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Revival of REIT Rulings Could Mean Good News for Companies with Non-Traditional Assets Considering Becoming REITs

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In recent years, there has been a considerable expansion of the types of companies holding non-traditional real estate assets that have elected to become real estate investment trusts for US federal income tax purposes ("REITs"). Companies considering becoming REITs have been able to receive private letter rulings ("PLRs") from the US Internal Revenue Service (the "IRS") confirming that their non-traditional assets qualified as real estate assets that may be owned by a REIT. This recognition of the different types of non-traditional real estate assets that may be held by a REIT, along with liberalization of the rules governing "taxable REIT subsidiaries" (which are corporate subsidiaries of REITs that operate businesses and hold assets that are not REIT-eligible), has encouraged many C corporations (corporations taxed under the standard corporate tax provisions of the US Internal Revenue Code of 1986, as amended (the "Code")) to convert to REITs. Other companies with assets eligible to be held by a REIT have considered undertaking tax-free spin-offs of such assets into REITs.

However, some companies considering becoming REITs had been facing uncertainty after the IRS suspended issuing PLRs as it undertook a review of what are qualifying "real estate assets" (as described below) under the REIT rules. In early June, three companies, Iron Mountain Inc., Lamar Advertising Co. and Equinix Inc., announced in filings with the Securities and Exchange Commission (the "SEC") that the IRS had suspended the consideration of their PLR requests. This created uncertainty regarding whether the IRS was changing its view on qualifying real estate assets under the REIT rules. This concern was attributable to the fact that Lamar Advertising and Equinix were seeking PLRs with respect to categories of assets that the IRS had previously confirmed were qualifying real estate assets. On November 15, the three companies announced in SEC filings that the IRS had again resumed work on their PLR requests.

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It is not yet entirely clear whether the IRS has changed its view on what are qualifying REIT real estate assets, but it appears from statements made by IRS representatives that the IRS has not made a significant change and will once again issue PLRs confirming the types of assets that are qualifying REIT assets.

This article summarizes the categories of non-traditional assets that the IRS has confirmed are qualifying REIT assets. In addition, this article discusses recent REIT conversions and spin-off transactions in which non-traditional businesses have converted operations from C corporation form to REIT form.

Background on REITs

A REIT is an entity with special tax status under US federal income law. The REIT tax rules were enacted to promote and facilitate widely-held investment in portfolios of real estate. A REIT has a hybrid tax treatment. From an investor's tax perspective, a REIT is a separate taxable entity. Unlike an investor in an entity taxed as a partnership, an investor in a REIT generally only is taxed on dividends paid by the REIT and on gains on the disposition of shares in the REIT. Tax-exempt and non-US investors also are not directly taxed on the REIT's underlying income. From the entity's tax perspective, the REIT is allowed a "dividends paid deduction" so that it generally is not subject to US corporate tax provided that each year it distributes to its shareholders an amount at least equal to its annual taxable income.

In order to qualify as a REIT, among other requirements, (i) at least 75 percent of the REIT's assets must be "real estate assets" (the "asset test"), (ii) at least 75 percent of the REIT's gross income must be from items related to real estate, such as "rents from real property," and (iii) at least 95 percent of the REIT's gross income must be from items related to real estate or certain passive investments ((ii) and (iii) together, the "income tests").

For purposes of the asset test, "real estate assets" include interests in real property, which in turn includes land or improvements thereon, such as buildings or other inherently permanent structures. Assets that are affixed to these structures may also qualify as real estate assets, provided they are deemed "structural components" of a building or other inherently permanent structure and not assets "accessory to the operation of a business." The IRS has often distinguished between these two classes of assets without articulating its rationale for doing so when ruling on a particular set of facts. As a result, the dividing line is not always easy to identify. Plumbing systems, electrical wiring, elevators and central air conditioning are generally considered structural components and, therefore, treated as qualifying REIT assets. Machinery, individual air conditioning units, office equipment and hotel furnishings, in contrast, are generally considered "accessory to the operation of a business." However, categorical distinctions such as these do not readily identify whether a particular asset qualifies for purposes of the REIT rules. Machinery, equipment and other items that are specifically listed as examples of assets that are "accessory to the operation of a business" in the Treasury Regulations have been given favorable treatment by the IRS where they comprise part of a system that is inherently permanent or structurally integrated with a building or other permanent structure. In PLRs, the IRS has applied a "movability" criterion to classify structural components as "real property," focusing on the manner of attachment to the land or the structure and the permanence of the structure. The less movable and more connected to land or other permanent structure the property is, the more likely it is to be treated as real property for purposes of the asset test. The IRS also has recognized that real estate assets include intangibles, such as voting rights and goodwill, that are inextricably and compulsorily tied to real property or otherwise inseparable from real property.

