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United States REIT Structure and Real Estate Assets

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목 차

미국 자본시장에서 REITs에 투자하는 투자자의 수는 지속적으로 증가하고 있고 REITs가 소유하고 있는 자산도 매우 다양해지고 있다. 이 논문은 REITs의 기본적인 형성구조와 과세에 관한 이해를 높이는 것을 기초로 하여 독자들에게 신탁이 어떻게 형성되는지, 그리고 신탁이 무엇으로 구성되어 있는지에 대한 명확한 설명을 시도하는데 그 목적이 있다. 구체적으로는 REITs 내부의 운용구조에 대한 설명을 한 후, REITs로서 조직되고 IRS의 과세 규칙 등에 기초하고 있는 다른 유형의 회사들에 대하여도 추가적인 논의를 할 것이다. 마지막으로 이 논문은 REIT의 조직유형으로부터 장점을 취할 수 있는 여러 가지 잠재적인 사업 모델들을 찾아보는 노력을 시도하도록 한다.

[주제어] 소득세, 내국세법전, 미국 국세청, 부동산자산, 리츠, 리츠 과세, 부동산, 주주, 과세

Ⅰ. Introduction

The main purpose of Real Estate Investment Trusts (REIT) is to act as a vehicle for risk to be shared among different investors in real property. REITs are set up as corporations, which allowed investors to be shielded from personal liability for any debts of the entity.

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Corporations are developed so that many people can pool their resources to fund a project or enterprise. They buy small parts of the business (shares) and share in the profits. When investors buy shares of REITs, they are buying a piece of a corporation that manages property. REITs allow small investors to get involved with real estate and currently REITs own a dazzlingly variety of assets, so investors have many investment options.

REITs are special because they are taxed differently than a standard corporation. As long as the organization meets all the requirements of a REIT, such as distributing most of its income to shareholders, the corporation itself does not pay taxes on the income that is distributed as dividends.[1] The different tax structure makes them attractive to investors. REITs typically do not pay taxes on dividends that are distributed to their shareholders, which means single-level taxation, unlike corporations, which often must pay double taxation on distributions to shareholders.

If investors want to invest in property, but either do not have the funds to buy the property themselves, or are looking for liquidity, REITs are a good choice. REITs offer low-risk investment in property, but because the shares are traded on the public stock exchange, they are easily sold. The goal of REITs is to give investors liquidity, but also a stable investment. One of the attractive features of REITs is that they are required to pay out a majority of income as dividends. Usually increasing stock value is not the motivation for this type of investment.[2] REITs allow investors to own stock in land, without having to actually own the land or deal with management issues.

There is a large variety of REITs, but they are basically broken down into two categories, equity REITs and mortgage REITs. Equity REITs have an ownership interest in real property, while mortgage REITs make loans that are secured by real property.[3] Within these two categories, there are many different types of assets that REITs hold. Organizers who want to use the REIT structure to help finance their plans and limit the taxation of profits have shown a lot of originality in converting assets to REIT real property.

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1) Boris I. Bittker and Lawrence Lokken, Fed. Tax'n Income, Est.& Gifts ¶ 99.5.1, Thomas/RIA 2012.

2) Ralph L. Block, Investing in REITs 8-20 3rd ed. 2006.

3) Theodore S. Lynn, Micah W. Bloomfield, and David W. Lowden, Real Estate Investment Trusts § 6:2.

In the following three sections, this paper will examine the requirements and taxations regulations for REITs found mainly in Sections 856 and 857 of Chapter 26 of the US Code and the different real estate assets that REITs can hold and still qualify for REIT treatment. Chapter 26 of the U.S. Code is also referred to as the Internal Revenue Code (IRC), and it sets out the requirements for how REITs must be organized, their income, their assets and their distributions. If all the requirements are met, there should not be any taxes at the corporate level and distributions will only be taxed at the shareholder level. However, there are circumstances in which REITs are required to pay taxes. Secondly, this paper examines regular REITs taxes, taxes on foreclosure property, taxes on prohibited transactions, taxes on excessive nonqualifying income and taxes on undistributed income. Finally, this paper will examine the creative interpretations of "real estate asset" so that they qualify as real property under Section 856.

Ⅱ. REIT Requirements

1. Organization Requirements

As mentioned, REITs get special tax treatment, but in order to qualify as a REIT, the entity must meet the requirements set out by the IRC related to its organization, income, assets and distributions.

Starting with organization, the entity must:

(1) be set up as a corporation incorporated in one of the states of the United States of America and not be a closely held corporation;[4]

(2) be managed by a trustee or board of directors;[5]

(3) have transferable shares or certificates (stock);[6]

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4) 26 U.S.C. § 856(a)(3). A closely held corporation is one in which 50% of the shares are held by 5 or less individuals. This requirement only applies after the first year the organization elects REIT treatment. 26 U.S.C. § 856(a)(6), (h)(2).

5) 26 U.S.C. § 856(a)(1).

6) 26 U.S.C. § 856(a)(2).

(4) have at least 100 shareholders;[7] and

(5) not be a financial institution (e.g., a bank) or insurance company.[8]

It must also elect to be a REIT when it files its tax returns.[9] If an entity fails to meet the requirements of a REIT for any year, its status will be revoked for the taxable year after the year the election was made.[10] The entity must meet these requirements every year after it has indicated on its tax returns that it elects REIT status. If the entity loses its status, it usually cannot elect REIT status again until the fifth taxable year after the first taxable year the termination or revocation was effective.[11] But even if the REIT fails to meet one or more of the requirements, it will not automatically lose its status. The entity has the opportunity to show that the failure is "due to reasonable cause and not…willful neglect" and the organization must pay a penalty of $50,000 for each failure.[12] The entity must meet these requirements in order to have REIT status, but the IRC allows the entity the chance to fix the situation without losing its status.

