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VIEWPOINT

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Infrastructure REITs: A Tax Code Patch to Fill America's Potholes

by Steve Butler and Ryan Phelps

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In this article, Butler and Phelps present a proposal for attracting private capital into the U.S. infrastructure industry through an expansion of the real estate investment trust regime.

Need for Private Infrastructure Investments

The dismal state of America's infrastructure is widely reported. A quick survey of recent news reports reveals headlines like "America's Infrastructure Is Decaying,"[1] "The Massive Cost of America's Crumbling Infrastructure,"[2] and "The Regional Impacts of America's Deteriorating Infrastructure on Families, Businesses and Competitiveness."[3] The American Society of Civil Engineers (ASCE) publishes a quadrennial *Infrastructure Report Card* on the state of the nation's physical plant.[4] In 2017, the most recent iteration of this report, America received a D+, and has consistently received a D-range grade since 1998.[5] The effects of continued underinvestment in infrastructure of all sorts (including transportation, electrical transmission; water and wastewater treatment; and ports) has a significant and growing effect on the nation's economy, competitiveness, and ability to respond to natural disasters and climate change. ASCE estimates that from 2016-2025, each American household will lose the equivalent of $3,400 per year in disposable income, and there will be $3.9 trillion in losses to the U.S. GDP, due to infrastructure deficiencies such as travel delays, higher shipping costs, increased business operational costs due to electrical and water delivery system failures, and the rising cost of business production.[6]

Occasionally, these nationwide systemic failures lead to catastrophic results, like the failure of the Interstate 35W bridge in Minneapolis over the Mississippi River in 2007, where 50 cars plunged into the river and shoreline, leading to 13 deaths and 145 injuries.[7] There have also been near-disasters such as the potential collapse of the 770-foot-tall, 50-year-old Oroville Dam in California in 2017, which prompted a call for 188,000 residents from downstream communities to evacuate their homes after a 50-foot hole appeared in the side of the dam.[8] While not every form of infrastructure is at immediate risk of failure (ASCE gives America's freight railways a solid B, for example), many of our most important assets, such as transit, roads, dams, levees, and drinking water, fall short of the ideal.

Solutions are at hand, but they require political will and significant deployment of capital. ASCE recommends that overall public

[1] Cadie Thompson and Mark Matousek, "America's Infrastructure Is Decaying — Here's a Look at How Terrible Things Have Gotten," *Business Insider*, Feb. 5, 2019.

[2] Niall McCarthy, "The Massive Cost of America's Crumbling Infrastructure," *Forbes*, Mar. 13, 2017 (infographic).

[3] ASCE, "The Regional Impacts of America's Deteriorating Infrastructure on Families, Businesses and Competitiveness" (2017).

[4] ASCE, *2017 Infrastructure Report Card* (Mar. 9, 2017).

[5] ASCE, "Report Card History" (2017).

[6] ASCE, "Failure to Act: The Impact of Infrastructure Investment on America's Economic Future" (May 10, 2016).

[7] David Schaper, "10 Years After Bridge Collapse, America Is Still Crumbling," NPR (Aug. 1, 2017).

[8] Steve Patterson, Bita Ryan, and Phil Helsel, "One Year Later, Oroville Dam Crisis Still Weighs on Residents' Minds," NBC (Feb. 11, 2018).

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sector (including federal, state, and local governmental bodies) and private sector investment in infrastructure be increased from 2.5 percent to 3.5 percent of GDP by 2025.[9] No one-size-fits-all solution exists to achieve this goal, and no single governmental entity or capital provider can do it alone. Indeed, all participants in the American economy would need to play a role. The White House highlighted the issue in a 2018 Infrastructure Fact Sheet calling for additional federal governmental spending, increased state and local "self-help," divestment by the federal government of underused capital assets, and increased use of public-private partnerships.[10]

Investor appetite for private infrastructure investment is significant. *Infrastructure Investor*, an industry publication that tracks fundraising in the private equity infrastructure sector, identified $80.39 billion of capital raised globally for infrastructure investment funds in 2018 (although only a minority of that capital was raised by funds with a North American focus).[11] And in Europe, transportation infrastructure such as airports, bridges, and parking lots have enjoyed particularly significant investor interest. A controlling interest in London's Gatwick Airport was recently sold at a valuation equal to 20 times its EBITDA.[12] (EBITDA, or earnings before interest, taxes, depreciation, and amortization, is a free cash flow analog often used by financial investors for valuation purposes.)

The United States has both a compelling need for additional private infrastructure investment and also meaningfully increased investor demand. However, private sector investment in U.S. infrastructure has not risen nearly as fast as might have been expected in recent years. Indeed, the opposite may be true. Joao Gomes, a Wharton finance professor, acknowledged in a recent interview that since the global financial crisis of 2008, private sector investment in infrastructure assets (including public-private partnerships) may be 25-30 percent lower than it would have been had there been a continuation of the historic macroeconomic trends that existed before the global financial crisis.[13]

Some green shoots may be emerging. America's Water Infrastructure Act of 2018, signed into law in October, authorizes spending up to $6 billion of federal funds on water infrastructure projects over the next decade.[14] *Infrastructure Investor* identified only 40 of the top U.S. airports as being owned (in whole or in part) by private parties, highlighting potential opportunities for future private sector investment.[15] However, most private sector activity in infrastructure has focused in recent years on the energy space. In an interview in *Infrastructure Investor's* "North America Report," Todd Bright of Partners Group stated that investment in core infrastructure assets like airports, toll roads, and ports has not gained momentum in the United States in the same way that it has in other parts of the world, in part because of "a lack of public sector expertise in procurement and contracting, as well as the complexities of dealing with federal and state governments."[16] Instead, private equity and infrastructure investors often focus on spaces like the renewable energy markets and midstream energy, which are not subject to the same degree of governmental regulation and political scrutiny.

