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What's New for REITs: Private Letter Rulings in 2019

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Now is a good time to look back and think about the fact patterns and tax questions underlying private letter rulings issued to real estate investment trusts ("REITs") during the past year.

Tax professionals know that each private letter ruling is written for a taxpayer's specific facts and is precedent only for that taxpayer; pursuant to section 6110(k)(3),[1] a private letter ruling "may not be used or cited as precedent" by other taxpayers. As a practical matter, tax professionals also realize that a private letter ruling provides an indication of the IRS's position on the issues addressed. Thus, it is not uncommon for tax professionals advising real estate investment trusts ("REITs") to consider private letter rulings because REITs are subject to various qualification requirements for which published guidance may be limited. As discussed in more detail below, thus far during 2019, the IRS released the following private letter rulings, in which:

- The IRS ruled that a privately held subsidiary REIT of an exchange-listed REIT, as described in the letter ruling, would be considered a "publicly offered REIT"; thus, the subsidiary REIT would not be subject to the preferential dividend rule.
- The IRS ruled that floating docks that are affixed to (1) pilings, which are represented by the taxpayer to be inherently permanent structures, or (2) the seabed by winches and cables at certain

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[1] Unless otherwise indicated, section references are to the Internal Revenue Code of 1986, as amended (the "Code") or the applicable regulations promulgated pursuant to the Code (the "regulations").

marina properties would be considered real property under the REIT rules. The IRS also ruled that while certain cabins together at a given marina property would be considered a lodging facility, the presence of those cabins at the marina property would not cause the assets at the marina property (other than the cabins and any areas reserved for cabin guests) to be treated as lodging facilities for REIT purposes.

— The IRS ruled that payments received by a REIT under certain agreements for allowing others to use its fiber optic cable systems would qualify as rents from real property for purposes of REIT income tests.

In addition to the three ruling described above, the IRS released Private Letter Ruling 201939001, in which the REIT held certain partnership interests and its capital accounts in these partnerships did not fairly reflect what it would receive upon a liquidation of a partnership or its interest in the assets of the partnership. For purposes of determining the REIT's "capital interest" in these partnerships (so the REIT can include its proportionate share of a partnership's assets and items of gross income for the REIT's asset and income tests), the IRS ruled that the REIT could determine the "capital interest" in a partnership on a given date by:

— Deeming the partnership to have made a distribution in complete liquidation of all the partners' interests in an amount equal to the fair market value of the partnership assets on that date less the partnership liabilities on that date, and

— Computing the percentage of the deemed distribution to which the REIT would be entitled.[2]

During 2019, the IRS also released Private Letter Ruling 201907001, in which it ruled that amounts received by an energy-infrastructure REIT from unrelated parties for the use of an offshore oil and gas platform, storage tank facilities, and pipelines would qualify as rents from real property. It is worth noting that some of these properties may be concurrently used by multiple users based on reserved capacity, which is similar to capacity leases with respect to fiber optic cables in Private Letter Ruling 201901001 (described in detail below). Further, in this letter ruling, the IRS might have required certain assets (such as compressors or pumps of pipeline systems) to be owned and operated by the REIT's taxable REIT subsidiary ("TRS"). This is also similar to Private Letter Ruling 201901001, in which a TRS is used to own and operate all the equipment that receives, amplifies, converts, and returns a signal originated by a tenant.[3]

Recently, the IRS released Private Letter Ruling 201944011, in which it ruled that income received by the REIT from its tenants for the use of the boat slips and storage spaces at a marina (as described) would constitute rents from real property for REIT qualification purposes. Consistent with its view (expressed in Private Letter Ruling 201812009), the IRS further ruled that income attributable to making

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[2] For more discussions of this letter ruling, see Stephen J. Giordano, *New Private Letter Ruling Addresses REITs' Investments in Partnerships*, What's News in Tax (Oct. 16, 2019.

