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MEMORANDUM

To: File

From: Ameek Ashok Ponda
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Date: May 26, 2026

RE: Selected REIT Tax Issues in Constructing a Data Center

I. Statement of Facts

A limited liability company (the "**Company**") has been formed to acquire land, to construct a data center, and to operate the data center building as a landlord.[1] The data center building will contain sufficient floor space to house thousands of tenant-owned computing and storage systems (including and especially tenant-owned artificial intelligence hardware). Following development of the data center, the Company's recurring revenue streams will come primarily from the licensing of space to tenants and from related offerings to such tenants. Thus, the Company's recurring revenue streams will be REIT-compliant. The Company is an accrual-basis taxpayer. The Company intends to elect to be taxed as a real estate investment trust under Sections 856 through 860 (a "**REIT**") beginning with its first taxable year. The Company expects and intends to maintain its qualification for taxation as a REIT in all subsequent years.

A. Construction Operations

For the data center building to be constructed, the Company will enter into a construction agreement with a general contractor that will govern the construction of the building. The period to complete the physical construction of the building, measured from groundbreaking until the time that the building is ready for occupancy, is expected to be one to three years, and could be as long as three to four years.

[1] The term "**Company**" includes any Section 856(i) qualified REIT subsidiaries as well as other disregarded entities for federal income tax purposes (*e.g.*, disregarded entities under Treas. Reg. § 301.7701-3). The term also includes any successors by way of a reorganization described in Section 368(a)(1)(F), but it excludes any Section 856(l) taxable REIT subsidiaries (each, a "**TRS**") of the Company. All "**Section**" references in this memorandum are to sections of the Internal Revenue Code of 1986, as amended and in effect from time to time (the "**Code**"), all "**Treas. Reg. §**" references are to sections of the Treasury regulations promulgated thereunder, and all references to "**Service**" or "**IRS**" are to the Internal Revenue Service.

In connection with the construction process and the construction agreement with the general contractor, the Company expects to purchase directly some of the building's Materials and some or all of the building's Components, each as defined as follows:

- The "**Materials**" comprise building materials that will be incorporated into the building during its construction and thereupon become a permanent part of the building within the meaning of Treas. Reg. § 1.856-10. Examples of the Materials include construction elements such as steel, cement, plaster, millwork, fastenings and brackets, bricks and concrete blocks, sheetrock (drywall), and tile. For the most part, the Materials are generic and do not require any special preparation; that said, there can be significant lags and delays in procuring certain Materials for construction. For the avoidance of doubt, Materials do not include anything that is a Component.

- The "**Components**" comprise various building system elements and components of these building system elements, each of which will be integrated as a structural component into the data center building within the meaning of Treas. Reg. § 1.856-10. Examples of the Components include systems of building infrastructure such as central HVAC systems, electrical distributions panels and systems (including breaker panels), electrical redundancy systems, electrical generators, telecommunications systems, security systems, fire suppression systems, water circulation piping and pumping systems, water chillers, and humidity control systems. Unlike the Materials, the Components are often large and technologically sophisticated, and they usually need to be designed and manufactured to precise specifications. Again, for the avoidance of doubt, anything defined as a Component is excluded from the definition of Materials.

- Due to the vibrant market for construction of new data centers, there is a significant amount of lead time between the ordering and the receipt of both Materials and Components. Most Materials and some Components have lead times that are no longer than several months. However, for certain types of Components, the lead time currently ranges from several months to as much as four years or more.

- Because of these long lead times between ordering and receipt for the Components, the Company expects that it will need to make advance payments to most of the relevant suppliers that will supply these items, with initial payments due at the time of initial contracting or shortly thereafter, and additional payments occurring at different time milestones prior to delivery. Some of these advance payments will be deposits, which represent those intangible rights that accrete to the Company under the relevant purchase contracts upon payment of these advance amounts. That is, a deposit constitutes a prepayment to the supplier of a portion of the purchase price for the relevant Material or Component. Other payments may represent soft costs (such as engineering design work) that are recorded as part of the purchase cost of a Component if (as is often the case) that particular Component needs to be customized by the supplier for use in the to-be-constructed data center building. When such a deposit or other payment is paid to a supplier, the paid money becomes the property of the supplier.

In due course, and following any applicable prepayments, the Materials and the Components will be delivered to and received by the Company (at which time the remaining balance of the purchase price will also become due). Upon receipt, items included in the Materials and the

Components typically will be stored by the Company or by its agents (*e.g.*, the general contractor) at an appropriate location (often onsite) to prevent any damage or deterioration until such time as the items are installed and permanently affixed into the data center building that is under construction; this integration and permanent affixation will often (but not always) occur in the same calendar quarter as delivery, and in most cases will occur within a few months (up to a calendar quarter or two) after delivery. The timing of this integration and permanent affixation may depend upon, among other factors, the exigencies of the construction process for the building, the timing of delivery of the specific Materials or Components within the quarter (*e.g.*, early in the calendar quarter versus toward the end of the calendar quarter), the timing of the completed construction of any prerequisites required in order to proceed with permanent affixation of the subject items, the specific type of Materials or Components received, and other factors that may be encountered during the construction of a new building of the magnitude and complexity of a data center.

Accordingly, it is very possible that various Materials and Components, following their respective receipt by the Company, but before their respective integration and permanent affixation in the Company's data center building, will be in the possession of the Company at the close of one or more calendar quarters.

B. GAAP Accounting Treatment

As Materials and Components are ordered, paid for, and received, the Company will record them for financial accounting purposes as required by generally accepted accounting principles in the United States ("**GAAP**"). In compliance with GAAP and as explained in more detail below, the Company uses two types of GAAP balance sheet asset accounts to record the construction of a data center building: "Deposits" (each, a "**Deposit Account**"),[2] and "Construction in Progress" (the "**CIP Account**").[3] Under GAAP, all payments for construction (*i.e.*, whether deposits or construction in progress) must be capitalized, *i.e.*, recorded as assets, just as one would expect real property to be recorded.

[2] Alternatively, the Company could record deposits as "Prepaid Construction in Progress" (the "**Prepaid CIP Account**") for GAAP purposes. All references to "Deposits" herein are intended to also refer to "Prepaid Construction in Progress". Under GAAP, the Prepaid CIP Account is properly viewed as the right (contractual or otherwise) to pay a vendor or other payee correspondingly less "cash" in the future, and for that reason prepaid items are properly viewed within GAAP as "cash items". In addition, under GAAP, a prepaid item is not the item being purchased or paid for, nor does it take on the complexion of the item that is being purchased or paid for. It is simply the right to pay out less cash in the future to a payee, and for that reason alone is a "cash item". Finally, a prepaid item can be for goods or for services (*e.g.*, Rev. Rul. 79-229 (prepaid livestock feed)); a prepaid item can be for ordinary course activities or for activities outside the ordinary course (*e.g.*, Rev. Rul. 80-71 (prepaid development costs)) – understanding of course that REIT construction of real property is nevertheless ordinary course (as explained in more detail below); and a prepaid item can be a current item (resolved within twelve months) or a longer-term item (extending for longer than twelve months) (*e.g.*, prepaid rent for realty or personalty under Section 467 can last many, many years).

[3] All construction in process will be tracked in the CIP Account (or, as applicable, a Deposit Account for advance payments). The details of expenses incurred with regard to particular Components, for eventual transfer to a fixed asset account to track GAAP depreciation, will be maintained in separate project software for mapping capital improvement tasks.

A simplified overview of this GAAP treatment is summarized as follows:

1. When deposits are made, the Company will debit a Deposit Account.

2. When the Materials and/or Components are received, the Company will credit the applicable Deposit Account and debit the CIP Account.

3. Materials and Components will remain in the CIP Account after receipt (including after permanent affixation) until the completion of the construction project (known as the "placed in service" date), which completion is denoted by either a certificate of occupancy for the building or a "ready for service" confirmation from the project manager.

4. At the "placed in service" date for the constructed building, the Company will credit the CIP Account and debit the applicable GAAP in-service fixed asset accounts of GAAP distinct assets that make up the completed data center building (*e.g.*, Building, Electrical, HVAC, etc.).[4]

The specific accounting entries for these GAAP accruals can be summarized as follows:

1. A) Where one or a series of advance payments (either prepayments or progress payments) must be made by the Company before the item is delivered (which is generally true for Components but may also be required for Materials), each prepayment or progress payment would be accounted for upon payment as follows:

   Debit: Deposit Account
   Credit: Cash

   These amounts debited into the Deposit Account will remain in that category until the subject item has been received and accepted by the Company.[5]

   B) Upon receipt of the subject item by the Company, the Deposit Account will be credited in the same aggregate amount the Deposit Account was previously debited for the subject item; and that amount plus the invoice for the balance of such item will equal the amount debited to the CIP Account:

   Debit: CIP Account (equal to deposit balance for received item)
   Debit: CIP Account (equal to invoice for remaining purchase price for received item)
   Credit: Deposit Account (equal to deposit balance for received item)
   Credit: Cash (equal to invoice for remaining purchase price for received item)

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[4] GAAP depreciation of the in-service fixed asset accounts also begins as of this placed in service date.

[5] In the case of Components, sometimes the received "item" might have soft costs such as embedded prepaid design, which item is "completed" for GAAP purposes before the related item itself is delivered to the Company, and if so the cost of such embedded design will be moved from the applicable Deposit Account to the CIP Account (or will be accrued into the CIP Account directly as contemplated by the next step), all as appropriate and in accordance with GAAP.

2. If the purchase order did not contemplate prepayments of purchase price (and thus did not involve deposits), then the entry made when the item has been received and paid for by the Company would simply be the following:

   Debit: CIP Account
   Credit: Cash

3. From and after receipt of the same by Company, the specific Materials and Components remain as part of the CIP Account regardless of when they are installed and permanently affixed into the building; but, as discussed, they are typically installed and permanently affixed rather quickly, often in the same calendar quarter as they were received, and quite typically they are installed and permanently affixed within several months of being received by the Company. Once the Materials and Components are installed and permanently affixed into the data center building, it is absolutely clear that they will count as "real property" within the meaning of Treas. Reg. § 1.856-10.

4. At the very end of the construction cycle, once the building is placed into service, the CIP Account is closed out into the appropriate property, plant, and equipment accounts (each, a "**PPE Account**" and, together, the "**PPE Accounts**") (again, with the identity of any specific item being maintained in a subaccount that is part of the larger PPE Account):[6]

   Debit: PPE Account
   Credit: CIP Account[7]

Thus, under applicable GAAP rules, Materials and Components are tracked from the time that they are ordered, and through and until the time that they are received, as part of either a Deposit Account (for an initial period) or the CIP Account. Thereafter, such Materials and Components stay in the CIP Account, even after they are permanently affixed as part of the construction process, until such time as the building is placed into service, at which time the value associated with those assets is effectively moved from the CIP Account into the PPE Accounts.

<u>C. Tax Accounting Treatment</u>

Similarly, for tax accounting purposes under Section 263(a)(1) and subject to certain exceptions not relevant here, no deduction shall be allowed for (in other words, the Company must capitalize) any amount accrued or paid for new buildings or for permanent improvements or betterments made to increase the value of any property or estate. In particular, Treas. Reg. § 1.263(a)-2(d)(2)(Example 8) provides that, in connection with the

[6] The in-service PPE accounts that collectively constitute the constructed data center generally have GAAP titles such as: Structure Improvement, Electrical, Fire Prevention, HVAC, Security, and Telecommunications. Quite expectedly, these GAAP accounts correspond to the data center and component building systems described in Treas. Reg. § 1.856-10(g)(Example 6).

[7] For federal income tax purposes, the Company does not utilize component depreciation. Therefore, depreciation of permanently affixed Materials and Components is done through the PPE Account for buildings.

construction of a building, amounts accrued or paid[8] for construction must be capitalized under Treas. Reg. § 1.263(a)-2(d)(1) in accordance with Section 263A (which details the costs required to be capitalized to the real property). Thus, the deposits and construction in progress, all of which represent amounts accrued or paid in respect of the cost of new buildings or permanent improvements, would also be capitalized items for tax accounting purposes.[9]

D. REIT Treatment

The REIT rules regarding treatment of the Deposit Accounts and the CIP Account are not as clear as the rules provided by GAAP (or even by Sections 263 and 263A), as will be discussed in Part III of this memorandum. In particular, neither Treas. Reg. § 1.856-2(d), nor Treas. Reg. § 1.856-10, nor their preambles, include any discussion regarding the classification principles to be applied to the Deposit Accounts and the CIP Account during a taxpayer's construction of its real property. This memorandum has been prepared as a direct result of the silence in Treas. Reg. §§ 1.856-2(d) and 1.856-10, and accordingly is grounded in the statutory standards of Sections 856(c)(5)(A)-(B). For example, as explained below, the favorable rule for construction in progress in Treas. Reg. § 1.856-5(c) is properly understood as a definition of "real property" for Section 856(c)(5)(B) purposes and a definition of the real property's "value" for Section 856(c)(5)(A) purposes, and in both cases the favorable statutory definitions would also control for purposes of the issues in Part II of this memorandum.