If there is a pivotal moment in which the federal government could consider sweeping infrastructure legislation, 2019 may be the year. With divided power in Congress, some commentators have expressed hope that a bipartisan infrastructure package could be enacted. Leading Democrats in the House have proposed a spending package of up to $1 trillion in support of the country's crumbling infrastructure and pledged to work with President Trump to enact such a bill.[17] This took

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[9] ASCE, "Investment" (2017).

[10] The White House, "Fact Sheet 2018 Budget: Infrastructure Initiative."

[11] Bruno Alves and Daniel Humphrey Rodriguez, "Fundraising Report 2018," *Infrastructure Investor*, Jan. 23, 2019.

[12] "Barbarians at the Departure Gate," *The Economist*, Jan. 3, 2019.

[13] Wharton University of Pennsylvania, "Why Private Investment in Public Infrastructure Is Declining" (Sept. 27, 2018).

[14] PEI staff, "The U.S. Airport Structure Is Still Taxiing for Take-Off," *Infrastructure Investor*, Nov. 28, 2018.

[15] *Id.*

[16] "Shale Revolution Continues to Breed Midstream Opportunity," *Infrastructure Investor*, "North America Report," Dec. 2018/Jan. 2019.

[17] Melanie Zanona, "Hopes for Infrastructure Deal With Trump Rise if Dems Win House," *The Hill*, Oct. 4, 2018.

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on new life on April 30, 2019, when Democratic congressional leaders and the White House reached an agreement in principle to pursue an infrastructure plan with a $2 trillion price tag (if appropriate revenue sources could be found).[18] The political prospects of such a proposal remain uncertain, however, given the need to find sources of revenue to pay for the spending package. Many Republicans in Congress would prefer legislation that prioritizes private sector investment and public-private partnerships, rather than focusing solely on a large spending bill (which might require tax increases or other new sources of financing).[19] Given the unclear future of any large public sector spending package, private sector capital will continue to play a critical role in any development of new U.S. infrastructure projects in the foreseeable future.

This article sets out a proposal for attracting badly needed private capital into the U.S. infrastructure industry, using long-standing existing incentives in the federal tax code: through an expansion of the real estate investment trust regime to encompass infrastructure assets and income derived from the use or operation of infrastructure assets.

Even if policymakers are unable to agree on a significant public spending package, a reform along the lines outlined in this article could attract meaningful additional funds into the industry in a transformative manner. While separate analysis must be done to evaluate the effect of such a change on the U.S. fiscal balance, the authors' hypothesis is that — by attracting significant additional private capital to an asset class that is currently underinvested — this proposal might increase economic activity in the infrastructure space, and increase federal tax revenues as a result. In other words, if this statute incentivizes investments that would never have been made in the absence of the new regime (and creates incremental economic activity — a portion of which would be captured by the federal tax system — as a result), it could still result in a net improvement to the U.S. budget balance. If this theory proves accurate, this would have the double benefit of creating new meaningful capital assets that benefit all of America's citizenry, with little net cost (and the possibility of meaningful benefits) to the federal budget balance. While this proposal in itself will not solve the issue of long-standing underinvestment in America's infrastructure, it has the potential to play a positive role in renewing America's infrastructure for the 21st century and beyond, without requiring a massive outlay of new federal funds.

History of the REIT Statute

The REIT statute and its history has been well-documented elsewhere, so this article will only give a brief overview.[20] Various REIT regimes have existed since the 1850s, when the state of Massachusetts permitted a limited liability business trust structure, which for decades served as the primary collective investment vehicle for participation in real estate, stocks, and securities.[21] Congress created the fundamental precepts of the modern REIT regime in 1960, following various changes to the tax code affecting the taxation of early REITs (including a 1930s ruling that subjected early REITs to corporate taxation).[22] The goal of this new regime was to make investments in large, income-producing real estate projects accessible to small retail investors. Congress also saw that facilitating investment into larger real estate projects would provide meaningful additional capital for the real estate facilities required by the booming post-war economy, encouraging investments in office buildings, apartment complexes, shopping centers, and other real estate complexes.[23]

The REIT rules have been an unqualified success. The National Association of REITs (Nareit) estimates that 15 percent of America's commercial real estate is now held in public or private REIT structures. The market capitalization

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[18] Clare Foran, Ted Barrett, and Phil Mattingly, "Democrats Say $2 Trillion for Infrastructure Agreed to After Meeting With Trump," CNN, Apr. 30, 2019.

[19] *Id*.

[20] *See, e.g.*, Peter M. Fass, Michael E. Shaff, and Donald B. Zief, *Real Estate Investment Trusts Handbook*, ch. 1 (2018-2019); David F. Levy, Nickolas Gianou, and Kevin M. Jones, "Modern REITs and the Corporate Tax: Thoughts on the Scope of the Corporate Tax and Rationalizing Our System of Taxing Collective Investment Vehicles," *Taxes*, Mar. 2016.

[21] *Id.*; *see also Attorney General v. Proprietors of the Meetinghouse*, 69 Mass. 1 (1854), writ of error dismissed, 66 U.S. 262 (1861).

[22] 82 Reg. 86, section 801-2 under the Revenue Act of 1934.

[23] *See* Fass, Shaff, and Zief, *supra* note 20.

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of all publicly traded REITs at the end of 2018 exceeded $1 trillion.[24] And unlike some other sectors of the economy, REITs are an area that has seen continued growth at a time when other public companies are disappearing. Put simply, Congress's goals in creating the REIT regime have been achieved and exceeded. The tax benefits provided by the REIT legislation have driven continued interest in real estate by a broad base of investors, from small retail investors to large pension plans, sovereign wealth funds, and private equity investors. Without the tax benefits afforded by the REIT regime, U.S. commercial real estate might have remained concentrated in far fewer hands.