Notwithstanding the difficulty that can be encountered in classifying certain assets at the margin, the law informing these determinations has remained relatively static for some time. During the first two decades following the creation of the REIT regime in 1960, the definition of real property was given a broad reading by the IRS and the difficult to articulate meaning of "accessory to the operation of a business" was continually narrowed. The body of law that emerged from these developments has seen little change in the intervening years. However, changes in market demand for investment opportunities in REITs have encouraged other companies with assets eligible to be held by a REIT to engage in various REIT structuring transactions. As described below, this has led to an expansion of the categories of real estate assets that have been put into REIT form as companies that operate in other industries continue to convert to REITs.

Recent Expansion of REIT Vehicles into New Industries

The traditional types of real estate assets that have been held by REITs include office buildings, warehouses, industrial complexes, shopping centers, multi-family residential properties and health care facilities. However, because of the tax benefits afforded to REITs, as well as the positive market perception and investor demand for REIT investments, in recent years companies in other industries that hold significant real property have looked to operate as REITs. The IRS has issued PLRs to REITs approving certain non-traditional real estate assets as qualifying REIT assets and the income on such assets as qualifying REIT income. The growing use of REIT vehicles by companies operating in non-traditional REIT industry sectors is, however, more properly viewed as a product of changing market demand than a liberalization of current law. Review of the authorities cited by the IRS in recently issued PLRs makes clear that the IRS is relying on well established law in determining whether particular assets qualify as real property.

Summarized below are categories of non-traditional assets that the IRS has recognized as qualifying REIT assets. For each category of real estate asset, we have provided one or more PLRs or published rulings that have approved the category of asset as a qualifying REIT asset and have provided examples of REITs holding such non-traditional assets. Please note that the rulings cited below may not correspond to the specific REIT or REITs identified.

Rooftop Sites

Rooftop sites include the physical space on top of buildings and the right to use air space above a roof's surface, as well as leasehold interests in such space. Rooftop sites may be used for purposes such as telecommunication towers, solar panels or billboards.

- PLR 200831020 (8/1/2008). In the PLR, the IRS ruled that leasehold interests in rooftop space are qualifying REIT assets because the physical space on top of a roof relates to real property.

- Crown Castle International Corp. is a telecommunications REIT that owns and operates wireless communication towers. As part of this business, Crown Castle leases rooftop space from building owners and then subleases the space to its own customers.

Wireless Communication Systems

Wireless communication systems include wireless communication towers, broadcast communication towers and the sites on which such towers are located, including fencing, shelters, and permanently installed backup generators.

- PLR 201129007 (7/22/2011). In the PLR, the IRS emphasized the permanence of the wireless communication structures as being important to their treatment as real estate assets. The fact that the tower systems were large steel structures built deep below the ground and constructed to remain permanently in place demonstrated that these were real property assets for purposes of the asset test and the income tests.
- American Tower Corporation is a REIT that leases antenna space on multi-tenant communications sites to wireless service providers, radio and television broadcast companies, wireless data providers, government agencies and municipalities and tenants in a number of other industries.
- Crown Castle International Corp. is a telecommunications REIT that owns and operates wireless communication towers.

Manufactured Housing

Manufactured housing includes manufactured homes and land available for lease by manufactured home owners.

- PLR 8931039 (5/8/1989). In the PLR, the IRS emphasized the difficulty and cost in relocating a manufactured home, which demonstrated its permanence.
- UMH Properties, Inc. is a REIT that owns and operates manufactured home communities in the northeastern United States.
- Equity LifeStyle Properties, Inc. is a REIT that owns manufactured home communities, recreational vehicle resorts and campgrounds.

Power Distribution Facilities

Power distribution facilities include systems of physically connected and functionally interdependent assets that serve as a conduit to allow a created-by-generation source to flow through the system to an end-user.