Achieving clarity for the Deposit Accounts and the CIP Account is vitally important to the Company, because Section 856(c)(4)(A) requires that, at the close of each quarter of a REIT's taxable year, at least 75 percent of the value of its total assets is represented by "real estate assets, cash and cash items (including receivables), and Government securities" (the "**75% Asset Test**"). For some REIT taxpayers, such a classification question would not create a problem with regard to the 75% Asset Test, because the REIT taxpayer would already be in possession of significant amounts of real property, and the amount of other property purchased and utilized as part of new construction projects would not be significant (much less, "make-or-break") by comparison. But in the case of the Company, because it is constructing its first data center, its existing real property asset base is just starting, and the value of the Materials and the Components that it is acquiring (including prepayments in respect thereof) will thus be material to its 75% Asset Test compliance for some time. In addition, the issues described in this memorandum are particularly acute when the REIT taxpayer is building its own power generation infrastructure on or adjacent to the data center site.

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[8] Treas. Reg. § 1.263(a)-2(b)(1) provides that the terms "amount paid" and "payment" include a liability incurred by an accrual basis taxpayer such as the Company.

[9] *See infra* Part III.B.2.

E. Factual Assumptions

For purposes of this memorandum, we have assumed the following facts:

1. The Company is acquiring Materials and Components for the sole purpose of having them installed and permanently affixed in the data center building that it is constructing.

2. The Company is funding prepayments to the suppliers of Materials and Components solely for the purpose of receiving those Materials and Components, which are required to complete the data center building being constructed by the Company.

3. Once they have been installed and permanently affixed, all Materials will be part of a building within the meaning of Treas. Reg. § 1.856-10(d)(2)(ii) and will not be distinct assets within the meaning of Treas. Reg. § 1.856-10(e).

4. Once they have been installed and permanently affixed, all Components will be structural components of a building within the meaning of Treas. Reg. § 1.856-10(d)(3) and will be distinct assets within the meaning of Treas. Reg. § 1.856-10(e).

5. Deposits represent those intangible rights to Materials or Components that accrete to the Company upon the Company's payments of advance amounts under the relevant purchase contracts; these rights are matched by a corresponding obligation on the part of the sellers of Materials or Components.

6. Upon receipt of a Material or Component, the applicable amount in a Deposit Account is replaced as an asset of the Company with the same amount in the CIP Account.

7. If at any point the Company's plans are altered so that some Materials or Components are no longer to be installed and permanently affixed to the Company's data center building, the Company will immediately reclassify the applicable amount in the CIP Account (including for all applicable prior calendar quarters) as something other than real property (*i.e.*, personal property or other appropriate classification) for purposes of Section 856(c)(4)(A) and for all other REIT purposes.

II. Issues Presented

This memorandum analyzes the following issues:

1. Will the amounts recorded to the Deposit Accounts be treated as "cash and cash items (including receivables)" within the meaning of Section 856(c)(4)(A)?

2. Will the amounts recorded to the CIP Account for items not yet permanently affixed (whether for Materials or for Components) be treated as "real property" within the meaning of Sections 856(c)(4)(A) and 856(c)(5)(A)-(B)?

III. Statement of Law and Analysis

A. Statement of Law

The Trump Administration has issued an executive order providing that it is a priority of the Administration "to facilitate the rapid and efficient buildout of [AI data centers and infrastructure] by easing Federal regulatory burdens."[10] The authorities described in this Part III should be interpreted in the context of the Administration's policy priorities regarding the construction of AI data centers.

We appreciate that this memorandum is requesting that the Treasury Department issue new guidance in the form of a Notice (or Revenue Procedure), but guidance is sorely needed in this area. It is the Treasury's privilege and role to provide guidance in such situations. In fact, we are reminded of the story of the three umpires (available at http://www.barrypopik.com/index.php/new_york_city/entry/three_umpires): Three umpires were discussing the fine art of judgment, and the calling of balls and strikes was the subject of the day. "I call them as I see them," stated the first. The second responded, "I call them as they are." The third closed the conversation by declaring, "They ain't nothing until I call them."

1. Sections 263 and 263A

Section 263(a)(1) provides that, subject to certain exceptions not relevant here, no deduction shall be allowed for any amount paid out for new buildings or for permanent improvements or betterments made to increase the value of any property or estate.

Treas. Reg. § 1.263(a)-1(a)(1) provides in relevant part that, subject to certain exceptions not relevant here, no deduction shall be allowed for any amount paid for new buildings or for permanent improvements or betterments made to increase the value of any property or estate.

Treas. Reg. § 1.263(a)-2(b)(1) provides that, for purposes of Treas. Reg. § 1.263(a)-2, in the case of a taxpayer using an accrual method of accounting, the terms "amount paid" and "payment" mean a liability incurred within the meaning of Treas. Reg. § 1.446-1(c)(1)(ii) (which defines the accrual method of accounting).

Treas. Reg. § 1.263(a)-2(d)(1) provides that, subject to certain exceptions not relevant here, a taxpayer must capitalize amounts paid to acquire or produce a unit of real or personal

[10] Executive Order 14318, 90 Fed. Reg. 35385, "Accelerating Federal Permitting of Data Center Infrastructure" (signed on Jul. 23, 2025) (revoking Executive Order 14141, 90 Fed. Reg. 5469 (signed on Jan. 14, 2025)). The Trump Administration previously identified the promotion of American leadership in AI as a paramount goal for the administration and has issued an executive order and guidance directing federal government agencies to "develop public AI strategies that elevate AI adoption and innovation as a priority, while increasing transparency to the American public, civil society, and industry." OMB Memorandum M-25-21, "Accelerating Federal Use of AI through Innovation, Governance, and Public Trust", at 2 (Apr. 3, 2025), *implementing* Executive Order 14179, 90 Fed. Reg. 8741, "Removing Barriers to American Leadership in Artificial Intelligence" (signed on Jan. 23, 2025) (revoking Executive Order 14110, 88 Fed. Reg. 75191 (signed on Oct. 30, 2023)). *See also* OMB Memorandum M-25-22, "Driving Efficient Acquisition of Artificial Intelligence in Government" (Apr. 3, 2025).

property, including leasehold improvements, land and land improvements, buildings, machinery and equipment, and furniture and fixtures.

Treas. Reg. § 1.263(a)-2(d)(2)(Example 8) provides that, in connection with the construction of a building, amounts paid for construction must be capitalized under Treas. Reg. § 1.263(a)-2(d)(1) in accordance with Section 263A.

Sections 263A(a)-(b) provide that a taxpayer must capitalize certain identified costs associated with its production of real or tangible personal property, to the extent that such property is not inventory in the hands of the taxpayer.

Treas. Reg. § 1.263A-1(a)(3) provides in relevant part that taxpayers subject to Section 263A must capitalize all direct costs and certain indirect costs properly allocable to real property and tangible personal property produced by the taxpayer.

Treas. Reg. § 1.263A-1(e)(3)(i)(A) provides in relevant part that indirect costs include all costs other than direct material costs and direct labor costs (in the case of property produced) or acquisition costs (in the case of property acquired for resale). . . Indirect costs are properly allocable to property produced or property acquired for resale when the costs directly benefit or are incurred by reason of the performance of production or resale activities.[11]

Treas. Reg. § 1.263A-2(a) provides that Section 263A applies to real property and tangible personal property produced by a taxpayer for use in its trade or business or for sale to its customers, and that Section 263A applies to property produced for a taxpayer under a contract with another party.

Treas. Reg. § 1.263A-2(a)(1)(i) provides that the term "produce" means to construct, build, install, manufacture, develop, improve, create, raise, or grow.

2. *Section 851*

Section 851(b)(3)(A)(i) provides that at the close of each quarter of the taxable year at least 50% of the value of the total assets of a regulated investment company (a "**RIC**") must be represented by cash and cash items (including receivables), Government securities, securities of other RICs, and a diversified portfolio of other securities.

Section 851(c)(6) provides that all terms not otherwise defined in Section 851(c) shall have the same meaning as when used in the Investment Company Act of 1940, as amended (the "**40 Act**").

Treas. Reg. § 1.851-2(c)(1) provides that at the close of every quarter, at least 50% of the value of the total assets of a RIC must be represented by one or more of the following: (i) cash and cash items, including receivables, (ii) Government securities, (iii) securities of other RICs,

[11] Examples of indirect costs expressly include engineering and design costs, which include pre-production costs, such as costs attributable to research, experimental, engineering, and design activities (to the extent that such amounts are not research and experimental expenditures as described in Section 174 and the regulations thereunder). Treas. Reg. § 1.263A-1(e)(3)(ii)(P).

or (iv) securities (other than those described in subdivisions (ii) and (iii) of Treas. Reg. § 1.851-2(c)(1)) of any one or more issuers which meet certain limitations.

3. Section 856

Section 856(c)(3) requires that, for each REIT taxable year, at least 75 percent of the REIT's gross income must be derived from the sources specified therein (the "**75% Income Test**"). Section 856(c)(3)(B) lists one of those permitted sources for the 75% Income Test as "interest on obligations secured by mortgages on real property or on interests in real property".

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

Section 856(c)(5)(A) and Treas. Reg. § 1.856-3(a) both provide that the term "value" means, with respect to securities (other than securities for which market quotations are widely available) and assets, fair value as determined in good faith by the trustees of the REIT (except in the case of securities of REITs, where such fair value shall not exceed market value or asset value, whichever is higher).

Section 856(c)(5)(B) and Treas. Reg. § 1.856-3(b)(1) both generally provide that the term "real estate assets" means real property (including interests in real property and interests in mortgages on real property or on interests in real property), shares (or transferable certificates of beneficial interest) in other REITs which meet the requirements of Sections 856 through 859, and debt instruments issued by publicly-offered 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 856(c)(5)(F) provides that all terms not otherwise defined in Section 856(c) shall have the same meaning as when used in the 40 Act.

Section 856(c)(9)(B) provides rules to determine the amount of real property present when personal property is mortgaged along with real property.

- Section 856(c)(9)(B)(i) provides that, if the fair market value of the personal property mortgaged does not exceed 15% of the fair market value of all property mortgaged, then the entire mortgage obligation shall be treated as a mortgage on real property and thus as a real estate asset for purposes of Section 856(c)(4)(A).

- Section 856(c)(9)(B)(ii) provides that, for purposes of determining the fair market value of property secured by a mortgage on both real and personal property, the fair market value of all such property shall be determined in the same manner as the fair market value of real property is determined for purposes of apportioning interest income between real property and personal property under Section 856(c)(3)(B) ("interest on obligations secured by mortgages on real property or on interests in real property").

Treas. Reg. § 1.856-2(d)(1) provides that at the close of each quarter of the taxable year at least 75% of the value of a REIT's total assets must be represented by one or more of "real estate assets", "Government securities", and "cash and cash items (including receivables)".

Treas. Reg. § 1.856-2(d)(1)(iii) defines the term "receivables" for purposes of Section 856(c)(4)(A) to mean only those receivables which arise in the ordinary course of the REIT's operation and does not include receivables purchased from another person.

Treas. Reg. § 1.856-2(d)(3) provides that (1) the term "total assets" means the gross assets of the REIT determined in accordance with GAAP, and (2) in connection with rules relating to when a REIT is not required to revalue its assets at the end of a quarter, "a change in the nature of 'cash items', for example, the prepayment of insurance or taxes, does not constitute the acquisition of 'other property' for purposes of this subparagraph."

Treas. Reg. § 1.856-3(b)(1), which is similar to Section 856(c)(5)(B), provides that the term "real estate assets" means real property, interests in mortgages on real property, and shares in other qualified real estate investment trusts.