REIT Requirements and Incentives

There are several significant benefits to investing through a REIT structure. Despite being treated as a corporation for tax purposes, it is most important that a REIT receives a special dividends paid deduction for its distributions, and thus may avoid federal corporate taxation altogether if it distributes 100 percent of its taxable income to its shareholders each tax year.[25] Thus, a REIT can take advantage of the benefits of the corporate form (such as issuing a Form 1099 to each shareholder rather than a Schedule K-1), has easier access to the public capital markets than partnerships or limited liability companies, and has the ability to use the tax-free reorganization and merger rules of subchapter C,[26] all without being required to pay any entity-level corporate taxation. Individual U.S. investors in REITs receive the additional benefit of a new 20 percent passthrough deduction on REIT dividends from operating income (which are otherwise typically taxed at ordinary income rates), for tax years beginning before 2026.[27]

REITs also have specific benefits for U.S. tax-exempt investors and non-U.S. investors. A U.S. tax-exempt investor such as a private pension plan or university endowment can hold shares of a REIT, receiving dividends and capital gains from the sale of REIT shares, without incurring tax at a rate of up to 37 percent from unrelated business taxable income that might result from an investment in the REIT's underlying assets.[28] And non-U.S. investors can take advantage of additional benefits from investing in REITs. Non-U.S. investors receive REIT ordinary dividends subject to a 30 percent withholding tax (or lesser amount under an applicable tax treaty).[29] However, those REIT dividends are not generally treated as effectively connected income (ECI) with the conduct of a U.S. trade or business, and a non-U.S. investor that received the dividends would not be subject to U.S. federal income tax on a net basis, avoiding a need to file U.S. federal income tax returns in years where its only U.S. income took the form of REIT ordinary dividends.[30]

Additional tax benefits exist for non-U.S. investors in REITs through exceptions to the tax imposed by the 1980 Foreign Investment in Real Property Tax Act. FIRPTA generally imposes a capital gains tax on non-U.S. investors selling U.S. real estate (generally at the same rates that apply to U.S. investors: 20 percent for an individual or trust that has held the real estate for at least 12 months, and 21 percent for a corporate investor), backstopped by a 15 percent gross proceeds withholding tax.[31] In contrast to this general tax rule, non-U.S. investors in REITs are exempt from FIRPTA tax in the following cases:

- an investment in a public REIT (including on both sales of REIT shares or on a capital gain dividend from the REIT, attributable to a REIT's sale of its underlying assets), when the non-U.S. investor owns less than 10 percent of each class of the REIT's equity interests;[32]
- an investment in any REIT (regardless of whether it is publicly traded) that is

[24] Nareit, "U.S. REIT Industry Equity Market Cap."

[25] Section 857(b)(2)(B).

[26] Section 856(a)(3).

[27] Section 199A(b)(1)(B).

[28] Section 512(b)(1), (5); Rev. Rul. 66-106, 1966-1 C.B. 151. A limited exception to this rule applies to a pension-held REIT, when a single pension plan owns at least 25 percent of the REIT or multiple pension plans (each owning at least 10 percent of the REIT) own 50 percent or more of the REIT. Section 856(h)(3)(C).

[29] Section 1441.

[30] Section 864(b)(2); reg. section 1.6012-1(b)(2)(i) and -2(g)(2)(i).

[31] Sections 897(a) and 1445(a). Non-U.S. corporate investors recognizing FIRPTA gains may also be subject to a branch profits tax of 30 percent (or lesser amount under an applicable tax treaty). Section 884(a).

[32] Section 897(c)(3), (h)(1), (k)(1).

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"domestically controlled" (owned more than 50 percent by U.S. persons at all times in the five years before sale of the REIT shares), if the non-U.S. investor exits its investment by selling REIT shares (rather than selling an underlying asset);[33] and
- an investment by a non-U.S. governmental entity (such as a central bank or sovereign wealth fund), when that entity owns less than 50 percent of the equity interests and voting control of the stock of the REIT (regardless of whether the REIT is domestically controlled), if the non-U.S. governmental entity exits its investment by selling REIT shares (rather than selling an underlying asset).[34]

Those benefits come with significant limitations. In terms of key requirements, the most significant for the purpose of this article is the requirement that a REIT be primarily a passive owner of real estate equity or debt.[35] Under the REIT rules:

- A REIT's gross income must be composed:
  - at least 75 percent of real-estate-related passive income, such as rents from real property, interest on mortgage loans, gains from the sale of real property or mortgages, and income from other REITs;[36] and
  - at least 95 percent of passive income more generally, including income qualifying for the 75 percent gross income test, as well as dividends, interest, and capital gains from other investment assets.[37]
- A REIT's assets must be composed at least 75 percent of real estate assets (including both equity and debt interests in real estate), and limitations apply to the REIT's ownership of securities of subsidiary entities.[38]
- For purposes of the 75 percent and 95 percent gross income tests set forth above:
  - a REIT's rental income can include income from personal property leases, but only from leases under which rents attributable to personal property represent less than 15 percent of the total rental receipts from the lease (for example a furnished apartment when the furniture represents a relatively small portion of the value of the rental income stream);[39]
  - a REIT's rental income can include charges for services that are customarily furnished in connection with the rental of real property (for example, electricity, sewage, on-site security, elevators, and laundry facilities), but cannot include "impermissible tenant service income" (generally, income from non-customary services, the value of which exceeds 1 percent of the REIT's income stream from a particular property);[40]
  - a REIT's rental income cannot include income that is determined in whole or in part on a tenant's net income (that is a profit participation), but it can include a participating rent stream that is calculated solely on a tenant's gross sales of receipts;[41] and

[33] Section 897(h)(2).

