ENERGY INFRASTRUCTURE
REAL ESTATE INVESTMENT TRUSTS

REITs and MLPs: The Future of Single-Tax Formats for Energy Infrastructure Facilities

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Comments and questions are invited

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Electronic links are provided to a number of source documents but the links are only functional via an electronic version of this material. An electronic version is available upon request.

INTRODUCTION

- On June 22, 2007, a private letter ruling (PLR) was released by Treasury (PLR 200725015) that confirmed the real property status of a broad range of energy and other tangible non-building, non-machinery infrastructure assets for real estate investment trust (REIT) purposes (the Conduit PLR). Through a series of footnotes, Endnotes and Annexes, the Conduit PLR is dissected, discussed and analyzed with a view to assessing the suitability of REIT formats for energy infrastructure assets, with a particular emphasis on comparisons to master limited partnerships/publicly-traded partnerships (MLPs).

- REITs (publicly-traded) and MLPs have exhibited substantial growth since 1995:

  - The market capitalization of all publicly-traded equity REITs at the end of 1995 approximated $55.5 billion, at the end of 2000 $138.7 billion and at the end of 2007 $312 billion (Source: NAREIT).

  - The market capitalization of energy MLPs at the end of 1995 approximated $5.6 billion, at the end of 2000 $15.7 billion and at the end of 2007 $126.2 billion (Source: Alerian/S&P).

- Growth in market capitalization for REITs and MLPs underscores the inherent attractiveness of single-tax formats for infrastructure, both buildings and other infrastructure.

- The Conduit PLR illuminates new asset classes for REITs and, to a more limited extent, MLPs.

- The Conduit PLR opens new sources of tax-exempt equity funding for energy infrastructure via REITs; the same is not true for MLPs. MLPs can, however, employ REIT technology to raise tax-exempt private equity to supplement capital raising through the MLP. Endnotes 10 and 24

- Energy sector MLPs are expected (Wachovia) to need to raise $8.5 billion of equity in 2008 to fund organic growth projects and acquisitions (primarily sponsor dropdowns). Announced pipeline MLP capital programs for 2006 to 2011 exceed $24.5 billion (Morgan Stanley). While secondary offerings and PIPE transactions have been meeting capital needs to date, new issue absorption capacity of public equity markets appears to be tightenting. Public and private REITs can provide a means of accessing non-MLP capital funding.

- Many REITs have successfully implemented significant private equity platforms. ProLogis (NYSE:PLD) and Developers Diversified Realty (NYSE:DDR) are prime examples. MLPs have not sought to implement private equity/funds management strategies. Select MLPs that are considered to be "best of breed" have an operating platform that can be "rented" by private investors seeking to realize energy sector-specific objectives.

INTRODUCTION
(continued)

- Energy infrastructure is generally comprised of fee-based assets with limited commodity price risk. Resulting stable cash flows are ideally suited for REIT equity markets.
- REIT shares have broader acceptance as an acquisition currency. Endnotes 1 and 14
  - -- Plum Creek Timber (NYSE:PLC): MLP to REIT.
  - -- U.S. Restaurant Properties: MLP to REIT.
- The current "C" corporation structure of many energy infrastructure companies (those where "wires and pipes" predominate) suppresses enterprise value when the bulk of tangible assets are most efficiently held in single-tax formats, "C" corporation status should be limited to those aspects of a business that cannot be held in single-tax format.
  - -- Hospitality Properties (NYSE:HPT)/Travel Center of America (AMEX:TA).
- Communications tower REIT.
  - -- Global Signal, Inc. (later acquired by Crown Castle, Inc.).
- Conversion to REIT status.
  - -- Rayonier (NYSE:RYN).
  - -- Potlatch (NYSE:PCH).
  - -- Catellus Development (later acquired by Prologis, a REIT).
  - -- Vencor (now named Ventas) via spin-off of operator/lessee.
- REIT Acquisitions.
  - -- 10 year hold/basis step-up.
- The Future of Single-Tax Formats.
  - -- Comparison of REITs and MLPs. Annex B and Annex D

Following the text of the PLR[1] are Endnotes and Annexes that expand on certain topics addressed in these annotations.

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[1] *See Endnote 34 for IRS Circular 230 disclosure.* The publicly-available version of this private letter ruling (Conduit PLR) does not disclose the nature of the "system" assets being addressed. It is understood that the "system" assets were electric distribution and transmission assets. Gas transmission and distribution systems have similar energy conduit features which indicate a response similar to that in the Conduit PLR would be forthcoming for a gas distribution REIT and a gas transmission REIT (the REIT could not, however, own the gas in the pipelines). This PLR directly addresses certain issues in the context of a REIT. The Conduit PLR also has significant implications for publicly-traded partnerships (MLPs) under section 7704 of the Code. Under section 7704(d)(1)(C), "rents from real property" (defined by section 7704(d)(3) with reference to the section 856 REIT provisions) are included within "qualifying income" from MLP purposes. While MLPs can invest in assets such as electric transmission and electric and gas distribution via the "rents from real property" source of qualified income, such investments would still generate (i) unrelated business taxable income (UBTI) issues for tax-exempt holders (rents from energy transmission and distribution facilities are treated as rents from personal property for UBTI purposes even though the facilities are real property for section 856 purposes) and (ii) FIRPTA tax issues for non-U.S. investors. *See Endnote 1 and Annex B for observations and material about the comparative advantages of a REIT approach over an MLP approach. See Endnote 10 for more on UBTI considerations. See Endnote 10 for more on UBTI considerations. See Endnote 17 for a reference to a* recent *MLP whose assets include non-U.S. electric transmission interests /investments.*

TEXT OF PLR WITH FOOTNOTE ANNOTATIONS

This is in reply to a letter dated September 29, 2006, and subsequent submissions, requesting rulings on behalf of Taxpayer. You requested rulings that Taxpayer's System is a "real estate asset" as defined in section 856(c)(5) of the Internal Revenue Code[2]; and that Taxpayer's activities under a lease of its System will not cause amounts received by Taxpayer under the lease to be treated as other than "rents from real property" within the meaning of section 856(d).

[A]. FACTS:

[1].Taxpayer is a domestic corporation organized on Date 1[3] that intends to elect to be taxed as a real estate investment trust (REIT) under subchapter M of Chapter 1 of the Internal Revenue Code. OP was organized as a limited liability company under state law on Date 2 and will be classified as a partnership for federal tax purposes. Taxpayer will own as its sole asset an interest in OP and will be the sole managing member in OP. It is anticipated that third parties will own non-managing membership interests in OP.[4]

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[2] "Real estate assets" are defined, in part, to include real property and interests in real property, section 856(c)(5)(B). "Interests in real property" include, among other things, fee and leasehold interests in land and improvements thereon, section 856(c)(5)(C). "Improvements" on land include "buildings or other inherently permanent structures [on land] (including items which are structural components of such buildings or structures)," Treas. Reg. 1.856-3(d). See paragraphs [B][1] through [3] of the text of the Conduit PLR.

[3] The preponderance of existing publicly-traded REITs are organized under Maryland law either as Maryland corporations or Maryland real estate investment trusts. See http://www.publicstorage.com/Corporateinformation/2007_reports/proxy2007.pdf for a 2007 proxy statement for a REIT proposing to convert from a California corporation to a Maryland trust for a statement of the relative benefits of Maryland law for REITs in comparison to California corporation law. An issue in choosing between trust and corporate form is state tax related: certain states impose franchise, income and other state and local taxes on corporations owning property in the state but not on trusts owning the same property. Simon Property Group, Inc. (NYSE: SPG) is an example of a REIT which is a Delaware corporation. Global Signal, Inc. (*see* footnote 21) is also a Delaware corporation.

[4] The structure describes an umbrella partnership REIT (UPREIT) structure. *See Endnote 2 for more on UPREITs.* See Diagram D for a diagram of a recent REIT initial public offering (IPO) which utilized the UPREIT structure.

For REIT purposes, the REIT is not required to control the management of the UPREIT. REITs can either be self-managed or externally managed or self-advised or externally-advised. *See Endnote 27 for a description of the differences.*

[2]. Property Partnership was organized as a limited partnership under state law on Date 3. OP will own an interest in Property Partnership as its sole asset. [5]

[3]. Taxpayer, through OP, intends to acquire one or more Systems.[6] The Systems will be contributed by OP to Property Partnership in exchange for additional interests in Property Partnership.[7] Neither Taxpayer, OP, nor Property Partnership will seek to be licensed by state or

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Making the REIT the sole managing member of the UPREIT holding company is necessary with a REIT that is to be publicly-traded so that the REIT does not become subject to regulation as an investment company under the Investment Company Act of 1940 (the "1940 Act"). To avoid 1940 Act regulation, the UPREIT holding company must remain a "majority-owned subsidiary" of the REIT with "majority-ownership" being measured by ownership of 50% or more of an entity's outstanding voting securities. Two recent initial public offerings (IPOs), El Paso Pipeline Partners, L.P. (http://www.sec.gov/Archives/edgar/data/1410838/000095012907005296/h48563a3sv1za.htm) and Williams Pipeline Partners, L.P. (http://www.sec.gov/Archives/edgar/data/1411583/000103570408000023/h49597b4e424b4.htm), suggest an alternative structure for the UPREIT: organize the UPREIT as a general partnership. Since a general partnership interest is generally believed to not constitute an "investment security" for 1940 Act purposes, a REIT could own a minority position in the UPREIT (perhaps as low as 10%) without becoming thereby subject to regulation as an investment company (provided that, as general partner, the REIT had a significant decision making role). See Diagram E for a diagram of the El Paso Pipeline Partners MLP IPO. *See Endnote 15 for more on 1940 Act considerations.* Presumptively, the holders of the "non-managing membership interests in OP" mentioned in the PLR would be private investors.

[5] The Conduit PLR is silent as to the tax classification of the Property Partnership. It could elect to be treated as a partnership for tax purposes or elect to be treated as a "C" corporation notwithstanding its partnership form. Since the Conduit PLR states that the REIT holding company will own "an" interest in the Property Partnership as the REIT holding company's sole asset, partnership status for the Property Partnership is at least implied. If the Property Partnership were to elect corporate status, it could be (i) a corporation which, if it were wholly-owned by the REIT, would be a "qualified REIT subsidiary" under section 856(i), or (ii) a separately qualified REIT. *See Endnote 3 for more on qualified REIT subsidiaries (QSRs) and Endnote 4 for more on REIT ownership of subsidiary REITs.*

[6] Frequently energy infrastructure assets are owned in common via undivided interests by more than one operator/user. An undivided interest can be made subject to a lease, Rev. Rul. 82-61, consistently with election-out of subchapter k, Treas. Reg. § 1.761-2(a)(1). A REIT could, therefore, own an undivided interest in a System and lease the same in such a way as to derive REIT qualifying rents. *See Endnote 18 for more on undivided ownership interests and election-out of subchapter k.*

[7] This is the classic function of an UPREIT structure: enabling the acquisition of high value, low basis property in a manner such that the contributor does not have an immediate gain recognition event. The additional interests in the Property Partnership are usually convertible into a pre-determined number of REIT units to provide the contributor with liquidity (in addition to the diversification obtained via the contribution to the Property Partnership).

federal regulatory authorities to operate a System. Property Partnership will lease a System to Lessee, an entity that will be licensed to operate the System. It is represented that Lessee will not be related to Taxpayer within the meaning of section 856(d)(2)(B)[8] and rent paid to Taxpayer will not be based in whole or in part upon Lessee's net income or profits within the meaning of section 856(d)(2)(A).[9]

[4]. The lease arrangement between Taxpayer[10] and Lessee is "triple net".[11] Lessee will be responsible for operating and maintaining the System and is responsible for all expenses

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The first sentence of [3] of the Conduit PLR does not specify how Systems will be acquired "through OP." The second sentence seems to imply contribution in addition to purchase. _See_ *Endnote 5 for more on acquisitions by REITs* _via_ *UPREITs.* The section 467 pre-paid true lease/sublease is an alternative means for low basis assets to be acquired by a REIT. _See_ *footnote 13 and Annex A*. One of the asset tests applicable to a REIT is that (subject to a number of exceptions) REIT may not own more than 10% of any one issuer's outstanding securities, as measured either by voting power or value. The 10% asset test does not apply to QRSs or TRSs. Also, the 10% asset test does not apply to section 467 rental agreements (_see_ Annex A), section 856(m)(1)(C).