Treas. Reg. § 1.856-3(c), which is similar to Section 856(c)(5)(C), provides that the term "interests in real property" includes, among other things, 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.

Treas. Reg. § 1.856-3(d) provides that the definition of real property is given in Treas. Reg. § 1.856-10.

Treas. Reg. § 1.856-3(e) provides that the term "securities" does not include "interests in real property" or "real estate assets" as those terms are defined in Section 856 and Treas. Reg. § 1.856-3.

Treas. Reg. § 1.856-5(c) provides rules to apportion interest income to a REIT for purposes of the 75% Asset Test when a mortgage covers both real property and other property:

- Treas. Reg. § 1.856-5(c)(1)(i) provides that, if the loan value of the real property securing the loan is equal to or exceeds the amount of the loan, then the entire interest income shall be apportioned to the real property.

- Treas. Reg. § 1.856-5(c)(1)(ii) provides that, if the amount of the loan exceeds the loan value of the real property, then the interest income apportioned to the real property is an amount equal to the interest income multiplied by a fraction, the numerator of which is the loan value of the real property and the denominator of which is the amount of the loan.

- Treas. Reg. § 1.856-5(c)(2) defines loan value of the real property as the fair market value of such property, determined as of the date that the loan becomes binding on the trust. However, in the case of a construction loan or other loan made for purposes of improving or developing real property, the loan value of the real property is the fair market value of the land plus the reasonably estimated cost of the improvements or developments (other than personal property) which will secure the loan and which are to be constructed from the proceeds of the loan. The fair market value of the land and the reasonably estimated cost of improvements or developments shall be determined as of the date on which a commitment to make the loan becomes binding on the trust. If the trust does not make the construction loan but commits itself to provide long-term financing following completion of construction, the loan value of the real property is determined by using the principles for determining the loan value for a construction loan. Moreover, if the mortgage on the real property is given as additional security (or as a substitute for other security) for the loan after the trust's commitment is binding, the real property loan value is its fair market value when it becomes security for the loan (or, if earlier, when the borrower makes a binding commitment to add or substitute the property as security).

- Treas. Reg. § 1.856-5(c)(3) provides that, for purposes of this paragraph, the amount of the loan means the highest principal amount of the loan during the taxable year.

Treas. Reg. §§ 1.856-10(b) and (d)(1) provide that the term "real property" means land and improvements to land, and the term "improvements to land" means inherently permanent structures and their structural components.

Treas. Reg. § 1.856-10(d)(2)(i) provides that the term "inherently permanent structure" means any permanently affixed building or other permanently affixed structure where affixation may be to land or to another inherently permanent structure and may be by weight alone, and the affixation is considered permanent if the affixation is reasonably expected to last indefinitely based on all the facts and circumstances.

Treas. Reg. § 1.856-10(d)(2)(ii) provides that a "building" encloses a space within its walls and is covered by a roof, and includes houses, apartments, hotels, motels, enclosed stadiums and arenas, enclosed shopping malls, factory and office buildings, warehouses, barns, enclosed garages, enclosed transportation stations and terminals, and stores, to the extent permanently affixed to land.

Treas. Reg. § 1.856-10(d)(3)(i) provides that the term "structural component" means any distinct asset (within the meaning of Reg. § 1.856-10(e)) that is a constituent part of and 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.

Treas. Reg. § 1.856-10(e)(1) provides that 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.

Treas. Reg. § 1.856-10(e)(2) provides that the determination of whether a particular separately identifiable item of property is a distinct asset is based on all the facts and circumstances, and that the following factors must be taken into account: (i) whether the item is customarily sold or acquired as a single unit rather than as a component part of a larger asset; (ii) whether the item can be separated from a larger asset, and if so, the cost of separating the item from the larger asset; (iii) whether the item is commonly viewed as serving a useful function independent of a larger asset of which it is a part; and (iv) whether separating the item from a larger asset of which it is a part impairs the functionality of the larger asset.

4. Definition of Cash

Treas. Reg. § 301.7701-13A(e)(1) provides that "cash" is defined as cash on hand, and time or demand deposits with, or withdrawable accounts in, financial institutions.

5. Revenue Rulings and Private Letter Rulings

In Rev. Rul. 77-199, 1977-1 C.B. 195, the Service held that certificates of deposits held by RICs and REITs constituted "cash items" for purposes of Sections 851 and 856, respectively, where they are generally held in large denominations with a maturity date of one year or less (while noting that, because there is a ready secondary market for the certificates, a holder may avoid any penalty otherwise due on an early withdrawal of funds), and that a court had determined that such a certificate constituted a "cash item" for purposes of Section 3(a)(3) [now Sections 3(a)(1)(C) and 3(a)(2)] of the 40 Act as a type of time deposit.

In Rev. Rul. 2012-17, 2012-25 I.R.B. 1018, the Service held that money market fund shares held by a REIT were "cash and cash items (including receivables)" within the meaning of Section 856(c)(4)(A), based in part on its analysis of an SEC No Action Letter that provided that, under the principles of section 3(a)(1)(C) of the 40 Act, "cash items" hold a "high degree of liquidity and relative safety of principal", and that such a conclusion was not inconsistent with the language of Section 856(c)(4)(A) or its underlying legislative history.

In PLR 201845001 (Aug. 10, 2018), the Service held that a REIT's right to receive certain refundable brownfield income tax credits in connection with its remediation of contaminated land constituted a "receivable" within the meaning of Section 856(c)(4), where the right to receive the brownfield credits was not purchased from another person and where the right arose from the development of real property on land in connection with the leasing business of the REIT (*i.e.,* the right arose in the ordinary course of the REIT's operation within the meaning of Treas. Reg. § 1.856-2(d)(1)).

In each of PLRs 201816001, 201816002, and 201816003 (each Jan. 3, 2018), the Service held that annual payments due from a city in connection with the development of (and construction on) a vacant lot constituted a "receivable" that arose in the ordinary course of the REIT's operation as owner and lessor of real property within the meaning of Treas. Reg. § 1.856-2(d)(1) and was therefore a receivable for purposes of Section 856(c)(4).

In PLR 201518010 (Jan. 29, 2015), the Service held that the right of a parent REIT and its subsidiary REITs to receive a refundable state franchise tax credit in connection with remediation of contaminated land was a "receivable" in the ordinary course of each REIT's business as an owner and lessor of real property within the meaning of Treas. Reg. § 1.856-2(d)(1)(iii) and therefore a "receivable" for purposes of Section 856(c)(4).

In PLR 201428002 (Apr. 2, 2014), the Service held that a REIT's right to receive a refundable state franchise tax credit in connection with its remediation of contaminated land was a "receivable" in the ordinary course of the REIT's business as an owner and lessor of real property within the meaning of Treas. Reg. § 1.856-2(d)(1)(iii) and therefore a "receivable" for purposes of Section 856(c)(4).

B. Analysis

1. Issue 1: Will the Amounts Recorded to the Deposit Accounts Be Treated as "Cash and Cash Items (Including Receivables)" Within the Meaning of Section 856(c)(4)(A)?

As an initial item in this discussion, we note that the meanings of the terms in the phrase "cash and cash items (including receivables)" are not explicitly defined within Section 856 but have their origin in a predecessor provision to Section 851, which pertains to RICs under the Code. As collective investment vehicles, both RICs and REITs are subject to the special tax provisions of subchapter M of the Code; as a consequence, aspects of the REIT rules are modeled on the RIC rules, which were enacted in current form approximately 20 years before the REIT rules and just after the enactment of the 40 Act.[12] Each of Section 856 and Section 851 provide that, to the extent a term used in the REIT or RIC rules (respectively) is undefined, the definition of such term in the 40 Act will govern. As outlined below, because none of the terms in the phrase "cash and cash items (including receivables)" are expressly defined by Section 856, Section 851, or the 40 Act, use of the terms in guidance promulgated under the RIC rules or the 40 Act may be probative, but is not dispositive, for the purposes of determining their meaning under Section 856; instead the terms must be analyzed under Section 856 and guidance promulgated thereunder.

a. "Cash and Cash Items (Including Receivables)" Under the RIC Rules

Section 170 of the Revenue Act of 1942 amended Section 361 of the Internal Revenue Code of 1939 (such provision, "**Former Section 361**") to expand the preferential tax treatment, previously accorded solely to "mutual investment companies", to certain "regulated investment companies" registered under the 40 Act. As amended in 1942, Former Section 361 included certain asset composition requirements and limitations and provided in relevant part that (emphasis added):

> a corporation shall not be considered a regulated investment company for any taxable year unless . . . At the close of each quarter of the taxable year (A) at least 50 per centum of the value of its total assets is represented by *cash and cash items (including receivables)*, Government securities, securities of other regulated investment companies, and other securities for the purposes of this calculation limited in respect of any one issuer to an amount not greater in

[12] Although "mutual investment companies" first received special tax treatment under the Revenue Act of 1936, the version of the RIC rules that served as the predecessor to subchapter M of the Code was first introduced in 1942. Revenue Act of 1942, Pub. L. No. 77-753, §170, 56 Stat. 798 (1942); *see also* Portfolio 740-3rd: Taxation of Regulated Investment Companies and Their Shareholders, II. Historical Background (providing that "[t]he definition of a 'mutual investment company,' as finally incorporated into the Revenue Act of 1936, was added by the Conference Committee without comment" and "[i]n the Revenue Act of 1942, the provisions of supplement Q of the 1939 Code (the predecessor of subchapter M of the 1954 Code) relating to investment companies were substantially amended."). The REIT rules were subsequently introduced into the Code in 1960. Pub. L. No. 86-779, Part II, 74 Stat. 998, 1003-10 (Sept. 14, 1960); *see* Portfolio 742-4th: Real Estate Investment Trusts, I. Introduction, A. Background on REITs ("The real estate investment trust (REIT) has been described as a mutual fund for real estate. The original REIT legislation, enacted in 1960, was intended to provide a tax-favored vehicle through which the average person could invest in a professionally managed portfolio of real property.").

> value than 5 per centum of the value of the total assets of the taxpayer and to not more than 10 per centum of the outstanding voting securities of such issuer . . . .

This limitation continues to apply to RICs today, almost verbatim, under Section 851(b)(3)(A) (emphasis added):

> A corporation shall not be considered a regulated investment company for any taxable year unless . . . at the close of each quarter of the taxable year . . . at least 50 percent of the value of its total assets is represented by *cash and cash items (including receivables)*, Government securities and securities of other regulated investment companies, and other securities for the purposes of this calculation limited . . . in respect of any one issuer to an amount not greater in value than 5 percent of the value of the total assets of the taxpayer and to not more than 10 percent of the outstanding voting securities of such issuer[.]

Section 851(c) provides definitions for certain terms used in the RIC rules, but not for "cash", "cash items" or "receivables". *See* Section 851(c).[13] In addition, Section 851(c)(6) provides that, for purposes of Section 851(b)(3), "[a]ll other terms shall have the same meaning as when used in the Investment Company Act of 1940, as amended".[14] The regulations under

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[13] Earlier versions of Section 851 and Former Section 361 similarly do not define any of these three terms.