[34] Section 892(a)(i)(A)(i); reg. section 1.892-3T(b), Example 1.

[35] Section 856(c). REITs are also subject to requirements regarding (1) annual distribution of at least 90 percent of their taxable income, (2) excessive concentration of ownership (no single group of five or fewer individuals can own 50 percent or more of a REIT's value), (3) transferable shares, and (4) centralization of management. Sections 856-857.

[36] Section 856(c)(3).

[37] Section 856(c)(2).

[38] Section 856(c)(4)(A). Not more than 25 percent of the value of a REIT's total assets may be represented by securities (other than securities of a "qualified REIT subsidiary" and securities that constitute qualifying assets for purposes of the 75 percent asset test). Section 856(c)(4)(B)(i). Also, not more than 20 percent of the value of a REIT's total assets may be represented by securities of one or more taxable REIT subsidiaries (TRS). Section 856(c)(4)(B)(ii). Finally, except regarding securities of a TRS or qualified REIT subsidiary and securities that constitute qualifying assets for purposes of the 75 percent asset test: (a) not more than 5 percent of the value of a REIT's total assets may be represented by securities of any one issuer; (b) a REIT may not hold securities possessing more than 10 percent of the total voting power of the outstanding securities of any one issuer; and (c) a REIT may not hold securities having a value of more than 10 percent of the total value of the outstanding securities of any one issuer. Section 856(c)(4)(B)(iii).

[39] Section 856(d)(1)(C).

[40] Section 856(d)(1)(B). While the Treasury regulations permitted only limited services, a series of private letter rulings over the past few decades have permitted REITs in the multifamily, office, and industrial spaces to offer a wide variety of services that are now viewed as customary in the marketplace, such as unattended fitness centers (LTR 200101012), swimming pools (*id.*), and club rooms (LTR 9646027).

[41] Section 856(d)(2)(A).

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- a REIT's rental income cannot include income from a tenant that shares at least 10 percent common ownership with the REIT (the related-party rent test).[42]

Fundamentally, these requirements ensure that a REIT limits its activities primarily to the passive ownership of real estate (or real estate debt) and does not engage in more than de minimis ancillary business activities (including providing non-passive services to its tenants).[43] Thus, REITs typically focus primarily on traditional real estate asset classes, such as multifamily (apartments), industrial, office, and retail properties.

In the early 2010s, there was a move to convert various non-conventional corporations into REIT structures, including billboard companies, data storage facilities, cellphone towers, prisons, and pipelines (many of which had an infrastructure character to them, if they were not quite pure-play infrastructure).[44] The IRS paused this trend in 2013 when it announced a hold on new private letter rulings on novel REIT asset classes, although it later resumed issuing rulings.[45]

However, all those REITs, including the newly converted REITs, changed their businesses to match the requirements of the existing REIT legislation — often using a sale-leaseback structure when a newly created or spun-off REIT held an existing corporation's real estate portfolio, but generated sufficient qualified rental or interest income to meet the requirements of the 75 percent and 95 percent gross income tests. Many pure-play infrastructure assets simply cannot meet those requirements as the statute is currently written.

Issues With Infrastructure Under REIT Regime

As described above, the REIT rules are a natural fit for traditional real estate projects like apartment buildings, office towers, retail complexes, and industrial and logistics facilities when limited or no services are provided. The REIT rules do not fit as neatly with infrastructure projects. Of the two key criteria, the asset test may be easier to satisfy than the income test. Infrastructure projects often are heavily composed of land, buildings, and other fixed structures that are not intended to (and likely never will be) moved. Final IRS regulations published in 2016 seemed to acknowledge this, specifically identifying infrastructure assets such as "microwave transmission, cell, broadcast, and electrical transmission towers; telephone poles; parking facilities; bridges; tunnels; roadbeds; railroad tracks; transmission lines; pipelines; fences; in-ground swimming pools; offshore drilling platforms; storage structures such as silos and oil and gas storage tanks; and stationary wharves and docks" as "inherently permanent structures" that would be treated as real estate assets for purposes of the REIT asset tests.[46] The regulations also acknowledge that other distinct and permanently affixed assets that serve a passive function (such as to "contain, support, shelter, cover, protect, or provide a conduit or a route") rather than serve an active function (such as to "manufacture, create, produce, convert, or transport") may be treated as real estate assets for purposes of the REIT asset tests.[47]

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[42]Section 856(d)(2)(B). A limited exception to the related-party rent rules, which is beyond the scope of this article, exists for hotel and hospitality REITs that lease property to their TRSs, when a third-party contractor operates the property. Section 856(d)(8)(B).

[43]*See* H.R. Rep. No. 86-2020 (1960), reprinted at 1960-2 C.B. 819 ("One of the principal purposes of your committee in imposing restrictions on types of income of a qualifying real estate investment trust is to be sure that the bulk of its income is from passive sources and not from the active conduct of a trade or business. . . . A second restriction, intended to limit the definition of rents from real property to those of a passive nature, excludes from the definition amounts when the trust directly furnishes or renders services to the tenants or manages or operates the property. However, the bill permits these services, or management or operation of the property to be provided through an independent contractor.").

