January 9, 2015

The Honorable John Koskinen
Commissioner
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, DC 20024

Re: Comments on Proposed Regulations Issued Under Section 856

Dear Commissioner Koskinen:

Enclosed please find comments on the proposed regulations addressing the definition of real property for purposes of section 856 of the Internal Revenue Code of 1986, as amended (“Comments”). These Comments represent the view of the American Bar Association Section of Taxation (the “Section”). They have not been approved by the Board of Governors or the House of Delegates of the American Bar Association, and should not be construed as representing the policy of the American Bar Association.

The Section would be pleased to discuss the Comments with you or your staff if that would be helpful.

Sincerely,

[Signature]
Armando Gomez
Chair, Section of Taxation

Enclosure

cc: Hon. Mark J. Mazur, Assistant Secretary (Tax Policy), Department of the Treasury
    Emily S. McMahon, Deputy Assistant Secretary (Tax Policy), Department of the Treasury
    Hon. William J. Wilkins, Chief Counsel, Internal Revenue Service
    Helen Hubbard, Associate Chief Counsel (Financial Institutions and Products), Internal Revenue Service
These comments ("Comments") are submitted on behalf of the American Bar Association Section of Taxation (the "Section") and have not been approved by the House of Delegates or Board of Governors of the American Bar Association. Accordingly, they should not be construed as representing the position of the American Bar Association.

Principal responsibility for preparing these Comments was exercised by A. Cristina Arumi and Robert G. Honigman of the Section’s Real Estate Committee, with a substantive contribution from David A. Miller. The Comments were reviewed by L. Wayne Pressgrove, Chair of the Real Estate Committee. The Comments were further reviewed by Barbara Spudis de Marigny of the Section's Committee on Government Submissions, Bahar A. Schippel, the Section’s Council Director for the Real Estate Committee, and by Peter H. Blessing, the Section’s Vice Chair (Government Relations).

Although the members of the Section of Taxation who participated in preparing these Comments have clients who might be affected by the federal income tax principles addressed by these Comments, no such member or the firm or organization to which such member belongs has been engaged by a client to make a government submission with respect to, or otherwise to influence the development or outcome of, the specific subject matter of these Comments.

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Date: January 9, 2015
EXECUTIVE SUMMARY

On May 14, 2014, the Department of the Treasury (the “Treasury”) and the Internal Revenue Service (the “Service”) issued proposed regulations (the “Proposed Regulations”) addressing the definition of real property for purpose of section 856. The preamble requested comments on all aspects of the Proposed Regulations.

We commend Treasury and the Service for providing an analytical framework in the Proposed Regulations regarding the definition of real property for purposes of section 856 consistent with the numerous long-standing authorities issued over the last 50 years. These Comments set forth recommendations intended to clarify and supplement a few matters addressed by the Proposed Regulations to be considered by Treasury and the Service when finalizing the Proposed Regulations.

Our recommendations are divided into three major sections. First, we discuss the basic definition of real property set forth in the Proposed Regulations. Second, we discuss the definition of structural component of an inherently permanent structure set forth in the Proposed Regulations. Third, we make specific observations regarding certain examples, the proposed treatment of intangible assets owned by a real estate investment trust (“REIT”), and the character of licenses or permits to lease and operate real property.

I. With respect to the basic definition of real property, we recommend that the Regulations, when finalized:

A. clarify that air rights and water rights are considered “land” notwithstanding that such rights might be owned separately from the ground below the air or water rights;

B. clarify that improvements to land such as clearing, grading, landscaping, earthen dams, etc. constitute improvements to land;

C. clarify that the definition of building includes buildings with open-air architectural features such as outdoor or open-air stadiums;

D. expand the list of “per se” buildings to include all structures commonly understood to be buildings, including a presumption where a state or local government has granted a certificate of occupancy or similar license or certification with respect to a structure;

E. eliminate the use of the terms “active,” “passive,” and “transport” from the definition of “inherently permanent structure” and instead use a term such as “real estate function” or some other neutral term; and

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2 References to a “section” are to a section of the Internal Revenue Code of 1986, as amended (the “Code”), unless otherwise indicated.
F. link the “indefinite” affixation requirement for purposes of determining whether a distinct asset is inherently permanent to the distinct asset’s expected economic useful life and provide that the test focus primarily on the objective facts regarding the manner of affixation.