[14] Although the RIC rules provide that terms otherwise undefined in the RIC statute have the meaning provided under the 40 Act, neither does the 40 Act include a statutory definition for "cash", "cash item" or "receivables" – meaning that the use of any of these terms withing the 40 Act is, at most, probative for purposes of the RIC statute, but will never be dispositive for purposes of the RIC statute or, for that matter, the REIT statute. *See* 15 USC § 80a-2. Section 3(a)(1)(C) of the 40 Act uses the term "cash items" in its definition of "investment company": it provides that an "investment company" is any issuer that, among other things, acquires or intends to acquire "investment securities having a value exceeding 40 per centum of the value of such issuer's total assets (exclusive of Government securities and *cash items*) on an unconsolidated basis". 15 USC § 80a-3(a)(1)(C) (emphasis added). It is generally understood that, for purposes of Section 3(a)(1)(C) of the 40 Act, the term "cash items" includes cash, coins, paper currency, demand deposits with banks, timely checks of others (which are orders on banks to immediately supply funds), cashier checks, certified checks, bank drafts, money orders, traveler's checks and letters of credit. *See* Robert H. Rosenblum & American Bar Association, Section of Business Law, INVESTMENT COMPANY DETERMINATION UNDER THE 1940 ACT: EXEMPTIONS AND EXCEPTIONS 148–49, 602–03 (2d ed. 2003) [hereinafter Rosenblum]. Notably, certificates of deposit and time deposits typically are not considered "cash items" for this purpose, absent convincing evidence of no financial investment intent. *See id.* at 602–03. This treatment of certificates of deposit and time deposits as "cash items" being dependent on the financial investment intent of the holder is rational in the 40 Act context of defining "investment company", where an underlying investment position could be in the form of cash or some equivalent. In fact, for 40 Act purposes, the term "cash items" can be distinguished from "cash and cash equivalents" "held for investment", as follows: cash items used to meet day-to-day expenses, including working capital, is excluded from the scope of the phrase "cash and cash equivalents" as such cash is not "held for investment". *See* Rosenblum, at 482–83. Thus, for purposes of the 40 Act, one can view "cash items" as a relatively liquid asset that will be utilized in the day-to-day operations of the business (*e.g.*, working capital), while "cash and cash equivalents" can be viewed as a relatively liquid asset that is intended to be held on a longer-term basis for financial investment purposes. As explained in the remainder of Part III.B of this memorandum, the meaning of the phrase "cash and cash items

Section 851 provide no further guidance regarding the meaning of these terms; instead, Treas. Reg. § 1.851-2(c)(1)(i) merely reiterates the statutory requirement that at least 50% of the value of a RICs total assets be represented by certain assets, including "[c]ash and cash items, including receivables".[15]

Although the terms in the phrase "cash and cash items (including receivables)" are not defined in the RIC rules, particular aspects of these definitions were explored in detail in a 1986 General Counsel Memorandum. *See* GCM 39531 (Feb. 5, 1986). In GCM 39531, the IRS Chief Counsel evaluated whether a taxpayer-RIC's use of "overnight loans" (*i.e.*, unsecured loans of money to be returned the following day) constituted a "cash or cash item" rather than an (investment) "security". Acknowledging that none of the terms were defined in Section 851 and that only the term "security" was defined in the 40 Act, the IRS Chief Counsel took an "alternative approach" (today, we would call this a "purposivist" approach, as opposed to a "textualist" approach) in order to determine whether the overnight loans qualified as "cash items" or instead as a "security". In this regard, GCM 39531 stated:

> In light of the absence of specific statutory guidance concerning the distinctions between 'securities' and 'cash or cash items,' we believe that an alternative approach to the instant issue is mandated. Thus for us, the issue as to whether the 'overnight loans' here are 'cash or cash items,' and to be distinguished from 'securities,' under [then] [S]ection 851(b)(4) [*i.e.*, current Section 851(b)(3)] is translated into the issue whether classifying the 'overnight loans' as 'cash or cash items' rather than 'securities' under [S]ection 851(b)(4) runs counter to the purpose for the enactment of the subsection.

Then, drawing on the 1960 legislative history for Section 851, the IRS Chief Counsel determined that a key purpose of the RIC asset tests is to ensure diversification of investment assets (which, by extension, is also true of the REIT asset tests). In light of this, the IRS Chief Counsel concluded:

> We do not believe that the RIC here will be spreading the risks of its investments if it 'sells' federal funds to any single borrower in an amount in excess of 5% of the value of its total assets. Whatever the labels put on the transactions, the

(including receivables)" under Section 856(c)(4)(A) is reasonably viewed as having a broader scope than both of the 40 Act phrases "cash and cash equivalents" and "cash items".

[15] Regulations were promulgated under Former Section 361 in 1943 (the "**Former Section 361 Regulations**"), but they did not address the terms in the phrase "cash and cash items (including receivables)"; instead, they merely reiterated the statutory requirement. *See* 8 Fed. Reg. 1916 (Feb. 13, 1943) (initial promulgation of Former Section 361 Regulations) and 8 Fed. Reg. 15159 (Nov. 4, 1943) (repromulgation of Former Section 361 Regulations as part of reorganization and repromulgation of income tax regulations). Subsequently, when Former Section 361 was moved to Section 851 under the Internal Revenue Code of 1954, Treas. Reg. § 1.851-2 was promulgated in substantially the same form and substance as the Former Section 361 Regulations, and therefore also did not address the terms in the statutory phrase "cash and cash items (including receivables)". Since its promulgation on June 3, 1957, Treas. Reg. § 1.851-2 has remained unchanged as to the references therein to "cash and cash items (including receivables)". The Service and Treasury Department commentary on Treas. Reg. § 1.851-2, including in connection with the initial proposed and final regulation and subsequent amendments, do not address the phrase "cash and cash items (including receivables)" or the terms utilized therein.

> RIC's transactions in federal funds here constitute unsecured loans to the recipient-banks for purposes of [then] [S]ection 851(b)(4). That the length of the transactions is only overnight does not change this. The RIC is at risk in respect of each of the transactions that it makes in federal funds, and we believe we would be remiss if we were to conclude that these arrangements were 'cash or cash items' under [S]ection 851(b)(4). If the RIC could invest more than 5% of its assets in federal funds, nothing would prevent it from loaning 100% of its assets to a single borrower, a circumstance that is inconsistent with the diversification requirement [applicable to RICs under Section 851]. Consequently, the 'overnight loans' are securities for purposes of [S]ection 851(b)(4).

Thus, the IRS Chief Counsel found that the overnight loans were a "security" because (i) to rule otherwise could enable taxpayer-RICs to circumvent the Section 851 diversification requirement and (ii) the taxpayer-RIC had risk of loss in the transaction.[16]

b. "Cash and Cash Items (Including Receivables)" Under the REIT Rules

Section 856 parallels Former Section 361 and current Section 851 in several key respects in connection with the phrase "cash and cash items (including receivables)". First, Section 856(c)(4)(A) similarly provides that a REIT must comply with certain asset composition requirements and limitations. Section 856(c)(4)(A) ("at the close of each quarter of the taxable 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") (emphasis added). Second, Section 856(c)(5) provides definitions for certain terms used in the REIT rules, but not definitions for "cash", "cash items", or "receivables". *See* Section 856(c)(5).[17] Third (and finally), Section 856(c)(5)(F) also provides that "[a]ll other terms shall have the same meaning as when used in the Investment Company Act of 1940, as amended (15 U.S.C. 80a-1 and following)".[18]

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[16] It is worth reiterating that the IRS Chief Counsel struggled with distinguishing between a "security" and "cash and cash items", stating that the "term 'cash and cash items' is to be narrowly construed for purposes of [S]ection 851(b)(4)", but nonetheless acknowledging that "drawing a line between 'cash' and 'near cash' necessarily involves arbitrary choices. Thus the determination as to where to draw the line is not a simple one".

[17] Earlier versions of Section 856 similarly do not define these terms.

[18] *See supra* note 14 for a discussion on the treatment of "cash", "cash items", and "receivables" under the 40 Act. Significantly, the cross-reference in Section 856(c)(5)(F) (and in Section 851(c)(6) as well) is to the 40 Act itself, and not also to the regulations and rules thereunder. Thus, if Section 2 of the 40 Act itself does not define a particular term (*e.g.*, "cash", "cash item", or "receivable"), then the more correct interpretation, from both a textual and a purposivist perspective, would be to interpret such terms in light of Section 856 and the Regulations and other authorities thereunder, rather than wander off into esoteric uses of such terms within the rules and regulations under the 40 Act. For example, "real property" is not defined in Section 856 itself, nor is it defined in the 40 Act, but can there be any doubt that the proper meaning of "real property" for REIT purposes is to be found under Treas. Reg. §§ 1.856-3, 1.856-5, and 1.856-10 and other authorities under Section 856, rather than by considering uses of the term "real property" under the rules and regulations promulgated under the 40 Act? Notably, in Rev. Rul. 2012-17, which addressed whether a money market fund constituted "cash and cash items (including receivables)" within the meaning of Section 856(c)(4)(A), the ruling indicates that where a

Unlike Treas. Reg. § 1.851-2(c)(1)(i), which merely reiterates the Section 851(b)(3) standard, Treas. Reg. § 1.856-2(d) provides a definition of "receivables" and two examples of "cash items"; thus, this regulation should be controlling regarding the meaning of these terms in the REIT context.[19] Specifically, Treas. Reg. § 1.856-2(d)(1)(iii) states:

> Cash and cash items (including receivables). For purposes of this subparagraph the term "receivables" means only those receivables which arise in the ordinary

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term is not defined by the 40 Act itself (and perhaps the regulations thereunder), the Service views other guidance under the 40 Act that defines or discusses a term as probative, but not dispositive, for purposes of determining the meaning of the undefined terms in Section 856. In the published ruling, the Service stated at the outset that "the term 'cash item' is not defined in either the 1940 Act or the regulations under the 1940 Act". Rev. Rul. 2012-17. Although the ruling did discuss the use of the term "cash item" under an SEC No-Action Letter, the Service did not give it determinative weight and made its own determination of whether the money market fund qualified as "cash and cash items (including receivables)" under Section 856(c)(4)(A), stating merely that "[t]he conclusion reached in the SEC No-Action Letter *is not inconsistent with the language of [S]ection 856(c)(4)(A) or its underlying legislative history*" (emphasis added). Ultimately, the conclusion in Rev. Rul. 2012-17 made no mention of such letter and cited only Section 856:

> R's shares in F are described in [S]ection 856(c)(4)(A), which includes 'cash and cash items (including receivables).' R, therefore, satisfies the 75 percent value test under [S]ection 856(c)(4)(A). In addition, as an investment that is includible under subparagraph (A) of [S]ection 856(c)(4), R's shares in F are not treated as investments in securities for purposes of [S]ection 856(c)(4)(B).

Thus, the analysis and holding of Rev. Rul. 2012-17 indicate that sub-regulatory (maybe even sub-statutory) guidance under the 40 Act may be probative, but is not dispositive, of the meaning of undefined terms utilized in the REIT rules. *See also infra* note 19 for an elaboration and confirmation of this point.

[19] IRS guidance has explicitly and repeatedly indicated that a Treasury regulation or other IRS guidance (and not the 40 Act definition itself or its silence) would control if a term is not defined within the statutory text of Section 856(c)(5) but is defined or expounded upon by a Treasury regulation or IRS guidance. For example, the term "security" is not defined by Section 856, but Treas. Reg. § 1.856-3(e) provides that the term "securities" "does not include 'interests in real property' or 'real estate assets' as those terms are defined in [S]ection 856 and this [Treas. Reg. § 1.856-3)]". Under the 40 Act, a REIT's interest in a loan to its TRS would constitute a "security" regardless of whether such loan were secured by real property, yet the Service has correctly concluded that a REIT's ownership interest in a loan to its TRS that is secured by real property is not a "security" for purposes of Section 856(c)(4)(B)(ii), on account of the Treas. Reg. § 1.856-3(e) definition of "security" taking precedence over the 40 Act definition. *See, e.g.*, PLR 200630010 (Feb. 28, 2006):

> There is nothing in the statute or legislative history to indicate that Congress intended that the definition of securities in § 1.856-3(e) not apply for purposes of . . . [S]ection 856(c)(4)(B)(ii). Thus, in applying the [test] under [S]ection 856(c)(4)(B)(ii), the term "securities" does not include real estate assets as defined in sections 856 and 1.856-3.

Similarly, for purposes of its analysis of whether certain tax credits constituted a receivable, and therefore a qualifying asset under the 75% Asset Test, the Service looked solely to the REIT rules and to the real estate industry in which the REIT operated, and so it did not look to the RIC rules or the 40 Act to understand the scope or meaning of "cash and cash items (including receivables)". *See, e.g.*, PLR 201845001 (Aug. 10, 2018) (citing three REIT rules in analyzing whether a brownfield credit constituted a "receivable" within the meaning of Section 856(c)(4)(A), all without reference to the 40

> course of the [REIT]'s operation and does not include receivables purchased from another person.

Further, in describing when a REIT must revalue its assets and when it need not do so under Section 856(c)(4), the regulations provide two examples of "cash items":

> A revaluation of assets is not required at the end of any quarter during which there has been no acquisition of a security or other property since the mere change in market value of property held by the trust does not, of itself, affect the status of the trust as a real estate investment trust. *A change in the nature of "cash items", for example, the prepayment of insurance or taxes, does not constitute the acquisition of "other property" for purposes of this subparagraph*.