[44]Theodore S. Lynn, Micah W. Bloomfield, and David W. Lowden, "Real Estate Investment Trusts," at section 6:60 (Nov. 2018). Examples of such companies include CorEnergy Infrastructure Trust Inc. (pipelines, storage tanks, transmission lines, and gathering systems); Crown Castle International Corp.; SBA Communications Corp.; American Tower Corp. (cellphone towers, fiber optic transmission lines, and other wireless and broadcast communications infrastructure); Landmark Infrastructure Partners LP (wireless communication, outdoor advertising, and renewable power generation); Hannon Armstrong Sustainable Infrastructure Capital Inc. (real estate related to solar, wind, hydropower, and geothermal generating facilities); and InfraREIT Inc. (rate-regulated electric transmission and distribution assets). *See* the section on existing infrastructure REITs, below.

[45]The IRS resumed issuing rulings on novel REIT asset classes in 2014, which once again accelerated the number of companies converting to REITs. However, the number of conversions ground to a halt at the end of 2015 when section 856(h) was enacted, which largely prohibits future REIT spinoffs under section 355.

[46]Reg. section 1.856-10(d)(2)(iii)(B).

[47]Reg. section 1.856-10(d)(2)(i), (iv).

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Based solely on the plain language of these regulations, many infrastructure assets qualify as real estate assets under the REIT rules. Bridges, airports, tunnels, and ports all seem likely to qualify in significant part as real estate assets. Some exceptions would apply to more active infrastructure asset classes, such as water and wastewater treatment plants (which provide a more transformative function), power plants and cogeneration facilities, and oil drilling platforms. However, the IRS has already cracked the aperture open for many categories of infrastructure that could nominally meet the REIT asset tests.

Unfortunately, the REIT income tests are not as permissive. The income streams that qualify for REIT treatment are generally passive in nature, with a requirement that 75 percent of a REIT's gross income take the form of passive categories of income like rental or mortgage interest income, or capital gains from the sale of real estate investments.[48] Many infrastructure projects that might easily satisfy the REIT asset tests — such as bridges, parking facilities, airports, rail yards, and ports — do not satisfy the REIT gross income tests if they are owned and operated by the same party, because most of their income may take the form of tolls, concession charges, and payments from private parties that do not take the form of a rental or lease income stream.[49] And many new greenfield or development infrastructure projects may receive substantial accommodation payments during construction (often because of the tax accounting rules for projects under development) that are not treated as rental income from the lease of real estate.[50]

Recently, the IRS issued a new private letter ruling that indicated a growing comfort with permitting infrastructure assets to satisfy the REIT gross income and asset test requirements. The IRS ruled that an energy infrastructure REIT could invest in an offshore oil and gas platform, storage tank facilities, and pipelines.[51] The oil and gas platform and storage tanks were leased to third-party tenants in fairly typical REIT-compliant structures with fixed or percentage rent revenue streams, with any percentage rents calculated based on gross volume of production (in the case of the oil platform) or volume of stored product (in the case of the storage tanks). However, in the case of the pipelines, the REIT entered into pipeline use agreements that required third-party users to pay the REIT both (1) a fixed monthly payment for a reserved amount of pipeline capacity (although in some cases, this fixed payment would be $0), and also (2) an excess capacity payment "computed based upon a fixed dollar amount set forth in the Pipeline Use Agreement multiplied by the volume of product that exits the Pipeline."

In some of these contracts, the pipeline use payment would consist solely of variable payments calculated based on the volume of product transported in the pipeline. Surprisingly, the IRS concluded that these pipeline use payments that (1) were not structured as a lease, (2) included no fixed rent, and (3) secured no exclusive right to use the pipeline (but only guaranteed a minimum amount of pipeline capacity) were qualifying REIT income. In the IRS's view, "the Pipeline Use Fees that are solely based upon the volume of product that exits the Pipeline are comparable to amounts received that are based upon a percentage of gross receipts . . . accordingly, the . . . Pipeline Use Fee [is] an amount received for the use of, or the right to use, real property of Taxpayer and [qualifies] as rents from interests in real property under section 856(d)(1)(A)."[52] The IRS made clear in the ruling that a taxable REIT subsidiary (TRS) — a corporate subsidiary of the REIT — provided all services to pipeline users, including scheduling the use of the pipelines, loading and unloading product onto the pipelines, and operating compressors and pumps.

[48] Section 856(c)(3).

[49] *See, e.g.*, "REITs and Infrastructure Projects, the Next Investment Frontier?" Deloitte (2010); *see also* Adam M. Handler and Stephanie M. Tran, "Infrastructure Investment Trusts: A Proposal for Attracting Capital," *Tax Notes*, Mar. 2, 2009, p. 1127 ("most infrastructure investments are operated by a developer rather than leased to an unrelated party . . . the REIT would be generating operating income that would be 'bad income' under the 95 percent income test").

[50] Deloitte pointed out in its 2010 publication that in the early years of a greenfield infrastructure project, accommodation payments may constitute all or nearly all of the project's gross income, thereby causing a per se failure of the REIT income tests.

[51] LTR 201907001.

[52] *Id.*

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Existing Infrastructure REITs

Despite the limitations for infrastructure projects under the REIT income test, certain REITs have successfully invested in specific passive infrastructure assets. Before Congress enacted section 856(h) to deny tax-free treatment for REIT spinoffs under section 355, several companies engaged in real-estate-intensive infrastructure businesses chose to spin off their real property to new subsidiaries, which then leased that transferred property back to the related operating company on a triple net basis.[53]

Today, many infrastructure REITs acquire passive infrastructure assets through sale-leasebacks with energy companies. CorEnergy Infrastructure Trust Inc., for example, has acquired pipelines, storage terminals, offshore platforms, rights-of-way, and electric transmission and distribution lines from energy companies and leased those assets back to those companies on a triple net basis. These arrangements allow infrastructure sellers to benefit from the monetization of assets while remaining operationally and commercially in control. And they allow the REIT to both hold infrastructure assets that satisfy the asset test under section 856(c)(4) while also receiving rental income from those assets through leases that satisfy the REIT gross income tests.