II. With respect to the definition of a structural component of an inherently permanent structure, we recommend that the Regulations, when finalized:

A. adopt a definitional standard consistent with existing authority;

B. eliminate the Proposed Regulations’ requirement to apply the mandatory multi-factor test for determining whether a distinct asset is a structural component of an inherently permanent structure and instead provide that a distinct asset is a structural component so long as it is intended to protect, preserve, secure, or support the safe operation of the inherently permanent structure.

C. delete the reference to “passive” function and transport;

D. provide a safe harbor for structural components which serve a utility-like function with respect to an inherently permanent structure;

E. provide that income-producing activities of a structural component of an inherently permanent structure will not “per se” cause that structural component to be excluded from the definition of real property; and

F. eliminate the equivalent interest requirement set forth in the Proposed Regulations for interests in inherently permanent structures and their structural components;

III. With respect to certain examples contained in the Proposed Regulations, the treatment of intangibles and other contract rights, we recommend that the Regulations, when finalized:

A. correct, expand, and modify certain examples, as described in more detail below;

B. provide that intangibles created by or attributable to the ownership of, investment in, or operation of real estate assets are themselves “real estate assets” within the meaning of section 856; and

C. clarify that a contract or other agreement that otherwise would be an interest in real property, such as a leasehold interest, will not be excluded from the definition of real estate asset merely because it also addresses rights and obligations of the parties with respect to the
operation of the property or business at the property that is the subject of the agreement.

IV. With respect to the attempt to reconcile the meaning of “real property” for all purposes of the Code, we recommend not attempting such a reconciliation because the different provisions at issue arise in different contexts and may have varying legislative purposes.
DISCUSSION

I. Background

On May 14, 2014, Treasury and the Service issued the Proposed Regulations addressing the definition of real property for purposes of section 856.

We commend Treasury and the Service for providing additional guidance regarding the definition of real property for purposes of section 856. In addition, we support the approach and conclusions set forth in the Proposed Regulations as being entirely consistent with the numerous long-standing authorities issued over the last several decades. These Comments set forth recommendations primarily intended to clarify a few matters addressed by the Proposed Regulations.

II. Definition of Land

The Proposed Regulations provide that the term real property includes land. In that regard, the Proposed Regulations further provide that land includes water and air space superjacent to land and natural products and deposits that are unsevered from the land (although natural products and deposits, such as crops, water, ores, and minerals, cease to be real property when they are severed, extracted, or removed from the land). The foregoing conclusion is consistent with prior guidance.

We agree with the standard set forth in the Proposed Regulations for the definition of land and note its consistency with existing guidance. We recommend that the Regulations, when finalized, clarify that air space and water space need not be owned together with the subjacent ground or any improvements (such as a building) to meet the definition of land. For example, a REIT may own a building and purchase air rights superjacent to one or more neighboring buildings to enhance the value of the owned buildings, or a REIT may purchase air rights in anticipation of utilizing those rights to facilitate the future acquisition or development of property.

III. Definition of Improvements to Land

The Proposed Regulations provide that the term real property also includes improvements to land. In that regard, the Proposed Regulations provide that improvements to land mean inherently permanent structures and their structural

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5 Rev. Rul. 71-286, 1971-2 C.B. 263 (concluding that the air rights over real property are considered “interests in real property” within the meaning of section 856(c)(6)(C) and “real estate assets” within the meaning of sections 856(c)(5)(A) and 856(c)(6)(B)); PLR 201310020 (Mar. 8, 2013) (concluding that the right to use a geographically fixed plot of water (and the seabed underneath it) is directly analogous to air rights. Thus, a marina lease agreement conveying rights to a slip (a ship’s or boat’s berth between two piers) are the rights to use and occupy the space above the seabed which constitute a real property interest under section 856(c)).
6 Id.
components. In the interest of completeness, we recommend the final Regulations clarify that clearing, grading, landscaping, earthen dams, etc., be treated as improvements to land.

