Tax-efficient infrastructure investing

By David **SCHULTE**

The established REIT investment model is providing the foundation for investors to gain streamlined exposure to listed infrastructure.

Infrastructure has highly valuable attributes for investors including attractive, risk-adjusted returns, supported by predictable cash flows, with inflation protections. Over the past several decades, investment vehicles have been created to more easily allow public investors to access this desirable asset class, including real estate investment trusts (REITs), master limited partnerships (MLPs) and closed end funds (CEFs) that invest in MLPs.

In 2011, CorEnergy Infrastructure Trust, Inc. (NYSE: CORR, CORRPrA) compared the operating characteristics and investment attributes of each vehicle and set out to build the first listed REIT focused on energy infrastructure. The firm believes other infrastructure companies could benefit from considering this tax-efficient and investor-friendly structure.

The value proposition of REITs

When one generally thinks of a REIT, they think of shopping malls, office parks and apartment buildings; rarely do they think of natural gas pipelines and oil storage terminals. However, real estate companies which fulfill the requirements to be a REIT are not subject to corporate-level tax as long as they pay a dividend equal to at least 90% of the REIT's taxable income (thereby avoiding a 'double tax' where the corporation pays taxes on its income and its shareholders pay tax on the receipt of a dividend).

MLPs offer a similar value proposition to investors who wish to avoid double taxation, but certain characteristics of the MLP limit the scope of the investor base because they may produce unrelated business-taxable income (UBTI), economically connected income (ECI) and require complex K-1 tax forms. This can be undesirable and burdensome for tax-exempt investors, foreign investors, and retail investors. >

The REIT structure offers a proven vehicle to benefit companies and the public, both as users of this infrastructure as well as potential investors in it.

CorEnergy reviewed the limitations which master limited partnerships create for institutional capital formation, and decided to focus on the over $1tn invested in the equity of the REIT sector as a proxy for investor preference and benchmarking. Although the retail portion of REIT ownership may expand in the coming years due to the growing population utilizing tax-exempt accounts as sources of income, these companies remain overwhelmingly held by institutional investors. This is a key difference from MLPs, who can have large sponsor or general partner ownership, but which have had more limited appeal to institutional investors for tax and governance reasons.

CorEnergy's structure and portfolio seek to combine desirable energy infrastructure exposure with a tax and governance structure suited to institutions. The analysts who publish research on our company provide investors with the expertise of both energy sector awareness, and REIT-structure familiarity.

The company currently has three research analysts which publish on it. Two, Selman Akyol of Stifel Financial Corp. and TJ Schultz of RBC Capital Markets LLC cover the midstream energy sector, while one, Barry Oxford of D.A. Davidson & Co., covers the real estate sector. We believe energy sector analysts help communicate CorEnergy's risk and opportunity of diversification through exposure to oil and gas infrastructure, while REIT analysts can discuss the expectation that leases are able to promote long-term contractual revenue visibility from critical assets to support a stable dividend.

Comparison of technical characteristics of infrastructure vehicles

	MLPs	MLP / Closed End Funds	C-Corps	REITs
Investor Tax Form	K-1	Form 1099	Form 1099	Form 1099
Investment Company Friendliness	No	No	Yes	Yes
Non-U.S. Investor Friendliness	No	No	Yes	Yes
Tax Exempt Owners	No	Yes	Yes	Yes
Shareholders Vote	No	Yes	Yes	Yes
Primarily Institutionally Held	No	No	Yes	Yes
Single Level Tax	Yes	No	No	Yes

REIT structure provides investors the most attractive access to energy infrastructure

Institutional, tax exempt and non-US investors desire access to the infrastructure asset class.

REIT qualifications expansion and utilization

When CorEnergy adopted a strategy to provide investors with direct exposure to energy infrastructure assets, it began by examining third-party private letter rulings (PLRs) from the Internal Revenue Service (IRS) to determine what was likely to be considered REIT-qualifying. In December of 2012, CorEnergy purchased its first real property asset, the Pinedale Liquids Gathering System, which supports natural gas production in Wyoming through its operating lease. For this asset, and with each acquisition thereafter, CorEnergy relied upon tax opinions from reputable law and accounting firms to gain comfort in its ability to qualify as a REIT.

