

Client Alert

A report
for clients
and friends
of the Firm May 2009

Infrastructure and REITs: Happy Together

The Opportunity

The American Recovery and Reinvestment Act of 2009 was signed into law by President Obama on February 17, 2009 (“ARRA”). It includes significant spending and tax cuts in connection with improving the nation’s infrastructure. The spending is focused on improving roadways, updating the aviation system, replacing and maintaining water systems, and making the energy grid more modern, reliable and efficient. The tax cuts target infrastructure improvements such as modernizing the electrical transmission grid. While the dollar amounts appropriated by ARRA are staggering and the projects encompass virtually every facet of infrastructure, this public funding is only a small portion of what will be needed over the next decade. Private investment is necessary to bridge the gap between what has been appropriated by ARRA and actually what will be needed to finance the infrastructure improvements.

This focus on infrastructure investment recalls a private letter ruling issued by the Internal Revenue Service (the “Service”) less than two years ago that added to the permissible investments for a real estate investment trust (“REIT”) to include infrastructure systems. While a private letter ruling cannot be relied upon by taxpayers, other than the actual taxpayer who requested and received the ruling, they do provide insight into the views of the Service’s National Office. At the time it seemed that this ruling would generate interest by REITs to explore the opportunity to own infrastructure assets as part of their portfolios. It has yet to be seen if this will be the case; however, the debate on ARRA brought to light the need for improving and updating the nation’s infrastructure systems which in countless instances have become or soon will be antiquated. In view of the government’s

focus on infrastructure improvement, REITs should be considered as vehicles to efficiently finance and sustain some of these infrastructure projects on a tax-advantaged basis. Further, REITs should be looked at as vehicles to fund internal growth and the acquisition of infrastructure companies by master limited partnerships (“MLPs”) which could contribute assets to a REIT subsidiary for that purpose. This subsidiary would then execute an offering of shares to raise the necessary capital. MLPs also could consider electing REIT status in order to eliminate some of the negative tax structural aspects of MLPs (as compared to REITs), including complex tax accounting, the pass-through of “unrelated business taxable income” to tax-exempt investors, and the U.S. taxation of foreign investors’ “effectively connected income.” Furthermore, REITs generally have deeper access to capital than MLPs.

Infrastructure as a REIT Asset

In Private Letter Ruling 200725015,¹ the Service determined that an infrastructure system qualified as a “real estate asset” within the meaning of Section 856(c)(4)(A) and (5)(C) (i.e., a qualifying REIT asset), and that the REIT’s activities in relation to the system will not cause income received under the lease of such system to be treated as other than “rents from real property” under Section 856(d) (i.e., qualifying REIT income).²

The ruling stated that the REIT acquired one or more “systems” that it leased to a lessee licensed to operate the system. The REIT did not attempt to obtain a license to operate the system. The lease arrangement was a “triple net” lease and rent was not based on the lessee’s net income or profits. The lessee provided all the tools, equipment and personnel necessary to operate the system. Furthermore, the lessee paid the REIT for the use, or the right to use, the system, and the REIT did not furnish any services in connection with the lease.

¹ June 22, 2007.

² All section references are to the Internal Revenue Code and the Treasury Regulations thereunder.

According to the ruling, the system was a unit of physically connected and functionally interdependent assets that serve as a conduit to allow a certain commodity created by a generation source to flow through the system to end users. The system was passive and did not include any machinery or equipment that creates or generates any of the commodity or any audio, video, electrical signal or other commodity. It further stated that the system was clearly distinct from the system that generated the commodity. While the ruling does not state so, it is understood that the “system” referred to was an electric transmission and distribution company’s wires and pipes and the commodity was electricity.

A REIT must meet certain requirements on an on-going basis in order to take advantage of the special tax treatment it is afforded under the Internal Revenue Code. In particular, among other things, a REIT must meet certain asset and income requirements.

At the end of each quarter of a REIT’s taxable year, at least 75% of the value of its total assets must consist of real estate assets, cash and cash items, and government securities.³ The term “real estate assets” includes real property (including interests in real property) and shares in other REITs.⁴ The term “Interests in real property” includes fee ownership and co-ownership of land or improvements on the land, leaseholds of land or improvements to the land, options to acquire land, leaseholds, and options to acquire leaseholds.⁵ “Real property” includes land or land improvements such as buildings or other inherently permanent structures (including items which are structural components of such building or structures).⁶ What was not clear in these definitions was whether infrastructure assets constituted real estate assets.

The Service concluded that the system in question was an inherently permanent structure that is not accessory to the operation of a business. It also noted that the system was designed so that the components were physically and

functionally interdependent and that the system was a passive conduit that allows a commodity produced somewhere else to flow through the system to end users. Furthermore, the passive components in the system can be differentiated from the active machinery that generates the commodity that is conducted through the system. In reaching its conclusion, the Service analogized the system to the properties of a railroad (i.e., tracks, roadbeds, bridges, tunnels, etc.). The Service had ruled in Revenue Ruling 69-94⁷ that such railroad assets were real estate assets under Section 856(c).