A. Inherently Permanent Structures

The term inherently permanent structure means any permanently affixed building or other structure. The Proposed Regulations provide that a distinct asset that “serves an active function, such as an item of machinery or equipment, is not a building or other inherently permanent structure.”

i. Buildings

The Proposed Regulations provide that a building encloses a space within its walls and is covered by a roof. The Proposed Regulations provide a list of “per se” buildings, including “houses; apartments; hotels; factory and office buildings; warehouses; barns; enclosed garages; enclosed transportation stations and terminals; and stores.”

We recommend that the definition of “building” not rest on whether a space is completely enclosed even though it may still be considered real property under the inherently permanent structure test. An outdoor sports stadium or amphitheater arguably may not be “enclosed” under this proposed definition. A parking garage may not be fully enclosed even though it forms the lower floors of a building that is otherwise enclosed. Instead of resting on the term “enclosed,” the definition should provide that a building encloses or defines a space within or by its walls, roof or similar architectural features.

Moreover, the list of per se buildings should be expanded to include other buildings that are commonly considered to be similar to the listed buildings, including shopping malls, hospitals, museums, municipal buildings, other storage buildings, other housing (such as assisted living), parking garages (whether or not fully enclosed), and mixed-use properties combining one or more of the foregoing.

Furthermore, although we agree that state or local definitions of property should not control what is real property for purposes of section 856, where a state or local government has granted a certificate of occupancy or similar license or certification with respect to a structure, the final Regulations should provide that such structure is presumed to constitute real property for purposes of section 856 unless the facts and circumstances clearly indicate that such structure is not inherently permanent.

ii. Other Inherently Permanent Structures

The Proposed Regulations provide that, in addition to buildings, inherently permanent structures include other inherently permanent structures that “serve a passive

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function, such as to contain, support, shelter, cover, or protect, and do not serve an active function such as to manufacture, create, produce, convert, or transport.” The Proposed Regulations define as other inherently permanent structures assets such as towers (for microwave transmission, cell, broadcast, and electrical transmission); telephone poles; parking facilities; bridges; tunnels; railroad tracks; transmission lines; pipelines; fences; in-ground swimming pools; offshore drilling platforms; storage structures such as silos and oil and gas storage tanks; stationary wharves and docks; and outdoor advertising displays for which an election has been properly made under section 1033(g)(3). Any asset not listed as either a building or another inherently permanent structure in the Proposed Regulations may still be treated as an inherently permanent structure based on a facts and circumstances test.

While we agree with the specific assets set forth in the Proposed Regulations as inherently permanent assets and the facts and circumstances test to determine whether an asset not listed in the Proposed Regulations is an inherently permanent asset, we do not believe it is necessary, appropriate, or advisable to characterize REITs or the assets they own as being “passive” or serving a “passive function.” In that regard, it is clear that REITs may be actively engaged in business and that any real property (including, for example, a factory which is included as a per se building in the Proposed Regulations) that a REIT owns can be used in an active business. We believe that distinguishing between “passive” and “active,” even if looking to an asset’s “function” rather than its role in a “business,” in the Proposed Regulations could lead to unintended consequences due to the lack of a standard definition of active and passive and the difficulty in applying those terms to assets. Creating this type of distinction is inconsistent with the analysis used by the authorities in the past 50 years which have not made the determination as to whether an asset is real property based on whether the asset is “passive” or “active.” In that regard, we recommend modifying the Proposed Regulations to eliminate all references to “passive” or “active” and instead provide that a distinct asset “in the nature of equipment or machinery that manufactures, creates, produces, converts or undertakes a similar process with respect to a product or commodity is not an inherently permanent structure.” We recommend defining the types of activities that are consistent with an asset being real property be referred to as a “real estate function” (and other activities as a “non-real estate function”) or some other neutral term.