Treas. Reg. § 1.856-2(d)(3) (emphasis added). Although prepaid taxes and prepaid insurance are the only types of prepaid items mentioned by the regulation, they are cited as examples

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Act); *see also infra* note 22 and accompanying text. Further, this interpretive question is addressed explicitly by the IRS Chief Counsel in GCM 36580 (Feb. 11, 1976), which provides in relevant part:

> We have determined that the present condominium units are not securities for REIT purposes even though they may be securities under the Investment Company Act of 1940. The fact that the units are "real estate assets" and "interests in real property" under [former Section] 856(c)(6) precludes them from being securities for REIT purposes. The present problem is addressed by Treas. Reg. § 1.856-3(e) which recognizes that there can be an overlap between assets that should be "interests in real property" or "real estate assets" for REIT purposes and "securities" as that term is used under the Investment Company Act of 1940. . . .
>
> It might be argued that Treas. Reg. § 1.856-3(e) is an invalid restriction of the statutory reference found in [former Section] 856(c)(6)(D) to the Investment Company Act of 1940. However, such an argument would fail. [Former Section] 856(c)(6)(D) provides only that terms other than those defined in [former Section] 856(c)(6) have the same meaning as under the Investment Company Act of 1940. "Real estate assets" and "interests in real property" are specifically defined in [former Section] 856(c)(6). Treas. Reg. § 1.856-3(e) simply takes the position that assets that meet the statutory definition of either "real estate assets" or "interests in real property" such as the present condominium units, are not to be labelled under the Investment Company Act of 1940 because those assets have already been defined and therefore [former Section] 856(c)(6)(D) does not apply. We believe Treas. Reg. § 1.856-3(e) is a valid application of the statute.

While Section 6110(k)(3) provides that private letter rulings may not be used or cited as precedent, such guidance is nonetheless indicative of the IRS's position with respect to technical issues. *See* Internal Revenue Manual section 4.10.7.2.9(3) (Sept. 12, 2022) ("A private letter ruling to a taxpayer . . . provide[s] insight with regard to the Service's position on the law and serve[s] as a guide."); *see also Hanover Bank v. Commissioner*, 369 U.S. 672, 686 (1962) (private letter rulings "reveal the interpretation put upon the statute by the agency charged with the responsibility of administering the revenue laws"); *Rowan Cos., Inc. v. United States*, 452 U.S. 247, 261 n.17 (1981) (private letter rulings provide "evidence" about the application of the Code). Accordingly, the IRS's private letter rulings make it clear that, where the REIT statute or a REIT regulation provides the definition of a term utilized in the REIT rules, the IRS considers that the definition in the regulation properly controls even if the 40 Act is silent on the matter or contains a different definition of the same term.

of "cash items". That these items are explicitly described as examples of "cash items" clearly implies that other prepaid items can (and therefore should) also constitute "cash items".

We note that prepaid taxes and prepaid insurance do not have any similarity to each other, beyond the characteristic of being "prepaid" (and, perhaps, as described below, being incurred in the ordinary course of business). An entry for prepaid insurance reflects premiums paid to acquire insurance for a future period. Insurance is a type of financial service and, therefore, the payment or prepayment of premiums reflects an exchange with the insurer, whose receipt of the premium results in a series of rights for the insured. In contrast, the payment or prepayment of taxes reflects merely the satisfaction (or "pre-satisfaction") of a legal obligation: by making a payment or prepayment in respect of taxes, the taxpayer simply relieves itself of that legal obligation in the future, but it does not acquire an entitlement to a service or product. This dissimilarity between prepaid insurance and prepaid taxes, coupled with the fact that each is listed as a nonexclusive example of a "cash item", serves to confirm that Treas. Reg. § 1.856-2(d) contemplated that a broad range of other prepaid items, perhaps even all prepaid items, should also be "cash items". Moreover, the foregoing dissimilarity confirms that Treas. Reg. § 1.856-2(d) should not and cannot mean that, other than being prepaid (and, perhaps, other than being incurred in the ordinary course of business, as described below), there is some common characteristic shared by these two prepaid items, the absence of which would then serve potentially to exclude other prepaid items from similar treatment as a "cash item".

In addition, it is particularly notable that prepaid taxes and prepaid insurance are identified as "cash items", despite the fact that neither prepaid item creates a cash entitlement to the REIT payor (like a revenue "receivable" denominated in currency normally would) and are instead merely prepaid expenditures that mean smaller cash outlays in the future: the definition of "receivables" and the examples of "cash items" in Treas. Reg. § 1.856-2(d) together indicate that a "cash item" includes "near cash" items such as items that may become actual cash (*e.g.*, ordinary course monetary receivables) as well as items that were previously cash and have been paid over to a payee as a prepaid item (*e.g.*, prepaid taxes and prepaid insurance). This definition of "receivables" and the examples of "cash items", which omit any requirement of liquidity or safety (discussed below) that may apply to invested cash, are consistent with the practice of the real estate industry, where tenants (and vendors, including even insurers) may or may not be credit-worthy at a given time.

Two published rulings by the Service analyze whether certificates of deposit and money market funds constitute "cash and cash items" within the meaning of Section 856(c)(4)(A). *See* Rev. Rul. 2012-17, 2012-25 I.R.B. 1018 (June 18, 2012); Rev. Rul. 77-199, 1977-1 C.B. 195 (Jan. 1, 1977).

First, the Service held in Rev. Rul. 77-199 that certificates of deposits are cash items, noting that they are generally held in large denominations with a maturity date of one year or less, but that because there is a ready secondary market for the certificates a holder may avoid any penalty otherwise due on an early withdrawal of funds, and that a court had determined that such a certificate constituted a "cash item" for purposes of then Section 3(a)(3) [now Sections 3(a)(1)(C) and 3(a)(2)] of the 40 Act as a type of time deposit. Rev. Rul. 77-199; *see also* PLR 8516043 (Jan. 17, 1985) (holding that a time certificate of deposit is a "cash item"); Treas. Reg. § 301.7701-13A(e)(1) (identifying time or demand deposits as "cash and cash items").

Similarly, in Rev. Rul. 2012-17, the Service held that money market fund shares held by a REIT were "described in [S]ection 856(c)(4)(A), which includes 'cash and cash items (including receivables)'". The Service accepted the position taken in an SEC no-action letter, which provided that under the principles of section 3(a)(1)(C) of the 40 Act, "cash items" essentially hold a "high degree of liquidity and relative safety of principal", and found that because money market funds must abide by these principles such funds should be classified as cash items because "[t]he conclusion reached in the SEC No-Action Letter is not inconsistent with the language of [S]ection 856(c)(4)(A) or its underlying legislative history".[20] Each of these rulings treats as a cash item a liquid, safe asset held as an investment.[21]

Several PLRs issued by the Service analyze whether an entitlement to refundable state tax credits may be treated as "receivables" within the meaning of Section 856(c)(4)(A). In PLR 201845001 (Aug. 10, 2018), the Service analyzed whether a "brownfield credit" (*i.e.*, a refundable income tax credit based on expenditures associated with remediating, rehabilitating, and redeveloping contaminated land) constituted a "receivable" within the meaning of Section 856(c)(4)(A). In its analysis of this question, the Service cited three REIT rules: (i) Section 856(c)(4)(A) for the requirement that at each quarter-end at least 75% of a REIT's gross assets must "be represented by real estate assets, cash and cash items (including receivables), and Government securities"; (ii) Treas. Reg. § 1.856-2(d)(1) for the definition of "receivables" as receivables that arise in the ordinary course of a REIT's operation, excluding receivables purchased from another person; and (iii) Treas. Reg. § 1.856-2(d)(3) for the definition of "total assets" as the gross assets of the REIT determined in accordance with GAAP.[22] The Service then concluded that the brownfield credits constitute a "receivable", stating:

> Taxpayer will not purchase the Brownfield Credits from another person. The right of Taxpayer to receive the Brownfield Credits arises from the development of real property on land in connection with the leasing business of Taxpayer and Subsidiary. Therefore, the right is a receivable that arises in the ordinary course of Taxpayer's operations within the meaning of [Treas. Reg.] § 1.856-2(d)(1).

[20] *See supra* note 18 for a discussion of the weight given by the Service to the SEC no-action letter when interpreting Section 856. The Securities and Exchange Commission considers a security to be liquid if it can be disposed of in a short period of time in the ordinary course of business (typically seven business days). *See* Response of the Office of Chief Counsel Division of Investment Management, n. 18 and accompanying text (Oct. 23, 2000) (responding to Willkie, Farr & Gallagher, SEC No-Action Letter, dated September 27, 2000 / File No, 132-3), available at https://www.sec.gov/divisions/investment/noaction/2000/willkiefarrgallagher102300.pdf. Money market funds are open-ended management investment companies that largely invest in short-term securities and maintain a high degree of liquidity and safety because they are required to satisfy redeemable securities within seven days. *See id*.

[21] *See supra* note 14.

[22] In its analysis, the Service did not reference the RIC rules or the 40 Act or otherwise suggest that the terms "cash" and "cash items" are not fully and adequately defined by the REIT rules so as to warrant a review of the RIC rules or the 40 Act.

PLR 201845001. This same holding that refundable tax credits constitute a "receivable", without any discussion with regard to the proscription on purchase,[23] takes place in five other rulings issued by the Service:

- PLRs 201816001, 201816002, and 201816003 (each Jan. 3, 2018) ("The right of Taxpayer to receive Taxpayer's share of the Total Annual Payment through its interest in Partnership arises from the development of real property on land in connection with the leasing business of Partnership and Taxpayer. To the extent that Taxpayer's right to receive Taxpayer's share of the Total Annual Payment is an asset under GAAP, such right is a receivable that arises in the ordinary course of Taxpayer's operations within the meaning of [Treas. Reg.] section 1.856-2(d)(1)(iii) . . .");

- PLR 201518010 (Jan. 29, 2015) ("Parent REIT and the Subsidiary REITs will own and lease the Project for the purpose of generating qualifying rents from real property under [Sections] 856(c)(2) and (c)(3). The right of the Parent REIT and each Subsidiary REIT to receive the State franchise tax refund attributable to the Tax Credits constitutes a receivable that arises in the ordinary course of their operations within the meaning of [Treas. Reg.] § 1.856-2(d)(1)(iii) . . ."); and

- PLR 201428002 (Apr. 2, 2014) ("Taxpayer's right to receive a State franchise tax refund attributable to the Credits arises from the redevelopment of real property on contaminated land in connection with Taxpayer's leasing business. . . . Taxpayer's right to receive the State franchise tax refund attributable to the Credits constitutes a receivable that arises in the ordinary course of Taxpayer's operations within the meaning of [Treas. Reg.] section 1.856-2(d)(1)(iii) . . .").

Consistent with the definition of "receivables" in Treas. Reg. § 1.856-2(d), these rulings determine that a "near cash" asset that may become cash in the future is a receivable (and therefore a "cash or cash item") without any inquiry into the liquidity or safety of the asset.[24]

c. Reconciliation of Authorities

Given the absence of fulsome guidance defining the terms in the phrase "cash and cash items (including receivables)" in the REIT and RIC rules, it is reasonable to analyze the terms based

[23] Given a plain reading of Treas. Reg. § 1.856-2(d)(1) and the several PLRs interpreting the meaning of "receivables", it is correct to conclude that the proscription on "receivables purchased from another person" is a separate, independent requirement from (rather than a component of) the requirement that receivables "arise in the ordinary course of the [REIT's] operation".

[24] In fact, one could argue that a refundable state tax credit is highly illiquid and unreliable because it is subject to the uncertainties of audit and the processes of a state bureaucracy to affirm and issue such a credit. We further note that, while it could be questioned as to whether receivables arising from land improvements or the construction of a building to be used in the REIT's rental business constitute receivables "in the ordinary course of…operation", these private letter rulings confirm that receivables that arise from constructing a building and improving land are in fact receivables in the "ordinary course of…operation" for purposes of Treas. Reg. § 1.856-2(d).

on a plain reading of the above authorities. A plain reading of these authorities can be fairly summarized as applying Section 856(c)(4)(A) as follows:

- "cash and cash items (including receivables)" always includes liquid and safe assets such as demand deposits and money market funds;

- when the taxpayer is holding the asset under evaluation as a financial investment, then the asset must be liquid and safe in order to qualify as "cash and cash items (including receivables)"; but, if the asset is not held for financial investment (such as an ordinary course receivable), then the asset need not be liquid or safe in order to qualify as a "cash or cash item", as further described below;

- when not being held for financial investment, "cash and cash items (including receivables)" also includes "near cash" assets that reflect cash to which the taxpayer has an entitlement, such as tenant-related rent receivables and state tax credits generated by construction activities, in each case regardless of the creditworthiness of the tenant, governmental agency, or other payor;

- "cash or cash items" also includes items that were previously cash and have been paid over to a supplier as a prepaid item, such as prepaid taxes and prepaid insurance (again, regardless of the creditworthiness of the supplier-payee obligated to deliver performance), thus translating into smaller cash outlays in the future; and

- a cash item (other than a receivable) apparently need not satisfy the "ordinary course of . . . operation" standard, but even so it is absolutely clear that the "ordinary course of . . . operation" standard encompasses a REIT's activities in constructing a building and improving land.