[8] The Lessee cannot have 10% or more of its voting stock, or 10% or more of the value of its shares, owned directly or indirectly by the REIT, Section 856(d)(2)(B). Section 318 constructive ownership rules (with certain modifications applicable to REITs) apply to determining the nature and extent of a REIT's relationship to a tenant, Section 856(d)(5). _See_ *Endnote 16 for more on attribution rules applicable to REITs.* Section 856(d)(2)(B) includes an exception which would enable a REIT to own its lessee and still include the rents as "good" rents for REIT qualification purposes. The exception applies _only_ to certain taxable REIT subsidiaries (TRSs) that lease qualified lodging facilities from their parent REIT, section 856(d)(8). _See_ *Endnote 6 for more on TRSs.* While a TRS _cannot_ serve as the lessee of a System, the TRS can perform certain functions in the design and implementation of an energy infrastructure REIT. _See_ *Endnotes 6 and 9.*

[9] § 856(d)(2)(A): "except as provided in paragraphs (4) and (6), any amount received or accrued, directly or indirectly, with respect to any real or personal property, if the determination of such amount depends in whole or in part on the income or profits derived by any person from such property (except that any amount so received or accrued shall not be excluded from the term "rents from real property" solely by reason of being based on a fixed percentage or percentages or receipts or sales)…" _See_ *Endnote 7 for more on rent design.*

[10] Presumably, a reference to the "Property Partnership" was intended: _See_ *[A][3] above*.

[11] While the Conduit PLR describes the lease as "triple net," a triple net lease, as such, is not required for REIT purposes. If the lessor were to be required to make capital improvements or major repairs to the leased property (such as repairs to the roof of a building) it is commonly called a "double net" lease. REIT status is not dependent upon whether a lease is "double net" or "triple net."

The "leasing" activity of public storage REITs--Public Storage (NYSE:PSA), U-Store-It (NYSE:YSI), Sovran Self-Storage (NYSE:SSS) and Extra Space Storage (NYSE:EXR)--all involve the provision of storage services under terms that depart significantly from triple-net

associated with the leased property including the payment of insurance, taxes, operating expenses and utilities. Lessee will own or lease all of the vehicles, tools, and equipment and will employ or contract with all of the personnel necessary to operate the System.

[5]. Amounts received by Taxpayer under the lease will be for the use of or the right to use the System. Taxpayer will not furnish or render any services to Lessee in connection with the lease.[12] Taxpayer will only conduct activities in connection with the management of its own affairs such as negotiating lease terms[13] and dealing with taxes, interest, and insurance relating to

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leases (self-storage "leases" are typically for periods as short as 30 days). PLR 20008036 addresses aspects of the self-storage REIT business.

The electric utility business does not employ long-term leases as a means of transferring system capacity. Electric transmission sale and leaseback financings exist (Public Service Company of New Mexico, Portland General Electric Company and Niagara Mohawk Power Corp. are the examples) but they are rare. Capacity transfer via long-term lease is less rare in the natural gas pipeline business, and the use of pipeline capacity lease agreements seems to be growing. An initial review of the most recent pipeline capacity lease agreements on file with the Federal Energy Regulatory Commission (FERC) shows that such agreements can (and do) meet REIT requirements for "good rent" from "good leases." *See Endnote 32 for more on pipeline capacity leases.*

A "true lease" for federal income tax purposes is, however, required. *See Part A of Endnote 8 for more on this topic. See Endnote 19 for a discussion of a REIT that was designed and implemented as a counterparty to a sale and leaseback transaction.* Existing infrastructure tariff structures are already very "lease-like." For example, but for ownership of electric transmission revenues, the typical regional transmission operator (RTO)-style open access transmission tariff (OATT) and the related transmission owner (TO) agreements in combination seem to be very close to a lease under generally accepted accounting principles particularly in light of Emerging Issue Task Force (EITF) Issue No. 01-8, *Determining Whether an Arrangement Contains a Lease*. ETIF Issue No. 01-8 equates the right to control the use of underlying property with conveying the right to use the property. A conveyance of the right to use specified property is the sine qua non of a lease.

[12] The statement that "Taxpayer will not furnish or render any services to Lessee in connection with the lease" does not preclude the possibility that Taxpayer (either directly or through the Property Partnership) might own (or own an interest in) a TRS organized to provide services to the Lessee (so long as the pricing for such services meets the requirements of section 857(b)(7)(B)(v): such pricing by the TRS must result in gross income equal to not less than 150% of the TRS's direct cost in furnishing or rendering services to a tenant of the REIT). PLR 200625025 (describes a non-TRS, partially-owned partnership subsidiary of an UPREIT that provides services to the UPREIT. *See Endnote 9 for more on provision of services to a tenant by a REIT or its affiliates.*

[13] An important item because the sublease in any section 467 pre-paid true lease/sublease structure will be significantly shorter than the Lease due to "lease-in, lease-out" (LILO) considerations raised by Rev. Rul. 2002-69 and the district court opinion in BB&T Corp. v. U.S., ___ F. Supp. 2d ____ (M.D.N.C. 2007), Slip Opinion 2007 WL 37798, 99 A.F.T.R.2d 2007-376,

its property. Taxpayer also may undertake limited activities such as forwarding property tax invoices to Lessee and may make capital expenditures with respect to the System.[14]

[6]. A System is a system of physically connected and functionally interdependent assets that serve as a conduit to allow *[redacted material]* created by a generation source to flow through the system to end-users.[15] Taxpayer represents that a System is passive and does not include any machinery or equipment that creates or generates any *[redacted material]*, audio, video, electrical signal or other commodity.[16] The System is clearly distinct from the system that

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2007-1 USTC ¶ 50, 130, appeal docketed, No. 07-117 (4th Cir., March 7, 2007). *Annex A* presents a case study for a section 467 pre-paid true lease/sublease structure utilized by an infrastructure REIT (Global Signal, Inc, *see footnote 21 below*) as a means of acquiring zero-basis (in the hands of the lessor/sublease) infrastructure assets (cell towers). The section 467 pre-paid true lease/sublease will likely be an important means by which low basis gas and electric distribution and transmission assets can be transferred into a REIT.

[14] The regulations provide, §§ 1.856-4(b)(5)(ii), that the "trustees or directors [of the REIT] may also make capital expenditures with respect to the [REIT's] property…and make decisions as to repairs of the [REIT's] property…, the cost of which maybe borne by the [REIT]." Note two things about this aspect of the REIT regulations: first, the REIT appears entitled to make capital expenditures but only make *decisions* as to repairs; and, second, the PLR does not reference the Taxpayer making "decisions as to repairs."

[15] The Conduit PLR appears to encompass the "conduit" system up to the end user: it thus appears to permit both energy transmission and distribution to be owned by a REIT. *It is understood that the "System" addressed by the PLR encompassed electric transmission and distribution assets from the generator buss bar through (and including) the meters at retail delivery points.*

The components of a hydroelectric/pumped storage system (reservoirs, dams, canals, watersheds, tunnels, pipes, flumes, aqueducts and associated land, but not the turbines in the power houses) have many of the attributes of the Conduit system described in the PLR. Prospects seem favorable for a PLR addressing the "real property" nature of hydroelectric/pumped storage systems for REIT purposes. The turbines are well-sized in relation to the overall hydroelectric system such that the turbines could reside in taxable REIT subsidiaries. *See Endnotes 6 and 25*.

The described "System" bears a strong resemblance to the "network assets" that are excluded from the unit of property rules in the proposed regulations that "explain how section 263(a) of the Internal Revenue Code (Code) applies to amounts paid to acquire, produce or improve tangible property," Treas. Reg. (proposed) § 1.263(a)-1 to -3. "Network assets" are defined as "railroad tracks, oil and gas pipelines, water and sewage pipelines, power transmission and distribution lines, and telephone and cable lines that are owned or leased by taxpayers in each of those respective industries. Network assets include, for example, trunk and feeder lines, pole lines, and buried conduit," Treas. Reg. (proposed) § 1.263(a)-3(d)(2)(i).

[16] Generally speaking, items of machinery such as electric generating facilities cannot be owned by a REIT. An electric generating facility closely associated with the buildings it serves, if included as a whole with such buildings, would appear to constitute real property for REIT

generates *[redacted material: over one-half page of material appears in the original PLR as having been redacted].*[17]

[B]. LAW AND ANALYSIS:

Issue 1:

[1]. Section 856(c)(4)(A) provides that at the close of each quarter of its tax year, at least 75 percent of the value of a REIT's total assets must be represented by real estate assets, cash and cash items (including receivables), and Government securities.

[2]. Section 856(c)(5)(B) defines the term "real estate assets," in part, to mean real property (including interests in real property and interests in mortgages on real property) and shares (or transferable certificates of beneficial interest) in other REITs. Section 856(c)(5)(C) provides that the terms "interests in real property" includes fee ownership and co-ownership of land or improvements thereon, leaseholds of land or improvements thereon, options to acquire land or improvements thereon, and options to acquire leaseholds of land or improvements thereon, but does not include mineral, oil or gas royalty interests. [18]

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purposes, Rev. Rul. 73-425, 1973-2 C.B. 322 (a structural component, such as a total energy system, will be treated as real property if included with land, buildings, or other inherently permanent structures). See also *the Dupont Fabros PLR discussed at Endnote 26 below.* The REIT may, however, have indirect interests in electric generation via a TRS. See *Endnote 25 for a discussion of ownership by a TRS of electric generation.* See *Endnote 20 for a discussion of how some of the principle elements of a coal-fired or nuclear electric generation station might be able to come to rest in a REIT.* See *Endnote 21 for a discussion of a possible renewables REIT.*

[17] REITs are not limited to United States real property interests and/or dollar-denominated rents. Revenue Ruling 74-191, 1974-1 C.B. 170, holds that otherwise qualifying assets do not fail to satisfy REIT requirements (section 856(c)(4) in particular) merely because the assets are foreign. Some of the intricacies of foreign currency gains (a potential source of non-qualifying REIT income) are addressed in Revenue Ruling 2007-33, 2007-21 I.R.B. 1281, and in Notice 2007-42, 2007-21 I.R.B. 1288.