Based on this ruling, the following list of infrastructure assets can preliminarily be identified as assets that would or would not constitute qualifying REIT assets, absent specific guidance from the Service:⁸

ASSET	QUALIFICATION
Above Ground Storage	Qualified
Barges	Non-Qualified
Drilling Rigs	Fact Dependent
Gathering Systems	Fact Dependent
Liquefied Natural Gas Terminal	Qualified
Pipelines	Fact Dependent
Roads	Qualified
Railcars	Non-Qualified
Trucks	Non-Qualified
Underground Storage	Qualified
Distribution System	Qualified ⁹
Wind Turbines	Qualified
Electrical Grids	Qualified ¹⁰

³ Section 856(c)(4).

⁴ Section 856(c)(5)(B).

⁵ Section 856(c)(5)(C).

⁶ Section 1.865-3(d).

⁷ 1969-1, C.B. 189.

⁸ While private letter rulings provide guidance as to the Service’s position on certain issues, they cannot be relied upon by taxpayers other than the actual taxpayer who requested and received the ruling. Due to the highly factual nature in determining what infrastructure assets are good REIT assets, in some instances there may be substantial uncertainty as to whether certain assets qualify. In those situations it may be prudent to approach the Service when setting up the REIT for a private letter ruling to support the position that the particular infrastructure assets qualify.

⁹ PLR 200725015 (June 22, 2007).

¹⁰ *Id.*

Lease Structure

On a second issue, the Service determined that the activities of the REIT in connection of the lease would not cause the amounts received under the lease to be other than “rents from real property.” As mentioned above a REIT must meet certain income requirements. At least 75% of a REIT’s gross income must be derived from, among other things, “rents from real property,”¹¹ and further, at least 95% of a REIT’s gross income must be derived from, among a broader group of sources, “rents from real property.”¹² Rents from real property generally means the gross amount received for the use of, or the right to use, real property of the REIT.¹³ Rents from real property can also include charges for services customarily rendered in connection with the rental of real property¹⁴ and rent attributable to personal property leased in connection with the lease of real property, but only if the rent attributable to the personal property is not more than 15% of the total rent accrued or received.¹⁵ The Service noted that the REIT would not be providing any services to the lessee under the lease.

It should be noted there is significant flexibility in structuring the lease terms. However, there are certain basics that must be complied with:

- The lease must be a true lease pursuant to which the tenant has a right of possession and all the benefits and risks of the operation of the leased premises;
- The tenant must be unrelated to the REIT (i.e., the REIT, directly or indirectly, cannot have more than a 10% interest in the tenant);
- Rents attributable to personal property leased with the “real property” cannot exceed 15% of total rents; and
- Rents must be based on gross income rather than profit or net income (although a base rental rate and percentage rental rate (based on gross revenues) is permitted).

Final Conclusions

The Service has continually clarified what property qualifies as a real estate asset. Such non-traditional assets such as timberlands,¹⁶ ski resorts,¹⁷ cell phone towers,¹⁸ microwave transmission systems¹⁹ and railroads²⁰ have been approved as real estate assets for REITs through the years. The Service has now approved infrastructure assets as real estate assets for REITs.

- The ability of REITs to invest in infrastructure assets provides a great opportunity to invest capital in a tax-efficient manner in acquiring and improving our nation’s infrastructure.
- Infrastructure companies should explore tapping into the breadth and depth of the REIT capital markets in order to fuel their growth strategies.
- The types of transactions that can be structured, ranging from sale-leasebacks and highly structured leases that could limit liability to a particular source of underlying payments, creates enormous flexibility in accommodating the needs of the REIT, the tenant and, if different, the end users of the infrastructure assets;
- MLPs that own infrastructure assets could elect REIT status (or contribute assets to a subsidiary REIT which then executes an offering of shares) and gain some of the structural and legal benefits that REITs possess over MLPs, including, avoidance of unrelated business taxable income and effectively connected income, structural flexibility with respect to investor transfers, and broader access to a deeper group of capital markets investors.

¹¹ Section 856(c)(3).

¹² Section 856(c)(2).

¹³ Section 1.856-4(a).

¹⁴ Section 1.856-4(b)(1).

¹⁵ Section 1.856-4(b)(2).

¹⁶ PLR 200052021 (Dec. 29, 2000).

¹⁷ PLR 9843020 (July 24, 1998).

¹⁸ PLR 200041024 (Oct. 13, 2000).

¹⁹ Rev. Rul. 75-424, 1975-2 C.B. 269.

²⁰ Rev. Rul. 69-94, 1969-1 C.B. 189.

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