- PLR 200725015 (6/22/2007). In the PLR, the IRS emphasized the fact that it was not feasible to move all or any substantial part of the power distribution system and that each component was intended to serve indefinitely and remain in place once affixed to other system parts and to the underlying land. The IRS compared the system parts to railroad tracks and other components that allow transmission through a railroad system.
- Hannon Armstrong Sustainable Infrastructure Capital, Inc. is a REIT that provides debt and equity financing to renewable energy systems and energy efficiency projects (debt secured by qualifying real estate assets is a qualifying real estate asset). Hannon Armstrong received a PLR regarding the qualification of its assets, but the PLR has not yet been made public.

Timberlands

Timberlands include the forestland on which trees are grown commercially as well as the standing timber thereon. The sale of timber cut from the forestland is treated as qualifying REIT income and not a sale of “dealer property.” This is because timber REITs may elect under Code Section 631(a) to treat the cutting and sale of timber as a sale or exchange that could be treated as a gain from the sale of real property. In addition, the sale of uncut trees can qualify as capital gain derived from the sale of real property.

- PLR 8838016 (6/21/1988), PLR 199927021 (7/9/1999), PLR 199945055 (8/13/1999) and PLR 200052021 (12/29/2000). In PLR 200052021, the IRS ruled that income derived from timber cutting contracts entered into by a REIT through its operating partnership was qualifying income under the REIT rules.

- Rayonier, Inc., Potlatch Corporation and Plum Creek Timber Co., Inc. are REITs that own significant amounts of forestland in the United States and internationally.

Pipeline Systems

Pipeline systems include interests in land associated with the pipelines, structures for storage and pumping of gas or oil.

- PLR 200937006 (9/11/2009) and PLR 201005018 (2/5/2010).
- Hunt Consolidated Inc. owns a private REIT engaged in natural gas transmission.

Railroads

Railroads include railroad land and associated structures, including tracks, roadbeds, buildings, bridges and tunnels.

- Revenue Ruling 69-94.
- Power REIT is a REIT that owns, among other REIT qualifying assets, land and tracks leased to the Norfolk Southern railroad.

Refrigerated Warehouses

Refrigerated warehouses include a central refrigeration system, which includes the structural components of the building and refrigeration system.

- PLR 199904019 (1/29/1999). In the PLR, the IRS ruled that a refrigeration system that is designed such that the components are physically and functionally interdependent and each component is intended to serve indefinitely and remain in place once affixed to the system and the underlying property is a real estate asset for purposes of the REIT asset test.
- Americold Realty Trust is a REIT that owns and operates temperature-controlled warehouses.

Billboards

Billboards include the physical billboard structures which can be attached to other building structures or separately constructed structures that are designed and constructed to remain permanently in place.

- In PLR 201143011 (10/28/2011) and PLR 201204006 (1/27/2012), the IRS ruled that, because billboard sign structures are bolted to real property and designed to permanently stay in place, they are real estate assets for purposes of the REIT asset test, and the fees for using such structures are rents from real property for purposes of the REIT income tests.
- CBS Outdoor Americas, the billboard advertising unit of CBS Corp., and Lamar Advertising, a competitor of CBS Outdoor Americas, are both in the process of converting into REITs. Notably, CBS Outdoor Americas has stated in SEC filings that it plans for the resulting REIT to eventually be spun off to shareholders of CBS Corp. This strategy of separating the real estate assets of an existing company from its non-real estate business is one of the available REIT transaction structures discussed below.

Data Centers

Data centers are buildings that house computer systems, servers and related equipment that are capable of remotely processing large amounts of information.

- Digital Realty Trust, Inc. is a REIT that owns data centers.

- CyrusOne Inc. In August 2012, Cincinnati Bell Inc., a telecommunications company, announced its intention to form a separate publicly traded subsidiary, CyrusOne, its data center unit, as a REIT to be taken public in an IPO. CyrusOne owns, operates and develops data center properties and leases out its data centers. Prior to completing the separation and IPO of CyrusOne, Cincinnati Bell received a PLR from the IRS (likely PLR 201314002) ruling that its data centers would be qualified real estate assets for purposes of the REIT asset tests.

Boat Slips

Boat slips come in a variety of forms including individual or shared partitions of a dock and anchored buoys to which waterborne vessels can attach. Each boat slip represents the right to use and occupy a geographically fixed plot of water within a marina.

- In PLR 201310020 (3/8/13), the IRS ruled that the boat slips within a marina that are leased to boat owners constitute real estate assets for purposes of the REIT rules.

