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REITs and infrastructure projects
The next investment frontier?

Coming out of the economic downturn, private investors are seeking new avenues to generate tax-efficient returns on their invested funds. Could the use of Real Estate Investment Trusts (REITs) as a funding mechanism for major infrastructure projects provide such an opportunity?

The challenges faced by the United States in maintaining and updating its current infrastructure have been well documented. While the American Recovery and Reinvestment Act of 2009 provided some stimulus money for U.S. infrastructure projects, and the Obama Administration has made a commitment to fund high speed rail and other select infrastructure categories, public funds simply will not be sufficient to meet all of the United States' ongoing infrastructure maintenance and new construction needs. Additional sources of capital will be necessary to fill the gap.

In recent years, private investors have expressed interest in adding infrastructure assets to their investment portfolios. In general, private investments are often made via flow-through investment vehicles, such as limited liability companies (LLCs). However, recent Internal Revenue Service (IRS) private letter rulings may now allow investors to use REITs as an alternative investment structure. Like any investment strategy, though, using a REIT to invest in U.S. infrastructure has advantages and disadvantages.

Private investments in infrastructure

Because of the increased interest in infrastructure and the importance of infrastructure to the overall economy, private investments in infrastructure have become a topic of discussion among politicians, as well as investment bankers, professional advisors, and other investment managers of private equity funds and pension funds. In many countries, including Australia, Canada, France, and the United Kingdom, the participation of the private sector in infrastructure provision through the use of a "public-private partnership" (also referred to as a "P3" or "PPP") has reached a level of maturity across numerous infrastructure sectors. In a P3, the public sector grants a private sector party or consortium a long-term concession to assume responsibility for some or all of the design, construction, financing, operations, and maintenance of a publicly owned asset.

In the United States, transactions involving P3s to create or operate infrastructure assets are relatively new and have been controversial in some cases. Over the past few years, though, several high-profile transactions in the United States reported significant financial benefits. Those successes, combined with a growing need to spend trillions of dollars repairing and constructing roads and bridges, airports, and electric, gas, and water distribution systems, as well as hospitals, courthouses, and prisons [1], are causing supporters to believe that increased access to private capital through P3s would be a welcome complement to traditional infrastructure financing using tax-exempt bonds.

1. The American Society of Civil Engineers, in its "2009 Report Card for American Infrastructure," estimated that $2.2 trillion would need to be invested in U.S. infrastructure over the next five years to bring it up to good condition.

As evidence of this trend, several states have established P3 bodies to create frameworks for setting up and executing P3 transactions. These include the Public Infrastructure Advisory Committee in California, the State Asset Maximization Commission in New York, and the Public Private Partnership Authority in Puerto Rico. Other states, such as Virginia, Florida, Texas, and Illinois, have had significant P3s executed within their borders and therefore have frameworks established.

Although P3s are sometimes referred to as privatizations of assets, this is generally not an accurate description. By definition, a P3 is a long-term partnership between the public and private sector in which the private sector, through a performance-based and highly prescriptive long-term concession agreement, provides a public infrastructure asset or service in exchange for compensation that may or may not come directly from the project. A P3 generally does not transfer ownership or control of the asset to the private sector. Unfortunately, confusion around this point has led to much concern that the public interest is not being protected in P3 transactions because assets are "privatized."

Types of P3 transactions

P3s consist of two types of infrastructure transactions: brownfield and greenfield projects. Brownfield projects are the "concessioning" of existing facilities, such as toll roads, ports and airports, as well as buildings like hospitals or prisons. Such transactions have generally involved a large up-front payment by a private party in return for the right to operate, maintain, and collect income related to the project for a long period of time — typically 40 to 75 years.

In contrast, greenfield projects are those in which the P3 participates in creating new assets. In the United States, this typically involves design, construction, financing, operation, and maintenance of the asset. The P3 either retains the right to earn revenue directly from that asset — for example, tolls on a toll road — or from a performance-based "availability payment" from the public sector.

Private capital for infrastructure: The rise of REITs?

To date, pooled or syndicated capital raised in the United States to invest in infrastructure projects has largely used the fund model: a privately offered investment pool structured to be taxed as a partnership for U.S. tax purposes. This allows losses, which are common in a project's early years, to flow directly up to investors as a shelter against other income. In addition, income and proceeds from an ultimate sale would be distributed without tax penalties at the entity level, as would be the case if a corporation served as the syndication vehicle.

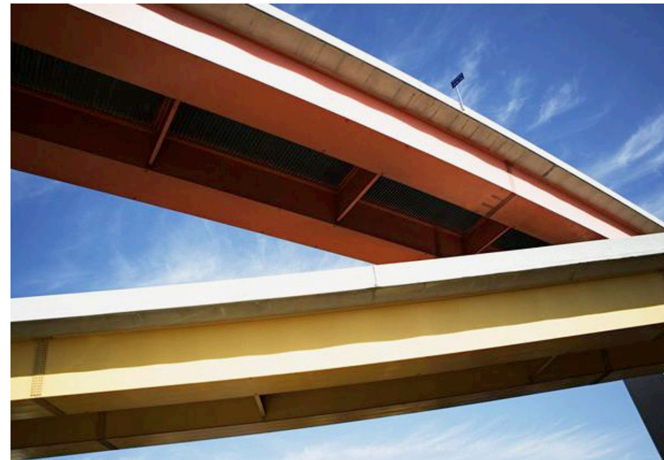
Although rarely applied until recently, a REIT is another vehicle that can be used to raise capital for infrastructure investments in P3 transactions. In the abstract, REITs have certain advantages over the fund model. Recently, several favorable IRS private letter rulings sanctioning the use of REITs to own electric and gas distribution systems have increased interest in their role in infrastructure investments.