Generally, infrastructure REITs focus their businesses on a specific class of infrastructure assets. American Tower Corp., an independent owner, operator, and developer of wireless and broadcast communications real estate and one of the largest REITs in operation, was converted from a corporation into a REIT in 2012 to more efficiently lease land for cell towers and other property to wireless providers. Another company, InfraREIT Inc., owns and leases rate-regulated electric transmission tower and power lines in Texas (at the time of writing this article, InfraREIT had signed a definitive merger agreement to be acquired by Oncor Electric Delivery, another utility company).[54] In many cases, operating companies that lease property from infrastructure REITs identify desirable property for the REIT to buy and lease to them.

REITs also may invest in infrastructure projects by offering and holding real estate mortgage loans for the purchase of infrastructure assets. Hannon Armstrong is an example of a REIT that lends money for financing energy infrastructure and renewable assets. To meet the gross income test under section 856(c)(3), such mortgage loans must be primarily securing real estate assets, but up to 20 percent of the total value of money lent may be secured by non-real-estate assets through a TRS.[55]

A Possible Approach to Expanding the Statute

With this history in mind, we propose that Congress consider a new class of qualifying REIT investment — infrastructure facilities owned in public-private partnerships or with a clear public use. Many infrastructure projects already satisfy the REIT asset tests, as in many (but not all) cases the project's asset value is at least 75 percent composed of real estate. But as described above, the REIT gross income tests create meaningful impediments to holding infrastructure assets in a REIT structure, other than in the rare case when the asset is triple net-leased to a tenant who is also the operator of the asset. Thus, the tax benefits that Congress designed to lure retail investors into the public real estate space are unavailable except for a few outliers.

This is unfortunate given America's clear need for infrastructure investment. Much like the post-war economy of the 1950s, which needed the commercial infrastructure of office buildings, homes, industrial facilities and retail centers, the America of 2019 needs a massive infusion of capital to refresh and reinvigorate its public infrastructure base. Congress could incentivize this flow of capital by updating and expanding

[53] A triple net lease is a lease agreement on a property in which the tenant or lessee agrees to pay all real estate taxes, building insurance, and maintenance (the three "nets") on the property in addition to any normal fees that are expected under the agreement (for example, rent and utilities).

[54] *See* Jon Prior, "Oncor Makes Bigger Push in Texas With $1.27B Deal for InfraREIT," *Dallas Business Journal*, Oct. 18, 2018.

[55] Section 856(c)(4)(B)(ii).

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the REIT regime to encompass infrastructure investments.

Conveniently, a model for this approach exists. In a late 2018 revenue procedure, the IRS (referring to the White House's outline of target asset classes, when seeking to expand tax-exempt bond financing for private infrastructure) created a special exception that treats some core infrastructure assets as real estate for the limited purpose of qualifying for an exemption from interest expense deductibility limitations — an exemption that is available only for a "real property trade or business."[56] That procedure listed the following infrastructure asset classes as eligible to be treated as real property trades or businesses:

- airports;
- docks and wharves;
- maritime and inland waterway ports, and waterway infrastructure, including dredging and navigation improvements;
- mass commuting facilities;
- facilities for the furnishing of water;
- sewage facilities;
- solid waste disposal facilities;
- facilities for the local furnishing of electrical energy or gas;
- local district heating or cooling facilities;
- qualified hazardous waste facilities;
- high-speed intercity rail facilities;
- hydroelectric generating facilities;
- qualified public educational facilities;
- flood control and stormwater facilities;
- surface transportation facilities;
- rural broadband service facilities; and
- environmental remediation costs on brownfield and Superfund sites.[57]

This 2018 safe harbor was created for the purpose of a specific statutory rule, the new interest expense deductibility limitations of section 163(j). As amended by the Tax Cuts and Jobs Act, section 163(j) generally prohibits taxpayers from claiming interest expense deductions in excess of 30 percent of their adjusted taxable income.[58] However, because of a Senate amendment to the TCJA, some real property businesses (including development, construction, leasing, management, or brokerage businesses) are generally permitted to elect out of this 30 percent limitation — at the expense of using slower, straight-line depreciation in lieu of faster accelerated or bonus depreciation.[59] The Senate amendment is widely understood to have been enacted to facilitate and provide incentives for investment in the real estate industry, which tends to use leverage more heavily than many operating industries. With the 2018 revenue procedure, the IRS has clarified that eligible infrastructure assets could also be treated as real estate trades or businesses, and thereby are eligible to elect out of the 30 percent limitation.

The procedure's scope is not unlimited — the infrastructure exemption is only available for a party to a contract with a term longer than five years, to "provide one or more of the functions of designing, building, constructing, reconstructing, developing, redeveloping, managing, operating, or maintaining" infrastructure that is either publicly owned or subject to governmental rate regulation. Thus, private parties developing infrastructure with no governmental involvement or regulation are unable to claim the exemption from the 163(j) limitation, unless another exemption applies. The goal of this new administrative safe harbor was to encourage investment of public-private partnerships in core infrastructure. Such partnerships that develop capital-expenditure-heavy core infrastructure projects often use substantial amounts of debt financing, and permitting these entities to deduct only a portion of their interest expense could meaningfully affect after-tax returns when (and if) a profit was eventually turned.

Consistent with the policies supporting the 2018 revenue procedure, we propose expanding the REIT statute such that (1) assets described in the procedure would be qualifying assets for the

[56] Rev. Proc. 2018-59, 2018-50 IRB 1018.