In addition, we recommend excluding the term “transport” or a functional purpose of transportation as preventing an asset from being treated as real property. We are concerned that “transport” is overly broad and introduces uncertainty and confusion with respect to assets that are real property. It is clear, for example, that an asset such as a railroad track or pipeline is and has always been real property, even though its purpose is to facilitate transportation (rather than support or contain).14

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iii. **Definition of Inherently Permanent**

The Proposed Regulations provide that a distinct asset not specifically listed in the Proposed Regulations may be an inherently permanent structure based on all the facts and circumstances. Affixation may be to land or to another inherently permanent structure and may be by weight alone. If the affixation reasonably is expected to last indefinitely based on all the facts and circumstances, the affixation is considered permanent.\(^\text{15}\)

Because any distinct asset may be removed and no distinct asset lasts forever, “indefinitely” should not be read to imply that the distinct asset must be expected to remain in place forever. Rather, we believe an asset of a type described in the safe harbor lists should be treated as inherently permanent so long as the manner of affixation is of a permanent, rather than temporary, nature. In that regard, the manner of affixation should be treated as being of a permanent nature if the affixation is of a nature that is consistent with the asset remaining in place for its entire economic useful life. Stated differently, a distinct asset that is affixed in a permanent, rather than a temporary, manner should be treated as inherently permanent for this purpose. For example, in Rev. Rul. 71-220,\(^\text{16}\) the Service concluded that the mobile home units are “real property” within the meaning of section 856 where the units were set on foundations when delivered to the site, the units’ wheels and axles were removed, and the units were affixed to the ground by six or more steel straps. In addition, a carport or screened porch was attached to the unit and the unit was connected to water, sewer, gas, electric and telephone facilities.

We believe the test should be based primarily upon an objective analysis of the physical nature of the manner of affixation. If the manner of affixation is permanent in nature, the distinct asset should be considered to be inherently permanent. A particular taxpayer’s subjective intent or belief as to the time period the asset will remain in place should be relevant only insofar as it sheds light on whether the manner of affixation itself is temporary. Otherwise, it appears that the exact same asset affixed in the exact same manner could be personal property as to one taxpayer and real property as to another based solely upon their intent as to how long the asset will remain in place. In fact, it appears that an asset that is personal property in the hands of one taxpayer could become real property when acquired by another taxpayer with a different intent as to how long the asset will remain in place. As a result, we believe the better, more administrable and logical approach is to determine whether the manner in which a distinct asset is attached is temporary or permanent in nature based primarily on the objective factors set forth in the Proposed Regulations.

The Proposed Regulations further provide a number of factors that must be taken into account in making this determination, including “[a]ny 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).”\(^\text{17}\) Removal provisions are common in commercial leases and as a practical matter may not be


determinative as to whether the asset is ultimately removed by the lessee at the expiration of the lease. While we believe these factors should be taken into account, they should be relevant only insofar as they indirectly shed light on the permanence of the manner of affixation (not the period of time the asset is intended to remain in place).\textsuperscript{18}

We recommend clarifying the foregoing in the Proposed Regulations. In that regard, we recommend modifying the language in Proposed Regulation section 1.856-10(d)(2) to read as follows:

If the manner of affixation is of a permanent nature and is consistent with the distinct asset remaining in place indefinitely based on all the facts and circumstances, the affixation is considered permanent.

In addition, we recommend modifying Proposed Regulation section 1.856-10(d)(2)(iv)(D) to provide as follows:

Any circumstances that suggest the manner of affixation is temporary in nature rather than permanent.

B. Structural Components of Inherently Permanent Structures

i. \textit{The Proposed Regulations' Definition of Inherently Permanent Structures}

The Proposed Regulations provide that a structural component of an inherently permanent structure that is real property likewise is real property.\textsuperscript{19} The term structural component means any distinct asset that is a constituent part of and is integrated into an inherently permanent structure, serves the inherently permanent structure in its passive function, and, even if capable of producing income other than consideration for the use or occupancy of space, does not produce or contribute to the production of such income.\textsuperscript{20}

A distinct asset is analyzed separately from any other assets to which the asset relates to determine if the asset is real property, whether as land, an inherently permanent structure, or a structural component of an inherently permanent structure.\textsuperscript{21} The determination of whether a particular separately identifiable item of property is a distinct asset is based on all the facts and circumstances.\textsuperscript{22} In particular, the following factors must be taken into account:

- Whether the item is customarily sold or acquired as a single unit rather than as a component part of a larger asset;

\textsuperscript{18} In fact, we note that there is precedent in a different area indicating that an asset can be an inherently permanent structure if it is affixed in a permanent manner even if it is intended to be and is in fact moved every few years. \textit{See} Rev. Rul. 77-21, 1977-1 C.B. 251 (concluding that relocatable classroom units are inherently permanent structures due to the special steps that must be taken in order to move them).
• Whether the item can be separated from a larger asset and, if so, the cost of separating the item from the larger asset;
• Whether the item is commonly viewed as serving a useful function independent of a larger asset of which it is a part; and
• Whether separating the item from a larger asset of which it is a part impairs the functionality of the larger asset.  