2. Income Requirements

A REIT's sources of income must meet certain requirements in order for the entity to retain its REIT status. It must obtain at least 95% percent of its gross income from dividends, interest, and income from real property.[13] Seventy-five percent of its gross income must come from rent or mortgages on real property, which would be considered passive income.[14] Interest excludes any amount that depends on the income or profits of a person, though there are exceptions.[15] Rent also cannot be based on the income or profits of any person.[16] Rent

7) 26 U.S.C. § 856(a)(5).

8) 26 U.S.C. § 856(a)(4).

9) 26 U.S.C. § 856(c)(1).

10) 26 U.S.C. § 856(g)(1).

11) 26 U.S.C. § 856(g)(3).

12) 26 U.S.C. § 856(g)(5).

13) 26 U.S.C. § 856(c)(2). Income from real property includes rent, property that is held but not for sale to customers in the ordinary course of business, income and gain from foreclosure property, fees made on mortgage loans and fees made on entering into purchase contracts and leases.

14) 26 U.S.C. § 856(c)(3).

from real property (the most common type of income to a REIT) includes rent from interest in real property, charges for services customarily furnished when renting property and rent from personal property that is leased in the same lease agreement or is connected to the lease of real property.[17] Also, rent will not count towards the percentage of income requirements if it comes from a person (legal entity) that the REIT owns 10% or more interest in.[18]

If the corporation fails to meet either of these income requirements (95% test and 75% test), it can still keep its REIT status as long as it describes each item of its gross income in a schedule for the taxable year that is filed according to the regulations set out by the Internal Revenue Service (IRS) and the failure to meet one or both of these requirements was because of reasonable cause and not that the REIT was willfully neglectful.[19] The entity must also pay a penalty tax, which could be as high as 100% of the excess nonqualifying income.[20] Obviously the IRS wants to discourage REITs from earning nonqualifying income and they make it as unprofitable as possible.

3. Assets Requirements

For an entity to meet the assets requirement, the REIT can only own certain types of resources. At the end of each quarter of the taxable year, 75% of the REIT's assets must be "real estate assets," cash, "cash items (includes receivables)" and government securities, and no more than 25% of the assets can consist of securities and ownership of REIT subsidiaries.[21] "Real estate assets" are real property and shares in other REITs.[22] They can

15) 26 U.S.C. § 856(f)(1). For exceptions, see 26 U.S.C. § 856(f)(1)(B).

16) 26 U.S.C. § 856(d)(2)(A).

17) 26 U.S.C. § 856(d)(1). The rent from the personal property, in connection with real property, cannot be more than 15% of the total rent. 856(d)(1)(C).

18) 26 U.S.C. § 856(d)(2)(B). Like any corporation, REITs can own other business entities.

19) 26 U.S.C. § 856(c)(6).

20) *See generally* 26 U.S.C. § 857(b)(5).

21) 26 U.S.C. § 856(c)(4)(A), (B)(i)-(ii). "Cash items" is not defined in the Code. But the IRS has stated that they at least include shares in a money market fund. IRS Rev. Rul. 2012-17, 2012-25 I.R.B. 1.

22) 26 U.S.C. § 856(c)(5)(A).

also include temporary investments of new capital, which covers stock and debt instruments, but only for one year after they are acquired.[23] The REIT must dispose of these "temporary investments" after holding them for one year, or these investments might cause the REIT to fail to meet the asset requirements.

If the REIT fails to meet these asset requirements, it can retain its REIT status, but it must perform some actions first. After the trust identifies that is has not met the requirements, it must describe each asset that is causing the problem in a schedule filed at the close of the quarter, and show that the failure to meet the requirements was not due to willful neglect. The REIT must depose of the assets within six months after the last day of the quarter in which the assets were identified.[24] For the time period that the REIT owns the assets causing the failure, it will be taxed either $50,000 or at the highest tax rate on the net income created by the assets causing the failure to meet the requirements during the time period the assets cause a failure until they are deposed of, whichever is greatest.[25] Even though the REIT will not lose its status, it must still pay a penalty tax for owning disallowed property.

Another asset requirement has to do with ownership issues. The first is that no single investor can own more than 5% of the organization's assets.[26] The second is that the REIT cannot own securities that equal more than 10% of the total voting power or 10% of the total value of the shares issued by any one corporation.[27] By failing these requirements, the REIT would only be suffering from a *de minimis* failure. In the event of failing to meet these requirements, the REIT will still be considered to have met the requirements of the IRC for the taxable quarter as long as the value of the assets that cause the failure is the lesser of $10 million or 1% of the total value of the trust's assets at the end of the quarter at issue.[28] Once the assets have been identified, they must be deposed of within six months of the last day of the quarter in which they were identified.[29] The failure to meet the

23) 26 U.S.C. § 856(c)(5)(B).
24) 26 U.S.C. § 856(c)(7)(A).
25) 26 U.S.C. § 856(c)(7)(C).
26) 26 U.S.C. § 856(c)(4)(B)(iii)(I).
27) 26 U.S.C. § 856(c)(4)(B)(iii)(II), (III).
28) 26 U.S.C. § 856(c)(7)(B)(i).
29) 26 U.S.C. § 856(c)(7)(B)(ii).

requirements must have been from a "reasonable cause," and not "willful neglect".[30] The REIT will have to pay the same penalty tax that is required for failing the general asset requirement.[31]

When REIT ownership of another entity is being examined for purposes of the 10% asset ownership requirement, a REIT's interest as a partner in a partnership is not considered to be a security interest.[32] Instead, the assets in the partnership will be deemed to belong to the REIT according to the REIT's proportionate share of the partnership assets.[33] Any debt instruments issued by a partnership are not considered securities for the REIT's interest as a partner in a partnership and they will not be considered a security if at least 75% of the partnership's gross income (not including gross income from prohibited transactions) comes from passive investments in real property.[34] This gives REITs some protection from failing the assets requirements as long as the partnership it owns an interest in is also engaged in similar business as the REIT.

