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Phone: +1 646 783 7100 | Fax: +1 646 783 7161 | customerservice@law360.com

Fiber Optic Networks Newest Consideration For REITs

By **Andrew McIntyre**

Law360, New York (August 06, 2014, 10:31 PM ET) -- As fiber optic network businesses join the host of companies seeking to restructure as real estate investments trusts and challenge the traditional rules of what's considered real estate in the process, lawyers say they face challenges in determining whether telecommunications companies can call their assets REITs.

The news last week that Windstream Holdings Inc. was spinning off a real estate investment trust with fiber optic networks as much of its core assets offers some clarity on the issue, since companies now know it's possible to get Internal Revenue Service blessing for such structures. But companies that own such networks are still trying to make sense of their options.

And while, as with any new asset class, the rules are not yet entirely clear, lawyers say companies will consider setting up similar structures in the wake of the Windstream news.

"It has been a hot topic under consideration with clients and others for a period of time now," said Michael L. Hermsen of Mayer Brown. "Now that this is out there, we're going to see more activity in this area."

Over the past few years a spate of companies have sought convert to REITs or spin off real estate portions of their company into REITs, which by definition distribute at least 90 percent of their taxable income to shareholders. Companies have successfully made their case with the IRS that billboards and cellphone towers can be considered real estate assets for REIT purposes.

And REITs have become attractive places for investors to park their money, given their relatively high yields.

"Fiber optics as real estate seems to be new as an asset class that's held within a REIT," Carl J. Riley of Greenberg Traurig LLP said. "If you have a fiber optic cable system laid in ground and expected to be there long term ... then under the IRS regulations, it probably would be considered real estate."

REITs have to satisfy two main tests: Assets have to be primarily real estate, and those assets have to generate rental income. Both of these tests pose issues for companies looking to use fiber optics as real estate assets.

Although the government's proposed regulations released earlier this year touch on issues that could apply to fiber optics — as in its examples involving oil pipelines — those proposed regulations don't directly address the question of fiber optics, and lawyers are faced with the ever more complex challenge of advising companies on just what is and is not real property for REIT purposes.

Karen F. Turk of Goodwin Procter LLP said a law firm can analyze a company's assets and compare them to the scenarios in the proposed IRS rules to offer advice on whether the company may or may not have qualifying assets.

When nontraditional assets are involved, the process of gaining the green light from the IRS typically involves a back and forth between the IRS and the company, with which lawyers help. Companies lay out their pitches for how they plan to structure the REIT, the IRS responds, the company may offer revised pitches, and assuming the IRS approves, it issues a so-called private letter ruling.

"As you get into some of these other asset classes, the question becomes whether that qualifies. You've needed the IRS to give you comfort," Hermsen said. "With Windstream coming out, they're starting to give people comfort when they ask for it. ... It becomes a little more of a complicated structure."

Companies also need to determine whether fiber optics, if considered real estate, can generate rental income to pass that portion of the REIT test. In the case of Windstream, the company was able to structure its spinoff such that the new REIT would lease the use of the fiber optics networks back to Windstream.

Structuring such a spinoff and lease agreement in compliance with REIT rules, though, is no easy task, lawyers say. And it's further complicated given that the real estate asset in question is a highly nontraditional asset.

But despite the complexities, what often happens when a company gains approval for a nontraditional REIT is that other companies follow suit, says Susan Persin of real estate research firm Trepp LLC.

"I imagine they are all looking at it," Persin said.

So as the definition of REIT real estate assets evolves, companies' areas of focus may shift too, attorneys say.

"As the world changes, we're having to take a different look at what real estate assets are. In the 1960s, we didn't have data storage centers or cellphone towers," said Patricia McGowan of Venable LLP. "This may open up some opportunities."

--Additional reporting by Tom Zanki. Editing by Kat Laskowski and Chris Yates.
