**REITs Expansion**

**7891.01 What is the definition of “land” for determining whether an asset qualifies as a real estate asset for purposes of the REIT asset tests?**

In order to qualify as a REIT, at least 75 percent of the REIT’s assets must consist of certain defined assets, including real estate assets (see Q 7891). “Land” is a type of real property asset that qualifies as a real estate asset for this purpose.[[1]](#footnote-1) The IRS has recently clarified what types of property constitute “land” in the context of REITs.

Land includes any water or air space that is adjacent to the physical land itself, and also includes any natural products (such as crops growing on the land) and deposits that remain physically attached to the land. However, once a product is severed from the land (such as when crops are harvested or minerals are extracted) it no longer qualifies as land and is no longer treated as a real estate asset.[[2]](#footnote-2)

The new IRS proposed regulations clarify that if crops, minerals or other products that were previously physically attached to the land are stored upon the land after they are severed, such storage does not serve to recharacterize the stored property as “land” for REIT asset testing purposes.

* 1. **When is an asset considered to be an “inherently permanent structure” so that it qualifies as a real estate asset? Are there any safe harbor provisions?**

Buildings and other “inherently permanent structures” qualify as real estate assets for purposes of the REIT asset tests (see Q7893). Generally, an inherently permanent structure is a building or other structure that is reasonably expected to last indefinitely based on all of the surrounding facts and circumstances. However, the new proposed regulations provide that if the asset serves an active function (such as a piece of machinery or equipment) it is *not* a building or other inherently permanent structure.[[3]](#footnote-3) Inherently permanent structures are those that serve a *passive* function, as described in the regulations as a function that is designed to contain, support, shelter, cover, or protect—rather than an active function, such as one that is designed to manufacture, create, produce, convert or transport.

The regulations provide a safe harbor listing of the types of assets that will qualify as buildings or other inherently permanent structures without the need for a facts and circumstances analysis. “Buildings” are defined to include houses, apartments, hotels, factory and office buildings, warehouses, barns, enclosed garages, enclosed transportation stations and terminals, and stores.[[4]](#footnote-4)

The safe harbor for “inherently permanent structures” includes the following specifically enumerated structures:

1. microwave transmission, cell, broadcast and electrical towers,
2. telephone poles,
3. parking facilities,
4. bridges and tunnels,
5. roadbeds,
6. railroad tracks,
7. transmission lines,
8. pipelines,
9. fences,

(10)in-ground swimming pools,

(11)offshore drilling platforms,

(12)storage structures such as silos and oil and gas storage tanks,

(13)stationary wharves and docks,

(14)outdoor advertising displays for which an election has been properly made under IRC Section 1033(g)(3).[[5]](#footnote-5)

If a structure is not specifically enumerated within the safe harbor provision of the proposed regulations, a facts and circumstances analysis is necessary to determine whether it qualifies as a building or inherently permanent structure for purposes of meeting the REIT asset tests. Q 7893 outlines the analysis that is undertaken if the asset does not qualify for the safe harbor protection.

* 1. **What is a structural component? When will a structural component qualify as a real estate asset for purposes of the REIT asset tests?**

Structural components of inherently permanent structures also qualify as real estate assets for purposes of the REIT asset tests.[[6]](#footnote-6) Structural components are, generally, those assets that are integrated into an inherently permanent structure and serve the inherently permanent structure in its passive function. The proposed regulations provide a safe harbor listing of structural components that qualify as real estate assets as follows:

1. wiring,
2. plumbing systems,
3. central heating and air conditioning systems,
4. elevators or escalators,
5. walls, floors and ceilings,
6. permanent coverings of walls, floors and ceilings,
7. windows and doors,
8. insulation,
9. chimneys,
10. fire suppression systems (such as sprinkler systems and fire alarms),
11. fire escapes,
12. central refrigeration systems,
13. integrated security systems, and
14. humidity control systems.[[7]](#footnote-7)

An asset that is not listed in the safe harbor regulation may still qualify as a structural component that is a real estate asset based on a facts and circumstances analysis that considers several factors, including the following specifically enumerated factors:

