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REIT's Real Property

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After an extended delay, the IRS released the letter ruling that likely was issued to Iron Mountain on its conversion to REIT status. The ruling approved various aspects of the document storage company's plan, which required considerable restructuring of its domestic and foreign businesses.

Proposed Regulation

The request for this ruling and others likely contributed to the issuance of Prop. Reg. §1.856-10 about two months before the ruling was dated. That proposed regulation would establish a much more detailed definition of real property for purpose of REIT qualification. However, little of the proposal is reflected in the ruling. Instead, the ruling relies on pre-existing revenue rulings that make the issuance of the ruling seem easier than it was.

Facts

The taxpayer is a U.S. multinational that files a consolidated return. Its primary business is the storage of documents and related activities. It stores the documents in warehouse-like buildings that it either owns or rents on long-term leases. Within each building, it constructs a racking structure, which is like a very heavy duty cage that sits inside the walls of the building and is attached to the floor. The cage is divided into storage levels and may be as much as three stories high.

The taxpayer receives material from customers for storage, but the customers do not have direct access to the materials, as would be the case in a conventional storage unit. Rather, the taxpayer takes control of the material and determines where and how it will be stored. If the customer needs the material, the taxpayer

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retrieves it, or destroys it, or whatever the customer wants.

The taxpayer proposed retaining the leases and real estate ownership interests in the corporation that would elect to be a REIT and moving the activities related to manipulating the stored materials into taxable REIT subsidiaries.

Rulings: Real Property

The principal assets of value owned by the taxpayer for use in the storage business are the racking structures. The principal issue in the ruling was whether the racking structures are real property for REIT purposes. Under the current regulation, real property cannot be accessory to the operation of a business. It might seem that the racking structures were accessories to the operation of a storage business.

Instead, the ruling ruled that they were real property, relying primarily on a ruling that mobile homes placed on blocks in a mobile home community were real property and that microwave transmission tower components were real property.

The ruling emphasized the permanence of the racking structures, which is an important requirement in the proposed regulation. The taxpayer asserted that it never removed racking structures for reuse when it stopped using a building. The racking structures are described as being more substantial than interior walls themselves.

The REIT would have other assets that needed to be qualifying real property, and the ruling so ruled. First is contact intangibles: certain accounting assets acquired when other businesses had been acquired. Second, loans to taxable REIT subsidiaries and foreign affiliates secured by real property were qualifying real property.

Rulings: Rents from Real Property

Prior favorable rulings on what is real property had not always also ruled that rents received for the use of the property would be the type of income that REITs must receive. This ruling did so rule, primarily because it approved of the separation of the materials handling business from the storage business. The taxable REIT subsidiary would handle the materials and the REIT will bill its charges through to the customers. This pattern had already been established in a ruling on a cold storage warehouse and has been widely applied in practice.

The REIT also will receive rent from its taxable REIT subsidiary, which will be qualifying income. To qualify, such rent received from a related party must not amount to more than a small specified portion of the REIT's income.

Rulings: Depreciation and E&P

Incident to converting to REIT status, the taxpayer had to change its accounting method for depreciation of the racking structures and incurred a Section 481 adjustment. This income item produced a different earnings and profits (E&P) adjustment and also was subject to Section 1374 built-in gain tax. Due to the various changes involved, it was unclear what amount of E&P had to be distributed to insure that the taxpayer could successfully become a REIT.

The ruling ruled that where the Section 481 adjustment exceeded the E&P adjustment, the taxpayer's distribution of the difference would be treated as from E&P, even though it literally was not.

Conclusion

This ruling contained 15 or more separate rulings. It shows how complex the transition from C corporation status to REIT status can be when foreign and active businesses must be disengaged from the REIT. The proposed regulation may make the qualification of real property assets easier, but it is uncertain when they will be finalized and whether there will be further changes.

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