Even if the REIT does not meet the described requirements for a subsequent quarter, it can keep its status as a REIT as long as it meets the requirements for the current quarter. If the REIT does not meet the requirements because of the acquisition of real property or securities for a quarter, it will not lose its status as long as the problem is fixed within 30 days after the close of the quarter.[35] This means the REIT has 30 days to sell or otherwise get rid of the property that caused the REIT to fail the requirements tests. For valuation purposes under these requirements, securities are valued based on market quotations which are readily available to the public. For property, as long as the trustee acts in good faith, her evaluation will be accepted.[36]

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30) 26 U.S.C. § 856(c)(7)(B).
31) *Id.*
32) 26 U.S.C. § 856(m)(3).
33) *Id.*
34) 26 U.S.C. § 856(m)(4). Only those debt instruments that are not described in 26 U.S.C. § 856(m)(1).
35) 26 U.S.C. § 856(c)(4).
36) 26 U.S.C. § 856(c)(5)(A).

4. Distribution Requirements

The fourth requirement of REIT status deals with distributions to the shareholders. The rule is that the REIT must distribute 90% of all taxable income for the year and 90% of the surplus of net income from foreclosure properties divided by the tax on the income, minus any "excess noncash income."[37] The REIT's taxable income is computed by disregarding any deductions for dividends paid and excluding any net capital gain.[38] Excess noncash income is the amount that the sum of the following four items exceeds 5% of the REIT taxable income for the taxable year. This is determined by excluding the deduction for dividends paid (as defined in 26 U.S.C. § 561) and any net capital gain.[39] The four items are:

(a) gross income from rent (26 U.S.C. § 467) which exceeds the amount that would have been included if Section 467 was ignored;

(b) any gain made from the disposition of a real estate asset, if it is determined that the income is not eligible for nonrecognition under 26 U.S.C. § 1031 (property exchanged for like kind), and that the failure to meet the requirements of 26 U.S.C. § 1031 was "due to reasonable cause and not to willful neglect;"

(c) amounts that could be included in gross income as the owner of a residual real estate mortgage investment conduit interest (26 U.S.C. § 860E(a)) or as original issue discount (26 U.S.C. § 1272) (debt that is not payable when it is made) that exceed the "cash receipts under the instruments;"[40] and

(d) income from the cancellation of debt.[41]

The IRS can waive these requirements for any taxable year if the REIT can prove to the IRS that the REIT could not meet the requirements because it made distributions in compliance with 26 U.S.C. § 4981.[42]

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37) 26 U.S.C. § 857(a)(1).

38) *Id.*

39) 26 U.S.C. § 857(e)(1).

40) Bittker and Lokken, *Fed. Tax'n Income, Est.& Gifts* ¶ 99.5.2, 5, 2012.

41) 26 U.S.C. § 857(e)(2).

42) 26 U.S.C. § 857(a). 26 U.S.C. § 4981 requires that the REIT make up for any failure to distribute

Ⅲ. Taxation of REITs

What makes REITs attractive vehicles for investment is that they can function as pass-through entities, which means that the entity itself does not pay taxes on income that is distributed to shareholders. Other pass-through entities that might be more familiar are S corporations and limited liability corporations. But, even though a REIT can function entirely as a pass-through entity, there are potential taxes it could be liable for. The ones discussed below are the regular taxes that REITs have to pay if they operate according to the requirements. There are special taxes on foreclosure property, prohibited dealer transactions, excessive nonqualifying income and undistributed income.

1. Regular Taxes

REITs are required to pay taxes on "real estate investment trust taxable income." This income is taxed just like any other corporation under 26 U.S.C. § 11.[43] REIT taxable income is computed according to the following adjustments:

(a) no deductions allowed for dividends received (except for deductions from organizational expenses;[44])

(b) deductions for dividends paid are allowed except for those related to foreclosure property;

(c) any changes in the annual accounting period are disregarded (ignore 26 U.S.C. § 443(b));

(d) net income from foreclosure properties will be excluded;

(e) any taxes imposed by failing to meet the income requirements are to be deducted; and

(f) any net income from prohibited transactions (such as those not conducted at arm's length) must be excluded.[45]

Once all these types of income are removed from the REIT taxable income, the taxes

dividends that should have been distributed in another calendar year.

43) 26 U.S.C. § 857(b)(1). Section 11 sets out the tax rates for each income bracket.

44) 26 U.S.C. § 248.

45) 26 U.S.C. § 857(b)(2).

owed on the REIT's income can be calculated based on the rules in Section 11.

2. Foreclosure Property Taxes

The REIT has to follow special tax rules when dealing with income from foreclosure property. "Foreclosure property" is any property acquired by a REIT by bidding on the property at foreclosure auctions, which means the owner of the property was in default or subject to a security interest, and the property was sold by agreement or by process of law.[46) Foreclosure property keeps its status as foreclosure property usually until the end of the third taxable year after the taxable year the REIT acquired the property.[47) This period of being a "foreclosure property" for tax purposes can be extended by request of the REIT to the IRS. The REIT must show that it is "necessary" so that the REIT's interest in the property can be liquidated.[48) This extension can only be for an additional three years and will only be granted once.[49) This grace period will end if the REIT performs any of the following actions: (1) enters a lease that will produce rent that does not meet the 75% qualified income test; (2) performs construction on the property; or (3) uses the property in the trade or business of the REIT more than 90 days after the property was acquired.[50)