REIT Conversions and REIT Spin-Offs Involving Non-Traditional Real Estate Assets

A variety of transaction structures are available for assets to be converted into REIT form. In recent years, operating companies that are not traditionally considered real estate companies but own significant amounts of real property have announced their intention to convert, or begun the process of converting, from taxable C corporations to REITs. In order for a C corporation to convert to a REIT, it must take certain operational steps (as well as make sure its organizational documents contain provisions to maintain REIT status). First, to the extent the corporation has more than an insignificant amount of assets that are not qualifying REIT assets or income that is not qualifying income, it must either transfer such assets and activities to a taxable REIT subsidiary (a "TRS") or otherwise dispose of such assets or activities. Second, the corporation must distribute as a dividend all of its accumulated earnings and profits. This may require a significant distribution. The IRS allows up to 80 percent of the distribution to be paid in the form of stock of the REIT. In order for the distribution of stock to be taxed as a dividend, shareholders must have the ability to elect to receive stock or cash in the distribution.

Additional transaction structures are available to would-be REITs. For example, a tax-free spin-off similar to that anticipated by CBS Outdoor Americas can be used to separate a single C corporation into two separate entities in a tax-efficient manner. Through this transaction, a C corporation may separate its REIT assets into a separate corporation and undertake a tax-free spin-off of the stock of such corporation to its shareholders. The spun-off corporation would then elect to be a REIT. Penn National Gaming, Inc. ("Penn") is another recent example of a tax-free spin-off structure. Penn announced in November 2012 that the company intended to separate the majority of its operating assets and real property assets into two publicly traded companies. Penn has since confirmed in its SEC filings that it has been issued a PLR by the IRS regarding the tax treatment of the separation and the qualification of the separate real estate company as a REIT. The PLR issued to Penn is believed to be PLR 201337007, which was released by the IRS on September 13, 2013.

The following is a discussion of recent public companies that own significant amounts of real estate and are in the process of converting to REITs or creating a related REIT entity.

1. Geo Group, Inc.: In April 2012, Geo Group, Inc. ("Geo"), an operator of private correctional facilities, announced plans to convert to a REIT beginning on January 1, 2013. Prior to the conversion, Geo took steps to prepare its corporate structure and operations to allow it to qualify as a REIT. This included the December 2012 payment of a special dividend representing accumulated earnings and profits, divestiture of certain health care-related operations that were inconsistent with REIT status and the reorganization of its operations into separate wholly-owned business units and TRSs. Geo received a PLR from the IRS confirming its ability to operate as a

REIT and that its correctional real estate assets would be qualifying REIT assets and would not be considered a health care facility (PLR 201317001).

2. Iron Mountain Inc.: In April 2012, Iron Mountain Inc. ("Iron Mountain"), a document storage business, announced plans to operate as a REIT beginning January 1, 2014. In connection with the conversion to a REIT, Iron Mountain announced plans to distribute accumulated earnings and profits of approximately $1.0 billion to $1.5 billion to stockholders, to be paid out in a combination of at least 20% in cash and up to 80% in Iron Mountain common stock. As discussed above, Iron Mountain's PLR request is still under review by the IRS.

3. Lamar Advertising Co.: Lamar Advertising Co. ("Lamar") is a provider of outdoor advertising including billboards, posters, digital billboards, buses, benches, transit shelters and highway logo signs. In August 2012, Lamar announced it was exploring converting into a REIT beginning January 1, 2014. Lamar's PLR request is still under review by the IRS.

4. Ryman Hospitality Properties Inc. (formerly Gaylord Entertainment): Ryman Hospitality Properties Inc. ("Ryman") is a hospitality and entertainment company based in Nashville, Tennessee, that owns notable properties such as the Grand Ole Opry and numerous resorts and hotels. After announcing its intention to convert to a REIT, Ryman paid a special dividend representing accumulated earnings and profits of approximately $300 million in cash and stock and sold off segments of its hotel management business to Marriott International that would not be qualifying real estate assets for purposes of the income and asset tests. Ryman elected REIT status as of January 1, 2013.

REITs have become an increasingly desirable vehicle for companies across industry sectors with significant real property holdings that are looking to obtain favorable tax treatment and capitalize on market demand for REIT investments. There is a variety of transaction structures and planning alternatives that are available to would-be REITs that can be adapted to fit the particular needs of a business. If you wish to receive more information on REITs generally or the REIT transaction structures that may be available to your business, please contact your regular Shearman & Sterling contact person or any contact person listed in this publication.

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