[18] Rev. Rul. 73-428, 1973-2 C.B. 303 states that a "royalty interest in oil and gas in place is a fee interest in mineral rights and real property for Federal income tax purposes."; Rev. Rul. 68-226, 1968-1 C.B. 226 states that "the interest of a lessee in oil and gas in place … is an interest in real property for Federal income tax purposes ... "

Underground gas and products storage facilities (including tanks, salt domes and gas storage fields) should constitute real estate assets, rather than personal property for purposes of

[3]. Section 1.856-3(b) of the Income Tax Regulations provides, in part, that the term "real estate assets" means real property. Section 1.856-3(d) provides that "real property" includes land or improvements thereon, such as buildings or other inherently permanent structures thereon (including items which are structural components of such buildings or structures). Local law definitions will not be controlling for purposes of determining the meaning of "real property" for purposes of section 856 and the regulations thereunder. Under this regulation, "real property" 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 a 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,

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the various REIT qualification tests. Cushion gas/cavern blanket volumes would not, however, be REIT-able.

Geothermal resources may also constitute real estate assets for REIT purposes. The section 856(c)(5)(C) definition of real property was enacted as part of the Tax Reform Act of 1976. Treasury Regulation 1.611-1(d)(5) provides "'Minerals' includes ores of the metals, coal, oil, gas, and all other natural metallic and nonmetallic deposits, except minerals derived from sea water, the air, or from similar inexhaustible sources. It includes but is not limited to all of the minerals and other natural deposits subject to depletion based upon a percentage of gross income from the property under section 613 and the regulations thereunder." This provision of the regulations was enacted in Treasury Decision 6446 in 1960. Two years after the Tax Reform Act of 1976, section 613(e) which provides for percentage depletion deductions for geothermal deposits located in the United States and its possessions was enacted as part of the Energy Tax Act of 1978. Thus, the reference to minerals in Section 856 and in Treasury Regulation §1.611-1(d)(5) was made before Congress addressed the depletion of geothermal resources in Code 613. The issue (one that would need to be addressed via private letter ruling request) is whether a geothermal resource is a "mineral interest" for purposes of section 856(c)(5)(C) or a natural resource that, even though it benefits from a depletion allowance, is not a mineral.

Standing timber is an example of a non-mineral natural resource for which a depletion allowance is made. Timberlands and standing timber are clearly "REIT-able". PLR 199925015 (March 19, 1999). A timber REIT (one of a number of publicly traded timber REITs) is noted in Endnote 1. *See Endnote 21 for a discussion of a possible renewables REIT for the energy infrastructure sector.*

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. [19]

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[19] For many years, the distinction between "real property" (generally, "section 1250 property") and "personal property" (generally, section 1245 property) has been critical for the availability of the investment tax credit and various types of accelerated/incentive depreciation deductions for federal income tax purposes. The lynch-pin to the distinction is whether or not a particular item of non-land tangible property is "inherently permanent." Many energy infrastructure tax payers have undertaken so-called "cost segregation studies" the focus of which was differentiating between buildings, which are section 1250 property depreciable straight-line over 39 years, and tangible personal property such as equipment, fixtures and furniture depreciable over shorter periods. A lively metaphysical debate continues: see Rev. Rul. 2003-54, 2003-1 C.B. 982 (depreciation status of gasoline pump canopies: good example of application of "inherent permanence" test to infrastructure–like asset with real property and personal property attributes) and Rev. Rul. 2003-81, 2003-2 C.B. 126 (the depreciation status of work benches, bookcases and parking lots). Most energy infrastructure property has been largely excluded from the section 1250/section 1245 debate due to provisions of the Code which categorize as section 1245 property "other tangible property [i.e., not tangible personal property] (not including a building or its structural components) but only if such other property is used as an integral part of . . . furnishing . . . electrical energy [or] gas . . . by a person engaged in a trade or business of furnishing any such services . . . " Treas. Regs. 1.1245-3(b); 1.48-1(a); 1.48-1(d); 1.48-1(e). *Included in Annex H are extracts from section 38, section 48 and section 1245 regulations that bear on energy infrastructure issues (Part I of Annex H) and an overview of the Whiteco Industries factors (Part II of Annex H).*

The REIT provisions of the Code and related regulations expressly enable REITs comprised by tangible property (irrespective of its depreciation status) that is inherently permanent but not a building. Indeed, Treas. Reg. defines "real property" for REIT purposes as "land or improvements thereon, such as buildings *or other inherently permanent structures thereon* (including items that are structural components of those buildings or structures). [emphasis supplied]". Although not conclusive, section 38 classification cases have been found to be "instructive" in determining what assets constitute real property for REIT purposes. *See* PLR 19990419 ("The classification of property for purposes of the investment tax credit is anxlogous to such determinations for REIT purposes.") PLR 19990419 is addressed in the immediately following paragraph.

Two PLRs address the real estate status for REIT purposes of cold storage warehouses and central refrigeration systems, PLR 199904019, http://www.taxboard.net/ForTaxProfs/irs-wd/1999/9904019.pdf and PLR 200027034, http://www.irs.gov/pub/irs-wd/0027034.pdf. Both PLRs discuss in detail how the inherent permanence analysis is to be applied in the REIT context. The second PLR notes that the requesting party represented that it would file on Form 3115 to change the depreciation status of the central refrigeration systems from personal property depreciable over seven years to nonresidential real property for depreciation purposes. The requesting party, Americold Corporation, remains a REIT that is 40% owned by Vornado Realty Trust, another REIT (NYSEArca: VNO). See also Rev. Rul. 68-184, 1968-1 C.B. 7 (modified by Rev. Rul. 81-199, 1981-2 C.B. 9) which was predicated on a steam distribution system (primarily for use in heating and air conditioning) being an "inherently permanent facility," and thus not "tangible personal property."

[4]. Rev. Rul. 69-94, 1969-C.B 189, concerns whether properties of a railroad, including land with improvements or other inherently permanent structures situated thereon which may be under, along, or adjacent to certain lines of the railroad, and including the tracks, roadbed, buildings, bridges and tunnels of the railroad, are real property for purposes of section 856. The revenue ruling holds that the railroad properties owned by the trust that are leased to another corporation are not "assets accessory to the operation of a business" within the meaning of section 1.856-3(d), but are "real estate assets" within the meaning of section 856(c). [20]

[5]. Rev. Rul. 75-424, 1975-2 C.B. 269, considers whether certain equipment used in connection with the transmission and reception of microwave signals is treated as real property, or assets accessory to a business, for purposes of section 856. The ruling concludes that the building, the heating and air conditioning system, the transmitting and receiving towers, and the chain link fencing are "real estate assets" within the meaning of section 856(c)(5)(B). The antennae, waveguides, transmitting, receiving, and multiplex equipment, and the prewired modular racks are "assets accessory to the operation of a trade or business" and are not "real estate assets" within the meaning of section 856(c)(5)(B). [21]

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[20] Pittsburgh & West Virginia Railroad (SEC File No. 1-5447) remains qualified as a REIT: it leases the entirety of its railroad properties (it owns no rolling stock) to an unrelated operating railroad. <u>See</u> *item 7 in Endnote 14 for a reference to a possible upcoming new railroad REIT.*

[21] The Conduit PLR might have also referenced Rev. Rul. 85-93, 1985-2 C.B. 9 (1985) which concluded that buried high voltage electrical transmission lines (carrying power to water pumphouses) are not tangible personal property but are "inherently permanent property not in the nature of machinery or equipment." Rev. Rul. 85-93 included this analysis: "The committee reports prepared when the investment credit was first enacted mention oil and gas pipelines as examples of real property. H.R. Rep. No. 1447, 87th Cong., 2d Sess. 12 (1962), 1962-3 C.B. 405, 416; S. Rep. No 1881, 87th Cong., 2d Sess. 16 (1962), 1962-3 C.B. 707, 722. Because they are analogous to oil and gas pipelines, extensive systems of underground piping are considered inherently permanent improvements to land and not tangible personal property. <u>See, e.g.</u>, <u>Johnston v. United Sates</u>, 80-1 U.S.T.C. paragraph 9199 (D. Mont. 1979) (underground water and sewer pipes); Rev. Rul. 69-273, 1969-1 C.B. 30 (underground pipes and valves in a golf course irrigation system); Rev. Rul. 66-269, 1966-2 C.B. 13 (underground pipes in a trailer park water and sewer system), all relying on the oil and gas pipeline analogy". *The 1962 legislative history is excerpted at the footnote to item 2 in Endnote 22 below.*

[6]. The System is designed so that the components are physically and functionally interdependent. It is not feasible to move all or any substantial part of the System. Each component of the System is intended to serve indefinitely and remain in place once affixed to other system parts and to the underlying land.

[7]. Similar to the tracks and other railroad components described in Rev. Rul. 69-94, the System is a passive conduit that allows *[redacted material]* created by a generation source to flow through the system to end-users. The System itself does not include any machinery or equipment that creates or generates *[redacted material]*. Also, like the equipment described in Rev. Rul. 75-424, the passive components that make up the System can be differentiated from the active machinery that generates *[redacted material]* and that is conducted through the System.

[8]. Based upon the information submitted and representations made, we conclude that the System is an inherently permanent structure that is not an accessory to the operation of a business. Accordingly, the System is a real estate asset within the meaning of sections 856(c)(4)(A) and (c)(5)(C).[22]

See also PLR 2000-41024 dated July 18, 2000 (released October 3, 2000) (certain rooftop platforms used in connection with wireless communications). A significant REIT, Global Signal, Inc., firmly established itself as a cell tower REIT on the basis of IRS pronouncements (Global Signal was acquired in January, 2007 by a non-REIT, Crown Castle Int'l (NYSEArca: CCI)). A prospectus for Global Signal (see http://www.sec.gov/Archives/edgar/data/1278382/000095013605002544/file001.htm) provides a good overview of an up and running non-building infrastructure REIT. Global Signal is the counterparty to the section 467 pre-paid true lease/sublease that is the subject of the case study contained in *Annex A*.

The most recent example of an infrastructure REIT (one involving highly specialized wholesale data centers – including dedicated electric power production facilities) is DuPont Fabros Technology, Inc. (NYSEArca: DFT). (See http://www.sec.gov/Archives/edgar/data/1407739/000119312507225035/d424b3.htm and PLR 200752012. While this REIT involves special purpose buildings, the buildings are essential links in the Nation's data infrastructure. *The Dupont Fabros PLR is described at Endnote 26.* Another REIT specializing in technology-related real estate (including telecommunications and information technology infrastructure properties) is Digital Realty Trust (NYSEArca: DLR).

[22] The conclusion reached in the Conduit PLR as to the REIT-ability of the described System may have substantial unintended consequences in that it may create (shed light on?) a number of United States real property holding corporations (USRPHCs) for whom much status may be a significant surprise. For example, the only domestic publicly-traded company that is

Issue 2:

[9]. Section 856(c)(2) provides that at least 95 percent of a REIT's gross income must be derived from, among other sources, "rents from real property." Section 856(c)(3) provides that at least 75 percent of a REIT's gross income must be derived from, among other sources, "rents from real property."