[57] *Id.*

[58] Adjusted taxable income is defined as a taxpayer's taxable income, computed without regard to (among other items) interest income or expense, net operating loss deductions, and (for tax years beginning before January 1, 2022) deductions for depreciation, amortization, and depletion. Section 163(j)(8)(A).

[59] Section 168(g)(8).

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REIT asset tests (to the extent not already eligible), and (2) income derived from the use or operation (by an owner or long-term tenant, not income derived by a third-party manager) of such facilities would be qualifying income for purposes of the REIT 75 percent or 95 percent gross income tests (regardless of whether that income would qualify as rents from real property or interest on a loan secured by real property under existing law). Thus, payments like landing and on-site parking fees at an airport, port tariffs, toll road collections, and similar periodic and usage fees for infrastructure assets would qualify for REIT gross income test purposes (in addition to more traditional income streams such as rents from triple net leases of infrastructure assets and interest from loans secured by infrastructure assets).

Those changes would permit private investors in designated core infrastructure assets to use the REIT statute, providing a meaningful improvement to their after-tax returns, even when their returns did not take the form of rents from real property or interest from loans secured by real property.

Similar proposals have been made in the past. In a 2009 *Tax Notes* article, Adam M. Handler and Stephanie M. Tran of PwC argued for making three changes to the REIT statute:

1. expand the definition of qualifying assets to include infrastructure assets;
2. modify the REIT related-party rent rules to permit qualified infrastructure investments to be leased to a TRS of the REIT; and
3. change the TRS rules to permit the TRS to operate an infrastructure investment.[60]

We believe that the time has come to reconsider the PwC proposal and for Congress to enact an updated and liberalized version of it for public-private partnerships, building off the momentum of the 2018 revenue procedure and the recent 2019 oil and gas pipeline ruling. The IRS has already adopted much of the first recommendation — as described above, 2016 final regulations define "real property" for REIT asset testing purposes to include many infrastructure assets such as pipelines, oil and gas storage tanks, railroad tracks, and road beds.[61]

The second and third PwC proposals (permitting a REIT to lease infrastructure assets to its TRS, a corporate subsidiary) draw from the experience of the hotel and healthcare industries. Congress changed the code in 2001 to permit a REIT to lease a hotel or healthcare facility to a TRS subsidiary (even a wholly owned TRS) without violating the REIT related-party rent rules, as long as the facility was operated by a third-party "eligible independent contractor" that did not share more than 35 percent common ownership with the REIT.[62] While a change to the REIT rules to permit a TRS to lease and operate infrastructure would open a path for REITs to (indirectly) own and operate infrastructure projects, it would do so at the cost of a complicated and nonintuitive structure. An infrastructure REIT formed under this regime would be required to own every asset in an internalized lease structure and use a taxable entity to operate the project, creating significant tax leakage and administrative costs along the way. Also, this change would run counter to the congressional trend of limiting the scope and size of TRSs since the publication of the 2009 PwC proposal.[63]

The authors of this article would go further than PwC's proposal, creating a new REIT gross income test for REITs that directly owned and operated qualifying infrastructure assets (rather than leasing the assets to a TRS or third-party manager). While this modification would require an act of Congress, the IRS has opened a path to this change with the 2018 revenue procedure, which acknowledges that a developer, lessor, or builder of core infrastructure assets could be treated as engaged in a real property trade or business for limited specified purposes (and thus would be eligible to claim a real estate business's

[60] Handler and Tran, *supra* note 49.

[61] Reg. section 1.856-10(d)(2)(iii)(B).

[62] Section 856(d)(8)(B). A TRS may also lease property from a REIT without violating the related-party rent rules, when at least 90 percent of the space at the property is rented to unrelated tenants of the REIT, and the TRS's rents paid under its lease are substantially comparable with those paid by other tenants. Section 856(d)(8)(A). This exception presumably would not be relevant in an infrastructure context, where a typical project would at most be subject to a single lease.

[63] The Protecting Americans From Tax Hikes Act of 2015 reduced the portion of a REIT's assets that can be composed of TRS securities from 25 percent to 20 percent for tax years beginning after December 31, 2017.

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election out of some interest expense limitations). That change would also result in a simplified infrastructure REIT structure, avoiding the need to enlist tax advisers to insert a related-party lease into an ownership structure that otherwise did not call for one. If Congress's goal is to use the REIT statute to create incentives for investment in infrastructure, a new paradigm is called for — and permitting REITs to directly receive operating income from infrastructure assets fits the bill neatly.

This approach is consistent in many ways with the existing REIT statute. The REIT rules offer incentives for participation as an investor in longer-term assets that generate stable cash flows (in the form of rents and interest) from relatively passive investments.[64] This proposed expansion of the statute would continue to offer incentives for long-term investment in stable, passive assets and projects with relatively steady cash flows; the cash flows would just come in a different form. The statute could also be tailored so that an operator's income from an infrastructure project would violate the 75 percent and 95 percent gross income tests when the operator provided excessive services (similar to the "impermissible tenant service income" regime in the existing REIT rules, for example, excessive services in this context might be defined as services that are not intrinsically associated with the ownership and operation of the infrastructure asset).[65]

Indeed, the statute could be drafted to require that a third-party manager or operator provide all day-to-day operational management activities and services at the project — much like the existing eligible independent contractor rules for hotel and healthcare facilities (albeit in those instances, the REIT must also lease the facility to a TRS before the TRS engages an independent contractor)[66] — so that only a truly passive owner or long-term lessor of the project could claim the benefit of the REIT rules. Active services provided beyond mere operation of the facility would be required to be run through a TRS or an independent contractor, which would not also receive the special benefits of the REIT regime. This would help attract investment to the underlying infrastructure asset without providing excessive tax benefits to service, construction, maintenance, and other businesses that had not taken the investment risk of acquiring or funding the underlying infrastructure project.

