

Internal Revenue Service

Department of the Treasury

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Date:

October 30, 1998

Legend:

Corporation =

State A =

Date 1 =

Z =

Dear :

This is in reply to a letter dated June 23, 1998, requesting certain rulings on behalf of Corporation. The requested rulings concern whether cold storage warehouses and central refrigeration systems constitute real estate assets for purposes of § 856(c) of the Internal Revenue Code.

Facts:

Corporation is a State A corporation that intends to elect to be taxed as a real estate investment trust (REIT) under subchapter M of Chapter 1 of the Code. Corporation currently provides public refrigerated warehouse space for customers to store perishable products. Corporation does not produce, manufacture, process, sell, or store food products on its own behalf. Corporation currently provides services typically provided in both the cold and dry storage industries, including shipping and handling, billing, order management and distribution related services. Prior to Date 1, Corporation will sell its service businesses to a third party. After the sale, Corporation's only assets will be warehouses and central refrigeration systems. Corporation will lease the warehouses and the central refrigeration systems to the new third party owner of the service businesses. After the sale and lease have been executed, Corporation will

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elect to be treated as a REIT.

Corporation owns and operates more than z cold storage warehouses that are substantially similar to other cold storage warehouses in the industry. The interior clearance for each warehouse is approximately 20-40 feet, and each warehouse generally encompasses 200,000 to 400,000 square feet. The warehouses are not designed or intended to be dismantled or relocated.

The foundations of the warehouses are reinforced concrete slabs approximately six inches thick installed over a gravel base with galvanized steel framing. To prevent the ground beneath the floor from freezing and cracking the warehouse floor, an underground heating system is generally installed comprised of piping originating from the roof that keeps the floor at approximately 40 degrees Fahrenheit. The exterior freezer walls are poured concrete tilt-up and insulated with six inches of pink fiberglass insulation over wood paneling. The dock walls are corrugated steel construction. The warehouse roof generally consists of a heavy duty tar product covering 12 inches of pink fiberglass insulation.

Corporation's warehouses generally include a large central room maintained at zero degrees Fahrenheit, one or more rooms for long-term storage maintained at a temperature well below zero, docking stations, a small office, a small machine shop, and an engine room. The interior of the freezer sections are large open areas used to store food. Each section contains wood or steel shelving used to stack customer products. Several mechanically operated doors with fiberglass exteriors over insulation connect the cold storage area with the docking areas. Floors of the freezer sections are treated concrete with vapor barriers.

Approximately 90 percent of the space in Corporation's warehouses is temperature controlled freezer space, maintained at zero degrees Fahrenheit and below. The remaining space is cooler and/or dry storage space. Docking space for loading and unloading represents only a minimal portion of each location.

Human activity in the refrigerated and freezer sections of the warehouse is restricted to unloading deliveries, storing the packaged goods, maintaining inventory, and loading shipments. Occasionally, minor repairs or maintenance are performed in the cold sections.

Each of Corporation's central refrigeration systems (systems) was installed as part of the original construction of the warehouse. None of the systems has ever been moved in its entirety to another location. The systems are either ammonia or freon systems and include compressors, boosters, condensers, pumps, evaporators, vessels, motors, storage tanks, and insulated pipes which connect the components of the systems. Although every component can be identified as a separate unit, each

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component works in conjunction with the other components to form a complete closed refrigeration system. The components function as a unit so that no component by itself is useful nor is the system functional without all the components.

The compressors and boosters lower the temperature of the ammonia or freon. The cooled refrigerant is then pumped through insulated pipes to the evaporators within the freezer or refrigerated areas. Evaporators attached to the ceilings of the refrigeration and freezer storage areas within the warehouses cool the storage area by forcing air, provided from the condensers, past the refrigerant into the storage area. The compressors and evaporators weigh several thousand pounds and must be transported by forklifts for installation or disassembly. The compressors are anchored to concrete stands by securing each foot of the compressor over an anchor stud in poured concrete. The evaporators are bolted to the roof of the warehouse. Compressors and evaporators are difficult and expensive to dismantle, and thus are infrequently dismantled and replaced.

The condensers are set on structural steel stands on the warehouse roof. Each stand is supported by beams that run from the roof, through the facility, to the concrete floor of the warehouse. The condensers generally weigh between 15,000 and 40,000 pounds and require a crane to be installed or dismantled. Generally, a condenser will only be removed when it is retired or cannot function to service the warehouse.

The refrigerant pumps are connected to the storage vessels and pump the refrigerant throughout the system. Both the vessels and pumps are anchored in concrete. Although the pumps, storage vessels, and boosters are somewhat more portable than the other components, they are rarely ever moved.

Pursuant to an audit by the Service for the tax years ended 1983, 1984, and 1985, Corporation treats the warehouses and systems as real property.

Law and Analysis:

Section 856(c)(2) provides that at least 95 percent of a REIT's gross income must be derived from, among other sources, "rents from real property."

Section 856(c)(3) provides that at least 75 percent of a REIT's gross income must be derived from, among other sources, "rents from real property."