Net income from foreclosure property is the gain from the sale of the property that the REIT holds for sale to customers in the ordinary course of business and the gross income earned from the foreclosure property that is not due to rent, interest, refunds of taxes and gains on the sale of real property.[51) This gross income is reduced by deductions that are "directly connected" with the production of this gross income.[52) This means expenses related to improving the property and managing it, for example, can reduce the REIT's gross income. Remember that the income and gain from foreclosure property counts towards meeting the

46) 26 U.S.C. § 856(e)(1).
47) 26 U.S.C. § 856(e)(2).
48) 26 U.S.C. § 856(e)(3).
49) *Id.*
50) 26 U.S.C. § 856(e)(4).
51) 26 U.S.C. § 857(b)(4)(B)(i).
52) 26 U.S.C. § 857(b)(4)(B)(ii).

income requirements mentioned previously.[53]

Each year, the REIT must pay a tax on the net income derived from foreclosure property, which is calculated at the highest tax rate under Section 11(b).[54] Also, because of the distribution requirements, the REIT must distribute 90% of the excess of net income over the tax imposed.[55] Foreclosure property is helpful to REIT status because all income and gain qualifies for the income requirements, but suffers from double taxation. First the REIT is taxed on the income it gets from the foreclosure property and no deductions are allowed for dividends that are paid or for losses. The REIT cannot take any deductions related to the property either. Then, the REIT is required to distribute at least 90% of the net income after paying this corporate tax. Lastly, the shareholders must also pay their taxes.[56] Foreclosure property has positive and negative consequences for REITs, since they can use it for income requirements, but will also have to pay double taxation.

3. Prohibited Dealer Transaction Taxes

The tax code punishes prohibited dealer transactions severely. Anytime a REIT engages in a prohibited dealer transaction, the REIT must pay a tax that is equal to 100% of the net income realized from the transaction.[57] A "prohibited transaction" includes the sale or distribution of property that is not foreclosure property held for sale to customers in the ordinary course of business.[58] REITs are not supposed to be in the business of buying and selling property. They are in the business of managing property. The net income is calculated in the same way that net income is calculated on the sale of foreclosure property. It is the gain from the prohibited transaction minus any deductions that are "directly connection with" the disposition of the property.[59] Any losses suffered by the REIT in relation to the prohibited

53) 26 U.S.C. § 856(c)(2), (3).
54) 26 U.S.C. § 857(b)(4)(A).
55) 26 U.S.C. § 857(a)(1)(A)(ii).
56) Bittker and Lokken, *Fed. Tax'n Income, Est.& Gifts* ¶ 99.5.3, 6, 2012.
57) 26 U.S.C. § 857(b)(6)(A).
58) 26 U.S.C. § 857(b)(6)(B)(iii).
59) 26 U.S.C. § 857(b)(6)(B)(i).

transaction have no effect on the net income.[60] As mentioned above, income from prohibited transactions is excluded from the REIT's taxable income, so it is only taxed once (at 100%).[61] There are exceptions as to what constitutes a prohibited sale, but those exceptions only occur in circumstances under which it would be difficult to argue that the property was being sold in the ordinary course of business.[62] The purpose of these exceptions is probably to protect REITs when they do sell property.

4. Excessive Nonqualifying Income Taxes

Whenever a REIT has excessive nonqualifying income, it must pay a special tax on that income. As already discussed, the nonqualifying income will not automatically cause an entity to lose its REIT status, but the REIT must report the nonqualifying income in a schedule it will file at the end of the quarter and show that the disallowed income was due to "reasonable cause and not due to willful neglect."[63] The REIT must also pay a tax on the excess nonqualifying income (net income would include deductions related to the nonqualifying income), which could be as high as 100%.[64] To determine this tax, first figure out which is greater: 95% of gross income for the REIT over the income that qualifies for the 95% income test, or 75% of gross income for the REIT over the income that qualifies for the 75% income test. Take that number and multiple it by the REIT's taxable income for the taxable year (disregard deductions for dividends paid, deductions for special taxes that are required because of nonqualifying income, net operating loss and net capital gain) over gross income for the year (excluding income from prohibited transactions, gross income and gain from foreclosure property, "long-term capital gain and short-term capital gain to the extent of any short-term capital loss").[65] The answer will be the tax rate for the excessive nonqualifying income. This tax is meant to deter REITs from earning nonqualifying income.

60) 26 U.S.C. § 857(b)(6)(B)(ii).

61) 26 U.S.C. § 857(b)(2)(F).

62) For more details, *see generally* 26 U.S.C. § 857(b)(6)(C), (D).

63) 26 U.S.C. § 856(c)(6).

64) 26 U.S.C. § 857(b)(5).

65) *Id.*

5. Undistributed Income Taxes

REITs are not allowed to earn certain types of income and if they do, they are taxed on them. They are also required to make certain distributions of earned income in order to keep their REIT status. If a REIT does not distribute income as required, it is subject to a tax that is 4% of the amount that should have been distributed.[66] Required distributions are the sum of 85% of the REIT's ordinary income for the calendar year plus 95% of the REIT's capital gain net income for the calendar year.[67] If there is a shortfall in the required distributions made by the REIT, 100% of the REIT's ordinary income and 100% of the REIT's capital gain net income, minus the amount distributed in the preceding year, is added to the required distribution for the next calendar year.[68] The distributed amount is the sum of the REIT's deduction for dividends paid out during the calendar year (ignoring the deductions from the net income from foreclosure property) and the REIT's taxable net capital gain or taxable gain.[69] When earnings and profits are treated like dividends by a REIT, the REIT can legally distribute dividends.[70] But this does not apply when the amount distributed by the REIT is more than what is required by 26 U.S.C. § 4981.[71]

Ⅳ. Qualifying Real Property

1. Current Qualifying Real Estate Assets

REITs were originally meant to be a vehicle in which small investors could invest in real estate. Typically, buying real estate is prohibitively expensive for the average person to invest in, but if a group of investors pool their money, they are able to afford the investment.

