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Utilizing REITs for Midstream Assets

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The real estate investment trust (REIT) has been a preferred vehicle for investment in income producing real estate portfolios. The REIT provides investors with many federal income tax benefits associated with C-corporations, generally with only a single level of federal income taxation at the shareholder level. Several requirements must be met to qualify as a REIT, including owning assets comprised primarily of real property and generating income comprised primarily of rents from real property. With the recent decline in the relative benefits of operating as a master limited partnership (MLP), the REIT has been considered as an alternative vehicle for investment in oil and gas midstream assets. Private Letter Ruling 201907001 (the Ruling) advanced the opportunity to utilize REITs for midstream investment by establishing that rental income and certain fees generated from the use of an offshore oil and gas platform, storage tank facilities and pipeline assets qualify as rents from real property.

Choice of Entity

MLPs were the most commonly utilized vehicle for investment in oil and gas midstream assets. MLP income is subject to a single level of federal income tax, at the unitholder level, even if publicly traded, if at least 90 percent of the partnership's gross income is qualifying income. Qualifying income generally includes income from the exploration, processing, transportation or marketing of oil and gas. As a result, midstream MLPs have enjoyed the benefits of public trading without the double federal income taxation imposed on public C-corporations and their shareholders.

Recently, however, the utilization of MLPs for oil and gas midstream assets has declined for a number of reasons. First, MLP unitholders are subject to complex partnership tax reporting on IRS Schedule K-1, which is burdensome to some investors. Second, the MLP can expose tax-exempt investors to unrelated business taxable income (UBTI) and foreign investors to effectively connected income (ECI) which, in each case, is subject to U.S. federal income taxation. As a result, certain tax-exempt and foreign investors invest in MLPs through U.S. blocker corporations. As tax-exempt and foreign investors have become a greater source of capital for U.S. energy companies, this tax inefficiency has become a more significant issue for MLPs. Finally, the Tax Cuts and Jobs Act (TCJA) reduced the federal income tax rate imposed on C-corporations to 21 percent from a maximum of 35 percent, making C-corporation form a less onerous alternative to MLP status.

Because of these and other challenges, several MLPs have converted to C-corporations to gain certain federal income tax advantages. C-corporation tax reporting to shareholders is significantly less complex on Form 1099. In addition, C-corporation dividends generally are neither UBTI nor ECI to tax-exempt or foreign shareholders, respectively, which facilitates direct ownership by such investors. The C-corporation, however, is not a perfect alternative to MLP form. Unlike the MLP, a C-corporation's earnings are subject to federal income taxation both at the entity level and the shareholder level. Even at the lower rates enacted by the TCJA, this can be costly to investors in midstream companies that generate both positive taxable income, without available net operating losses, and earnings and profits. Further, the federal corporate income tax rate may rise in the future, which could increase the tax cost of investing through a C-corporation.

The REIT may be a viable alternative to both the MLP and C-corporation form for midstream investment. REITs generally are entitled to a dollar-for-dollar deduction for dividends paid to shareholders, which typically eliminates entity-level federal income taxes. Further, REIT tax reporting to shareholders generally mirrors the simpler C-corporation tax reporting and, like the C-corporation, REIT dividends paid to tax-exempt or foreign shareholders generally are neither UBTI nor ECI. Finally, the REIT is not subject to the qualifying income test applicable to an MLP, although a substantial portion of a REIT's assets must qualify as real property and a substantial portion of a REIT's gross income must qualify as Rents from Real Property, as defined below.

Qualifications for REIT Status

To qualify as a REIT, an entity must be organized as a corporation, trust, or association, be owned by 100 or more persons, not be closely held, and properly elect to be treated as a REIT.