Subsequently, CorEnergy purchased and leased a crude-oil and petroleum products terminal in Portland, Oregon in January of 2014 and the Grand Isle Gathering System in June of 2015, which is a subsea-to-onshore pipeline and storage terminal for oil and water production in the Gulf of Mexico. In each of these cases, CorEnergy believed both the asset and the income generated were permissible to be held in a REIT. The scope of permissable assets was later confirmed through the IRS' release of final regulations on the *Definition of Real Estate Investment Trust Real Property* in September of 2016 (Below left).

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DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[TD 9784]

RIN 1545–BM05

Definition of Real Estate Investment Trust Real Property

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations that clarify the definition of real property for purposes of the real estate investment trust provisions of the Internal Revenue Code (Code). These final regulations provide guidance to real estate investment trusts and their shareholders.

DATES: *Effective date:* These regulations are effective on August 31, 2016.

Applicability date: For dates of applicability, see § 1.856–10(h).

FOR FURTHER INFORMATION CONTACT: Julianne Allen of the Office of Associate Chief Counsel (Financial Institutions and Products) at (202) 317–6945 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background

This document contains amendments to the Income Tax Regulations (26 CFR part 1) relating to real estate investment trusts (REITs). Section 856 of the Code defines a REIT by setting forth various requirements. One of the requirements for a taxpayer to qualify as a REIT is that at the close of each quarter of the taxable year at least 75 percent of the value of its total assets is represented by real estate assets, cash and cash items (including receivables), and Government securities. See section 856(c)(4). Section 856(c)(5)(B) defines *real estate assets* to include real property (including interests in real property and interests in mortgages on real property). Section 856(c)(5)(C) defines *interests in real property* to include fee ownership and co-ownership of ''land or improvements thereon.'' Prior to these final regulations, § 1.856–3(d) of the Income Tax Regulations, promulgated in 1962 in TD 6598 (the 1962 Regulations), defined real property for purposes of the regulations under sections 856 through 859. Under § 1.856–3(d) of the 1962 Regulations, the term *real property means* land or improvements thereon, such as buildings or other inherently permanent structures thereon (including items which are structural components of such buildings or structures). In addition, the term ''real property'' includes interests in real property. Local law definitions will not be controlling for purposes of determining the meaning of the term ''real property'' as used in section 856 and the regulations thereunder. The term includes, for example, the wiring in a building, plumbing systems, central heating, or central air-conditioning machinery, pipes or ducts, elevators or escalators installed in the building, or other items which are structural components of a building or other permanent structure. The term does not include assets accessory to the operation of a business, such as machinery, printing press, transportation equipment which is not a structural component of the building, office equipment, refrigerators, individual air-conditioning units, grocery counters, furnishings of a motel, hotel, or office building, etc., even though such items may be termed fixtures under local law.

The IRS issued revenue rulings between 1969 and 1973 addressing whether certain assets qualify as real property for purposes of section 856. Specifically, the published rulings address whether assets such as railroad properties,[1] mobile home units permanently installed in a planned community,[2] air rights over real property,[3] interests in mortgage loans secured by total energy systems,[4] and mortgage loans secured by microwave transmission property[5] qualify as either real property or interests in real property under section 856. After these published rulings were issued, REITs invested in various types of assets that are not directly addressed by the regulations or the published rulings, and some of these REITs received letter rulings from the IRS concluding that certain of these various assets qualified as real property. A letter ruling, however, may not be relied upon by taxpayers other than the taxpayer that received the letter ruling[6] and is limited to its particular facts. The Treasury Department and the IRS recognized the need to provide updated published guidance on the definition of real property under sections 856 through 859. On May 14, 2014, the Treasury Department and the IRS published in the **Federal Register** a notice of proposed rulemaking (REG–150760–13 at 79 FR 27508) (NPRM) to define ''real property'' solely for purposes of sections 856 through 859 and provisions that reference the definition of real property in section 856 and the regulations thereunder.