If interconnected assets work together to serve an inherently permanent structure with a utility-like function (for example, systems that provide a building with electricity, heat, or water), the assets are analyzed together as one distinct asset that may be a structural component.

The Proposed Regulations provide that structural components include the following distinct assets and systems: wiring; plumbing systems; central heating and air-conditioning systems; elevators or escalators; walls; floors; ceilings; permanent coverings of walls, floors, and ceilings; windows; doors; insulation; chimneys; fire suppression systems, such as sprinkler systems and fire alarms; fire escapes; central refrigeration systems; integrated security systems; and humidity control systems.

The determination of whether a distinct asset that is not identified as a structural component in the Proposed Regulations or in guidance published in the Internal Revenue Bulletin is a structural component is based on all the facts and circumstances. In particular, the following factors must be taken into account:

• The manner, time, and expense of installing and removing the distinct asset;
• Whether the distinct asset is designed to be moved;
• The damage that removal of the distinct asset would cause to the item itself or to the inherently permanent structure to which it is affixed;
• Whether the distinct asset serves a utility-like function with respect to the inherently permanent structure;
• Whether the distinct asset serves the inherently permanent structure in its passive function;
• Whether the distinct asset produces income from consideration for the use or occupancy of space in or upon the inherently permanent structure;
• Whether the distinct asset is installed during construction of the inherently permanent structure;
• Whether the distinct asset will remain if the tenant vacates the premises; and
• Whether the owner of the real property is also the legal owner of the distinct asset.

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23 Id.
Our recommendations relating to structural components are as follows:

ii.  *Adopt a definitional standard consistent with existing authority*

The final Regulations should provide that a distinct asset will be a structural component of an inherently permanent structure where that distinct asset is intended to protect, preserve, secure, or support the safe operation of the inherently permanent structure that is considered to be real property. The existing authorities describe the critical inquiry as whether the asset serves the purpose of the real property. A distinct asset is a structural component of a building or other inherently permanent structure if it is subservient to the real property to which it is attached in the sense that it furthers the operation, maintenance, or safety of such real property. Conversely, where the real property supports the operation or use of the distinct asset, the distinct asset is not a structural component of the real property. This analysis explains why a total energy system that includes an electric generator powered by a turbine is real property when supplying energy to a building to which it is attached whereas an electric generator powered by a turbine housed in a power plant is not. The singular difference between the generators in these examples is that the generator in the total energy system furthers the operation and use of the building to which it is attached, whereas the generator in the power plant does not.\(^\text{26}\) Similarly, this relationship explains why solar panels either may or may not be a structural component depending upon whether they are used to generate power for tenants of the building to which they are attached or are used to generate electricity to be sold to the grid. This well-established bright line test\(^\text{27}\) explains why structural components include machinery or equipment that support the operation, maintenance or safety of a building or other inherently permanent structure (such as a total energy system, central heating or central air conditioning machinery, elevators, sprinkler systems, boilers, pumps, compressors, fire-protection and alarm systems, including related computers and security systems). Equally important, this bright line test explains why machinery or equipment that is permanently attached to, but does not serve the purpose of, the real property to which it is connected, such as microwave transmission equipment or cellular transmission equipment located on a tower or car wash equipment in a car wash bay is not a structural component thereof.