A REIT also must satisfy an asset composition test (the Asset Test) and a source of income test (the Income Test), which together ensure that the entity's assets and activities are devoted primarily to passive investment in real estate. The Asset Test generally requires that at least 75 percent of the value of the entity's total assets be comprised of real estate assets, cash and governmental securities. The Income Test generally requires that at least 75 percent of the entity's gross income for the taxable year is derived from rents from real property (Rents from Real Property) and other types of passive income derived from real property, and at least 95 percent of the entity's gross income be derived from income qualifying under the 75 percent test and other specified interest, dividends, and portfolio-type income.

Rents from Real Property generally include amounts received for the use of real property and amounts attributable to personal property leased in connection with real property, but only if the amounts received in connection with personal property do not exceed 15 percent of the combined amount received as rent from the entity's real property and personal property for the taxable year. Rents from real property, however, exclude any amounts contingent upon profits derived by the tenant or any other person.

In addition, Rents from Real Property include charges for customary services provided in connection with the rental of real property, but exclude amounts received for other services provided to tenants (impermissible tenant service income, or ITSI). ITSI may be generated by a taxable REIT subsidiary (TRS) without jeopardizing the REIT status of the owner of the TRS, provided the aggregate value of the TRSs is not greater than 20 percent of the REIT's gross asset value.

The Facts of the Ruling

The taxpayer, a corporation that previously elected REIT status and principally invests in U.S.

energy infrastructure (the Taxpayer), planned to construct an offshore oil and gas platform (the Platform), and purchase storage tank facilities (the Storage Tanks) and pipelines (the Pipelines) from unrelated sellers. The Taxpayer requested a ruling that amounts received from unrelated third parties for the use of the Platform, the Storage Tanks and the Pipelines would qualify as Rents from Real Property.

The Taxpayer's Representations

The Taxpayer represented that the Platform, the Storage Tanks and the Pipelines each would constitute real property for purposes of the Asset Test, and that any personal property related to each of the Platform, the Storage Tanks and the Pipelines, respectively, that is leased to a third party, would constitute no more than 15 percent of the total fair market value of the real property and personal property subject to each lease. The Taxpayer also represented that none of the amounts received from third parties for use of the Platform, the Storage Tanks or the Pipeline, or any related personal property, would depend, in whole or in part, on the income or profits of any person.

Terms of the Platform Lease, the Storage Agreements and the Pipeline Use Agreements

- **The Platform Lease:** The Taxpayer intended to enter into a multi-year lease with a single unrelated third-party lessee for the exclusive use of the Platform and related oil and gas extraction and processing equipment (the Platform Lease). The rent paid under the lease (the Platform Rent) would be based on a fixed amount per volume of oil and gas flowing through the Platform, which would be subject to change after certain specified thresholds were met and to reflect changes in commodity pricing. The Platform Rent also would be subject to a specified minimum amount to ensure that the Taxpayer received a market-based return on its invested capital with respect to the Platform. Finally, the lessee would be permitted to sublease the Platform to one or more third parties, in which case the sublessee would be required to pay the initial lessee a fixed amount of rent plus additional payments based on volume, and the initial lessee would be required to pay a percentage of the gross revenue it receives from the sublessee to the Taxpayer as part of the Platform Rent.

- **The Storage Agreements:** The Taxpayer intended to enter into multi-year storage agreements (each, a Storage Agreement) for the Storage Tanks' capacity with unrelated third-party users. In some cases, the Storage Agreement would specify the particular tank or tanks in which the user's product would be stored and, in other cases, the Storage Agreement would provide the user with a fixed portion of storage capacity at a particular facility. The Taxpayer would not oversell storage capacity and would be obligated to ensure that capacity specified in each Storage Agreement is reserved and available for the user. Each user would pay a fixed monthly fee (the Storage Fee) pursuant to the Storage Agreement, regardless of whether the user utilized its reserved capacity, with the opportunity to exceed its reserved capacity in exchange for an additional fee. The Storage Fee would be subject to change after a specified volume was stored by the user, by mutual agreement of the parties or to reflect changes in a specified pricing index.