[3] For more discussions of this letter ruling, see Ian Holcomb, Kyle Seipert, and David Lee, *"Capacity" Lease and REIT Qualification*, What's News in Tax (June 10, 2019).

available to all tenants, at no additional cost, a space such as the shower facilities is not income from the provision of a service and is, therefore, not impermissible tenant service income. Finally, the IRS ruled that income from the services (as described) that will be provided at the marina is not impermissible tenant service income based on certain representations from the REIT and, therefore, would not cause otherwise qualifying rents from real property to be treated otherwise. It is worth noting that the definition of "impermissible tenant service income" takes into account rules for the unrelated business taxable income for exempt organizations; thus, it is not uncommon for a tax professional advising exempt organizations engaged (directly or indirectly) in rental activities to read letter rulings issued to REITs. It seems that the IRS might have become aware of this and lately has expanded its "typical" disclaimer by noting "an exempt organization providing the same services may have unrelated business taxable income because the income may not be excluded under section 512(b)(3) as rents from real property."[4]

Definition of "Publicly Offered REIT" and Preferential Dividend

For an entity to qualify and maintain REIT status, the entity generally must make distributions with respect to its stock that qualify as a dividends-paid deduction ("DPD") equal to at least 90 percent of its "ordinary" taxable income. Because a DPD reduces a REIT's taxable income, a REIT can generally avoid any corporate-level tax on earnings distributed to its stockholders. However, pursuant to section 562(c)(1), and with the exception of a "publicly offered REIT," a DPD will be unavailable for any distribution unless "such distribution is pro rata, with no preference to any share of stock as compared with other shares of the same class, and with no preference to one class of stock as compared with another class except to the extent that the former is entitled (without reference to waivers of their rights by shareholders) to such preference" (i.e., no preferential dividend). For this purpose, section 562(c)(2) defines a publicly offered REIT to mean a REIT that is required to file annual and periodic reports with the Securities and Exchange Commission ("SEC") under the Securities Exchange Act of 1934.

In Private Letter Ruling 201924003, a publicly traded REIT ("Parent REIT") owns (through lower-tier partnerships) a controlling interest in the taxpayer, which is also a REIT ("Subsidiary REIT"). As described in the letter ruling, Subsidiary REIT made a pro rata distribution on its common stock in the amount of $a ("the Distribution") on Date 2. At that time, Subsidiary REIT's new management team was not aware that the Subsidiary REIT also had x outstanding shares of preferred stock, the terms of which require all accrued but unpaid dividends on the preferred stock be paid first, or simultaneously, with any other dividends declared or distributed by the Subsidiary REIT. Because the Distribution was not made in accordance with the terms of Subsidiary REIT's preferred stock, it technically could be considered a preferential dividend and, thus, would not be included for purposes of determining Subsidiary REIT's DPD. The consequences of having a preferential dividend are more complex because, while a distribution may be considered "preferential" for purposes of section 562(c)(1), it may nevertheless reduce a corporation's earnings and profits ("E&P") that are needed to treat other non-preferential distributions as "dividends." That said, in Private Letter Ruling 200729021, the IRS ruled that a

[4] For more discussions of this letter ruling, see *PLR: Amounts REIT receives from tenants for boat slips, marina storage,* TaxNewsFlash (Nov. 1, 2019).

preferential distribution could not reduce a REIT's current E&P due to then-section 857(d)(1), so the REIT could have sufficient current E&P to support a DPD. However, the preferential dividend—while not eligible for computing a REIT's DPD—might still be taxable to the REIT's stockholders, an issue that was not addressed in Private Letter Ruling 200729021.

In connection with the ruling request, Subsidiary REIT represented that it is consolidated with Parent REIT under generally accepted accounting principles for purposes of the annual and periodic reports that Parent REIT is required to file with the SEC under the Securities Exchange Act of 1934. As such, Subsidiary REIT is included in the consolidated financial statements that Parent REIT files with the SEC. For purposes of the consolidated financial statements, Subsidiary REIT is disregarded as a separate entity; its assets are listed as assets of Parent REIT, and its income, loss, and other activities are included with those of Parent REIT and the other consolidated entities. Subsidiary REIT also represented that Parent REIT is a publicly offered REIT within the meaning of the preferential dividend rule.