Advantages of REIT investments in P3 infrastructure transactions

REITs offer several advantages over the Fund model as a way to raise and distribute capital:

- **Liquidity** — If publicly traded, REIT stock can be sold through recognized securities channels.
- **Incremental scalability** — Future capital raised for incremental investments after a project's start-up can be scaled to the size of the projected activities of the investment pool and its advisors through follow-on offerings without the complexity associated with Fund structures.
- **Capital market access** — REITs can access capital markets made up of the entire range of institutional and individual investors.
- **Taxation**
  - The dividends paid deduction under Internal Revenue Code section 561 allows a REIT to effectively operate without tax at the entity level as long as it distributes its taxable income annually.
  - Since ownership is via investment in stocks and income comes in the form of dividends, REITs provide a way to avoid characterization of a foreign owner as having a U.S. branch or effectively connected income.
  - No tax is imposed under the Foreign Investment in Real Property Tax Act (FIRPTA) on the sale of a non-U.S. Taxpayer's investment if either (i) the REIT stock is publicly traded and the investor owns less than 5 percent or (ii) the REIT is domestically controlled. If enacted, recently proposed legislation will lessen the adverse affect of FIRPTA on non-U.S. investors who use REITs to own U.S. real estate.
  - REIT dividends generally do not constitute unrelated business taxable income under IRC section 512 to tax-exempt entity owners, even where the REIT's property is leveraged.
  - Unlike Fund owners, REIT shareholders do not have to file tax returns in each state where a REIT owns assets or generates income.

In short, REITs offer certain advantages over partnerships in their ability to raise capital from diverse sources, particularly foreign investors. This may be especially helpful in the P3 market, where many of the current equity investors and project developers are global corporations that often need complex tax structuring to optimize their participation in P3s. In addition, expanding the investor base to individual investors may increase the availability of equity capital for infrastructure projects.



Disadvantages to using REITs

Despite these perceived advantages of REITs and the tax rules that allow them to avoid double taxation via the dividends paid deduction, significant barriers exist for those who want to use REITs as vehicles to invest in P3 infrastructure projects:

- Most P3 investments will generate significant tax losses in the first 10 to 15 years of operation. These losses do not pass through to REIT shareholders as they would to partners in a partnership.
- If significant distributions to investors comes from refinancing project assets, these will be taxable to REIT shareholders, even where there are no earnings and profits, to the extent they exceed tax basis in REIT stock. The partners in a partnership would not face this treatment due to the ability to increase "outside basis" by allocating shares of debt from a partnership to its partners.
- Two requirements relating to the types of income allowable for REITs may create issues for P3 projects if income cannot be characterized as derived from real estate ownership.
  - First, a REIT must derive not less than 75 percent of its gross income from real estate rents and mortgage interest payments.
  - Second, not more than 5 percent of a REIT's gross income can come from sources other than those included in the 75 percent basket, plus allowable interest, dividends, and certain other passive investment income sources.
  - It may be difficult for P3s involving toll roads, bridges, parking facilities, or transportation hubs like airports, seaports, or rail yards to qualify revenues as "rents from real property" under applicable tests.
  - Certain new construction, such as greenfield projects, may involve accommodation payments during periods of construction recognized as income under the percentage of completion method but not regarded as rent from real estate. These amounts may constitute 100 percent of gross income in the early years of a P3 project.
- Because REITs are not subject to tax, in certain regulated utility environments they may not be permitted to charge as much rent as a taxable entity would, thereby offsetting their tax advantage.

In short, some of the pass-through benefits of a partnership structure cannot be captured in a REIT.

Moving ahead

Despite these current limitations, deal makers continue to look for ways to use REITs in P3 transactions. Some groups have proposed a legislative fix to the most problematic REIT rules through the adoption of an Infrastructure Investment Trust (IIT).

As proposed, an IIT would eliminate the income test barriers for using REITs by including revenues from P3 infrastructure participation as qualifying income, regardless of whether that includes rent from real property. The proposal would also modify other rules, such as closely held limitations and asset tests, where a qualifying organization's assets consisted solely of concessions on infrastructure subject to a P3 arrangement.

Another approach would be to adopt a system allowing infrastructure assets to be owned or leased by a Taxable REIT Subsidiary (TRS) without current limitations on the total value of the REIT that can be represented by its TRS entities or current restrictions on rent that a REIT can derive from related parties, including its TRSs. This could potentially allow a fair return on capital to be REIT-eligible as rent or interest paid to the REIT by its TRS.

In summary, if the use of P3s to fund, rehabilitate, or develop infrastructure continues to proliferate in the United States, the role of REITs will likely be examined more closely. REITs represent a well-understood vehicle to access capital markets and allow the public to participate in owning qualifying infrastructure assets, aspects which may be attractive to both the public and private sector.

For additional Deloitte resources on P3s, please see:
www.deloitte.com/partneringforvalue
http://www.deloitte.com/view/en_XA/xa/services/public-private-partnerships-for-infrastructure/index.htm

Contacts	
Irene Walsh Managing Director Deloitte Corporate Finance LLC +1 212 436 4620 iwalsh@deloitte.com	**Lou Weller** Principal Deloitte Tax LLP +1 415 783 4459 lweller@deloitte.com
Mike Slattery Partner Deloitte Tax LLP +1 312 486 3125 mslattery@deloitte.com	**Charlie Temkin** Director Deloitte Tax LLP +1 202 879 4970 ctemkin@deloitte.com
Jim Ziglar Senior Vice President Deloitte Corporate Finance LLC +1 212 436 7630 jziglar@deloitte.com	**Larry Varellas** Partner Deloitte Tax LLP +1 415 783 6637 lvarellas@deloitte.com

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