Assets that have been treated as structural components of a building or other inherently permanent structure (and therefore as real property) include equipment and machinery such as:

a. Total energy systems (including electrical substations as well as electric generators powered by turbines or reciprocating engines, waste heat boilers, heat exchangers, gas-fired boilers, and cooling units in

\(^{26}\) See CCA 201238027 (Sept. 21, 2012).

addition to fuel storage tanks, control and sensor equipment, and air handling equipment for heat, hot water, and ventilation, as well as ducts, piping, conduits, wiring, and other associated parts, machinery and equipment); 28

b. Equipment or machinery to lower the temperature to freezing in a cold-storage facility; 29

c. Wiring, plumbing systems, central heating or central air conditioning machinery (including motors and compressors), elevators, escalators, and sprinkler systems, including removable sprinkler heads; 30

d. Boilers, pumps, tanks, water treatment equipment and main electrical equipment, lines suspended by hangers to transmit chilled and heated water, and electricity; 31

e. Fire-protection and alarm systems (including sensing devices, computer controls, sprinkler heads, sprinkler mains, associated piping or plumbing, pumps, visual and audible alarms, alarm control panels, heat and smoke detection devices, fire escapes, fire doors, emergency exit lighting and signage, and fire-fighting equipment, such as extinguishers and hoses); 32

f. Security systems (including security cameras, recorders, monitors, motion detectors, security lighting, alarm systems, entry and access systems, related junction boxes, associated wiring and conduit); 33

g. Gas distribution systems (including associated pipes and equipment used to distribute gas to and from property line and between buildings or permanent structures). 34

28 Samis, 76 T.C. 609 (1981), and Rev. Rul. 73-425.
29 PLR 200027034 (Jul. 10, 2000).
30 Reg. §§ 1.48-1(e), 1.263(a)-3T(e)(2), 1.856-3(d), and 1.897-1(b)(3)(iv).
31 Id.
32 Id.
33 Id.
34 Id.
38 Id.
39 Id.
The authorities are equally clear that an asset connected to a building or inherently permanent structure is not a structural component if it is not related to and necessary for the operation or maintenance of the real property to which it is connected.\textsuperscript{40} Examples of assets that are not structural components because they are not related to or necessary for the operation or maintenance of real property include:

a. Antennae, waveguides, transmitting, receiving, and multiplex equipment, and prewired modular racks that do not relate to the operation or maintenance of a building or inherently permanent structure;\textsuperscript{41}

b. Car wash equipment;\textsuperscript{42} and

c. Machinery located on a platform that extracts crude from undersea oil and gas wells.\textsuperscript{43}

iii. \textit{No mandatory multi-factor test}

As drafted, the Proposed Regulations \textit{require} an application of the multi-factor test. We recommend that the list be excluded. However, if it is included, it should be an \textit{optional} framework for establishing the qualification of a distinct asset as a structural component of an inherently permanent structure.

iv. \textit{Delete references to “passive” function and transport}

As with the definition of inherently permanent structure and for similar reasons, we recommend that any reference to the “passive function” of the inherently permanent structure be deleted or modified to refer to “real estate function” or some other neutral term.

We recommend an example illustrating that the components of an in-ground swimming pool include the pumps, heaters, chlorinators and other equipment that further the purpose and operation of the pool.

As stated above, we recommend excluding the term “transport” or a functional purpose of transportation as preventing an asset from being treated as real property. In that regard, inherently permanent structures, such as buildings, typically include structural components whose sole purpose is to transport (elevators and escalators). In addition, inherently permanent structures often have the primary purpose of transportation, including, for example, terminals, tunnels between buildings, and elevated or covered walkways between buildings or between portions of a single building. It is not uncommon for a terminal or tunnel to include a moving walkway (which functionally

\textsuperscript{40} See supra footnote 27.
\textsuperscript{41} Rev. Rul. 75-424, 1975-2 C.B. 269.
\textsuperscript{43} PLR 201250003 (Sept. 6, 2012).
differs from an escalator only in its horizontal rather than vertical orientation). Similarly, a terminal in an airport may include a train dedicated solely to the transportation of people from one point to another within the confines of the airport (which functionally differs from an elevator only in its horizontal rather than vertical orientation). An elevator, escalator, moving walkway or train (that otherwise satisfies the definition of a structural component of a building or other inherently permanent structure) should be treated as a structural component of the building it serves and therefore as real property.  

We do not believe the fact that a distinct asset facilitates transportation should preclude that distinct asset from being an inherently permanent structure or a structural component of an inherently permanent structure. Because a compressor in a pipeline serves the purpose of the pipeline and because the pipeline is itself real property, we believe a compressor should be treated as a structural component of the pipeline. We do not believe there is a sufficient distinction between a compressor in a pipeline and an elevator, escalator, or moving walkway or a train within the confines of a building to support treating them differently.