Because Subsidiary REIT's assets, income, loss, and other activities are reported to the SEC as part of Parent REIT's consolidated reports, the IRS reasoned "annual and periodic reporting to the SEC is required of [Subsidiary REIT], and [Subsidiary REIT] meets the definitional requirements to be a publicly offered REIT pursuant to section 562(c)(2)." Accordingly, the IRS ruled that the Distribution would not be a preferential dividend under section 562(c)(1).

It is worth noting that unsecured debt instruments issued by a "publicly offered REIT" are treated as real estate assets that are not subject to the 5 percent and 10 percent asset tests, and the term "publicly offered REIT" is cross-referenced to section 562(c)(2). Thus, if Parent REIT in the letter ruling were to hold an unsecured debt instrument of Subsidiary REIT in excess of five percent of Parent REIT's total assets, such security would likely not cause Parent REIT to fail the five percent value test. This letter ruling also serves as a reminder that a REIT that is not considered a "publicly offered REIT" must carefully review and strictly comply with the stock terms to avoid having a preferential dividend.

Marina Properties—Floating Docks as Real Property and Presence of Cabins

Among various requirements, a REIT must have at least 75 percent of the value of its total assets represented by real estate assets, which include real property, cash and cash items, and U.S. government securities. A REIT also must have at least 75 percent of its gross income from real estate sources, including "rents from real property," which are gross amounts received for the use of, or the right to use, real property. Accordingly, whether assets are considered real property for purposes of the REIT rules greatly influences an entity's ability to qualify as a REIT.

Section 1.856-10 defines real property to mean land, improvements to land (defined as inherently permanent structures ("IPSs") and their structural components), and certain intangible assets. Pursuant to section 1.856-10(d)(2), an IPS means any building or other structure permanently affixed to land or to another IPS. Further, to be considered an "other inherently permanent structure" ("OIPS"), a distinct asset must serve a passive function, such as to contain, support, shelter, cover, protect, or provide a conduit or a route, and must not serve an active function, such as to manufacture, create, produce,

convert, or transport. Finally, if a distinct asset is not included in the examples of buildings and OIPs listed under the regulations, for example, stationary wharves and docks, the determination of whether that asset is an IPS must take into account the following factors:

- The manner in which the distinct asset is affixed to real property
- Whether the distinct asset is designed to be removed or to remain in place indefinitely
- The damage that removal of the distinct asset would cause to the item itself or to the real property to which it is affixed
- Any circumstances that suggest the expected period of affixation is not indefinite (for example, a lease that requires or permits removal of the distinct asset upon the expiration of the lease)
- The time and expense required to move the distinct asset

In Private Letter Ruling 201930003, the taxpayer owned marina properties located on inland lakes or coasts through a partnership ("Company") and intends to elect REIT status. These properties contained boat slips, floating docks, storage facilities, boat servicing facilities, and support facilities such as laundry facilities and restaurants. One of the properties (Property C) also contained cabins that are made available to guests for one-week or shorter stays.

Floating Docks

According to the letter ruling, the properties' boat slips are bound by floating docks that have a limited range of vertical movement as necessary for tidal and weather conditions. The taxpayer represented that the floating docks provide a conduit or route for tenants to access their boat slips, delineate the area of the slips, and protect the boats from damage from the elements. The taxpayer further represented that the floating docks serve no active function within the meaning of section 1.856-10(d)(2)(iii)(A). The letter ruling describes the following methods of affixing floating docks:

