



# Call for REIT Guidance: Data Centers and Cloud Solutions

Over the last decade, the need for consumption and storage of data has increased at an exponential rate. This has sparked a revolution in the data center space, resulting in a movement towards hyperscale facilities that can meet the demands of companies in an increasingly cloud-based environment.<sup>1</sup>

Hyperscale facilities dwarf the footprint of traditional colocation data centers, host a variety of businesses, and cater to a wide range of scalable applications. Naturally, data center providers have been progressively investing in this space, including owners/operators that are structured as real estate investment trusts (“REITs”).<sup>2</sup>

Treasury Department guidance is severely lacking for REITs hosting cloud-based solutions in conjunction with traditional colocation arrangements in a hyperscale environment. The IRS has not issued any Private Letter Rulings (“PLR”) on cloud-based transactions and their impact on REIT qualification, leaving taxpayers to evaluate a single proposed regulation relating specifically to cloud transactions and analogies from PLRs issued in connection with unrelated REIT-compliant industries to draw conclusions on the permissibility of providing cloud arrangements to REIT tenants.

## Proposed Regulations

Proposed regulations (“Regulations”) on cloud transactions have been drafted from an international income tax sourcing perspective; however, in its current form, the guidance could extend into other areas of the tax law.<sup>3</sup> The Regulations take an “all or nothing” approach to classifying cloud transactions as either the provision of services or a lease, and they are heavily biased towards the former.<sup>4</sup> The Regulations do not provide a single example of a contract for cloud infrastructure being classified as a lease. In addition, the Regulations significantly understate the importance of long-established real estate legal

principals such as economic possession, location, or the provision of incidental services in a tenant/landlord relationship. While taxpayers are not bound by proposed regulations, the understatement of these factors and the “all or nothing” approach of the Regulations may dissuade cloud-heavy data centers from pursuing REIT structures, despite the inherently real estate-intensive nature of their business and contracts.

## Analogous Industries

An alternative approach to relying on the Regulations is to analyze previous PLRs and final regulations that address other industries that have business characteristics similar to those of cloud data centers.<sup>5</sup> For example, take the cold storage industry as an analogous sector. Cold-storage has generally been blessed by the IRS as a REIT-compliant endeavor and shares the following parallels with cloud-heavy data centers:<sup>6,7</sup>

- Real estate footprint, capital-intensive facility build-out, and specialized building systems<sup>8</sup>
- Arrangements with customers in terms of who controls the asset, how customers may access leased space, and the responsibilities of the provider<sup>9</sup>
- The significant lease of personal property and the provision of both customary and non-customary services<sup>10</sup>

Another comparable REIT-compliant industry is the oil and gas pipeline sector.<sup>11,12</sup> The pipeline and the cloud data center industries share the following contractual similarities, which all play a key role in REIT qualification:

- Customer fees based on throughput<sup>13,14</sup>
- The commingled nature of storage and usage of products<sup>15</sup>
- The substantial usage of personal property to facilitate the movement and storage of products<sup>16,17</sup>

Among other non-traditional REIT businesses, cold storage and pipelines suggest that there may be hope for structuring cloud-hosting hyperscale facilities into a REIT, despite the lack of authoritative guidance. As such, leveraging the technical and practical experiences gained from other unconventional real estate industries will be of paramount importance in navigating this emerging trend for data center REITs.

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## Endnotes

- <sup>1</sup> Maya Derrick, “The future of hyperscale data centres: exerting influence,” *DataCentre Magazine* (October 3, 2023), <https://datacentremagazine.com/articles/the-future-of-hyperscale-data-centres-exerting-influence>.
- <sup>2</sup> John Barwick, “2024 REIT Outlook Global REIT and Real Estate Performance and 2024 Expectations,” Nareit (December 4, 2023), <https://www.reit.com/news/blog/market-commentary/2024-global-reit-performance>.
- <sup>3</sup> Prop. Treas. Reg. §1.861-19.
- <sup>4</sup> Id.
- <sup>5</sup> Treas. Reg. §1.856-10.
- <sup>6</sup> PLR 200027034 (Jul. 7, 2000).
- <sup>7</sup> PLR 202012003 (Mar. 20, 2020).
- <sup>8</sup> PLR 200027034 (Jul. 7, 2000).
- <sup>9</sup> PLR 202012003 (Mar. 20, 2020).
- <sup>10</sup> Id.
- <sup>11</sup> PLR 202150014 (Dec. 17, 2021).
- <sup>12</sup> PLR 202410005 (Mar. 8, 2024).
- <sup>13</sup> Id.
- <sup>14</sup> PLR 202150014 (Dec. 17, 2021).
- <sup>15</sup> Id.
- <sup>16</sup> Id.
- <sup>17</sup> PLR 202410005 (Mar. 8, 2024).