1. The manner, time, and expense of installing and removing the asset;
2. Whether the asset is designed to be moved;
3. The damage that removal of the asset would cause to the item itself or to the inherently permanent structure of which it is a part;
4. Whether the asset serves a utility-like function with respect to the inherently permanent structure;
5. Whether the asset serves the inherently permanent structure in its passive function;
6. Whether the asset produces income from consideration for the use or occupancy of space in or upon the inherently permanent structure;
7. Whether the asset is installed during construction of the inherently permanent structure;
8. Whether the asset will remain if the tenant vacates the premises; and
9. Whether the owner of the real property is also the legal owner of the asset.[[8]](#footnote-8)
   1. **Does the Foreign Investment in Real Property Tax Act (FIRPTA) impose any special rules upon foreign individuals who invest in U.S. REITs?**

Yes. In general, the Foreign Investment in Real Property Tax Act (FIRPTA) imposes a 10 percent tax upon gains or losses stemming from the disposition of a foreign investor’s holdings in any United States real property interest.[[9]](#footnote-9) However, special rules apply in the case of REIT distributions of “United States real property interests” involving foreign individuals or corporations. If such a REIT distribution to a nonresident alien or foreign corporation is treated as a gain from the sale or exchange of U.S. real property, the REIT must deduct and withhold a 35 percent tax on the amount distributed.[[10]](#footnote-10)

The amount subject to this 35 percent tax is the foreign individual’s proportionate share of the amount of any distribution that is designated by the REIT to be a capital gain distribution.[[11]](#footnote-11)

See Q[5] for a discussion of the exceptions to the general treatment of foreign investments in REITs that can allow foreign individuals and corporations to avoid the 35 percent FIRPTA tax.

* 1. **Are there any exceptions to the 35 percent tax that is imposed upon certain REIT distributions to foreign individuals under FIRPTA?**

Yes. While the Foreign Investment in Real Property Tax Act (FIRPTA) imposes a 35 percent tax upon certain REIT distributions to foreign individuals and corporations (see Q[4]), this withholding requirement applies only to gains and losses resulting from a sale or exchange of a United States real property interest. Several exclusions apply to this general rule.

First, a foreign investor may avoid the 35 percent FIRPTA tax if he or she invests in certain publicly-traded REITs. If the shares of the REIT are regularly traded in a U.S. securities market, a distribution to a foreign individual will not be treated as gain recognized from the sale or exchange of a United States real property interest if the foreign individual (or foreign corporation) does not own more than 5 percent of the REIT shares at any time during the one-year period ending on the date of the distribution.[[12]](#footnote-12)

Further, if the REIT qualifies as a domestically controlled qualified investment entity, distributions to foreign individuals or corporations will not be subject to the 35 percent tax because the IRC defines the term “United States real property interest” to exclude interests in a domestically controlled qualified investment entity.[[13]](#footnote-13) A domestically controlled qualified investment entity includes a REIT (whether publicly or non-publicly held) in which foreign individuals and corporations own less than 50 percent of the value at all times during the shortest of the following periods:

1. The period beginning June 19, 1980 and ending on the date of the distribution;
2. The 5-year period ending on the date of the distribution; or
3. The period that the REIT has been in existence.[[14]](#footnote-14)

These rules effectively allow a foreign individual or corporation to avoid the 35 percent tax imposed upon REIT distributions under FIRPTA if the foreign ownership is limited to 5 percent of a publicly-traded REIT or less than 50 percent of any other REIT.

1. IRC Sec. 856(c). [↑](#footnote-ref-1)
2. Prop. Treas. Reg. §1.856-10(c). [↑](#footnote-ref-2)
3. Prop. Treas. Reg. §1.856-10(d)(2). [↑](#footnote-ref-3)
4. Prop. Treas. Reg. §1.856-10(d)(2)(ii)(B). [↑](#footnote-ref-4)
5. Prop. Treas. Reg. §1.856-10(2)(iii)(B). [↑](#footnote-ref-5)
6. Prop. Treas. Reg. §1.856-10(a). [↑](#footnote-ref-6)
7. Prop. Treas. Reg. §1.856-10(d)(3)(iii). [↑](#footnote-ref-7)
8. Prop. Treas. Reg. §1.856-10(d)(3)(iii). [↑](#footnote-ref-8)
9. IRC Sec. 1445(a). [↑](#footnote-ref-9)
10. IRC Sec. 1445(e)(6). [↑](#footnote-ref-10)
11. Treas. Reg. §1.1445-8(c)(2)(ii). [↑](#footnote-ref-11)
12. IRC Sec. 897(h)(1). [↑](#footnote-ref-12)
13. IRC Sec. 897(h)(2). [↑](#footnote-ref-13)
14. IRC Sec. 897(h)(4). [↑](#footnote-ref-14)