[10]. Section 856(d)(1) provides that "rents from real property" include (subject to exclusions provided in section 856(d)(2)): (A) rents from interests in real property, (B) charges for services customarily furnished or rendered in connection with the rental of real property, whether or not such charges are separately stated, and (C) rent attributable to personal property leased under, or in connection with, a lease of real property, but only if the rent attributable to such personal property for the taxable year does not exceed 15 percent of the total rent for the taxable year attributable to both the real and personal property leased under, or in connection with, such lease.[23]

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solely in the electric transmission business, ITC Holding Corp. (NYSEArca: ITC), would seem to meet all the requirements for USPRC status. Wires and pipes only companies (such as CenterPoint Energy, Inc.) and predominantly pipes companies would seem also to have issues to address. In 2001, Calpine Corporation (a merchant power company) began disclosing in its securities offerings the conclusion that it is "likely" it is a United States real property holding corporation. Section 897/1445 issues are bought into sharp focus in light of the section 897 implementing regulations expressly including as real property improvements "property . . . that constitutes" other tangible property under the principle of [§1.48 – 1(d)]".) § 1.897 – 1(b)(3)(iii)(B). "Other tangible property" is defined in relevant part at footnote 19 above; *see also* the Treasury regulations excepted at Annex H. Issues arising under Code sections 897 and 1445 are beyond the scope of these annotations. *See R.62 to R.72, pp. E-19 to E-21 below, for illustrative REIT disclosure on FIRPTA issues.*

[23] The Conduit PLR does not provide sufficient detail to determine which (if any) typical components of energy transmission/distribution system might have been outside the defined "System" and, therefore, might have been considered to not be real property. The Conduit PLR's description of the "System" in question seems broad enough to include as real property all tangible property comprising a transmission/distribution system. This is an important matter that would need to be addressed directly with Treasury in the context of a particular energy infrastructure REIT. Depending on the permissible scope of the "real property" components of an energy infrastructure system for REIT purposes, the leased assets could (subject to the 15% limit) encompass personal property such as computer hardware and software. For purposes of determining compliance with the 15% test, rents are to be apportioned between real and personal property based on relative fair market values, § 856(d)(1): "[W]ith the respect to each lease of

[11]. Section 1.856-4(a) defines the term "rents from real property" generally as the gross amounts received for the use of, or the right to use, real property of the REIT.

[12]. Section 1.856-4(b)(5)(ii)[24] provides that trustees or directors of the REIT are not required to delegate or contract out their fiduciary duty to manage the trust itself, as distinguished from rendering or furnishing services to the tenants of the property or managing or operating the property. Thus, the trustees or directors may do all those things necessary, in their fiduciary capacities, to manage and conduct the affairs of the REIT itself including establishing rental terms, choosing tenants, entering into renewal of leases, and dealing with taxes, interest, and insurance relating to the REIT's property. The trustees may also make capital expenditures with respect to the REIT's property (as defined in section 263).

[13]. Section 856(d)(2)(C) excludes from the definition of "rents from real property" any impermissible tenant service income as defined in section 856(d)(7). Section 856(d)(7)(A) provides, in relevant part, that the term impermissible tenant service income means, with respect to any real or personal property, any amount received or accrued directly or indirectly by the REIT for managing or operating such property. Section 856(d)(7)(B) provides that deminimis amounts of impermissible tenant service income, i.e., amounts less than one percent of all

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real property, rent attributable to personal property for the taxable year is that amount which bears the same ratio to total rent for the taxable year as the average of the fair market values of the personal property at the beginning and at the end of the taxable year bears to the average of the aggregate fair market values of both the real property and the personal property at the beginning and at the end of such taxable year." *For purposes of evaluating a possible energy infrastructure REIT, the critical element of the means of apportioning rent between real and personal is the use of relative fair market values rather than another basis, such as depreciated book cost. See Endnote 23 with respect to goodwill and assemblage valuation.*

[24] §§ 1.856-4(b)(5)(ii): "The trustees or directors of the real estate investment trust are not required to delegate or contract out their fiduciary duty to manage the trust itself, as distinguished from rendering or furnishing services to the tenants of its property or managing or operating the property. Thus, the trustees or directors may do all those things necessary, in their fiduciary capacities, to manage and conduct the affairs of the trust itself. For example, the trustees or directors may establish rental terms, choose tenants, enter into and renew leases, and deal with taxes, interest, and insurance, relating to the trust's property. The trustees or directors may also make capital expenditures with respect to the trust's property (as defined in section 263) and may make decisions as to repairs of the trust's property (of the type which would be deductible under section 162), the cost of which may be borne by the trust."

amounts received or accrued by the REIT with respect to a particular property during the taxable year, will not cause otherwise qualifying amounts to not be treated as rents from real property.

[14]. Section 856(d)(7)(C) excludes from the definition of impermissible tenant service income amounts received for services furnished or rendered, or management or operation provided, through an independent contractor from whom the trust itself does not derive or receive any income. Similarly, subparagraph (C) excludes amounts that would be excluded from unrelated business taxable income under section 512(b)(3) if received by an organization described in section 511(a)(2).

[15]. Section 512(b)(3) provides, in part, that there shall be excluded from the computation of unrelated business taxable income all rents from real property and all rents from personal property leased with such real property, if the rents attributable to such personal property are an incidental amount of the total rents received or accrued under the lease, determined at the time the personal property is placed in service.

[16]. Section 1.512(b)-1(c)(5) provides that payments for the use or occupancy of rooms and other space where services are also rendered to the occupant, such as for the use or occupancy of rooms or other quarters in hotels, boarding houses or apartment houses furnishing hotel services, or in tourist camps or tourist homes, motor courts or motels, or for the use or occupancy of space in parking lots, warehouses or storage garages, do not constitute rent from real property. Generally, services are considered rendered to the occupant if they are primarily for the tenant's convenience and are other than those usually or customarily rendered in connection with the rental of rooms or other space for occupancy only.

[17]. Taxpayer represents that they will not be providing any services to Lessee under the lease. The limited activities in which Taxpayer is involved are not services rendered for the convenience of Lessee under section 1.512(b)-1(c)(5). Trustees or directors of Taxpayer also may perform fiduciary functions as provided in section 1.856-4(b)(5)(ii). Accordingly, based on the information submitted and representations made, we conclude that Taxpayer's activities with

respect to the System will not cause amounts received under the lease of the System to be treated as other than "rents from real property" under section 856.

[18]. No opinion is expressed or implied with regard to whether Taxpayer otherwise qualifies as a REIT under subchapter M. Furthermore, no opinion is expressed or implied concerning the federal income tax treatment of Taxpayer under any section of the Code other than those upon which this ruling is based. This ruling is directed only to the taxpayer requesting it.[25] Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent. In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to your authorized representatives.

Sincerely,

William E. Coppersmith

Chief, Branch 2
Office of Associate Chief Counsel
(Financial Institutions & Products)

[25] While Private Letter Rulings are binding on the IRS only with respect to the particular taxpayer who requested the ruling, such rulings indicate the manner in which the IRS has approached a given topic and are generally understood to be a good indication of the IRS's position and rationale with respect to an issue.

ENDNOTES

Endnote 1. MLP v. REIT Format. 1. MLP's report taxable income and loss on cumbersome K-1's. REIT report distributions to shareholders on Form 1099. Tax-exempt U.S. stockholders in REITs benefit from a number of safe harbors from unrelated business taxable income (UBTI) with respect to REIT distributions. Rev. Rul. 66-106, 1966-1 C.B. 151, holds that the amounts distributed from a REIT to an exempt organization are treated as dividends and, thus, are excluded from UBIT, assuming that distributions are made out of its earnings and profits, and, therefore, were dividends within the meaning of section 316 of the Code[1]. These safe harbors are not available to tax-exempt U.S. holders of MLP interests. Generally speaking, taxation of non-U.S. stockholders is more beneficial with respect to REITs than it is with respect to MLPs particularly as it relates to withholding and U.S. real property interests (under the Foreign Investment in Real Property Tax Act of 1980—FIRPTA). REITs have a comparative disadvantage to MLPs in that MLPs can flow through tax losses to unit holders whereas tax losses cannot be flowed through by REITs (tax losses cumulate in the REIT). *A more detailed comparison of REIT and MLP structures for energy infrastructure is set forth in Annex B hereto. See footnote 22 for more on FIRPTA issues.*

2. The ability of REITs to transmute case flows that would otherwise constitute unrelated business taxable income (UBTI)—a bad thing if you are a tax-exempt investor such as a pension fund or a university endowment—into dividend cash flows is one of the more significant benefits of REITs in comparison to MLPs (and private partnerships generally). *See Endnote 10* for a discussion of UBTI considerations arising in connection with an energy infrastructure REIT. *See Endnote 29* for a more detailed discussion of private REITs and the role they can play in structuring investments by certain tax-exempt entities wishing to make private energy infrastructure investments.

3. MLP's continue their run through the energy infrastructure sector with NiSource being the most recent filing with its December 21, 2007 S-1 registration statement for the initial public offering for NiSource Energy Partners, L.P., the parent for its Columbia Gulf Pipeline System. http://www.sec.gov/Archives/edgar/data/1420783/000095012907006345/c18376sv1.htm. *Endnote 17* links to a recent spin-off of an MLP, Brookfield Infrastructure, that includes both (i) non-U.S. electric transmission and (ii) standing timber investments (including in the standing timber investments is a partial ownership of Longview Fibre, a timber company that was acquired by Brookfield as Longview was in the final stages of converting to a REIT (see item 5 below in this Endnote 1). Longview's REIT conversion was being pursued independently of (and was overtaken by) the Brookfield acquisition.

4. *Annex E contains the tax disclosure from both a recent REIT IPO, DuPont Fabros (linked at footnote 20 above), pp. E-1 to E-25, and a recent MLP, El Paso Pipeline Partners, L.P. (linked at footnote 2 above), pp. E-26 to E-45. The DuPont Fabros Technology prospectus did not include "ERISA considerations" disclosure comparable to that in the El Paso Pipeline*

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[1] See also Code Section 512(b) which expressly excludes dividends from UBTI. REIT distributions are taxed as dividends albeit not at the preferential current tax rate of 15%.

prospectus at pages E-44 to E-45. The "ERISA Considerations" excerpted below at R.79 to R.93, pages E-23 to E-25, are from the Douglas Emmett IPO prospectus (October 23, 2006) linked at item 2 in Endnote 27. These excerpts show the principal differences between REITs and MLPs from a Federal tax perspective. See Diagram D for a diagram of the structure of the Dupont Fabros REIT upon completion of its IPO. See Diagram E for a diagram of the structure of the El Paso Pipeline Partners MLP upon completion of its IPO.

5. MLP's that own/operate rate-regulated assets have been the subject of a lively ongoing debate in front of the Federal Energy Regulatory Commission (FERC) as chronicled in *Annex D*, pp. D-5 to D-7. The primary issues are (i) whether or not and to what extent an allowance for income taxes are to be included as a cost in calculating permitted rates for "pass-through" entities, and (ii) whether or not and how pass-through entities such as MLPs are to be included in proxy groups used for the discounted cash flow (DCF) analyses employed in setting the return in equity (ROE) component of rates. *Annex D* also sets forth talking points as to why REITs may present a better format for FERC-regulated assets. *Endnote 28* below describes the FERC's present position on the allowance for income taxes (ITA) in rates for pass-though entities such as MLPs. *Endnote 28* also addresses the prospects for REITs before the FERC in terms of extending the FERC's ITA policy to encompass REITs.