66) 26 U.S.C. § 4981(a).
67) 26 U.S.C. § 4981(b)(1).
68) 26 U.S.C. § 4981(b)(2), (3).
69) 26 U.S.C. § 4981(c)(1).
70) Traditional corporations have more limitations on when they are allowed to distribute dividends.
71) 26 U.S.C. § 857(d)(2).

After Congress passed the Real Estate Investment Trust Act of 1960, the SEC has issued some rulings expanding the definition of real property that is eligible for REIT treatment. Most of the revenue rulings were issued in the 1970s.[72] During the past five years, the SEC has been issuing rulings that have expanded the types of assets that qualify as REIT assets and income. Most REITs are in the business of managing property, but the types of assets that are managed have expanded in recent years.[73]

There is a set of criteria that hopeful real estate assets must meet. First, the IRS will consider if the property can be moved and has it been moved.[74] Second, the property must be designed or built to be a permanent part of the real property.[75] Third, the IRS will consider any evidence that shows how long the structure is expected to be installed.[76] Fourth, the IRS will look at how difficult it would be to remove the structure.[77] Fifth, it will evaluate the amount of damage the structure will suffer if removed.[78] Lastly, it will look at how the structure was installed or attached to the real property.[79]

There are various types of REITs that have been accepted as qualifying real property under Section 856. The two basic types, as mentioned in the introduction, are equity and mortgage REITs and these categories can be further subdivided to include office and industry, retail, residential, resorts, self-storage, health care, timber, infrastructure, home financing and commercial financing.[80] These categories now include assisted-living homes, data storage facilities and prisons.

REITs are meant to be passive but since their inception, the IRS has allowed some flexibility

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72) *See generally* Rev. Rul. 69-94, 1969-1 C.B. 189, Rev. Rul. 71-220, 1971-1 C.B. 210, Rev. Rul. 73-425, 1973-2 C.B. 222, Rev. Rul. 75-424, 1975-2 C.B. 269.

73) Brad Thomas, *REITs Boom As More Industries Discover This Tax-Friendly Structure*, Forbes, Nov. 26, 2012, *available at* 〈http://www.forbes.com/sites/bradthomas/2012/11/26/reits-boom-as-more-industries-discover-this-tax-friendly-structure/〉 last visited May 26, 2015.

74) I.R.S. Priv. Ltr. Rul. 2012-04-006, Oct. 24, 2011.

75) *Id.*

76) *Id.*

77) *Id.*

78) *Id.*

79) *Id.*

80) NAREIT REITWatch for April 2015, 27, 〈https://www.reit.com/sites/default/files/reitwatch/RW1504.pdf〉, last visited May 26, 2015.

in how REITs are set up to fulfill the passivity requirement.[81] Businesses such as hotels and health care providers have real property that can be leased, but require a lot of services to manage them. Hotels can be REITs, but since they are not passive receivers of rental income, there must be a taxable entity that runs the hotel, while a passive REIT owns the real estate and rents the property to the hotel manager.[82] REITs can also run health care facilities, which are included as real property under Section 856 and receive special exceptions as to how the managing corporation is taxed.[83] Heath care corporations will use the REIT model in order to finance an expansion of facilities.[84] New property is purchased by the REIT and then leased back to the health care corporation. The definition of a health care REIT has recently been expanded by the IRS. In a private letter ruling, it stated that an assisted-living home qualifies as a health care facility under Section 856(e)(6)(D)(ii).[85] This is just one example of creative expansion of the definition of property that qualifies as an asset of a REIT.

In order for property to be defined as "real property," it must have inherent permanence.[86] The IRS has defined "commercial buildings, HVAC systems, cellular towers, LED billboards, and railroads" as permanent property because they are a part of the real property.[87] Once the wheels have been removed, mobile homes were considered part of the real property, including buildings attached to the home.[88] Even though a mobile home is moveable, once it is attached to the ground, it will be treated like a normal building that was constructed on the property. There are currently three mobile home REITs.[89] Assets do not have to

81) 26 U.S.C. § 856(c)(3).

82) Charles L. Menges, *Fault Lines in Hotels: Financing the Hotel*, 30 No. 5 Prac. Real Est. Law 39, 47, 2014.

83) 26 U.S.C. § 856 (d)(8)(B), (d)(9), (e)(6), (i)(3).

84) Sarah Foster, *When is a Lease an Agreement to Sell Your Business?*, Norton Annual Survey of Bankruptcy Law ¶ 5, 1999.

85) I.R.S. Priv. Ltr. Rul. 2015-09-019, Feb. 27, 2015.

86) I.R.S. Section 1.856-3(d).

87) David Feldman, Michael Mendelsohn, & Jason Coughlin, *National Renewable Energy Laboratory, The Technical Qualifications for Treating Photovoltaic Assets as Real Property by Real Estate Investment Trusts (REITs)*, 4, 2012,〈 http://www.nrel.gov/docs/fy12osti/55396.pdf〉, last visited May 26, 2015.

88) Rev. Rul. 71-220, 1971-1 C.B. 210.

be built onto or into the existing real property. They can be brought on and installed, such as a mobile home.

In another revenue ruling, the IRS stated that railroad tracks and other permanent structures used by train companies qualify as real estate assets under section 856(c)(6)(B) of the Code.[90) They qualify because their operation is passive and they operate as a conduit for the business to use. Also, since they cannot easily be removed from the land and are not intended to be removed, they can be considered part of the real property. This passive and permanent nature of railroad tracks was compared to microwave transmission systems, which were also found to be within the definition of real estate assets.[91) The rulings covering these two situations were analogized to other situations where assets were permanent and passive, as will be seen below.