Moreover, as indicated by the recent 2019 oil and gas pipeline ruling, the IRS has already shown a willingness to adopt a flexible view of the REIT rules in the infrastructure industry. That ruling suggests that even user fees and non-lease payments from contractual arrangements can qualify as rents from real property for REIT income test purposes, when payments are comparable with a percentage rent scheme and when they represent "an amount received for the use of, or the right to use" real property, and when a TRS provides tenants or users with all impermissible services.[67] Given that the REIT asset test regulations already define real property as including many types of infrastructure assets,[68] it seems like a logical next step to expand the REIT income test regulations to cover usage fees and payments for the use of the real property, regardless of whether they are received from lease arrangements (as long as the REIT does not directly provide impermissible services to its tenants or users).

Existing REIT rules already mandate a long-term holding period, consistent with the intentions of many infrastructure investors. The "dealer property" rules effectively require a REIT to hold assets for at least two years after development to avoid a 100 percent prohibited-transaction tax imposed on a REIT selling assets as a dealer.[69] If the new infrastructure REIT statute was intended to incentivize only long-term investments in core infrastructure, this two-year statutory safe harbor could be extended (for example, to three to five years). A five-year minimum holding period also would be

[64] *See* H.R. Rep. No. 86-2020 (1960), reprinted at 1960-2 C.B. 819 ("One of the principal purposes of your committee in imposing restrictions on types of income of a qualifying real estate investment trust is to be sure that the bulk of its income is from passive sources and not from the active conduct of a trade or business.").

[65] Section 856(d)(7).

[66] Section 856(d)(8)(B).

[67] LTR 201907001.

[68] Reg. section 1.856-10(d)(2)(iii)(B).

[69] Section 857(b)(6)(C).

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consistent with the requirement of the 2018 revenue procedure.[70]

The use of the REIT regime would create a neatly aligned match between the sources of capital for many infrastructure projects (domestic and foreign pension plans) and an appropriate tax structure. Pension plans (in contrast with some more short-term private investors) are ideal investors in infrastructure projects because they have long-term investment horizons, the ability to tolerate lower returns, and (in many cases) a public service mission that encourages investments in assets like transportation, water, and energy infrastructure that serve a societal purpose. However, the current U.S. tax rules do not broadly accommodate pension plan capital in infrastructure investments. U.S. tax-exempt investors are subject to tax on UBTI, which arises from active business investments in noncorporate entities (and many infrastructure investments are not held in corporate entities).[71]

Similarly, non-U.S. pension plans are subject to tax on ECI, which arises from active U.S. business investments in noncorporate entities.[72] REIT structures assuage (for the most part) UBTI and ECI concerns for pension plan investors, as described above, because REIT operating dividends from operations are neither UBTI nor ECI, and non-U.S. pension plans are generally exempt from the FIRPTA tax on sale of U.S. real estate.[73] Thus, REITs present an attractive holding structure for pension plans. Under current law, this means that pension plans can invest in commercial real estate with little or no tax during the holding period and no tax on exit. Expanding the REIT statute to permit pure infrastructure investments would equalize the tax treatment of pension plans' investments in commercial real estate with investments in U.S. core infrastructure (which may in some cases be a more appropriate long-term risk-adjusted investments for many pension plans).

Also, the same policy reasons that drove the enactment of the original REIT statute — namely, attracting retail investors to an asset class that offers participation in large income-producing investments — are also relevant for infrastructure investments. Infrastructure investments may provide lower yields than commercial real estate investments in many cases, but offer a long-term and stable return that is appropriate for many retirees and other retail investors seeking alternatives to fixed-income investments. The 20 percent passthrough deduction for individuals receiving REIT ordinary dividends in tax years beginning before 2026 only heightens the attraction to retail investors.[74]

Further, to assuage concerns that this new REIT regime could cause an excessive loss of tax revenue for profitable projects, the regime's scope could be limited to assets owned in a public-private partnership with a governmental entity or when pricing was subject to governmental approval, similar to the requirements of the 2018 revenue procedure. This might result in excluding some types of infrastructure projects that are often privately owned or unregulated (such as railway tracks or some energy assets).[75] Policymakers would need to decide whether to create a broad-based expansion to the REIT rules that provided incentives to all types of infrastructure assets (regardless of whether they are undercapitalized under current law), or whether to narrowly tailor the new statute to focus only on specified areas like bridges, roads, ports, airports, water infrastructure, and other core infrastructure that has a compelling and immediate need for private investment.

Conclusion

The REIT rules (and indeed, the tax code as a whole) are not a silver bullet for America's chronic underinvestment in infrastructure. However, such rules may offer a step forward as part of a broader national focus on improving the country's physical plant and removing impediments to future growth. Pension plans and retail investors

[70] Rev. Proc. 2018-59.

[71] Section 512.

[72] Sections 864, 882.

[73] See the section on REIT requirements and incentives, above. Additional incentives exist for investors in publicly traded REITs.

[74] Section 199A(b)(1)(B).

[75] However, as the recent oil and gas pipeline ruling indicates, there may be an appetite within the IRS to expand the REIT rules to cover fees for the use of infrastructure property (and similar payments) that are comparable with a percentage rent arrangement, regardless of whether the asset is regulated. LTR 201907001.

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seeking stable yields are natural investors in core infrastructure, and in many countries outside the United States, pension plans already have invested heavily in privatized infrastructure projects. By expanding the REIT statute to align the tax treatment of commercial real estate and core infrastructure, Congress could encourage greatly needed investments that ensure the longevity of America's economic potential, while also opening the door to retail investor and pension plan participation in a new category of attractive long-term and stable investments. ■

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