6. The timber industry is an example of a business that can be organized as an MLP or a REIT (although the availability of the REIT option only became clear in 1999 when the IRS made available a PLR, PLR 199925015 (March 19, 1999), that reached a favorable determination as to the real property character of standing timber and the characterization of "stumpage contracts"). Indeed a timber company that was initially organized as an MLP upon its initial public offering in 1996 (Plum Creek Timber Company, L.P.) was converted from an MLP to a REIT in 1999 (Plum Creek Timber Company, Inc., NYSE: PLC). See http://www.sec.gov/Archives/edgar/data/849213/0000950150-99-000079.txt for the proxy statement/prospectus issued in connection with the conversion. Within eighteen months, Plum Creek made a major acquisition enabled by the currency of its new REIT-based shares: see http://www.sec.gov/Archives/edgar/data/849213/000091205701523786/a2051900zs-4a.txt. Plum Creek Timber Company, Inc. has a market capitalization in excess of $6 billion. A single timber MLP remains: Pope Resources, A Delaware Limited Partnership (NASDAQ: POPEZ). The 1934 Act filings for Pope Resources indicate that its failure to convert to REIT status is in part a function of debt covenants that restrict distributions to 50% of net income (March 31, 2004 letter to accompany December 31, 2003 annual report: Ex. 99.1).

7. The restaurant sector presents another example of a successful move from MLP to REIT format. U.S. Restaurant Properties, Inc. began as a MLP upon its IPO in 1986 (under the name BurgerKing Investor Master LP) and converted to REIT status in October, 1997. [http://www.sec.gov/Archives/edgar/data/1032462/0000912057-97-017439.txt]. In 2005, U.S. Restaurant Properties became TruStreet Properties, Inc., in connection with its merger with CNL Restaurant Properties and the roll-up of 18 CNL investment partnerships http://www.sec.gov/Archives/edgar/data/1032462/000119312504221796/d424b3.htm. In early 2007, TruStreet was acquired by General Electric Capital http://www.sec.gov/Archives/edgar/data/1032462/000119312507002309/ddefm14a.htm. As with Plum Creek, business expansion via acquisition accelerated substantially upon conversion from MLP to REIT format.

8. The REIT sector has not shown any inclination to follow MLPs into the cemetery business. StoneMor Partners, L.P., a publicly traded partnership/MLP, is NASDAQ listed: STON. http://www.sec.gov/Archives/edgar/data/1286131/000119312507267109/d424b5.htm

9. There is a single publicly-traded domestic transmission-only company, ITC Holdings, Corp. (NYSE:ITC). ITC is structured as a "C" corporation for tax purposes. Following is a link to a recent prospectus: http://www.sec.gov/Archives/edgar/data/1317630/000095012308000374/k22658e424b5.htm. The ITC prospectus gives a good overview of the nature of its federally-regulated electric transmission functions.

10. Overall, REITs have broader investor acceptance in the public equity markets than do MLPs. One measure is the presence of REITs in certain of the broader market indices: as of December 20, 2007, thirteen REITs were included in the S&P 500 index (including Plum Creek Timber, ProLogis and Public Storage) and twenty REITs were included in the S&P 400 Mid Cap Index (including two who entered the index prior to their becoming REITs: Potlatch and Rayonier). There are no MLPs in either index (although S&P and others maintain a separate MLP index).

11. There are three types of REITs: exchange-traded REITs, publicly-offered but not listed REITs; and private REITs. A principle difference between an exchange-traded REIT and a non-listed publicly-offered REIT is the applicability the REIT Guidelines (the "REIT Guidelines") of the North American Securities Administrators Association (NASAA). The REIT Guidelines impose a number of limitations on publicly-offered REITs that go significantly beyond the rules applicable to, for example, a REIT listed on the New York Stock Exchange.[2] Among the requirements are requirements that: (i) as few as 10% of shareholders can call a special meeting of shareholders and (ii) advisory contracts must have a term of one year or less. The REIT Guidelines are unique to publicly-offered, non-listed REITs and need to be reviewed carefully as part of the consideration of a publicly-offered but non-listed energy infrastructure REIT. www.nasaa.org/content/Files/REITs.pdf The two REITs linked at item 4 in Endnote 27 are both publicly-offered, non-listed REITs. The proxy material linked at item 5 in Endnote 27 describes the process of leaving the REIT Guidelines behind as a REIT both internalizes the advisory and management functions as it becomes an NYSE Arca-listed REIT.

12. The National Association of Real Estate Invest Trusts (NAREIT) maintains a website on which is available numerous REIT data sources: www.nareit.com. The National Association of Publicly Traded Partnerships (NAPTP) maintains a similar website with a number of MLP data sources: www.naptp.org.

13. February 1, 2008 saw the first filing with the SEC of a "blank check" company, K Road Acquisition Corporation, whose strategic focus will be on the acquisition of businesses

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[2] New York Stock Exchange listing of a REIT would require a majority of independent directors (the same requirements is also imposed by the REIT Guidelines) unlike for NYSE Arca-listed MLPs which, as "controlled entities" need only to meet the independent audit committee requirement (usually met with just two independent directors for the board of directors of an MLP's general partner).

and/or assets in the electric power sector. The filing envisions a $300 million first round. http://www.sec.gov/Archives/edgar/data/1425734/000104746908000794/a2182419zs-1.htm Principals of K Road include former senior Sithe Energies executives. A "blank check" company raises public capital at a point in time prior to particular assets and/or businesses having been identified for acquisition. The "blank check" approach is a possible point of initial entry of REITs into the energy infrastructure sector.

14. *A combination of a prepaid true lease (Annex A) and an undivided interest transaction (Endnote 18 and Annex C)—with or without an inward-bound section 1031 exchange (Endnote 24) into an UPREIT operating partnership (Endnote 5)—could make a REIT an economically compelling means to finance new energy infrastructure facilities and/or transfer existing energy infrastructure facilities whether as a free-standing, self-managed REIT or as a REIT side-car to an existing MLP.*

Endnote 2. UPREITs. 1. Most REITs operate through an umbrella partnership (UPREIT) structure in which substantially all of the REIT's properties and assets are held in a partnership in which the REIT is the sole general partner and is the holder of either all or the bulk of the limited partnership interests. Third parties can hold interests in the UPREIT. This structure is illustrated by Host Hotels and Resorts, Inc. (NYSE:HST), the REIT, and Host Hotels & Resorts, L.P., the UPREIT, each of which files its own 1934 Act reports. Host Hotels & Resorts, Inc. is the sole general operating partnership partner and 96% interest holder in Host Hotels & Resorts, L.P.

2. A DownREIT describes a REIT that holds some real property interests directly in the REIT and other interests via subsidiary partnerships whereas in an UPREIT structure virtually all real property interests are held in the UPREIT operating partnership.

3. The statutory basis for the UPREIT structure is Code Section 856. In an UPREIT structure, the REIT is treated as indirectly owning the assets held by the UPREIT. For purposes of the asset and income tests of Section 856, the REIT is deemed to own its proportionate share, in accordance with its capital interest, of each of the assets of the UPREIT and to receive partnership income corresponding to its share of the assets. Under § 1.856-3(g) of the Income Tax Regulations, a REIT that is a partner in a partnership is deemed to own its proportionate share of each of the assets of the partnership and to be entitled to the income of the partnership attributable to that share. For purposes of § 856, the interest of a partner in the partnerhip's assets shall be determined in accordance with the partner's capital interest in the partnership. The character of the various assets in the hands of the partnership and items of gross income of the partnership shall retain the same character in the hands of the partners for all purposes of § 856. For purposes of calculating REIT taxable income and the required annual REIT distributive share of the UPREITs income would be determined under Code sections 704(b) and (c).

4. The partnership anti-abuse regulations specifically bless the UPREIT structure. The regulations state that the decision to organize and conduct business through the operating partnership is consistent with the intent of Subchapter K. In addition, the regulations state that the form of the transaction should be respected under substance over form analysis. *See* Treas. Reg. § 1.701-2(d), Example 4 ("Example 4").

5. *See Endnote 5 for acquisitions by REITs via UPREITs.*

Endnote 3. Qualified REIT Subsidiaries. If a REIT owns a corporate subsidiary that is a "qualified REIT subsidiary" (QRS), that subsidiary is disregarded for federal income tax purposes, and all assets, liabilities, and items of income, deduction and credit of the subsidiary are treated as assets, liabilities, and items of income, deduction of credit of the REIT itself, including for purposes of the gross income and assets REIT qualification tests, section 856(i) and § 1.856-9. A qualified REIT subsidiary is any corporation (other than a TRS, see Endnote 6 below) that is wholly-owned by a REIT, or by one or more disregarded subsidiaries of the REIT, or by a combination of the two. Other entities that are wholly-owned by a REIT (including single member limited liability companies) are also generally disregarded as separate entities for federal income tax purposes, including for purposes of the REIT gross income and asset tests. Treas. Reg. § 301.7701–3(b)(1)(ii).

Endnote 4. Subsidiary REITs. 1. REITs are not allowed to hold, directly or indirectly, subsidiaries that are corporations, other than corporations that qualify as REITs, disregarded entities (such as QRSs, see *Endnote 3*) or TRSs (see *Endnote 6*).

2. A REIT may own unlimited interests in other REITs due to the fact that the Code defines "real estate assets" to include shares (or transferable shares of beneficial interest) in other REITs, section 856(c)(5)(B). A subsidiary REIT can be (and is quite often) established by causing the corporation (if it meets all other requirements for REIT status) to issue a class of preferred stock to approximately 125 stockholders (in order to satisfy the REIT 100 minimum stockholder requirement) and then to elect REIT status for federal income tax purposes. Typically the REIT subsidiary offers the preferred stock solely to accredited investors in reliance on the exemptions provided by Regulation D under the Securities Act. Each share of preferred stock has a liquidation preference of $1,000 and entities the holder to a specified annual dividend (the preferred stock terms typically include a right to put the preferred stock back to the issuer if dividends are not paid for two consecutive years). Subsidiary REITs can play significant roles in the area of foreign currencies (arising from non-U.S. operations: foreign currency gains results in non-qualifying REIT gross income) and in the area of appreciated properties (where built-in gains may have arisen) acquired via acquisitions of corporations were section 338(h)(10) elections were not made at the time of acquisition. A detailed analysis of the pros and cons of subsidiary REITs is beyond the scope of these Endnotes. Host Hotels & Resorts, Inc. (mentioned in *Endnote 1*) owns a number of subsidiary REITs for various reasons (see http://www.sec.gov/Archives/edgar/data/1070750/000119312506042989/ds4a.htm: search for "subsidiary REIT").

