such as machinery and equipment. Accordingly, in the committee reports, Congress admonished future interpreters of these provisions to not narrowly construe such provisions when determining which assets meet the personal property definition. By contrast, no such Congressional direction exists with respect to the REIT provisions. Accordingly, although the precedents under Sections 48/168 might provide guidance in certain
circumstances for REITs, Congress has indicated that the definitions of real property under the respective provisions should not be identical.

In contrast, the IRS has concluded that the uniform capitalization rules of Section 263A mandate a more expansive definition of real property. In pertinent part, subsection (f) provides that interest costs incurred in connection with the self-production of real property are to be capitalized. The definition of real property under the regulations bears similarity to that under Section 48, but the IRS has indicated that assets deemed personal property for purposes of the latter provision may be real property for the capitalization rules. For example, electrical and plumbing systems have been ruled as real property under Section 263A while qualifying as personal property for MACRS. To provide a rationale for different treatment, the IRS has cited the legislative comments in connection with the enactment of Section 189, the predecessor to the current provisions. The Section 263A precedents, therefore, may provide a more balanced definition of real property in its application, but because of the paucity of judicial and administrative pronouncements, that section most likely will be of limited use to the IRS in its endeavors to interpret Section 856.

The definition of real property is central also to Section 897, the so-called Foreign Investment in Real Property Tax Act or FIRPTA. Under FIRPTA, nonresident alien individuals and foreign corporations are subject to a special tax upon the disposition of U.S. real property interests. The definition of the latter term, however, may limit the referential value of precedents under FIRPTA. Specifically, the statute provides that real property includes movable walls, furnishings and other personal property associated with the use of real property. With this acknowledgement that certain personal property may be treated as real property, undoubtedly inspired by the desire to expand the types of
assets subject to the tax, it is doubtful that faced with an issue of qualification under the REIT provisions, the IRS would look to FIRPTA.

The final provisions to consider are the like kind exchange provisions set forth in Section 1031. Neither the Code nor the regulations thereunder provide for a definition of real property even though qualifying an asset as real property can have significant ramifications in completing a successful tax-free exchange. Specifically, real property is not like kind to personal property, thereby precluding qualification under Section 1031, and most real property is like kind to other real property. Despite the critical nature of the classification of the property, it fairly can be said that utter confusion has existed as to the applicable standards in determining such classification. Historically, the principal source of this confusion has been the role the courts and the IRS have extended to the state law classification of the asset. Opinions have ranged from the proposition that state law is dispositive to the declaration that only a federal definition, whatever that may entail, is to be considered. There may be some reason for a more optimistic view, however, in that very recently the IRS has taken the position that the real/personal divide is to be based on federal law and that state law, while it may be considered, is not to be the standard of delineation. Much needs to be done, though, towards creating a coherent standard of real property under Section 1031.

If referring to analogous definitions under the Code yields little benefit because of, among other things, different policy objectives embedded in those provisions, the question arises as to what extent policy considerations should be a factor in issuing Section 856 rulings. In contrast to some of the above provisions, the legislative history of that section does not reveal much as to how real property should be construed. Perhaps the most relevant statement is that the purpose of the REIT regime was to provide an
investment vehicle similar to mutual funds for small investors and that the investments were to be real estate that was passive in nature analogous to the stocks and bonds held by mutual funds. The recent ruling activity of the IRS (as well as certain legislative initiatives regarding the scope of permissible REIT income and the use of taxable REIT subsidiaries) reflects that the REIT vehicle has moved substantially beyond those original objectives. With that being the case, the question does arise as to whether in processing ruling requests to extend the REIT regime to other industries, policy issues such as equitable treatment among competing industries should be considered. For example, if the issue was the treatment of wind farms, should it be relevant that offshore oil platforms qualify as REITs? The tax purist of course would object to importing such policy considerations into decisions, which to his mind should be solely technical in nature. On the other hand, does such a perspective ignore the fact that these technical decisions have the consequences of effecting economic policy and altering financing cost among industries?

One potential solution is the legislative one, i.e., revising the Code to specifically provide which industries can qualify for REIT status. To a certain extent, that is the approach that has been embodied in the master limited partnership provisions of Section 7704. The downside to such an approach is that only those industries with the greatest lobbying clout most likely will be successful in securing inclusion and historically industry-specific provisions in the Code have tended to become ossified.

In summary, the IRS has embarked through its ruling process upon a course that unwittingly has benefitted a number of industries. There does not appear to be a clear course of action to determine which other industries, including those who are competitors
of those previously benefited, should similarly be favored. The proverbial ship has left
the port but the captain continues to search for a reliable navigator.