Taking into consideration all of the above principles, the conclusion from the totality of available guidance is that, because the scope of the phrase "cash and cash items (including receivables)" includes prepaid expenses (*e.g.*, prepaid taxes and prepaid insurance) as well as ordinary course monetary receivables from the construction of real property (*e.g.*, brownfield credits), it also includes prepaid expenditures for construction activities such as amounts recorded to the Deposit Accounts, both when the prepayments represent straight advance deposits on assets to be received later and also when the prepayments cover soft costs from the supplier (such as design activities).

d. Conclusion

The reconciliation of available authorities in subsections a-c, immediately above, clearly indicates that, because the amounts recorded to the Deposit Accounts are a prepayment deemed to create intangible assets that constitute entitlements either to receive Materials or Components in the future or in respect of soft costs in the future, the amounts recorded to the Deposit Accounts are appropriately viewed and treated as "cash and cash items (including receivables)" for purposes of Section 856. Because the amounts recorded to the Deposit Accounts are not assets held for financial investment purposes but are instead straight prepayments of contractual liabilities resulting from the construction of a new data center building by the Company, the liquidity and safety of these assets is not relevant to the analysis; instead, the proper analysis is under the definition of "receivables" and the nonexclusive examples of "cash items" provided in Treas. Reg. § 1.856-2(d) and, for example, described in the brownfield tax credit private letter rulings discussed above.

First, to the extent that the amounts recorded to the Deposit Accounts constitute entitlements to receive items in the future (whether Materials, Components, or soft cost items), the amounts recorded to the Deposit Accounts should, as an "in-kind" (rather-than-money) receivable, fit within the definition of "receivable" found in Treas. Reg. § 1.856-2(d)(1). Such an entitlement would be one that arose in the ordinary course of the applicable construction operations of the Company – *i.e.*, from the development of land improvements treated as real property in connection with the leasing business of the Company – and that was not purchased from another person. *See* Treas. Reg. § 1.856-2(d)(1)(iii); *see also* the discussions regarding the refundable tax credit PLRs in Part III.B.2.c of this memorandum (PLRs 201845001; 201816001-03; 201518010; 201428002).

Second, as "near cash" items that save cash outlays in the future, the amounts recorded to the Deposit Accounts would be indistinguishable from the prepaid taxes and prepaid insurance examples of "cash items" provided in Treas. Reg. § 1.856-2(d)(3). Like the prepaid taxes and prepaid insurance, the amounts recorded to the Deposit Accounts will be accrued as required under GAAP, which does not create a cash entitlement like a traditional "receivable". Further, even though the "ordinary course" standard does not apply to cash items other than "receivables", the amounts recorded to the Deposit Accounts are akin to prepaid taxes and prepaid insurance in that each represents an outlay in the "ordinary course" (with construction clearly being an activity within the "ordinary course of . . . operation" for the Company).

In sum, for the reasons summarized above in Part III.B.1 of this memorandum, the Treasury Department should issue a Notice (or Revenue Procedure) confirming that the amounts recorded to the Deposit Accounts should be properly viewed as "cash and cash items (including receivables)" within the meaning of Section 856(c)(4)(A).[25]

2. *Issue 2: Will the Amounts Recorded to the CIP Account for Items Not Yet Permanently Affixed (Whether for Materials or for Components) Be Treated as "Real Property" Within the Meaning of Sections 856(c)(4)(A) and 856(c)(5)(A)-(B)?*

Neither Sections 856(c)(5)(A)-(B) nor Treas. Reg. § 1.856-10 explicitly address "construction in progress" under the REIT rules. In fact, although Treas. Reg. § 1.856-10 otherwise endeavors to be thorough, its operative language and its examples focus on describing assets that, once completed, are (or are not) "real property".

First, if construction in progress were meant to be characterized and valued in such a way as to preclude such construction from being "real property" (or to make it very difficult to so qualify as a practical matter), then a clearer statement of that principle would have been

[25] As an alternative, one could conclude that the Deposit Accounts should be treated as "real property" within the meaning of Sections 856(c)(4)(A) and 856(c)(5)(A)-(B) for the same reasons that the CIP Account is properly treated as such, all as described in Part III.B.2 below with reference to Issue 2. As a second alternative, based on the cumulative weight of the authorities cited in this Part III.B.1 and in Part III.B.2 below, one could simply conclude that the Deposit Accounts should be treated as a qualifying asset under Section 856(c)(4)(A).

included in Treas. Reg. § 1.856-10 or its regulatory history.[26] Instead, Treas. Reg. § 1.856-10 nowhere boasts that its provisions provide an exclusive definition of "real property" for purposes of Sections 856 through 859. The preamble to the regulation contemplates that the Service would in appropriate circumstances entertain ruling requests on the proper meaning of "real property".[27] The regulation itself contemplates additional guidance in the Internal Revenue Bulletin.[28] This then implies, and perhaps compels, the conclusion that the meaning of "real property" and its "value" in Sections 856(c)(5)(A)-(B) can be broader than what is found in Treas. Reg. § 1.856-10, particularly in situations where that regulation itself is

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[26] When Treas. Reg. § 1.856-10 was under construction (forgive the pun), the only surfaced topic even tangentially related to the "construction in progress" at issue here was the following: already constructed improvements to real property owned by (or mortgaged to) an aspiring REIT that did not have an ownership or other possessory interest in (or, as applicable, a mortgagee interest in) the real property to which the subject constructed improvements were attached. The Treasury decision preamble, in explaining the "held together" legal standard of Treas. Reg. § 1.856-10(d)(3)(i)-(ii), makes the following comment about this topic:

> The Treasury Department and the IRS believe that, to treat an asset as a structural component, a REIT must hold its interest in the structural component together with a real property interest with respect to the space in the [inherently permanent structure] that the structural component serves. . . .
>
> [T]hese final regulations provide that a distinct asset qualifies as a structural component only if the REIT holds its interest in the distinct asset together with a real property interest with respect to the space in the [inherently permanent structure] that the distinct asset serves. In addition, as illustrated by Rev. Rul. 73-425, for a mortgage that is secured by a structural component to qualify as a real estate asset under these final regulations, the mortgage also must be secured by the [inherently permanent structure] served by the structural component.

Treasury Decision ("**T.D.**") 9784, 2016-39 I.R.B. 402, section IV.C. Here, however, the Company does indeed hold its interest in the assets that comprise the CIP Account (Materials and Components) together with a real property interest in the land and other real property into which the Materials and Components will be incorporated. Thus, a favorable conclusion on Issue 2 would not have implications with regard to the very different situation addressed in the preamble to the final regulations and embodied and fully addressed by the "held together" legal standard of Treas. Reg. § 1.856-10(d)(3)(i)-(ii).

[27] The original notice of proposed rulemaking ("**NPRM**") for this regulation (IRS REG-150760-13, issued at 79 F.R. 27508 on May 14, 2014) stated that "[t]he IRS and the Treasury Department view these proposed regulations as a clarification of the existing definition of real property and not as a modification that will cause a significant reclassification of property." Thus, further guidance, including private letter rulings, will continue to be sought for items not explicitly addressed in the final regulations. See, for example, the question in the preamble to T.D. 9784 regarding whether the Service should provide additional guidance as to whether "a distinct asset that serves an IPS may produce electricity that is also sold to third parties and [still] qualify as a structural component of the IPS for REIT purposes." *See also* PLR 201740017 (July 5, 2017), holding that a pipeline dehydrator constitutes real property for purposes of Section 856. The only question on which the Service ordinarily will not entertain a ruling on the meaning of "real property" for a REIT is whether an outdoor advertising display constitutes "real property" for purposes of Section 856. Rev. Proc. 2025-3, 2025-1 I.R.B. 142.

[28] *See* Treas. Reg. § 1.856-10(d)(2)(iv) (for inherently permanent structures) and Treas. Reg. § 1.856-10(d)(3)(iii) (for structural components).

silent.[29] As described below, notwithstanding that Treas. Reg. § 1.856-10 does not address the treatment of "construction in progress", other regulations and IRS precedents have already concluded that construction in progress constitutes "real property", and this approach has been recognized and solidified by Congress in recent years.

Second, given the regulatory preamble to Treas. Reg. § 1.856-10, the meaning of "real property" for Section 856 purposes is to give due regard and balance to (i) the treatment of such property under other Code provisions and (ii) the particular policies underlying the definition as used in the REIT provisions.[30] With regard to the "construction in progress" at hand, both of these interpretation imperatives point in the direction of favorably concluding upon Issue 2: as described above in Part I.C of this memorandum, all construction in progress

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[29] In addition, we have reviewed all 26 comment letters received, analyzed, and republished by the Service between the publication of the NPRM for IRS REG-150760-13 on May 14, 2014 and the finalization of Treas. Reg. § 1.856-10 in T.D. 9784 on August 30, 2016, available at https://www.regulations.gov/document/IRS-2014-0015-0001/comment. None of these 26 comment letters discuss "construction in progress" at all, whether as real property or not.

[30] T.D. 9784, *supra* note 26, contains the following comment regarding the varying definitions of "real property" in the Code as they relate to REITs:

> The preamble to the proposed regulations discussed various Code provisions in which the term real property appears. Noting the diverse contexts and varying legislative purposes of the Code provisions in which the term real property appears, the Treasury Department and the IRS requested comments on the extent to which the various meanings of real property that appear in the Treasury regulations should be reconciled.
>
> Several commenters were concerned that the term real property has different meanings as the term is applied for purposes of different Code provisions, which could lead to confusion and inconsistent treatment of taxpayers. A commenter noted that there is no Federal definition of real property and suggested that another Code provision's restrictions on the use of real property should not preclude a REIT from investing in or financing such real property so long as the property is otherwise inherently permanent. Another commenter noted that under [S]ection 197, certain intangible assets are amortized as separate assets not associated with another asset. A third commenter requested clarification that the final regulations apply only to the definition of real property for purposes of [S]ections 856 through 859, so that there is no conflict between the REIT provisions and other provisions of the Code that govern the investment tax credit and depreciation.
>
> As discussed in the preamble to the proposed regulations, in drafting the proposed regulations, the Treasury Department and the IRS sought to balance (1) the general principle that common terms used in different provisions should have common meanings with (2) the particular policies underlying the definition used in the REIT provisions. These final regulations retain the language in [Treas. Reg.] § 1.856-10(a) of the proposed regulations stating that [Treas. Reg.] § 1.856-10 provides definitions for purposes of part II, subchapter M, chapter 1 of the Code. This language addresses the commenters' concerns by limiting the application of the definition of real property under these final regulations to [S]ections 856 through 859.

is capitalized for Sections 263 and 263A purposes as part of a "building account",[31] and Section 856 conformity with the same is a desirable goal; as described in the balance of this Part III.B.2 of this memorandum, both as a textualist interpretation matter and as a policy matter, the structure of the REIT statute and the presence of a specific rule in Treas. Reg. § 1.856-5(c) mean that both REIT statutory meaning and REIT purposes are furthered by treating "construction in progress" as REIT "real property".

Third, and most important, not only is there a favorable rule for "construction in progress" under Treas. Reg. § 1.856-5(c), but also Section 856(c)(9)(B), which was re-enacted by Congress as recently as 2018, contemplates that such regulatory rule is not merely for purposes of characterizing and measuring qualifying income under Section 856(c)(3)(B) but is in fact a rule for characterizing and favorably valuing "construction in progress" as "real property" for purposes of Sections 856(c)(5)(A)-(B) generally, all as explained in more detail below.