3. REITs can be owned by entities other than REITs. For example, a number of Australian property trusts have as their principal asset indirect interests in U.S. REITs. Macquarie DDR Trust (ASX:MDT). Following is a link to the Australian product disclosure statement for ASX http://www.macquarie.com.au/au/business/acrobat/macquarie_ddr_trust_pds.pdf holds a 90% interest in a U.S. REIT and the U.S. REIT owns a 90% interest in the operating partnership (resulting in an effective 81% interest overall). Also, publicly-traded partnerships (PTPs) under section 7704 can also own REITs. KKR Financial Corp. (NYSE:KFN) was originally organized as a REIT. In 2007, the publicly-held entity was reorganized as a publicly-traded partnership (named "KKR Financial Holdings LLC") under section 7704 and KKR Financial Corp. retained its REIT status when it became wholly-owned subsidiary of the new PTP. http://www.sec.gov/Archives/edgar/data/1301508/000104746907002512/a2177075zdef14a.htm (Note that in the case of both Macquarie DDR Trust and KKR Financial a small amount of

preferred stock was issued by the REIT entity to each of 125 holders in order to meet the 100-holder REIT requirement).

Endnote 5. Acquisitions by REITs via UPREITs. The adoption of an UPREIT structure provides a flexible structure for acquisitions of new properties by permitting sellers to exchange their properties for UPREIT equity while deferring inherent tax gain. Similar tax-deferred acquisitions have been an important source of growth for many public REITs. UPREITs are typically established as limited partnerships with limited partner interests represented by units (which each unit having the economic equivalent of one share of the parent REIT). UPREIT units are typically redeemable at the option of the holder for cash and/or REIT shares. Unit redemption implicates Code provisions and related regulations under subchapter K concerning so-called "disguised sales", section 707(a)(2)(B) and Treas. Reg. 1.707 -3, -4 and -5. "Disguised sale" issues would also arise where the UPREIT incurs debt to fund cash payments to a partner who is contributing property to the UPREIT. See Chief Counsel Advice Memorandum (re: Leveraged Partnership) 200513022 (released April 1, 2005) and Chief Counsel Advice Memorandum (re: Leveraged Partnership) 200246014 (released November 15, 2002).

Endnote 6. Taxable REIT Subsidiaries (TRSs). 1. A REIT, in general, may elect with subsidiary corporations, whether or not wholly-owned, to treat the subsidiary corporation as a taxable REIT subsidiary (TRS) of the REIT. Code, § 856(l). The separate existence of a TRS or other taxable corporation, unlike a QRS or other disregarded subsidiary (*see Endnote 3 above*) is not ignored for federal income tax purposes. A parent REIT is not treated as holding the assets of a TRS or receiving any income that a TRS earns. Rather, the stock issued by the subsidiary is an asset in the hands of the parent REIT, and the REIT recognizes as income the dividends, if any, that it receives from the TRS. Because a parent REIT does not include the assets or income of TRSs in determining the parent's compliance with the REIT requirements, TRSs may be used by the parent REIT to undertake indirectly activities that the REIT rules might otherwise preclude it from doing directly or through QRS or other pass-through subsidiaries. A TRS can generally undertake third-party management and development activities and activities not related to real property.

2. PLR 200428019 addresses the situation of a REIT that owns and leases temperature-controlled storage facilities. The REIT has a TRS which performs product handling services. The PLR concludes, among other things, that fees for product handling and other services provided by the TRS will not be attributed to the REIT and the provision of such services will not cause otherwise qualifying amounts received by the REIT for providing space in its temperature-controlled storage facilities to fail to qualify as rents from real property. The PLR also addresses the status of services shared by the REIT and its TRS. An interesting aspect of the PLR is that the cold storage customer typically does not have access to the storage space (except for facilities dedicated to single customers). Also, customers do not have reserved storage locations within a particular storage facility. The relationship between the REIT, on the one hand, and the storage customers on the other hand, was nonetheless described as producing payments that were "rents from real property" as to the REIT.

3. For example, a TRS of an electric transmission REIT could own an electric generating plant. *See Endnote 25 for more on TRS ownership of generation.*

4. Among the asset-based requirements for REIT qualification are: (i) the value of any one issuer's securities owned by a REIT may not exceed 5% of the value of REITs total assets (the 5% asset test); and (ii) a REIT may not own more than 10% of any one issuers outstanding securities, as measured by either voting power or value (the 10% asset test), section 856(c)(4)(B)(iii). The 5% test and the 10% test do not apply to securities of TRSs, Section 856(c)(4)(B). The aggregate value of all TRSs held by a REIT may not exceed 20% of the value of the REITs total assets, section 856(c)(4)(B)(iii). Transactions between a REIT and its TRSs must occur "at arm's length" and on commercially reasonable terms, Code sections 482 and 857(b)(7).

5. Certain restrictions are imposed on TRSs. First, a TRS may not deduct interest payments made in any year to an affiliated REIT to the extent that such payments exceed, generally, 50% of the TRSs adjusted taxable income for that year (although the TRS may carry forward to, and deduct in, a succeeding year the disallowed interest expense if the 50% test is satisfied), section 163(j)(3)(A). Second, the parent REIT would be obligated to pay a 100% penalty tax on some payments from the TRS that it receives, including interest or rent, or on certain expenses deducted by the TRS, if the IRS were able to assert successfully that the economic arrangements between the REIT and the TRS did not meet the standards specified in the Code, sections 482 and 857(b)(7). Generally speaking, the 100% excise tax does not apply if: (i) the REIT charges substantially comparable rents to tenants who do and do not receive the TRS services; (2) the REIT charges substantially comparable prices for services to REIT tenants and to unrelated third parties; and (3) the gross income from TRS service charges is at least 150% of the direct costs of providing such services.

6. In the context of acquisitions of operating assets, REITs will occasionally structure the acquisition so that the REIT/UPREIT acquires the real property and a TRS acquires the personal property with both the REIT/UPREIT and the TRS entering separate leases with an operating company. For an example, see http://www.sec.gov/Archives/edgar/data/1261159/000119312506124432/d8k.htm; the real property lease and the personal property lease can be accessed at http://www.sec.gov/Archives/edgar/data/1261159/000119312506124432/dex101.htm and http://www.sec.gov/Archives/edgar/data/1261159/000119312506124432/dex102.htm., respectively.

Endnote 7. Rent Design. 1. Treasury Regulations expand on the language excerpted at footnote 7 at § 1.856-4(b)(3) as follows: "[a]n amount received or accrued as rent for the taxable year which consists, in whole or in part, of one or more percentages of the lessee's receipts or sales in excess of determinable dollar amounts may qualify as “rents from real property”, but only if two conditions exist. First, the determinable amounts must not depend in whole or in part on the income or profits of the lessee. Second, the percentages and, in the case of leases entered into after July 7, 1978, the determinable amounts, must be fixed at the time the lease is entered into and a change in percentages and determinable amounts is not renegotiated during the term of the lease (including any renewal periods of the lease) in a manner which has the effect of basing rent on income or profits. *In any event, an amount will not qualify as “rents from real property” if, considering the lease and all the surrounding circumstances, the arrangement does not conform with normal business practice but is in reality used as a means of basing the rent on income or profits.*" [emphasis supplied] The first part of the quoted language describes what is

called an "overage provision" in the real estate community: a fixed periodic amount of rent plus a percentage of a tenant's sales in excess of a determinable amount.

2. Other approaches to rent design are possible: in PLR 9230015, "rents from real property" were found to include amounts received by a REIT under leases containing a percentage rent component, adjusted to reflect (among other things) capital improvements. The adjustments were intended to make sure that the REIT received a constant rate of return on its capital investment in the property, and not to make the REIT an active participant in the lessee's business activity or create a profit-sharing arrangement. Other approaches to rent design can be undertaken consistently with the REIT regulations subject, in all cases, to the requirement of conformity with "normal business practices." Note that a "gross income" (sales less cost of goods sold) approach will not work because it is still a measure of income. *The IPO prospectus for Entertainment Properties Trust (EPT) (linked at* ***Endnote*** *19 below) provides a detailed description of rent and rent formulas that were believed by EPT to pass muster for REIT purposes. The IPO prospectus for DuPont Fabros (linked at* ***footnote*** *21 above) describes innovative rent design features that are believed by DuPont Fabros to provide good REIT income* (see, in particular, the excerpt at R.27 on page E-10 below). These rent provisions are illustrative of a number of possible options for rent design.

3. The Ventcor/Ventas spin-off Kindred Healthcare (*see Endnote 14*) provides an interesting example of the operation of a fair market value rent reset provision (including the use of appraisals) governing a large portfolio of operating properties. [http://www.sec.gov/Archives/edgar/data/740260/000119312506105107/dex991.htm]
http://www.sec.gov/Archives/edgar/data/1060009/000119312506105071/dex991.htm
http://www.sec.gov/Archives/edgar/data/740260/000119312506167464/dex991.htm
http://www.sec.gov/Archives/edgar/data/1060009/000119312506148103/dex991.htm
http://www.sec.gov/Archives/edgar/data/1060009/000119312506174997/dex991.htm
http://www.sec.gov/Archives/edgar/data/1060009/000119312506205035/dex991.htm
http://www.sec.gov/Archives/edgar/data/740260/000119312506205514/dex991.htm This series of press releases (and the disputes they describe) by the REIT and its lessee serve as the basis for a significant "lessons-learned" analysis.

Endnote 8. True Lease [A]; Concession Agreement [B]. A.1 True Lease. In order for rent payable under a lease to constitute "rents from real property," the lease must be respected as a true lease for federal income tax purposes and not be treated as a service contract, a management agreement, a joint venture or some other type of arrangement.[3] Whether or not a particular lease is a true lease depends on an analysis of all surrounding facts and circumstances. In addition, section 7701(e) of the Code provides that a contract that purports to be a service contract or a partnership agreement will be treated as a lease if the contract is properly treated as such, taking into account all relevant factors. *Section 7701(e) is addressed at Endnote 12 below.*

A.2 The IRS has issued revenue procedures setting forth guidelines that must satisfied to obtain and advance ruling that a "leveraged lease" will be respected for federal income tax purposes (the "Guidelines"): Rev. Proc. 2001-28 (superseding Rev. Procs. 75-21, 76-30 and 79-

[3] *See Endnote 11 for a discussion of management agreements. See Endnote 12 for a discussion of service contracts.*

48) and Rev. Proc. 2001-29. The Guidelines are not substantive law. Revenue Procedures are published to provide guidance to taxpayers concerning the internal practices and procedures of the IRS relating to a specific issue. See Rev. Proc. 89-14, 1989-1 C.B. 814 which states the objectives of and standards for the publication of revenue rulings and revenue procedures in the Internal Revenue Bulletin. The Guidelines provide a list of criteria which if satisfied ordinarily will entitle a taxpayer to a favorable ruling that a leveraged lease is a true lease for federal income tax purposes. Those criteria include, among other things, that the lessor have (i) a minimum specified at-risk equity investment in the property, (ii) a profit and positive cash flow with respect to the property, and (iii) a significant residual interest in the property at the end of the lease term. Guideline criteria address also ownership of non-severable improvements to the leased property. While fixed price purchase options (FPOs) in favor of the lessee are not consistent with the Guidelines, considerable case law supports grant of an FPO if the option price is not unreasonably low. *See Endnote 13 for more on fixed price purchase options.*

A.3 The Service itself has not relied exclusively on the criteria set forth in the Guidelines when analyzing the true lease status of a lease transaction. Rather, the Service generally has examined the relative distribution between the parties to the transaction of the benefits and burdens of ownership of the property to determine whether the transaction is a lease or a financing arrangement. See, e.g., PLR (TAM) 8144014 (July 29, 1981) (in discussing the relevance of profit motive and the existence of a significant residual interest to the tax ownership analysis and the appropriate approach to analyzing such ownership factors, the Service stressed that "the question of which party to a purported leasing transaction should be regarded as the true owner thereof for federal income tax purposes should be resolved by reference to the distribution of burdens and benefits between those parties"). For purposes of applying the benefits and burdens test, the Service has indicated that the Guidelines "establish conditions that, if met, produce a distribution of burdens and benefits that will ordinarily result in a determination that a lease should be recognized as such for federal income tax purposes." Id.