Because a locomotive or railroad car is in the nature of equipment or machinery, it may be treated as real property only if it is a structural component of a building or other inherently permanent structure. In that regard, a locomotive or railroad car does not serve the purpose of the track (rather, the track supports the operation of the train just as a microwave tower supports microwave transmission equipment or a cell tower supports cellular communications equipment) and, therefore, cannot be a structural component of the track. Accordingly, a locomotive or railroad car that does not transport people in a building or similar inherently permanent structure cannot be real property.

v. Add “utility” safe harbor

The “utility function” aspect of the definition in the Proposed Regulations underscores the importance of that type of structural component. We believe a distinct asset (alone or together with other distinct assets) that serves a utility function with respect to an inherently permanent structure should conclusively be considered a structural component of that inherently permanent structure.

vi. No mandatory disqualification due to other income

We understand that guidance regarding whether a structural component that produces income (other than consideration for the use or occupancy of space) remains under consideration. We do not believe that the final Regulations should condition real property classification of a structural component upon the absence of any non-qualifying income related activities of that structural component. For example, a total energy system in a building that produces excess energy that is sold back onto the grid serves a utility-

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44 Because a total energy system located outside a building may be treated as a structural component of the real property it serves if the taxpayer owns both the total energy system and the building, it follows that a train that is connected to and serves no purpose other than transporting passengers between terminals should likewise be considered a structural component.

like function for the building. The other income component does not change the nature of the system itself. Moreover, there may be bona fide non-tax policy reasons to encourage the dual use of the system, which should not be impeded by the final Regulations. We recommend considering basing the test on whether the primary purpose of the distinct asset is to serve the inherently permanent structure to which it is attached.

vii. No equivalent interest requirement

The Proposed Regulations also provide that structural components are real property only if the interest held therein is included with an equivalent interest held by the taxpayer in the inherently permanent structure to which the structural component is functionally related.\textsuperscript{46} We are troubled by this standard, for which there does not seem to be any precedent. For example, a REIT may have a leasehold interest in a building but an ownership interest in structural components of the building, and lease them as a whole to one or more tenants. In this rather common fact pattern, the REIT does not have an equivalent interest in the building and the structural component, as one is a leasehold interest and the other is ownership, but the two items together are no less functionally integrated because of that ownership structure. We recommend that this requirement be dropped from the Proposed Regulations in its entirety.

If Treasury and the Service are concerned about particular fact patterns (such as a total energy system that is not designed primarily to support the operation of a particular building, but rather is designed primarily to generate power to be sold on the grid), then we recommend excluding such an asset from the definition of structural component to the extent that its primary purpose is not to support real property.

IV. Other items: Examples, Intangibles, Contract Rights

A. Comments to Examples

i. Oil Pipelines

Oil pipelines do not use compression. Therefore, we recommend that Treasury Regulation section 1.866-10(g), Example 10, be changed to refer to a natural gas pipeline, which does use compression.

ii. Net leases

Several of the examples in the Proposed Regulations refer to a net lease of the relevant property. The term “net lease” is not defined for purposes of section 856 (or any other Code provision) and, therefore, is a vague term that may imply different economic arrangements. In fact, many REITs do not “net” lease their assets. There is (and should be) no requirement for a REIT to “net” lease its assets for purposes of the REIT gross income tests. Moreover, economic arrangements between the owner and lessee of property are not relevant to whether that property is real property. Therefore, we recommend that the term “net lease” not be used in the examples. Where necessary to

describe the underlying facts in an example, the word “lease” is sufficient and avoids the implication that a REIT must net lease an asset to generate rent from real property.

B. Intangibles

The Proposed Regulations provide that if an intangible asset (including an intangible asset established under generally accepted accounting principles as a result of an acquisition of real property or an interest in real property) derives its value from real property or an interest in real property, is inseparable from that real property or interest in real property, and does not produce or contribute to the production of income other than consideration for the use or occupancy of space, then the intangible asset is real property or an interest in real property.  