Accordingly, for the combined weight of these three reasons, Materials and Components included within the CIP Account should be favorably treated as "real property" for purposes of the Company's 75% Asset Test.

a. The REIT Mortgage Rules

Section 856(c) provides rules in subsections (c)(1) to (c)(4) that govern the activities of a REIT (*e.g.*, the 75% Asset Test and the 75% Income Test) and then provides definitions applying to those rules in its remaining subsections (c)(5) to (c)(10). Definitions in Section 856(c)(5) apply for purposes of "this part" (*i.e.*, Sections 856 through 859, or the sections of the Code dealing with REITs). Section 856(c)(5)(A) defines the term "value" for such purposes. In general, with respect to securities (except for highly marketable securities) and assets, its provisions mandate that "value" equals the fair value as determined in good faith by the "trustees" of the REIT, which is the board of directors for a corporate REIT. Section 856(c)(5)(B) defines the term "real estate assets" for such purposes. In general, it mandates that "real estate assets" include, in relevant part, "real property" (including "interests in real property" and interests in mortgages on "real property" or on "interests in real property"). As shown below, the REIT mortgage rules further define these statutory terms of "value" and "real property" broadly with regard to construction in progress, not just for purposes of the REIT mortgage rules, but for purposes of the REIT rules generally.

Treas. Reg. § 1.856-5(c) generally treats a mortgage loan as an interest in real property (a "**Good Mortgage**") to the extent of the ratio that the loan value of the real property

[31] *See*, *e.g.*, Section 263(a)(1) (holding that generally no deduction shall be allowed for any amount paid out for new buildings or for permanent improvements or betterments made to increase the value of any property or estate); Treas. Reg. § 1.263(a)-2(d)(1) (providing generally a taxpayer must capitalize amounts paid to acquire or produce a unit of real or personal property, including leasehold improvements, land and land improvements, buildings, machinery and equipment, and furniture and fixtures); Treas. Reg. § 1.263A-1(a)(3) (providing in relevant part that taxpayers subject to Section 263A must capitalize all direct costs and certain indirect costs properly allocable to real property and tangible personal property produced by the taxpayer); Treas. Reg. § 1.263A-2(a)(1)(i) (defining the term "produce" to mean "to construct, build, install, manufacture, develop, improve, create, raise, or grow").

securing the loan (the "**Loan Value of Real Property**") bears to the highest principal amount outstanding under the loan during the year; thus, interest is apportioned between the interest related to the portion of the loan that is secured by real property and the portion of the loan that is not. To make this determination, the Loan Value of Real Property is the fair market value of the collateral that is real property at the time that the loan is made or, if earlier, at the time that the commitment to make the loan becomes binding on the REIT.

The calculation in this regulation was crafted to apportion the REIT's total interest income between income satisfying the 75% Income Test (determined for purposes of Section 856(c)(3)(B)) and generic interest income (qualifying for purposes of Section 856(c)(2)(B) but not also Section 856(c)(3)(B)), but this calculation now provides a legal standard for the determinations required for both the 75% Income Test and the 75% Asset Test in Section 856(c).[32]

Treas. Reg. § 1.856-5(c)(2) also provides a rule for purposes of determining the Loan Value of Real Property when the real property is under construction or development – in other words, for purposes of identifying and valuing real property (i) that is in the process of construction or development and may not yet exist but (ii) that is expected to be completed and to exist in the period after the construction or development is complete. Under this regulation, the Loan Value of Real Property that is under construction or development (in other words, construction in progress) equals the sum of "the fair market value of the land plus the reasonably estimated cost of the improvements or developments (other than personal property)[33] which will secure the loan and which are to be constructed from the proceeds of the loan".

In providing a rule for the valuation of the Loan Value of Real Property, Treas. Reg. § 1.856-5(c)(2) apparently fleshes out the meaning of "value" and "real property" (as the terms are

[32] For example, this calculation was adopted as a "safe harbor" by Rev. Proc. 2014-51 (superseding the similar Rev. Proc. 2011-16) for purposes of determining the amount of a loan that may qualify as a Good Mortgage (*i.e.*, for 75% Asset Test purposes). Rev. Proc. 2014-51 amended the rule in Rev. Proc. 2011-16 to adjust for the fact that the Loan Value of Real Property remains constant at the fair market value as of the time of loan commitment by the REIT, but the value of the loan is the current fair market value, thus creating an anomaly that, if the value of the real property securing the loan *increases* in value over time, the portion of the loan that is treated as a qualifying asset for purposes of the 75% Asset Test *decreases*, exactly the opposite of the economic reality. The Service thus changed the rule to permit substitution of the current fair market value of the real property in place of the Loan Value of Real Property for purposes of the Good Mortgage calculation in such a situation. *See also* PLR 199923006 (Feb. 19, 1999) (adopting a similar rule for second mortgage loans).

[33] This exclusion within Treas. Reg. § 1.856-5(c)(2) for "personal property" is meant to carve out construction of (and corresponding value for) items such as a printing press, which will not be Treas. Reg. § 1.856-10 "real property" even after construction. By definition, neither Materials nor Components included in the CIP Account will become an item of property outside the definition of Treas. Reg. § 1.856-10 "real property", and so the Treas. Reg. § 1.856-5(c)(2) exclusion for "personal property" is not relevant here.

used in Sections 856(c)(5)(A)-(B)) by performing three functions with regard to construction in progress, not just one, and each is vitally important:

1) The regulation determines the **identification** of collateral (*e.g.*, whether collateral assets exist),
2) The regulation determines the **characterization** of such collateral (*e.g.*, whether the assets are real property), and
3) The regulation determines the **valuation** of such collateral (*e.g.*, the determination of the Loan Value of Real Property).

Absent the role played by Treas. Reg. § 1.856-5(c)(2), it might be possible to interpret the silence of the REIT statute in such a way that no "real property" of sufficient value would exist for Section 856 purposes: at the first step of identification, because the constructed property did not yet exist, in theory it could have a value of zero; at the second step of characterization, because the property was not (yet) permanently affixed, in theory it might not be (yet) "real property"; and at the third step of valuation, because of the labor required for permanent affixation, the to-be-constructed "real property" would be valued at its component cost rather than its installed value. But all three of these potential conundrums regarding construction in progress have been favorably and definitively resolved by the Treas. Reg. § 1.856-5(c)(2) interpretations of the terms "value" and "real property" as used in Sections 856(c)(5)(A)-(B). Stated differently, regulations under Section 856 have already concluded that the definition of "real property" includes construction in progress.[34]

b. Sections 856(c)(9)(B) and 856(c)(5)(A)-(B)

The rules provided in Treas. Reg. § 1.856-5(c) are not limited to the context of the 75% Asset Test or the 75% Income Test as applied to a mortgage loan asset. Instead, as shown below, Treas. Reg. § 1.856-5(c) is directly linked to the broader statutory framework provided by Section 856(c)(9)(B), as both the regulation and the statute address mortgage collateral (and not just the mortgage loan asset) that encompasses both real property and other property.

Section 856(c)(9) has the title "Special rules for certain personal property which is ancillary to real property". And one of Section 856(c)(9)'s subsections is Section 856(c)(9)(B), titled

[34] Although this is not under the REIT umbrella, we note that the Section 48 Investment Tax Credit (**"ITC"**) rules exemplify the same construction in progress principle that we describe. ITC is an "asset-identity-focused" regime (much like the REIT rules) that is more attentive to (rather than silent on) large capital-intensive construction projects, so its example is illuminating. Under Sections 48(a)(10) and (11), the prevailing wage and apprenticeship provisions require the taxpayer to determine what constitutes "energy property" at the outset of construction, so that laborers and mechanics are properly paid prevailing wages during the construction of that energy property. The ITC rules demand a highly granular look at whether particular components are functionally interdependent with, or integral to, the ultimate energy project. *See* Treas. Reg. § 1.48-9(f). And importantly, whether those components are as yet physically affixed to other components is irrelevant, to the point that the prevailing wage and apprenticeship rules can apply even when construction activities on energy property occurs off-site. *See* Treas. Reg. §§ 1.45-7(d)(7) and 1.48-13(b). In other words, ITC treats construction of components as a phase of the same asset, not as a different asset waiting to be transformed into something new. ITC's placed-in-service rule determines only when the credit crystallizes and not how the component property is classified while it is being built, and so "under-construction" property is treated as the very same "energy property" that will ultimately be placed in service, regardless of whether it has been finally affixed.

"Certain personal property mortgaged in connection with real property". Just as with Treas. Reg. § 1.856-5(c), Section 856(c)(9)(B) also performs identification, characterization, and valuation functions, as follows:

- Subsection (B)(i) provides that the entire mortgage shall be treated as real property for purposes of the 75% Asset Test and that all the income from it shall be treated as good income for purposes of the 75% Income Test, as long as the fair market value of the amount of personal property collateral securing the mortgage does not exceed 15% of the total fair market value of all the collateral property securing the mortgage; and

- Subsection (B)(ii)(I) provides that the fair market value of all such collateral property (*i.e*., as to identification, characterization, and valuation) shall be determined in the same manner as collateral property is identified, characterized, and valued for purposes of Section 856(c)(3)(B).

Tellingly, Section 856(c)(9)(B)(ii)(I) describes the rules applicable in Section 856(c)(3)(B) (and the Treasury regulations promulgated thereunder) as rules for determining the "value of real property" in a situation where there is personal property that is ancillary to real property. In turn, those rules are provided by Treas. Reg. § 1.856-5(c), which (as noted) includes the special rules in Treas. Reg. § 1.856-5(c)(2) for construction in progress. But of course, there is no special statutory rule for the meanings of "value" or "real property" in the text of Section 856(c)(3)(B), and instead these terms have the same meaning provided for them in Sections 856(c)(5)(A)-(B), which apply for purposes of "this part" (*i.e*., all of Sections 856-859).

In other words, when Section 856(c)(9) cross-references Section 856(c)(3)(B) for use in determining the value of real property, it means that the rules applicable for valuing the collateral under Section 856(c)(3)(B) are applicable for valuing the collateral in the entire part, not just for a special rule involving mortgage loan assets, since the value of the collateral is what feeds into the rest of Section 856(c)(9). Therefore, by the regulatory structure of Treas. Reg. § 1.856-5(c), Section 856(c)(3)(B), and Sections 856(c)(5)(A)-(B), Congress has decreed that the three principles laid out in Treas. Reg. § 1.856-5(c) pertaining to construction in progress with regard to identification, characterization, and valuation should apply for all purposes in the REIT rules of "this part".

Congress clearly provided for the above result in 2015 when it first adopted the language we currently see in Section 856(c)(9)(B)(ii)(I) as the flush language of then Section 856(c)(9)(B), and then Congress re-adopted this rule in 2018 when it moved the subject language into the present Section 856(c)(9)(B)(ii)(I).[35] We note that the accompanying legislative history does not discuss this issue and so it does not and cannot confirm the above exegesis, but, as the

[35] We note that the 2018 re-enactment of this principle post-dates the finalization of Treas. Reg. § 1.856-10, thus confirming the statutory primacy of the broader meaning of "real property" provided here.

Tax Court and U.S. Supreme Court have repeatedly ruled, we need look no further than the plain meaning of the statutory text.[36]

To read Treas. Reg. § 1.856-10 with regard to construction in progress in a narrow fashion is contrary to the canons of legal interpretation: (i) Treas. Reg. § 1.856-10 must be read holistically and congruently with Treas. Reg. § 1.856-5(c) and (ii) with regard to construction in progress whose attachment will happen soon, the rule in Treas. Reg. § 1.856-5(c), as codified by Section 856(c)(9)(B), must trump the silence in Treas. Reg. § 1.856-10 because the specific trumps the general and because the later-in-time statute that addresses construction in progress must trump the earlier regulation that is silent on construction in progress.

Finally, there is no statutory indication that the meaning of Section 856 "real property" should have one meaning for purposes of determining the existence of collateral for a mortgage and a different meaning more generally**.** In fact, we believe that Treasury and IRS must give a single and consistent meaning to "real property" throughout Section 856, because there would have to be a clear Congressional directive for a different meaning to be recognized for some purposes and not others, and Congress has already spoken to that point when it enacted Section 856(c)(9)(B). Under the Supreme Court's decision in *Loper Bright Enterprises v. Raimondo*, 603 U.S. 369 (2024), decisions by regulatory agencies cannot resolve possible interpretations in a statute in a way that contravenes the text and intent of Congress.

c. Other Interpretations Lead to Absurd Results

Although statutory intent is less important than the statutory text, we observe that the failure to treat construction in progress as "real property" under Sections 856(c)(5)(A)-(B) would be at odds with the Code's approach to retired property, which retains its character even after retirement.[37]

We further note that, without applying this approach of valuing construction in progress as real property for Sections 856(c)(5)(A)-(B) purposes by reference to the prescription in Treas.