Another revenue ruling dealing with real estate assets looked at a shopping center's energy system. In this hypothetical situation, the IRS noted that the energy system could not be mortgaged separately from the building it supported and be considered a real estate asset.[92) In order to qualify, the system had to be functionally related to the permanent structure and be mortgaged along with the shopping center it served.[93) These fixtures were able to be included as real estate assets. Accessories to the operation of a structure could not be real estate assets; therefore, ownership of accessories to the operation could cause the REIT to lose its status under Section 856.[94) The definition of real property under the Treasury Register is "land or improvements thereon, such as buildings or other inherently permanent structures thereon" and the structure's components, such as wiring and air-conditioning systems.[95) The IRS seems to be looking for permanence, such as built-in items and supporting assets.

The IRS has produced many private letter rulings stating that certain kinds of property can qualify as REIT real property. In these private letters, corporations that want to create

89) NAREIT REITWatch, *supra* note 80.
90) Rev. Rul. 69-94, 1969-1 C.B. 189.
91) Rev. Rul. 75-424, 1975-2 C.B. 269.
92) Rev. Rul. 73-425, 1973-2 C.B. 222.
93) *Id.*
94) Treas. Reg. § 1.856-3(c) (1992).
95) *Id.*

a REIT using assets that have not previous been used ask whether specific assets will qualify. There has been an increased interest in REITs in recent years.[96] The types of assets that have gotten the green light from the IRS include an electricity transmission and distribution system, crude oil storage, LED billboards, and pipelines, to name a few. These different types of assets seem to indicate the IRS has become accepting of creative interpretations of what is a permanent, passive asset suitable for REIT ownership.

As noted above, in a revenue ruling, the IRS stated that a microwave transmission system and railroad tracks were real estate assets. Expanding on this concept, the IRS wrote in a private letter ruling that an electricity transmission and distribution system was also a real estate asset.[97] They passively sit there and are used as a conduit, therefore they are passive. The system was also a part of the structure it supports, and because the operation of the system did not require a lot of management, it met the passivity requirement.[98] Just last year, the IRS made a private letter ruling that the fiber optic cables that are installed by a cell phone company in buildings to aid in giving service in population-dense areas met the definition of a real estate asset.[99] Items installed onto buildings and that provide a passive benefit, such as cables and reception of microwaves, can be real estate assets.

Pipelines used by a business are real property because they are a permanent part of the land and operation of them would not violate the passivity requirements for REITs.[100] In buildings that provide electricity, heating and air conditioning, humidity control, security, fire control and telecommunications infrastructure, all those components are real estate because they are permanent parts of the building.[101] They are not “assets accessory to the operation of a business,” so they qualify as real property.[102] Assets with moving or mechanical parts, for example, are usually described as accessories. Something passive, like a pipeline that water or oil runs through can be a real estate asset, but also something that is part of the

96) Thomas, *supra* note 73.

97) I.R.S. Priv. Ltr. Rul. 2007-25-015, June 22, 2007.

98) *Id.*

99) I.R.S. Priv. Ltr. Rul. 2014-50-017, Dec. 12, 2014.

100) I.R.S. Priv. Ltr. Rul. 2009-37-006, Sept. 11, 2009, *see also* I.R.S. Priv. Ltr. Rul. 2007-25-015, June 22, 2007.

101) I.R.S. Priv. Ltr. Rul. 2009-21-019, May 22, 2009.

102) *Id.*

building itself and supports the building is also a real estate asset.

LED billboards, off-shore oil rigs, ski lifts and plants are real estate assets that have been stuck into the ground. LED billboards that are rented out for advertisement purposes are real estate assets, not accessories to the structure.[103] These billboards are attached to the ground and not meant to be moved once installed and the management of the signs is passive.[104] An off-shore oil rig can be leased out by a REIT as long as the REIT only maintains the oil rig and does not do anything to support the lessee's actions.[105] The IRS stated that a ski lift tower can qualify as real property and is similar to a microwave transmission tower since it is a part of the property and not an accessory.[106] A ski lift tower also seems similar to a free-standing billboard.

Plants are another asset that are just stuck into the ground and then called real property. The United States has long considered standing timber as real property.[107] Also, unsevered crops and timber are real property according to the Treasury Department.[108] Orchard trees are also real estate assets, so it is not a stretch that the IRS stated that vines can also be a permanent asset.[109] Recently, the IRS stated that plants that have a complex root system can be considered permanent structures to the land.[110] The IRS considered these previous rulings and came to the conclusion that the parts of the plants not harvested are real property.[111] This ruling allowed a REIT to operate a vineyard, so even a plant that could die is considered real property.[112]

Other assets that can qualify are storage facilities, including those that store crude oil, things that require refrigeration, paper documents, and data. One approved REIT wanted to receive, store, and distribute crude oil.[113] The IRS stated that this was allowed since the

103) I.R.S. Priv. Ltr. Rul. 2012-04-006, Oct. 24, 2011.

104) *Id.*

105) I.R.S. Priv. Ltr. Rul. 2012-50-003, Dec. 14, 2012.

106) I.R.S. Priv. Ltr. Rul. 2015-21-006, May 22, 2015.

107) *Hutchins v. King*, 68 U.S. 53, 59; 17 L. Ed. 544, 1863.

108) Treas. Reg. § 1.897-1(b)(2), 2003.

109) Rev. Rul. 67-51, 1967-1 C.B. 68.

110) I.R.S. Priv. Ltr. Rul. 2014-24-017, June 13, 2014.