A REIT’s assets may include an intangible asset that is not related to a parcel of real property or an interest in real property alone. Section 856 was amended in 1986 to provide that REITs can engage in activities that include managing their own assets and activities. Largely due to the evolution of REITs from externally managed entities to self-managed operating companies over the past 20 years, the issue of REIT goodwill or other intangibles has been the subject of several private letter rulings on the treatment of real estate intangibles. For example, a REIT that owns apartment buildings or office buildings can, through its own employees, evaluate and make recommendations to the board of trustees or directors regarding the purchase of additional assets, the refinancing of assets, and the disposition of assets. Moreover, a REIT’s employees can develop leasing policies, negotiate leases with tenants, and engage in the related leasing activities. All of these activities potentially generate “goodwill” or other similar intangibles, including the value of workforce in place and customer-based intangibles. To the extent that these intangibles are attributable to investments in and operation of real property in a manner that would produce qualifying income for purposes of section 856(c)(3), such intangibles should constitute real property. This approach would be consistent with both the obvious intent of the statute and the manner in which the Service has addressed the issue in private letter rulings since 2007.

C. Other Contract Rights

The Proposed Regulations further provide that a license, permit, or other similar right solely for the use, enjoyment, or occupation of land or an inherently permanent structure that is in the nature of a leasehold or easement generally is an interest in real

48 See PLR 200726002 (June 29, 2007), PLR 200813009 (Mar. 28, 2008), PLR 200823014 (June 6, 2008), PLR 201129007 (July 22, 2011), and PLR 201314002 (Apr. 5, 2013). Certain of these rulings have addressed intangible value associated with particular properties because of their name, location or other value in excess of replacement value. We note that in PLR 201431020 (Aug. 1, 2014), the Service indicated that it may not view certain components of goodwill as real estate assets. Although there may be circumstances in which workforce in place of a REIT would be properly characterized as a non-qualifying asset (for example, to the extent it is not attributable to a business that generates qualifying income for purposes of the REIT 75 percent gross income requirement of section 856(c)(3)), it is obviously improper to punish – through an asset test failure – a REIT for being successful at managing and leasing its rental real estate.
property. A license or permit to engage in or operate a business, however, generally is not real property or an interest in real property because it produces or contributes to the production of income other than consideration for the use or occupancy of space.

We agree with the general intent of this provision. However, we believe that it should be clarified such that a lease of a specific use operating property (e.g., a hotel, a retail building, ground floor retail space, or a health care property) will not be denied treatment as real property and instead be treated as a license to operate the business. Leases of specific use property are standard in the real estate industry. Many leases require the property be operated for its specific use because the rents include a percentage of gross revenue. The property owner has a legitimate economic interest in requiring the property be operated for its intended purpose so that, among other reasons, the subject gross revenue will in fact be earned. Therefore, a dual-purpose agreement or specific-purpose lease should not be recharacterized as a license and excluded from the definition of real property when, under the general tests in the Proposed Regulations it would otherwise be treated as real property.

V. Other Definitions of Real Property

The preamble to the Proposed Regulations notes that the terms “real property” and “personal property” appear in numerous Code provisions. In that regard, the preamble requested comments on the extent to which the various meanings of real property that appear in the Treasury Regulations should be reconciled. In that regard, we do not recommend attempting to reconcile the meaning of “real property” for all purposes of the Code because, as noted by the preamble, the different provisions at issue arise in different contexts and may have varying legislative purposes. The meaning of “real property” or “personal property” for each of those different provisions should take into account the context and legislative purpose of the provision at issue.

50 See, e.g., PLR 9843020 (Oct. 23, 1998) (Forest Service permits for use of federal land as a ski-resort); PLR 200039017 (airport parking concession agreement); PLR 200705013 (Feb. 2, 2007) (concession arrangement for commercial property in an historical site).
52 See, e.g., U.S. Gov’t. Accountability Office, GAO-14-652R, Tax Policy: Differences in Definitions and Rules in the Tax Code (2014). In its Report, the GAO noted that tax simplification in the form of harmonizing rules and definitions has the potential benefits of eliminating complexity, computational burden, taxpayer confusion, and difficulties with enforcement in the current system. Notwithstanding the foregoing, the GAO observed that “some differences will always be required to appropriately target tax policy goals.” Here, due to the longstanding use of similar terms in different contexts, we do not believe this project is the appropriate venue for harmonizing definitions.