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[36] *See, e.g.*, *Varian Med. Sys., Inc. v. Comm'r*, 163 T.C. No. 4 (2024):

> For the reasons we have described, Congress spoke clearly on the point at issue when it enacted [S]ection 245A and selected the mismatched effective dates for that provision and the amendments to [S]ection 78. Appeals to policy and Congress's overarching purpose cannot overcome these choices, no matter how much the Commissioner may dislike them. *See Great-West Life & Annuity Ins. Co. v. Knudson*, 534 U.S. 204, 220 (2002) ("[V]ague notions of a statute's `basic purpose' are . . . inadequate to overcome the words of its text regarding the *specific* issue under consideration." (quoting *Mertens v. Hewitt Assocs*., 508 U.S. 248, 261 (1993))); *see* also *Metzger Tr. v. Commissioner*, 693 F.2d 459, 472 (5th Cir. 1982) ("As understandable as it may be, yielding to the temptation to `do equity' in a specific tax case by looking past plain language to judicially perceived purpose will not do."), *aff'g* 76 T.C. 42 (1981); *Metzger Tr.*, 76 T.C. at 59 ("Courts do not have the power to repeal or amend the enactments of the legislature even though they may disagree with the result; rather, it is their function to give the natural and plain meaning to the statutes as passed by Congress.").

[37] *See* Rev. Rul. 75-544, 1975-2 C.B. 343, which provides that depreciable property that had been used in a trade or business for its economically useful life prior to being sold retains its classification as Section

Reg. § 1.856-5(c)(2), the consequences to a REIT-mortgagee could be devastating if the REIT were constrained to take ownership of the mortgaged collateral following a borrower default (for instance, via a judicial foreclosure) due to the silence in Treas. Reg. § 1.856-10. That is, it would be paradoxical for a REIT-lender to be the holder of a real estate asset that constitutes a Good Mortgage while the REIT acts as a lender because, for instance, the entire projected cost of the collateral under construction is treated as real property under Treas. Reg. § 1.856-5(c)(2), but then upon foreclosure to have *that same collateral* treated as other than real property in the REIT's hands. Yet that would be the result for REIT purposes if the treatment of construction in progress used by Treas. Reg. § 1.856-5(c)(2) were somehow deemed not to apply for purposes of Sections 856(c)(5)(A)-(B), and instead the silence of Treas. Reg. § 1.856-10 were interpreted as a rejection of the treatment of such collateral items as real property.

In that event, the REIT might actually be unable to foreclose or otherwise take legal ownership of the collateral-under-construction, for fear that its ownership of the same would cause it to violate the 75% Asset Test. The effect of such an interpretation would be to discourage and dissuade the REIT from exercising its legal remedies as a secured lender. Not only would such an interpretation provide a competitive advantage to non-REIT lenders, but it could create financial havoc for REIT lenders.

Moreover, the Service has consistently interpreted the REIT rules in a manner such that compliance with the REIT rules does not interfere with the ability of REITs to pursue available legal remedies such as foreclosure. For instance, the Service has issued multiple private letter rulings, long predating Section 856(c)(5)(J), in which it ruled that receipt of gross income (under generally applicable federal income tax purposes) would be disregarded for purposes of Sections 856(c)(2) and (c)(3). The rationale for each of these rulings was in part that the REIT rules should not disadvantage REITs from pursuing remedies as an ordinary commercial actor:

1. PLR 200127024 (April 4, 2001) (merger "break fee"; "There is nothing in the legislative history or any statutory interpretation that would indicate that by imposing parameters on the sources from which REITs and RICs may derive income Congress intended to discourage REITs and RICs from pursuing legal remedies for which damages may be collected.").

2. PLR 200039027 (June 29, 2000) (litigation award; same).

1231 property (that is, property "used" in a trade or business) instead of Section 1221 property (that is, property held by a taxpayer whether or not used in its trade or business) when it is ultimately sold. *See also Graves Bros. Co. v. Comm'r*, 17 T.C. 1499 (1952) ("Property acquired for use in a trade or business does not lose its character as such property merely because it ceases to be actively used in the business."); *cf*. Section 864(c)(7) (property used in a trade or business in the United States retains this characterization for a period of ten years following the cessation of that usage). In *Graves Bros*., the property at issue was acquired as part of a larger parcel that was indeed used in the trade or business, but these parts of the property were not so used. *See id.* at 1506. But the Tax Court held that the property's acquisition as part of the larger property that was so used permitted the property itself to be so characterized. *Id.*

3. PLR 9636014 (June 6, 1996) (leasing dispute; same).

4. PLR 9308013 (Nov. 24, 1992) (treble damages; same).

5. PLR 200414025 (Dec. 17, 2003) (guarantor substitution payment; same).

In addition, with regard to the computation of earnings and profits ("**e+p**") for various REIT purposes (including the entity-level dividends paid deduction and the shareholder-level taxable dividend inclusion), the REIT statute itself is glitchy, but the Service nevertheless has, correctly in our view, found a way to look at the law holistically and come to the correct e+p answers. *See, e.g.*, PLR 200534013 (May 12, 2005) (a REIT with both net capital gains and a fully offsetting net operating ordinary loss would be permitted to treat as a dividend its full distribution of its net capital gains, despite it not having sufficient e+p for dividend treatment for the full amount under normal e+p rules, thereby allowing an amount of net capital gain equal to the designated capital gain dividends to be excluded under (today's) Section 857(b)(3)(D) in determining the REIT's net operating loss carryover from the taxable year); *see also* PLR 202235006 (June 3, 2022) (due to timing differences between the methods required for depreciation adjustments for e+p versus taxable income, taxpayer would under normal e+p rules have insufficient e+p to fully distribute its Section 481(a) income inclusions from depreciation method changes, but given the intent and purpose of Section 857(d), nevertheless the taxpayer could "top up" its e+p for the entity-level dividends paid deduction and the shareholder-level taxable income inclusion), which is just one of several such PLRs on this specific e+p "top up" topic.

That a secured lending presupposes the possibility of a foreclosure on the collateral securing the loan is clear and obvious. The right of a secured lender to exercise its remedies under the loan agreements and local law, including a right of foreclosure, would seem to be the type of legal remedy which the Service has agreed that the REIT rules are not supposed to impede. *See also* Rev. Rul. 74-191, 1974-1 C.B. 170 ("the term 'mortgages on real property' includes a security interest which, under the laws of the jurisdiction in which the property is located, is the legal equivalent of a mortgage or deed of trust in the United States.").

We note that the long-standing codification of the foreclosure property rules is strong evidence that Congress intended to support the ability of a REIT lender to exercise normal creditor's remedies, and to act as a normal secured creditor with respect to collateral under construction or development, without undue fear of violating the REIT rules. *See* Section 856(e) and Treas. Reg. § 1.856-6 (which provide special REIT rules for foreclosure property but do not otherwise address construction in progress). In fact, the ability to foreclose on real property collateral seems to be a mandatory component of a lender's ability to engage in mortgage lending as a "REIT-able business": for example, Rev. Proc. 2003-65 (relating to mezzanine loans) ***requires*** that a REIT be able to take possession of the collateral (in that case, an equity interest in a disregarded entity or partnership), the premise being that a foreclosure right is the *sine qua non* of being a Section 856 "mortgage". *See* Rev. Proc. 2003-65, 2003-2 C.B. 336, Section 3.04 ("[u]pon default and foreclosure on the secured loan, the lender will replace the borrower as a partner in the partnership or as the sole member of the disregarded entity. In the case of a loan secured by a partnership interest, the other partners in the partnership must have agreed that upon default and foreclosure they will not unreasonably oppose the admission of the lender as a partner.").

In addition to the absurd results explained above for a REIT-mortgagee, there are also absurd results for equity REITs like the Company, if the treatment of construction in progress used by Treas. Reg. § 1.856-5(c)(2) were somehow deemed not to apply for purposes of Sections 856(c)(5)(A)-(B), and instead the silence of Treas. Reg. § 1.856-10 were interpreted as a rejection of the treatment of such items as real property. For example, as described in Part III.B above with reference to Issue 1, the Company's deposits associated with the ordering of (and partial payment for) an expensive and long-lead-time Component, such as a data center building back-up generator, is properly treated as a qualifying asset under Section 856(c)(4)(A). Then, in due course and as part of the construction timeline: the Company will receive and take title to that Component such that the value of the same is then included in the Company's CIP Account, even though the Component may not be permanently affixed into the data center building for one or more calendar quarters following receipt; next, the Component (the value of which is still part of the Company's CIP Account) will be permanently affixed into the data center building in a manner that satisfies Treas. Reg. § 1.856-10. Without the benefit of the Congress-mandated interpretation explained and sought in this Issue 2, a contract order (and deposits thereunder) for a Component such as the building back-up generator would start off as a qualifying asset under Section 856(c)(4)(A), then toggle to a nonqualifying asset upon receipt and for the temporary duration prior to permanent affixation, and then toggle back to a qualifying asset under Section 856(c)(4)(A) upon permanent affixation. Development and construction of data centers is a natural extension of permitting REITs to own and lease out the same, and surely a pointless and counterproductive back-and-forth, REIT asset qualification toggle like this makes no sense.

The above brief summary thus illustrates the mischief that could have ensued had Congress not adopted a statutory rule confirming the characterization of construction in progress as "real property". As explained above, such favorable characterization is both consistent with and integrated into the remainder of the statutory text of Sections 856 through 859.

Finally, as a thought experiment, we posit the situation of a REIT taxpayer that relies on a "safe harbor" "reasoned, written opinion" (within the meaning of Treas. Reg. § 1.856-7(c)) with regard to a favorable conclusion on the subject matter of this Issue 2 for purposes of its compliance with the 75% Asset Test. We further posit that such REIT taxpayer later fears that its relied-upon legal conclusion was not in fact correct. Such REIT taxpayer could then self-report both its failure and its "reasonable cause" for the same (*i.e.,* the "safe harbor" reliance on the "reasoned, written opinion"), pursuant to the provisions of Sections 856(c)(7)(A) and (C). The tax cost for this self-remediation would then be the greater of (I) the net income generated by the "construction in progress" assets from the time of their receipt until the time of their permanent affixation (which amount of net income is nil), multiplied by the corporate tax rate of 21%, or (II) $50,000; in essence, this posited REIT taxpayer would simply owe $50,000 for its failure, which is not much of a penalty. The absence of a meaningful monetary penalty in the posited situation is indicative that there was no infraction of the 75% Asset Test in the first place on account of the construction in progress assets.[38]

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[38] "Because the law worketh wrath: for where no [penalty] is, there is no transgression". Romans 4:15 (King James Version). There is a recent working example of this interpretation principle under the REIT statute in PLR 202440007 (June 25, 2024). That PLR confirmed that Sections 856(c)(2)-(4) are satisfied

d. Conclusion

The Treasury Department should issue a Notice (or Revenue Procedure) confirming that amounts recorded to the CIP Account that pertain to unaffixed assets (whether for Materials or for Components) should be properly treated as real property under Sections 856(c)(4)(A) and 856(c)(5)(A)-(B) because such treatment is consistent with the REIT rules in all respects, regardless of the precise time the assets become permanently affixed.

* * *

by an "empty" REIT with zero gross income and zero gross assets. Our firm believes that PLR 202440007 was well reasoned and reached the correct conclusions, and in fact we have for many years been on published record with a deep analysis of this topic and also reached the same favorable conclusions. *See* Ponda, Wellings, & Lee, "Remediation of M&A REIT Targets", text accompanying notes 26-29 and notes 32-35, available at https://sullivan.gjassets.com/content/uploads/2024/10/Remediation-of-MA-REIT-Targets-4884-9137-8219.17.pdf. Among our many arguments for the favorable PLR 202440007 conclusions is that the IRS Form 1120-REIT, Part III instructions for the Section 857(b)(5) "reasonable cause" penalty very clearly arrive at a penalty of zero if an "empty" REIT tries to self-remedy a perceived failure for being "empty", thus signifying that there was no transgression in the first place, for where there is no penalty there is no violation of law. *See id.* at note 29.