Section 856(c)(4)(A) provides that at the close of each quarter of its tax year, at least 75 percent of the value of a REIT's total assets must be represented by real estate assets, cash and cash items (including receivables), and Government securities.

Section 856(c)(5)(B) defines the term "real estate assets", in part, to mean real

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property (including interests in real property and interests in mortgages on real property) and shares (or transferable certificates of beneficial interest) in other REITs. Section 856(c)(5)(C) provides that the term "interests in real property" includes fee ownership and co-ownership of land or improvements thereon, leaseholds of land or improvements thereon, options to acquire land or improvements thereon, and options to acquire leaseholds of land or improvements thereon, but does not include mineral, oil, or gas royalty interests.

Section 1.856-3(b) of the Income Tax Regulations provides, in part, that the term "real estate assets" means real property. Section 1.856-3(d) provides that "real property" includes land or improvements thereon, such as buildings or other inherently permanent structures thereon (including items which are structural components of such buildings or structures.) Local law definitions will not be controlling for purposes of determining the meaning of "real property" for purposes of § 856 and the regulations thereunder. Under this regulation, "real property" includes, for example, the wiring in a building, plumbing systems, central heating or central air-conditioning machinery, pipes or ducts, elevators or escalators installed in a building, or other items which are structural components of a building or other permanent structure. The term does not include assets accessory to the operation of a business, such as machinery, printing press, transportation equipment which is not a structural component of the building, office equipment, refrigerators, individual air-conditioning units, grocery counters, furnishings of a motel, hotel, or office building, etc. even though such items may be termed fixtures under local law.

Section 856(d)(1) provides that rents from real property include (subject to exclusions provided in § 856(d)(2)): (A) rents from interests in real property, (B) charges for services customarily furnished or rendered in connection with the rental of real property, whether or not such charges are separately stated, and (C) rent attributable to personal property leased under, or in connection with, a lease of real property, but only if the rent attributable to such personal property for the taxable year does not exceed 15 percent of the total rent for the taxable year attributable to both the real and personal property leased under, or in connection with, such lease.

Rev. Rul. 71-220, 1971-1 C.B. 210, considers whether mobile home units installed in a planned community are real property for purposes of § 856. The units were delivered to a site where they were set on foundations consisting of pre-engineered blocks. The wheels and axles were removed from the units, and the units were affixed to the ground by six or more steel straps. A carport or screened porch was attached to each unit and the unit was connected to utilities. The revenue ruling holds that the units are real property within the meaning of § 856.

Rev. Rul. 73-425, 1973-2 C.B. 222, considers whether a mortgage secured by a shopping center and its total energy system is an obligation secured by real property.

A total energy system is a self-contained facility for the production of all the electricity, steam or hot water, and refrigeration needs of associated commercial or industrial buildings, building complexes, shopping centers, apartment complexes, and community developments. The system may be permanently installed in the building, attached to the building, or it may be a separate structure nearby. The principal components consist of electric generators powered by turbines or reciprocating engines, waste heat boilers, heat exchangers, gas-fired boilers, and cooling units. In addition, each facility includes fuel storage tanks, control and sensor equipment, electrical substations, and air handling equipment for heat, hot water, and ventilation. It also includes ducts, pipes, conduits, wiring, and other associated parts, machinery and equipment. The revenue ruling holds, in part, that a mortgage secured by the building and the system is a real estate asset, regardless of whether the system is housed in the building it serves or is housed in a separate structure apart from the building it serves. This is because the interest in a structural component is included with an interest held in a building or inherently permanent structure to which the structural component is functionally related.

Rev. Rul. 75-424, 1975-2 C.B. 270, concerns whether various components of a microwave transmission system are real estate assets for purposes of § 856. The system consists of transmitting and receiving towers built upon pilings or foundations, transmitting and receiving antennae affixed to the towers, a building, equipment within the building, and waveguides. The waveguides are transmission lines from the receivers or transmitters to the antennae, and are metal pipes permanently bolted or welded to the tower and never removed or replaced unless blown off by weather. The transmitting, multiplex, and receiving equipment is housed in the building. Prewired modular racks are installed in the building to support the equipment that is installed upon them. The racks are completely wired in the factory and then bolted to the floor and ceiling. They are self-supporting and do not depend upon the exterior walls for support. The equipment provides for transmission of audio or video signals through the waveguides to the antennae. Also installed in the building is a permanent heating and air conditioning system. The transmission site is surrounded by chain link fencing. The revenue ruling holds that the building, the heating and air conditioning system, the transmitting and receiving towers, and the fence are real estate assets. The ruling holds further that the antennae, waveguides, transmitting, receiving, and multiplex equipment, and the prewired modular racks are assets accessory to the operation of a business and therefore not real estate assets.

Although not conclusive, cases classifying property as either real property or personal property for purposes of the investment tax credit under former § 38 (repealed by the Tax Reform Act of 1986, P.L. 99-514) are instructive in determining whether assets constitute real estate assets. The classification of property for purposes of the investment tax credit is analogous to such determinations for REIT purposes. In fact, the legislative history underlying the investment tax credit describes "assets accessory to a business" eligible for the credit largely the same as § 1.856-3(d)

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describes “assets accessory to the operation of a business” that are not considered real estate assets for REIT purposes. See S. Rept. No. 1881, 87th Cong., 2d Sess. (1962), 1962-3 C.B. 716, 722.