111) *Id.*

112) Of course, once it is dead, it would no longer meet the requirements of Section 856.

storage facilities were permanent and not meant to be removed and that the REIT would only be engaging in normal activity associated with that type of property.[114] Similarly, cold storage rented out for consumers to use met the requirements of a REIT.[115] A provider of document storage could elect REIT status and the steel racking used to store paper documents were of a permanent enough nature to be part of the leased premises.[116] Storage facilities provide passive enough services to qualify as REIT real property.

The IRS has even approved the storage of data, an intangible item.[117] The electing entity took care of computer systems and the infrastructure that supported them.[118] It produced income by leasing space to tenants, which was similar to storage facilities that rent out physical space.[119] This ruling has been criticized since perhaps data-storage is more similar to energy-producing businesses rather than passive holders of real estate, since most of the expenses associated with storage come from electrical use.[120] If this is just a type of storage, then perhaps other intangible items could also be stored, such as money or investments. However, if this is a type of energy-producer, perhaps this ruling will be cited in the event that the IRS approves passive forms of energy production, such as solar panels.

An article in the New York Times noted that a correctional facility company and an entity that runs casinos were approved by the IRS to change their designation to REITs.[121] The entities that run prisons convinced the IRS that they met the passive income requirements of Section 856 because they are collecting rent from the government.[122] Cell phone companies

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113) I.R.S. Priv. Ltr. Rul. 2010-05-018, Oct. 6, 2009.

114) *Id.*

115) I.R.S. Priv. Ltr. Rul. 1999-04-019, Jan. 29, 1999.

116) I.R.S. Priv. Ltr. Rul. 2015-03-010, Jan. 16, 2015.

117) I.R.S. Priv. Ltr. Rul. 2013-14-002, Apr. 4, 2013.

118) Lauren G. Citrome, Note, *Data Centers and REITs: Is There Real Estate in the Cloud?*, 11 N.Y.U. J. L. & Bus. 191, 206, 2014.

119) *Id.*

120) *Id.*, at 206 *citing* James Glanz, *Landlords Double as Energy Brokers*, N.Y. Times, May 14, 2013, at B1, *available at*〈http://www.nytimes.com/2013/05/14/technology/north-jersey-data-center-industry-blurs-utility-real-estate-boundaries.html?_r=0〉, last visited May 26, 2015.

121) Nathaniel Popper, *Restyled as Real Estate Trusts, Varied Businesses Avoid Taxes*, N.Y. Times, Apr. 22, 2013 at A1, *available at* 〈http://www.nytimes.com/2013/04/22/business/restyled-as-real-estate-trusts-varied-businesses-avoid-taxes.html?_r=0〉, last visited May 26, 2015.

122) *Id.*

operating signal towers have also successfully claimed that the towers are real estate.[123) It seems that almost any real property or permanent structure attached to it could elect REIT status. The entity needs to show that the suggested real estate asset is passive and permanent, which, considering all the examples previously discussed could potentially include almost any type of asset.

2. The Future of REITs

REITs can own vineyards, prisons, and cloud data storage units, which show the wide variety of real estate assets that can be owned by REITs. Perhaps the interpretation of what counts as a real estate asset will be almost any item attached to real property. As noted above, there has been an explosion of private letter rulings from the IRS allowing different assets to be classified as REIT real property. Subsidiaries can be created to deal with property that does not meet Section 856's requirements and perform work that is disallowed because of the passivity requirement. Because of the amount of private letter rulings coming from the IRS, it seems as though almost any kind of asset attached to property can be a real estate asset.[124) Investors, their advisors and scholars all have theories on what form future REIT assets will take.

Some scholars believe that REITs would be a useful vehicle for investment in renewable energy.[125) REITs could encourage small investors to get involved with renewable energy because of the low cost of buying an interest while being able to support sustainable energy.[126)

123) *Id.*

124) For a critique on the increase of IRS private letter rulings and their potential effect, see Peter E. Boos, *Runaway REIT Train? Impact of Recent IRS Rulings*, Tax Analysts, Apr. 3, 2015, 〈http://www.taxanalysts.com/www/features.nsf/Articles/FFF8F863CF33DB1E85257E1B004BAD8F?OpenDocument〉, last visited May 26, 2015.

125) *See* Kevin M. Walsh, *Renewable Energy: Where We are Now and How Renewable Energy Investment and Development Can Be Expanded*, 23 U. Miami Bus. L. Rev. 69, 2014, Felix Mormann, *Beyond Tax Credits: Smarter Tax Policy for a Cleaner, More Democratic Energy Future*, 31 Yale J. on Reg. 303, 2014.

126) Walsh, at 89, *citing* Glenn R. Mueller, *Securitization of Real Estate and Global Growth*, Global Executive Forum Reports, Winter 2005-2006, at 4, *available at* 〈http://www.ucdenver.edu/academics/InternationalPrograms/CIBER/GlobalForumReports/Documents/Global_Forum_

Unlike fossil fuels which are not considered "property," wind turbines could potentially be declared as qualifying assets and the profits from sale of electricity as REIT-eligible income.[127] Energy efficient assets qualify for special tax treatment, while renewable energy does not.[128] There is a REIT that exists that produces renewable energy, but the profits from the REIT are disallowed, so they have to be balanced against profits that are allowed.[129] Instead of making businesses that want to structure their renewable energy companies try to carefully balance their assets, the IRS could state that renewable energy meets the "asset and income test requirements for REIT-eligibility income."[130] Currently there are infrastructure REITs that own real estate related to energy and transportation.[131] There is already a market interested in energy-producing REITs. If the IRS found that structures that collect renewable energy were real estate assets, that would encourage more investment in that area, which in turn might help the environment.

Even if all renewable energy sources did not meet the requirement of passivity and permanence, perhaps solar panels would since they are usually attached to a building's roof, not moved once installed, do not have moving parts, and "convert radiation energy directly into electrical energy."[132] Solar panels seem very similar to a microwave or cellular transmission system. Solar panels do not do anything other than passively collect sunlight, which seems similar to the conduits that the IRS has approved for real estate asset status.