- **The Pipeline Use Agreements:** The Taxpayer intended to enter into multi-year agreements for the Pipeline's capacity with unrelated third-party users (each, a Pipeline Use Agreement) for a fee (the Pipeline User Fee). The Taxpayer would not oversell pipeline capacity and would be obligated to ensure that capacity specified in each

Pipeline Use Agreement is reserved and available for the user. In some cases the user would pay a monthly fee for a prescribed amount of reserved capacity on the Pipeline, regardless of whether the user utilized its specific reserved capacity, with the opportunity to exceed its specific reserved capacity in exchange for an additional fee based upon a fixed amount multiplied by the volume of product. Other users would pay a fixed amount multiplied by a volume of product that exits the Pipeline. In such case, the user would agree to use the Pipeline for all of the product it extracts from a particular area and the Taxpayer would agree to accept and reserve capacity for the product. The fixed monthly fee would be subject to change after a specified volume exits the Pipeline, by mutual agreement of the parties or to reflect changes in a specified pricing index.

Services Provided to Lessees and Users

- **The Platform:** The lessee would be solely responsible for operating, maintaining and repairing the Platform and any related equipment, and the Taxpayer would provide no services to the lessee.

- **The Storage Tanks:** A TRS would perform all services relating to the operation of the Storage Tanks, including loading, unloading and moving oil and gas product, blending and treating oil and gas product for the user and taking samples of product for the benefit of the user. The Taxpayer represented that all services provided to users are customarily provided to tenants of similar properties in the same geographic market. Fees for these services would be paid directly to the Taxpayer as part of the Storage Fee, and the Taxpayer would, in turn, compensate the TRS at arm's length rates for performing such services.

- **The Pipeline:** A TRS would perform all services relating to the operation of the Pipeline, including loading and unloading product from the Pipeline and monitoring, maintaining and operating any related compressors or pumps. The Taxpayer represented that all services provided to users are customarily provided to tenants of similar properties in the same geographic market. Fees for these services would be paid directly to the Taxpayer as part of the Pipeline User Fee, and the Taxpayer would, in turn, compensate the TRS at arm’s length rates for performing these services.

The Holding
The IRS held that the Platform Rent, the Storage Fee and the Pipeline User Fee would qualify as Rents from Real Property.

Importance of the Ruling
First, the Ruling confirms that the IRS is willing to treat revenue generated by certain multi-user storage and pipeline arrangements as Rents from Real Property. This represents a broadening of the scope of this term in the midstream context, which previously had been limited to revenue received pursuant to a master lease agreement for storage tanks or pipelines with a single tenant that operates and maintains the facility.

Second, the Ruling provides owners of oil and gas midstream assets with a roadmap for drafting and negotiating multi-user arrangements to ensure that revenue from such contracts constitutes Rents from Real Property for purposes of the Income Test. Such contracts should have a multi-year term, and provide that the taxpayer cannot oversell capacity and is obligated to ensure that the storage or pipeline capacity specified in a contract would be reserved for the user, and include a periodic fee. The Ruling also permits periodic payments under qualifying storage or pipeline agreements to be reduced after certain volumetric thresholds are achieved, and allows adjustments to fixed dollar fees for changes in commodity prices, the consumer price index or other measure of inflation.

Looking Ahead

Despite the Ruling's warm reception from practitioners and commentators, the REIT is not a perfect alternative vehicle for midstream investment, and it therefore is unclear whether the Ruling will significantly increase the use of REITs to own and operate midstream assets. Unlike the MLP, the REIT cannot directly provide services to users of storage and pipeline capacity, and such activities must be conducted through a TRS, which is subject to federal corporate income tax. Further, the value of TRS stock held by a REIT cannot exceed 20 percent of the value of the REIT's total assets. The REIT market, however, is strong and growing, and midstream REITs likely would have greater appeal than MLPs to most foreign and tax-exempt investors, which are a source of significant capital for the U.S. energy industry.