Whiteco Industries, Inc. v. Commissioner, 65 T.C. 664 (1975), considered whether outdoor advertising signs constituted tangible personal property eligible for the investment tax credit. In a decision granting the investment tax credit, the court set forth factors to be considered in the determination of whether property is realty or personalty. These factors are:

- 1) Is the property capable of being moved, and has it in fact been moved?
- 2) Is the property designed or constructed to remain permanently in place?
- 3) Are there circumstances that tend to show the expected or intended length of affixation?
- 4) How substantial a job is removal of the property and how time-consuming is it?
- 5) How much damage will the property sustain upon its removal?
- 6) What is the manner of affixation of the property to the land?

The Service applied the criteria set forth in Whiteco in Rev. Rul. 80-151, 1980-1 C.B. 7, and concluded that certain outdoor advertising displays are tangible personal property.

In Munford, Inc. v. Commissioner, 87 T.C. 463 (1986), aff'd 849 F.2d 1398 (11th Cir. 1988), the petitioner placed in service an addition to a refrigerated facility for the storage of frozen food products. The petitioner sought an investment tax credit, contending that the structure placed in service is tangible personal property eligible for the credit. Petitioner argued that the facility is merely a giant refrigerator or freezer that is in the nature of machinery, and thus personal property. In opposition, the Service argued that the addition is a building and thus is excluded from the definition of tangible personal property. The court denied the investment tax credit and concluded that the refrigerated area is a fixed, stationary structure. Its primary function is to store frozen foods at low temperatures. The court found that although the refrigerated area contained system components and functioned through the use of those components, which are in the nature of machinery, the structure's primary function could not be thought of as mechanical or accomplished by machinery in the ordinary sense of that term.

Loda Poultry Co., Inc. v. Commissioner, 88 T.C. 816 (1987), also involved the classification of a refrigerated warehouse and its central refrigeration system for purposes of the investment tax credit. In Loda, the asset consisted of a concrete base with prefabricated modular foam panels together with air-cooled condensers and a commercial engine which provide refrigeration to five separate compartments refrigerated to different temperatures for various purposes. The Service contended that the asset constitutes a building and thus is ineligible for the investment credit. In addition, the Service argued that the asset is not other tangible property used as an integral part of a manufacturing or production activity or as a bulk storage facility within the meaning of § 48. Finally, the Service argued that the air-cooled condensers and commercial engine do not qualify for the investment credit because they are structural components. The court examined each of the compartments individually and determined that only one compartment qualified for the investment tax credit as tangible personal property because it is used as an integral part of manufacturing, production, or extraction. The court found that each remaining compartment either does not function as an integral part of the production process or is considered a building for investment tax credit purposes. The court also found that the condensers and commercial engine do not qualify for the credit because they are part of a central refrigeration system that is a structural component of a building.

Corporation's cold storage warehouses are constructed to remain permanently in place, cannot be readily moved, are unlikely to be moved, and are not intended to be moved. Therefore, they are inherently permanent structures. See Whiteco, Rev. Rul. 80-151, and Rev. Rul. 71-220. Inherently permanent structures are real property, and the term "real estate assets" means real property. Section 1.856-3. The systems are designed and intended to be permanent. Although comprised of components that individually can be removed, the components are rarely if ever removed because they are part of a system. The systems are permanently affixed and functionally related to their associated warehouses. Moving all or part of the systems would be extremely difficult and would likely affect their function. Therefore, the systems are structural components of the warehouses, which are inherently permanent structures. See Rev. Rul. 73-425 and Loda. Under § 1.856-3, real property includes items that are structural components of a permanent structure. Furthermore, the warehouses and systems are not used in a manufacturing or production process and are not the functional equivalent of any item cited in the regulations under § 856 or the legislative history of the investment tax credit as an example of an accessory to the operation of a business.

Accordingly, based on the information submitted and representations made, we conclude that Corporation's cold storage warehouses and central refrigeration systems, as described above, constitute real property for purposes of §§ 856(c)(2)(C) and 856(c)(3)(A). In addition, because the warehouses and systems are real property, they

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constitute real estate assets for purposes of §§ 856(c)(4)(A) and 856(c)(5)(B).

No opinion is expressed or implied as to the federal tax consequences of this transaction under any provision not specifically addressed herein. Furthermore, no opinion is expressed concerning whether Corporation otherwise qualifies as a REIT under subchapter M, part II of Chapter 1 of the Code. Specifically, no opinion is expressed concerning the treatment of any shelving in Corporation's cold storage warehouses for purposes of § 856(d)(1)(c).

This ruling is directed only to the taxpayer requesting it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent. In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to your authorized representative.

Sincerely,

Assistant Chief Counsel
(Financial Institutions & Products)

By: _____
Alvin J. Kraft
Chief, Branch 1

Enclosures:

Copy of this letter
Copy for § 6110 purposes