Almost any structure that does not have complex moving parts would probably qualify for REIT status, considering the types of structures that IRS has already approved. Companies that are thinking of making the switch should consider if putting their assets into a REIT will benefit the company or the public when it comes to infrastructure REITs.[133] There

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Report_Winter_2005.pdf〉, last visited May 26, 2015.

127) Mormann, *supra* note 125, at 351.

128) Herman K. Trabish, *How Hannon Armstrong Got the IRS to Approve Its Renewable REIT*, Green Tech Media, May 30, 2013, 〈http://www.greentechmedia.com/articles/read/How-Hannon-Armstrong-Got-the-IRS-to-Approve-its-Renewable-REIT〉, last visited May 26, 2015.

129) *Id.*

130) Mormann, *supra* note 125, at 351.

131) *E.g.*, Power REIT 〈http://pwreit.com/〉.

132) Feldman, et al, *supra* note 87, at 4, 6.

133) *Compare* Jennifer Popovec, *REIT Conversions: A Creative Way to Unlock Shareholder Value*, Wealth Management, Nov. 14, 2012, 〈http://wealthmanagement.com/ibds/reit-conversions-

are currently two infrastructure REITs in existence and one runs a toll road.134) Perhaps following this theme of privately owned and operated public facilities, there will be port and airport REITs. REITs might be a way for the government raise funds for these entities.

In the private arena, REITs do offer the chance to raise funds for large projects or change the tax structure for existing corporations. A Jefferies study suggested that a car auction lot company could benefit from REIT status.135) The company owned parking lots, bought vehicles and facilitated the sale of these cars. In a similar vein, parking lots and cemeteries might also make a good REITs.136) What these companies have in common is the fact that they use large expanses of land for storage and the management of the land is minimal. REITs could offer these types of businesses the chance to raise investment funds and lower taxes paid on profits from their property.

In a country like the United States where there are wide expanses of land, land should be used to create investment opportunities. REITs offer the chance to pool funds from many investors to raise capital, as well as allow small investors to get involved with real estate, which is usually a stable investment. Considering the trend of the IRS issuing many letter rulings, perhaps a creative organizer will be able to create a REIT to own almost any type of asset.

Ⅴ. Concluding Thoughts

REITs are helpful and interesting entities that can be used in many inspired ways related to property investment. This article is meant to give an introduction to the nature of REITs

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creative-way-unlock-shareholder-value〉, last visited May 26, 2015, *and* Reuben Gregg Brewer, *Communications Sales & Leasing: Not Everything Should Be A REIT*, Seeking Alpha, May 6, 2015, 〈http://seekingalpha.com/article/3149306-communications-sales-and-leasing-not-everything-should-be-a-reit〉, last visited May 26, 2015.

134) NAREIT REITWatch, *supra* note 80, at 27.

135) Omotayo Okusanya and David Shamis, *RETIs: What's Next in the REIT Conversation Phenomenon?*, Jefferies, Apr. 10, 2013, 19, *available at* 〈https://javatar.bluematrix.com/docs/pdf/d8c5327d-0ce5-4a7a-addc-e9d2d7aefb2c.pdf〉, last visited May 26, 2015.

136) *Id.*, at 35-36.

and the different forms they can assume. The requirements of a REIT show that the IRS encourages them to focus on handling and managing property. The average REIT should provide low risk investment in property without the hassle of owning property directly or dealing with the management of property. The REIT law was signed into existence in the United States of America in 1960 as a way for average Americans to be able to invest in income-producing property that used to be available only to the elite.[137] Today, the United States has the largest number of REITs in the world.[138] As other countries develop their own REIT markets, it will be helpful to consider the American framework when deciding on the best organization for their own REITs.

The different types of REITs created show a lot of ingenuity on the part of organizers and willingness of the IRS to broadly define real estate assets. REIT organizers have taken advantage of these varied types of qualifying real property. Today, there are REITs that own landfills, vineyards, toll roads and data storage facilities. They have come a long way from the original concept of REITs which was meant as a way for investors to invest in real estate. As noted above, some scholars are excited about future opportunities in this field, while others are worried that the IRS has expanded the definition of real property asset too far. It would be difficult to rein back in the multiple types of assets that qualify, but the IRS might issue less private letter rulings. Investors and scholars alike will have to wait and see what the future holds for REITs.

137) Joshua Kennon, *Real Estate Investing Through REITs*, About.com, *available at* 〈http://beginnersinvest.about.com/od/reit/a/aa101404.htm〉, last visited May 26, 2015.

138) Robert W. Lehman and Howard S. Roth, *Against All Odds*, Global Real Estate Investment Trust Report (2010) 20, *available at* 〈https://www2.eycom.ch/publications/items/realestate/2010_reas_investment_trust_report/2010_EY_Global_REAS_ITR.pdf〉, last visited May 26, 2015.

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[Abstract]

United States REIT Structure and Real Estate Assets

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REITs are becoming increasingly popular in the United States with investors and the variety of assets that REITs own has also been increasing. This article explains the formation and basic taxation scheme of REITs, so that the reader can have a clear view of how these trusts are formed and what they are composed of. After exploring the inner workings of REITs, the article continues on to discuss the different types of companies that can be organized as REITs, based on IRS revenue rulings and IRS private letter rulings. The article ends with a look at some potential types of businesses that might benefit from REIT organization.

[Key Words] Income tax, Internal Revenue Code (IRC), Internal Revenue Service (IRS), Real estate assets, Real estate investment trusts (REIT), REIT organization, REIT taxation, Real property, Shareholder, Taxation

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