Written and electronic comments responding to the NPRM were received. The written comments are available for public inspection at *http://www.regulations.gov* or upon request. A public hearing was held on September 18, 2014.

After consideration of all the comments, these final regulations adopt the proposed regulations as revised by this Treasury decision.[7] The comments and revisions are discussed in this preamble.

Summary of Comments and Explanation of Revisions

I. The Definition of Land

The proposed regulations defined the term ''land'' to include water and air space superjacent to land and natural products and deposits that are unsevered from the land. A commenter requested clarification that land includes water space and air space above ground that the taxpayer does not own. For example, a taxpayer may own a building and purchase air rights superjacent to one or more neighboring buildings to enhance the value of the building the taxpayer owns, or a taxpayer may purchase air rights in anticipation of using those rights to facilitate the future acquisition or development of property. The Treasury Department and the IRS agree that air space or water space superjacent to land each qualify as land even if the taxpayer owns only the air space or water space and does not own an interest in the underlying land. The proposed regulations stated that superjacent water and air space qualify as land, and these final regulations retain the language of the proposed regulations.

[1] Rev. Rul. 69–94 (1969–1 CB 189).
[2] Rev. Rul. 71–220 (1971–1 CB 210).
[3] Rev. Rul. 71–296 (1971–2 CB 263).
[4] Rev. Rul. 75–423 (1975–2 CB 222).
[5] Rev. Rul. 75–424 (1975–2 CB 269).
[6] Rev. Proc. 2016–1 (2016–1 IRB 1), section 11.02; see section 6110(k)(3) of the Code.
[7] Under section 856(c)(2) and (3), in order for an entity to qualify as a REIT, certain prescribed percentages of that entity's gross income must be derived from certain types of income (which include ''rents from real property'' and ''interest on obligations secured by mortgages on real property or on interests in real property''). The definition of real property in these final regulations applies for purposes of section 856(c)(2) and (3), but these final regulations provide neither explicit nor implicit guidance regarding whether various types of income are described in section 856(c)(2) and (3).

CorEnergy's Omega Pipeline is an example of an asset that qualifies under the REIT asset and income tests. Omega is beginning the fourth year of its ten-year contract with the Department of Defense to distribute natural gas to the Army base, Fort Leonard Wood, in south-central Missouri and also serves a number of end consumers. A private letter ruling issued by the IRS to CorEnergy in July of 2017 concludes that revenue from the DoD's long-term contract qualifies as "rents" from real property, allowing CorEnergy to own and operate the asset. CorEnergy also owns one asset in a taxable REIT subsidiary.

Further adoption by infrastructure companies

Applying regulations and guidance from the IRS to energy infrastructure and capital formation activities are core competencies of CorEnergy. As an early adopter of the REIT structure for non-traditional assets, CorEnergy acts as an example of how the structure can address many of the infrastructure needs faced by the USA today. Through the majority of its assets, the company demon-

CorEnergy Correlation vs. REITs, infrastructure & energy transport
2010 to date

strates the ability to hold assets in a qualified REIT and serve the funding needs of a diverse customer and tenant base of public and private companies, end consumers and government entities.

These are imperative developments as numerous types of infrastructure, including energy, transportation and cellular networks, will require trillions of dollars of capital expenditures in the coming years. The REIT structure enables widespread ownership, transparent reporting, and permanent capital formation, consistent with the duration of the assets involved.

The structure offers a proven vehicle to benefit companies and the public, both as users of this infrastructure as well as potential investors in it. As the categorization of REIT-qualifying assets and revenues continues to develop, it is an increasingly flexible mechanism to allow companies to construct and maintain essential structures, while providing public investors with access to critical assets with stable cash flows.

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David Schulte is a co-founder, Chief Executive Officer and President of CorEnergy Infrastructure Trust, Inc. Previously, Schulte was a co-founder and a Managing Director of Tortoise Capital Advisors L.L.C. where, until 2015, he served on the investment committee. He is recognized in the industry as an expert on master limited partnerships and other financial structures for investing in energy infrastructure.