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Blog Post

Midstream REIT Guidance Creates Opportunities for Midstream Oil & Gas

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Thanks to recent IRS guidance, investors may now be able to hold certain midstream oil and gas assets in a tax-efficient real estate investment trust ("REIT").

Background: Historic Structures and REIT Benefits

Prior to the energy market dislocations of the past six years, the Master Limited Partnership ("MLP") was the vehicle of choice for publicly traded midstream companies. However, the total market capitalization invested through public MLPs has plummeted from more than $600 billion in 2012 to $288 billion in late 2019. A variety of factors have led investors to become more wary of the MLP as an option for monetizing midstream assets, such as the general investor pullback from the public energy markets, the tax reform passed by Congress in 2017 (which narrowed the difference in effective tax rates for investments in public corporations versus MLPs) and retail investor preferences for IRS Forms 1099 from a corporation or REIT over Schedule K-1 from an MLP.

REITs have many advantages as a vehicle for investing in the midstream oil and gas space — a REIT is a tax-efficient investment vehicle that facilitates capital accumulation and deployment for a wide variety of investor constituencies. A REIT has the unique ability to function as a blocker corporation while still maintaining some flow-through benefits and avoiding entity level corporate tax. This makes the REIT highly attractive to tax-exempt investors sensitive to unrelated business taxable income and to non-U.S. investors sensitive to income effectively connected with the conduct of a U.S. trade or business (and in some cases, to capital gains taxed under the Foreign Investment in Real Property Tax Act ("FIRPTA") rules as well). REITs are also appealing to U.S. individuals and other retail investors because of their streamlined reporting and administration requirements compared to MLPs and other pass-through structures (such as 1099 reporting and certain state tax benefits).

The following chart highlights some of these benefits:

REITS VS. MLPs for Midstream Oil & Gas

ISSUE	REITS	MLPS
Entity Level Tax	• 0% (provided all taxable income is distributed to shareholders)	• 0%
Entity Type	• Corporation; electing Partnership/LLC/Trust	• Partnership
Investment Limitations	• Must be a passive investor in infrastructure, real property or real estate-related debt • Must meet 75%/95% gross income tests and 75%/20%/5% asset tests	• At least 90% of gross income for each taxable year must be income from certain enumerated oil and gas, mineral, and other qualifying investments
Investors Subject to Additional State or Fed. Filing Obligations	• No	• Yes
Federal Tax Reporting	• Form 1099; 20% QBI deduction available	• Form K-1; 20% QBI deduction available
Income Treated as ECI	• No	• Yes
Income Treated as UBTI	• No	• Yes
Income subject to FIRPTA	• Gain is not subject to FIRPTA if the stock of a "domestically controlled" REIT is sold • Gain attributable to sale of FIRPTA assets is still subject to FIRPTA • Holders of less than 10% of a public REIT's shares are not subject to FIRPTA tax on either a sale of those REIT shares or capital gain dividends from the REIT attributable to asset sales	• Yes; except to the extent an investor owns 5% or less of MLP interests that are treated as traded regularly on an established securities market
Maximum Tax Rate for Foreign Corporate Investors	• No entity-level tax • Dividend income taxed at a maximum of 30% (potentially reduced to 15% under applicable treaty) • U.S. withholding tax for sovereign wealth funds and certain pension funds may be reduced to 0%	• U.S. tax at 21% on operating income and gain, plus U.S. branch profits tax at 30% or lower treaty rate (i.e., up to a 44.7% combined rate for non-U.S. corporate investors) • No treaty protection (except to the extent of branch profits tax)
Governance	• Standard board of directors	• General partner governance
FERC Income Tax Allowance?	• Likely no	• No

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The Midstream REIT Ruling

Historically, midstream and upstream energy assets were off-limits for REITs, as REIT investments are required to meet complicated tests regarding asset and income composition, and the REIT must limit services provided to certain "permissible" services. Among other requirements, more than 75% of a REIT's income must come from "rents" from real property in the form of leases or other real-estate related passive income, not service contracts or other active revenue streams. Owners of assets that generated "active" income such as a pipeline or energy storage facility could still satisfy the REIT rules by triple-net leasing the assets to an operator, but most midstream asset owners do not triple-net lease their assets.

The guidance issued by the IRS in February 2019 expanded permissible passive income under the REIT rules by treating income from industry-standard midstream contracts (including payments by customers for the use of pipeline or storage capacity) as “rents” for REIT purposes. The ruling also expands the scope of “permissible” services a REIT could perform with respect to midstream energy assets without compromising its REIT status, including certain maintenance, security and inspection services.

The chart below outlines some of the income streams and services permitted under the ruling. While non-precedential for other midstream investors, the ruling may be viewed as indicative of the IRS’s current views of the scope of the REIT rules in the midstream space, and may open the doors to a welcome new source of capital in the midstream space.

Midstream Oil & Gas REIT Ruling – Summary Table

MIDSTREAM ASSET	PERMISSIBLE INCOME STREAMS	PERMISSIBLE SERVICES	IMPERMISSIBLE SERVICES (TRS)	IMPERMISSIBLE PROPERTY
Pipelines	• Periodic fees that cover both pipeline use and related services • Fixed monthly payments for a reserved amount of pipeline capacity • Additional excess capacity payments • Periodic fees based on a fixed price multiplied by the volume of product transported, with no base fee or minimum	• Inspecting and monitoring the physical condition of the pipelines • Marking the location of buried pipelines to minimize the possibility of damage due to digging by unrelated parties • Making decisions with respect to and supervising the maintenance, repair, and construction of the pipelines • Testing product as it enters the pipelines to verify that it is the correct product solely to ensure the safety and integrity of the pipeline and the environment	• Scheduling the use of the pipelines with the end users • Unloading and moving customer product • Adding agents or additives to customer product • Owning, monitoring, maintaining, and operating personal property (such as compressors and pumps) to the extent such property exceeds 15% of the total fair market value of all property leased	• Pipelines that transport product for customers without an established agreement
Offshore Oil and Gas Platforms	• Fixed or percentage rent revenue streams, with any percentage rents calculated based on gross volume	• Unclear	• Services inconsistent with owning the offshore platform	• Offshore mobile platforms
Storage	• Periodic fees that cover both fixed storage capacity and related services • Additional excess capacity fees	• Constructing, inspecting, maintaining and repairing the storage tanks and other related property • Addressing safety and environmental issues • Testing customer product to confirm specifications • Providing security	• Loading, unloading, and moving customer product, • Adding agents or additives to customer product • Measuring or weighing customer product • Heating, circulating, and blending customer product • Operating, maintaining and repairing such equipment used to heat, circulate and blend	• Portable or temporary storage systems

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Next Steps

Companies in the midstream oil and gas space should look carefully at their investments and investor base to determine whether the use of REITs is feasible and beneficial under these new rules. Under appropriate facts, the use of a REIT to hold midstream energy investments could add significant value over historical structures.

Read more insights from Kirkland's Energy & Infrastructure blog.

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