- The piling method: The floating docks are permanently affixed to the pilings by steel pile guides that affix the docks to the pilings in a manner that allows the docks to float on the top of the water's surface as the tide ebbs and flows but keeps the docks affixed to the pilings. The steel pile guides contain rollers that surround and always touch the pilings and at no time is there space between the rollers and the pilings. The steel pile guides are permanently connected to the docks with at least b mechanical fasteners (steel or aluminum bolts or brackets) per piling. The floating docks are built around or surrounded by the pilings, and are not designed to be removed from the pilings. The taxpayer represented that the pilings at certain properties are IPSs for purposes of section 1.856-10(d)(2).
- The winch and cable method: The floating docks are attached to the seabed by a system of wire rope cables, concrete anchors, and winches. The cables attach the winches on the docks to the anchors on the seabed or lake bottom. The cables are the same type used to support suspension bridges, and are attached to the winches and concrete anchors in the same manner as cables are attached to suspension bridges. The anchors weigh in excess of h pounds and are embedded in

the seabed or lake bottom. Galvanized anchor bolts affix the winches to winch stands that are affixed to the floating docks using industrial steel mounting bolts. The winch and cable method allows the floating dock to move when water levels fluctuate and when affected by natural occurrences, such as tides, although the concrete anchors never move as they are permanently affixed to a specific point in the seabed or lake bottom.

The letter ruling also includes other information and representations from the taxpayer supporting that floating docks are permanently affixed to other real property. For example, removing a floating dock from its pilings would require total deconstruction of the floating dock, and would require cutting the pilings down to the surface level of the water thereby destroying the pilings as well. Also, in rare and extraordinary circumstances, a governmental body may close a marina (for example, due to a violation of the lease or willful neglect of the premises). In that case, all buildings would be completely demolished and removed, and the land restored to its natural condition. The taxpayer represented that this has never happened with respect to a marina owned by Company, and Company does not expect this to ever occur.

The IRS applied the above permanency factors to determine whether floating docks affixed under the described methods would be considered IPSs. After analysis, the IRS determined the floating docks would be considered real property because they are permanently affixed to the pilings (i.e., OIPs) or to the ground.

Cabins

Property C contains n cabins used by guests for stays of less than one week. Company provides cabin guests with linens and basic toiletries at the beginning of their stay, and cleans the cabin when the guests vacate the premises. The cabin guests are generally not the same parties that lease boat slips or dry dock storage space from Company. The taxpayer intends to have a TRS own the cabins and any areas reserved for cabin guests, and to have Company manage the cabins. The taxpayer represented that the income it receives attributable to the cabins would be treated as non-qualifying income for purposes of the income tests.

The IRS ruled that these cabins together would meet the definition of a lodging facility for purposes of the REIT rules (i.e., an establishment in which more than one-half of the dwelling units are used on a transient basis). However, for reasons discussed in the letter ruling, the IRS ruled that the presence of the cabins at Property C would not cause the assets at Property C other than the cabins and any areas reserved for cabin guests to be treated as lodging facilities for these purposes.

This particular ruling is meaningful for two reasons. First, it suggests the IRS's view that a short term by itself could prevent rental treatment even if no maid services were rendered during a stay (i.e., only cleaning after guests vacate the premises). Second, because a TRS is not permitted to operate or manage a lodging facility, isolating lodging activities to only a portion of the overall property preserves the REIT's ability to use its TRS for services to tenants occupying the remaining property.

Fiber Optic Cable Systems

In Private Letter Ruling 201901001, the REIT leases to wireless carriers, other telecommunication providers, and private companies:

- Systems composed of permanently affixed coaxial and fiber optic cable and the associated conduit piping (together, the "Real Property Assets"), and
- Indoor and outdoor distributed antenna systems or small cell systems ("DAS"), which are composed of Real Property Assets.

Some of the REIT's fiber optic cables are connected to and associated with DAS installations, while other fiber optic cables form independent networks that are connected to cell towers or utility poles or are buried under the ground.