A.4 Moreover, the courts have not treated the Guidelines as determinative when analyzing tax ownership in a lease transaction.[4] While the case law is inconsistent as to the most appropriate approach, the courts in leasing cases typically have applied one of two tests – the economic substance test or the benefits and burdens test – to determine whether a lease should be respected and the lessor should be treated as the owner of the leased property for federal income tax purposes. See, e.g., Frank Lyon Co. v. Commissioner, 435 U.S. 561 (1978) (in a landmark decision, the United States Supreme Court determined that a sale and leaseback should not be disregarded for federal income tax purposes if the transaction "is a genuine multi-party transaction with economic substance which is compelled or encouraged by business or regulatory realties, is imbued with tax-independent considerations, and is not shaped solely by tax-avoidance features that have meaningless labels attached"); Sun Oil Co. v. Commissioner, 562 F.2d 258 (3d Cir. 1977), cert. denied, 436 U.S. 944 (1978) (the court determined that a proposed

[4] In a footnote in Frank Lyon Co. v. Commissioner, 435 U.S. 561, 579, n.14 (1978) the United States Supreme Court, in fact, specifically recognized that the Guidelines "are not intended to be definitive." Moreover, in Estate of Thomas v. Commissioner, 84 T.C. 412, 440 n.15 (1985) the Tax Court noted that the lessor was the tax owner of the leased property even though the lessor had invested less than the minimum amount of equity required under the "safe-haven" of the Guidelines. According to the court, the failure to satisfy all of the Guidelines

sale and leaseback transaction was in reality a financing arrangement because the benefits and burdens of ownership of the property were retained by the lessee).

A.5 The economic substance test, which was first enunciated by the United States Supreme Court in Frank Lyon, has been applied most often, and consistently, by the courts in analyzing whether a lease should be respected for federal income tax purposes. The Frank Lyon case, however, does not render the benefits and burdens test inapplicable to lease transactions. Accordingly, some courts have applied the benefits and burdens test either alone or in conjunction with the economic substance test to determine whether a lease transaction should be respected.[5] In one recent case, for example, the Tax Court applied a two-step analysis requiring that a lease transaction satisfy both the economic substance and the benefits and burdens tests. See Larsen v. Commissioner, 89 T.C. 1229 (1987) (the court, applying the two-step analysis, held that a lease transaction was not a sham because the leased asset would have sufficient residual value to imbue the transaction with economic substance and that the form of the transaction would be respected because the lessor had acquired sufficient benefits and burdens of ownership of the asset).[6]

A.6 The courts typically examine all the facts and circumstances surrounding a leveraged lease transaction to determine whether the transaction has economic substance and/or whether the lessor has the benefits and burdens of ownership of the leased property. Although the Guidelines are not determinative, the courts, in applying the economic substance and benefits and burdens tests, have focused on factors that are consistent with certain of the criteria set forth in the Guidelines. Thus, like the Guidelines, the courts consider the existence of a significant equity investment by the lessor, a profit and positive cash flow with respect to the leased property, and a significant residual interest at the end of the lease term as indicative that the lease transaction has economic substance and the lessor has the benefits and burdens of ownership of the leased property. See, e.g., Larsen (the court upheld lease transactions where the leased equipment was expected to retain sufficient residual value to imbue the transactions with economic substance, and the lessors had invested sufficient equity and were expected to realize taxable income in excess of tax benefits in later years); Estate of Thomas v. Commissioner, 84

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[5] See e.g., Sun Oil Co. v. Commissioner; Coleman v. Commissioner, 87 T.C. 178 (1986) (the court examined whether the lessors in a "double dip" sale and leaseback transaction had produced "strong proof" that they had acquired the benefits and burdens of ownership of the leased property); Gefen v. Commissioner, 87 T.C. 1471 (1986) (the court held that a lessor in an equipment leasing transaction was the owner of the leased property for federal income tax purposes where the lessor had acquired the benefits and burdens of ownership of the property, and the transaction had economic substance); Estate of Thomas (the court held that lessor in an equipment leasing transaction was the tax owner of the leased property because it had acquired the benefits and burdens of ownership of the property, and the transaction had economic substance).

[6] According to the Tax Court in Larsen, "a holding that the . . . transactions in question are not tax avoidance schemes devoid of economic substance does not foreclose further discussion of whether the form of such transactions must be accepted for Federal tax purposes." Larsen, 89 T.C. at 1266. Thus, having determined that the transaction had economic substance, the court then analyzed whether the lessor had acquired benefits and burdens of ownership of the property to determine if the form of the transaction should be respected.

T.C. 412 (1985) (the court upheld a lease where, among other things, the lessors had a substantial equity investment in the leased equipment, were expected to realize taxable income in excess of tax benefits with respect to the transaction, and were expected to have a substantial residual interest in the leased equipment at the end of the lease term and the potential for profit upon realization of such residual value).

A.7 It is clear that the issue of tax ownership in a lease transaction is ultimately a factual issue. Accordingly, the facts and circumstances surrounding the lease transaction must be analyzed as whole to determine whether the transaction should be respected for federal income tax purposes. Under current law, a lessor will be treated as the tax owner of property subject to a leveraged lease if, based on all the facts and circumstances, the leveraged lease transaction has economic substance and the lessor has the benefits and burdens of ownership of the leased property.

B. Concession Agreement In a recent private letter ruling (PLR 200705013), the IRS addressed whether or not a "concession agreement" was the equivalent of an interest in real property for REIT qualification purposes. The IRS concluded that the subject concession arrangement was equivalent to a lease. The IRS also concluded that payments from subconcessionaires and sublessees were (so long as section 856(d)(2) requirements were otherwise met) rents from real property for REIT purposes. The most recent concession-as-lease PLR is consistent with a prior concession-as-lease PLR, PLR 200039017 (a concession for a parking lot at an airport) and an earlier PLR that addressed Forest Service permits to operate ski areas as interests in real property, PLR 9843020. The PLRs addressing concessions and the Code's service contract provisions (*see Endnote 12*) point to structuring techniques where a lease structure, as such, may not be optimal in light of local issues. See also Rev. Rul. 71-286 which concludes that air rights (long term leasehold or fee simple ownership of the space above the ground that a land owner can occupy or use in connection with the land, plus necessary easements on the surface for support of structures erected in such air space) are considered "interests in real property" for REIT purposes.

Endnote 9. Tenant services. For rents received to qualify as rents from real property for REIT purposes, the REIT generally must not operate or manage the property or furnish or render services to the tenants of the property, other than through an independent contractor from whom the REIT derives no revenue or through a TRS (*see Endnote 6 from certain minimum pricing parameters for TRS-provided services*). A REIT may, however, directly perform certain services that landlords usually or customarily rendered when renting space for occupancy only or that are not considered rendered to the occupant of the property, section 856(d)(1)(B) and Treas. Reg. 1-856-4(b)(1). The recent IPO for Dupont Fabros Technology (linked at *footnote 21* with federal income tax disclosure excerpted in Annex E, pp. E-1 to E-22) discloses a new PLR dated September 6, 2007 (released on December 28, 2007 as PLR 200752012) addressing the impact of REIT-provided services on "rents from real property." The PLR is discussed at items R.24-R.27 on pages E-9 and E-10. The Dupont Fabros PLR is described at *Endnote 26*.

Endnote 10. Unrelated Business Taxable Income (UBTI) Considerations. 1. Section 511 of the Code imposes a tax on the unrelated business income of organizations otherwise exempt from federal income tax under section 501(c) of the Code. For this purpose, an exempt organization's "unrelated trade or business" is any trade or business that is regularly carried on if

the conduct of the trade or business is not substantially related to the organization's exempt purposes. Code, section 513(a).

2. Not all tax exempt institutional investors are on equal footing when it comes to UBTI. For example, state pension funds (such as CALPERS and the Teachers Retirement System of Texas) that claim exemption from federal income taxes under section 115 of the Code (gross income does not include any income derived from any essential governmental function and accruing to a State or any political subdivision thereof) are not subject to the UBTI provisions of the Code. Political subdivisions include state colleges and universities (and their wholly-owned corporations) for section 115 purposes are nonetheless subject to the Code's UBTI provisions, section 511(a)(2)(A).

3. A REIT can block UBTI for tax-exempt investors in two areas important for energy infrastructure investment. First, for UBTI purposes rents from real property do not include rents from energy infrastructure assets. See item 5 in this Endnote 10. Second, for UBTI purposes, where property that produces income to the tax-exempt investor was acquired with proceeds from a debt financing, all or a fraction of such income will constitute UBTI. See item 6 in this Endnote. A tax-exempt investor which acquires with its own funds stock in a REIT that is not a pension-held REIT (see item 7 in this Endnote) will not be in receipt of UBTI even when (i) REIT income derives from property that is not real property for UBTI purposes and (ii) the REIT itself finances its acquisition of REIT real estate with outside debt financing.

4. Although the leasing of the real property by an exempt organization to unrelated parties is viewed as an unrelated trade or business activity, pursuant to a statutory exemption, the rents derived from such leases are not subject to tax under most situations. Code, section 512(b)(3). This exemption is not available in certain circumstances, including situations where the determination of rent depends in whole or in part on the income or profits derived by any person from the property leased. The rent may, however, be based on a fixed percentage of receipts or sales, as opposed to income or profits. Code, section 512(b)(3)(B)(ii). Another basis for losing the exemption provided by section 512(b)(3) arises if the lessor organization provides services to the occupant of the real estate that are primarily for the occupants convenience and go beyond the services customarily rendered in connection with the rental of space for occupancy only. "Permissible" services include furnishing heat and light, cleaning common areas and collecting trash. Treas. Reg. § 1.512(b)-1(c)(5).

5. Before enactment of the Tax Reform Act of 1969, section 512(b)(3) of the Code simply excluded rents from real property and personal property leased with real property from the computation of UBI. The Code did not define real property or personal property as used in section 512; however, Revenue Ruling 67-218 (1967-2 C.B. 213) was issued which utilized common law definitions.

> --Rev. Rul. 67-218 states that income derived from a lease of a pipeline system consisting of rights-of-way interests in land, pipelines buried in the ground, pumping stations, plants, equipment and other appurtenant properties, constitutes rent from real property (including personal property leased with real property) within the meaning of section 512(b)(3) of the Code. "The basic component of the pipeline system, i.e., the easement giving right-of-way interests in land constitutes real property. See 3 Powell, Real Property, paragraph 405 (1966)."