The letter ruling explains that a fiber optic cable is composed of ultra-thin strands of glass surrounded by layers of insulating materials. Because each strand can transport signals of different wavelengths simultaneously, multiple customers can use the same strand by having separately designated wavelengths for transporting data. With respect to a DAS installation, the letter ruling explains that it is a system for the transmission of telecommunication signals through fiber optic and coaxial cables. Wireless carriers supplement their antennas mounted on cell towers with DAS installations to improve capacity and signal strength in certain densely populated areas (e.g., a college campus, a sports stadium, or a convention center) and hard-to-reach areas (e.g., an underground transportation system).

The REIT enters into the following agreements with tenants and each agreement obligates a tenant to pay for the contracted usage, regardless of the tenant's actual usage:

- DAS Agreement. Under a DAS Agreement, the tenant has the exclusive right to use either a designated number of individual strands within the fiber optic pathway, or a dedicated wavelength within the fiber optic pathway of a DAS installation.
- Indefeasible Rights of Use (IRU). Under an IRU, the tenant has the exclusive right to use all of the wavelengths (or capacity) in one or more specified strands within a fiber optic cable over a specified route for the lease term.
- Capacity Lease. Under a Capacity Lease, the tenant has an exclusive right to use a specified subset of all the wavelengths (or capacity) within a strand located in a fiber optic cable over a specified route for the lease term.
- Wave Lease. Under a Wave Lease, the tenant has an exclusive right to use a dedicated wavelength in a strand within the fiber optic cable over a specified route for the lease term. The tenant under a Wave Lease, however, does not have a right to a specifically identified strand, or wavelength within a strand, in a fiber optic cable, unlike a tenant of an IRU Agreement or a Capacity Lease.
- Backhaul Lease. Under a Backhaul Lease, the tenant has an exclusive right to use all or a dedicated portion of the capacity of an identifiable fiber optic cable over a specifically identified

route from a cell tower to a collection point for the lease term. Under certain Backhaul Leases, the tenant does not have an exclusive right to a specifically identified wavelength on a strand within the fiber optic cable; however, the tenant has the exclusive right to either all of the capacity of a particular number of unidentified strands or to a dedicated portion of the capacity within a strand of a fiber optic pathway. Signals of different tenants are not intermingled. The tenant will own and operate a mobile switching center and base station equipment for the generation of the initial digital signal as well as the ultimate receipt of the signal.

With respect to DAS installations, the REIT represented that a TRS will own and operate all the equipment that receives, amplifies, converts, and returns a signal originated by a tenant, including optical converters, lasers, transponders, amplifiers, and regeneration equipment. With respect to systems that are not associated with a DAS installation, the REIT represented that either a TRS or the tenant will own and operate all the equipment that receives, amplifies, regenerates, converts, and returns a signal originated by the tenant, including optical converters, filters, lasers, transponders, amplifiers, and regeneration equipment.

The IRS reasoned that under each of the five types of agreements ranging from a to b years, a tenant has a right to use or to occupy space on the Real Property Assets. Further, each tenant is required to pay for the contracted usage, regardless of the tenant's actual usage. Accordingly, after taking into account certain representations, the IRS ruled that amounts received by the REIT from tenants for the use of REIT's Real Property Assets would qualify as rents from real property for purposes of the income tests.

It is worth noting that this is the third letter ruling (following Private Letter Rulings 201741002 and 201450017) addressing income issues associated with fiber optic cables, which can be used by multiple customers at the same time. For example, in Private Letter Ruling 201741002, the IRS noted, among other things, that each user has an exclusive use of a dedicated frequency within a single fiber optic pathway. It is also interesting that one of the agreements used by the REIT and addressed by the IRS in Private Letter Ruling 201901001 is a "capacity" lease, a concept that is also used for certain transmission systems for electricity and natural gas. In fact, in Private Letter Ruling 201907001, the IRS reached the same conclusion with respect to uses of storage tank facilities and pipelines based on reserved capacity.