The Tax Reform Act of 1969 modified section 512(b) by incorporating the definitional sections of section 1245 of the Code and by providing for the exclusion only if rents attributable to the personal property leased with the real property are an incidental amount (i.e., 10% or less; Treas. Reg. 1.512(b)-1(c)(2)(ii)) of the total rents received or accrued under the lease. Section 512(a)(3)(B) defines personal property as including any tangible property described in section 1245(a)(3)(B) of the Code. Section 1245(a)(3)(B) of the Code expands the definition of section 1245 property to include, in addition to personal property, "other property (not including a building or its structural components) but only if such property is tangible and has an adjusted basis in which there are reflected [depreciation or amortization] adjustments … for a period in which such property (or other property) -- (i) was used as an integral part of manufacturing, production or extraction or of furnishing transportation, communications, electrical energy, gas, water, or sewage disposal services …or (iii) constituted a facility used in connection with any of the activities referred to in clause (i) for the bulk storage of fungible commodities (including commodities in a liquid or gaseous state)…"(In an interesting twist, outside of section 1245(a)(3)(B) but nonetheless included as section 1245 property are "storage facilities" (not including a building or its structure components) used in connection with the distribution of petroleum or any primary product of petroleum", section 1245(a)(3)(C)). *In other words, energy infrastructure assets which are real property for REIT purposes can be personal property for UBTI purposes due to their status as other tangible property under section 1245(a)(3)(B).* Treasury regulations under section 1245(a)(3)(B) are excerpted in Part I of Annex H hereto.

6. A proportionate part of the rental income received from real estate property (directly or via an investment in a partnership) that has been acquire or improved with "acquisition indebtedness" will generally constitute UBTI. Section 512(b)(4) and 514 of the Code. Certain tax-exempt investors (pension plans and educational institutions) are subject to more lenient provisions, section 514(c)(9). The rules get even more complex where a tax-exempt investor invests through a partnership that included taxable partners: a number of conditions must be met before a tax-exempt investor other wise entitled to claim an exemption under section 514(c)(9) can continue to claim the exemption. *In other words, leverage causes UBTI complications of more or less economic significance for tax-exempt investors.*

7. A REIT structure may not completely eliminate UBTI in the case of REITs with a significant pension fund ownership. If at any time during a taxable year a private pension fund holds more than 10%, measured at cost, of a "pension-held REIT," any UBTI that would have been eliminated by investment through a REIT will constitute UBTI to the private pension fund holding such 10% or greater interest. A REIT is a pension-held REIT if (i) it would not have qualified as a REIT but for the fact that Section 856(h)(3) of the Internal Revenue Code provides that stock owned by qualified trusts will be treated, for purposes of the "not closely held" requirement, as owned by the beneficiaries of the rust (rather than by the trust itself); and either (a) at least on qualifies trust holds more than 25% by value of the interests in the REIT or (b) one or more qualified trusts, each of which owns more than 10% by value of the interests in the REIT, hold in the aggregate more than 50% by value of the interests in the REIT.

Endnote 11. Management Agreements. Courts have long held that the substance of an agreement rather than its form determines its true character as a management contract, lease or other arrangement. Amerco v. Commissioner, 82 T.C. 654 (1984); Kingsbury v. Commissioner, 65 T.C. 1068 (1976). In State National Bank of El Paso v. United States, 509 F.2d 832, 835 (5th Cir. 1975), the court found these factors typical of a management contract: (i) the property owner

or employer has the final word on expenses; (ii) the property owner or employer bears the expenses; (iii) the property owner or employer's income depends on the profits of the business; and (iv) the property owner or employer has the risk of loss. The Tax Court has provided that the two primary factors that indicate the existence of a management contract are (1) control of the venture by the property owner and (2) risk of loss in the property owner. Amerco, 82 T.C. at 670; Freesen v. Commissioner, 84 T.C. 920 (1985); Meagher v. Commissioner, T.C. Memo 1977-270, 36 TCM 1091 (CCH)(1977). The property owner relinquishing control over the business or the risk of loss is not indicative of a management contract. In Amerco, supra, the Tax Court held that the transaction was a lease, not a management contract, where the property owner failed to retain control over the entire operation and relinquished the risk of loss for operational damages and liability to rental companies or customers. Factors contrary to finding a management contract included (i) indemnification of the owner by the users for losses from the use of the property, whether by insurance or otherwise; (ii) the right of the user to control and supervise the day-to-day operation and maintenance of the business or other activity conducted on the property; (ii) the inability of the owner to terminate the rights of the user through a sale of the property; and (iv) the right of the user to control the incidence of operating costs and expenses. 82 T.C. at 675-682. A user's exclusive right to use and possess the property is not indicative of a management contract. See Kingsbury, 65 T.C. at 1083. The inability of, or significant limitations the right of, the property owner to terminate the user's right to use and possess the property is not indicative of a management contract. Nigh v. Commissioner, T.C. Memo 1990-349. The inability of an owner to sell or assign property without the user's consent is not indicative of a management contract. See Amerco, 82 T.C. at 682. A user's right of day-to-day control of the property is not indicative of a management contract. See Amerco, 82 T.C. at 675. Although section 7701(e), *see Endnote 12 below*, addresses "service contracts" and leases, the legislative history of such section cites McNabb, 81-1 USTC 9143 (W.D. Wash. 1980), and Meagher, supra, favorably and specifically adopts the control and risk of loss tests for determining if a transaction structured as a management contract is a lease. See S. Prt. 169 (Senate Print), 98th Cong., 2d Sess., 140, Example 3 (1984).[7] McNabb and Meagher and cases decided later have established a few principles for establishing that a purported management contract will not be treated as a lease: (i) the owner mush have overall supervisory control over the property. (ii) the manager may not be required to indemnify the owner for damage to or loss of the property not caused by the manager's negligence or other malfeasance; (ii) the manager may not guarantee the owner's profit from the venture; (iv) the manager must be obligated to keep adequate records and make reports to the owner; and (v) the owner must have the right to inspect its property. See General Counsel Memorandum 39240, June 15, 1984, for an example of an analysis that concluded that certain management contracts were properly categorized as management contracts and not as leases for federal income tax purposes. See also PLR 19940040 (released October 12, 1999) (an agreement under which a taxable rural electric

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[7] The citation to McNabb and Meagher is as follows: "however, the bill leaves open the possibility that an arrangement structured as a management contract could be treated as a lease (under which the tax-exempt entity provides services to third parties for its own benefit under present law rules. See McNabb v. Commissioner, 81-1 USTC 9143 (W.D. Wash. 198) (where an arrangement structured as a management contract was characterized as a lease because the taxpayer did not adequately control the venture and did not bear the risk of loss); Meagher v Commissioner, 36 T.C.M 1091 (1977) where the court held that an agreement was a management contract and not a lease, applying the same tests discussed in the McNabb case)."

cooperative would cede functional control over its transmission system to a not-for-profit independent system operator will be considered a management contract for federal tax purposes) and PLR 9814021 (released April 3, 1998) (a "pre-lease" transaction entered into by a rural electric cooperative and a public utility holding company is not a management contract for federal income tax purposes).

Endnote 12. Service Contracts. "If a contract that purports to be a service contract is treated as a lease under section 7701(e), such contract is to be treated as a lease for all purposes of Chapter 1 of the Internal Revenue Code…"Reg.1.168(j)-1T(A.18) Section 7701(e)(1) of the Code provides that for purposes of chapter 1: "A contract which purports to be a service contract shall be treated as a lease of property if such contract is properly treated as a lease of property, taking into account all relevant factors including whether or not-

(A) the service recipient is in physical possession of the property.
(B) the service recipient controls the property,
(C) the service recipient has a significant economic or possessory interest in the property,
(D) the service provides does not bear any risk of substantially diminished receipts or substantially increased expediting if there is nonperformance under the contract,
(E) the service provider does not use the property concurrently to provide significant services to entities unrelated to the service recipient, and
(F) the total contract price does not substantially exceed the rental value of the property for the contract period.

Section 7701(e)(1) and (2) provide that characterizing an arrangement as a service contract or lease requires "taking into account all relevant factors" as well as the six factors ((A) through (F)) listed above. Note: 7701(e)(2) relates to the recharacterization of "an arrangement (including a partnership or other pass-thru entity)" which is not described in 7701(e)(1) if "such arrangement is properly treated as a lease, taking into account all relevant factors including factors similar to those set forth in" section 7701(e)(1). To date, no Income Tax Regulations have been promulgated under section 7701(e) of the Code. It is not clear whether or not a REIT is to be categorized as a "pass-thru" entity for purposes of section 7701(e)(2). There is substantial legislative history to provide guidance interpreting the intent of Congress in applying the section 7701(e) general rule to agreements which purport to be service contracts. *For ease of reference, the legislative history of Section 7701(e) is excerpted at Annex F to this Annotated PLR.* See PLR 8918012 (released January 24. 1989) for a detailed use of the legislative history in the IRS's conclusion that a wheeling agreement was a service contract under section 7701(e) and not a lease. See also PLR 9142022 (released July 19, 1991) (contract to provide aircraft training is a service contract and not a lease).

Endnote 13. Fixed Price Purchase Options. 1. The courts consistently have concluded that a fixed price purchase option will not cause a lease transaction to be recharacterized for federal income tax purposes if the option price is not unreasonably low. For this purpose, a fixed purchase price purchase option is considered reasonable by the courts if it is not a bargain option, or if its based on a reasonable estimate of the future fair market value of the leased property. See e.g., Frank Lyon (existence of a fixed price purchase option based on a reasonable estimate of fair market value did not cause a sale and leaseback transaction to be recharacterized for federal income tax purpose); Belz Investment Co. v. Commissioner, 72 T.C. 1209 (1979), aff'd on other

grounds, 661 F.2d 76 (6th Cir. 1981) existence of a fixed price purchase option based on a reasonable estimate of future fair market value did not cause a sale and leaseback transaction to be disregarded for federal income tax purposes); LTV Corp. v. Commissioner, 63 T.C. 39 (1974) (existence of a fixed price purchase option equal to 10 percent of the original cost of the least property did not cause the lease to be recharacterized as a conditional sales contract because no portion of the rent payments were used to offset the purchase price and the purchase price was determined to be comparable to the estimated fair market value of the equipment at the end of the lease term); Northwest Acceptance Corp. v. Commissioner, 58 T.C. 836 (1972), aff'd per curiam, 500 F.2d 1222 (9th Cir. 1974) (fixed price purchase options ranging from 10 to 50 percent of the leased equipment original cost were held to be more than nominal option prices and therefore did not cause the leases to be recharacterized as conditional sales contracts). Cf. M&W Gear Co. v. Commissioner, 54 T.C. 385 (1970), aff'd on that issue, rev'd on other grounds, 446 F.2d 841 (7th Cir. 1971) (lease containing a nominal fixed price purchase option was recharacterized as a conditional sales contract where lessee paid rent in excess of the property's fair rental value and made significant nonseverable improvements to the property).

2. The Frank Lyon case, for example, involved a lease that contained a series of fixed price purchase options. In Frank Lyon, the United States Supreme Court determined that the existence of a fixed price purchase option did not indicate that the lessee had acquired a growing equity in the leased property. The Court relied specifically on the finding of the District Court that the fixed price purchase options represented reasonable estimates of the expected fair market value of the property at the option dates. According to the Court, a finding that the lessee had acquired a growing equity in the property would require the Court to speculate that the purchase options would be exercised. The Court, however, refused to indulge in such speculation where the District Court had found that the option prices were reasonable.

Endnote 14. REIT Conversions; etc. 1. On September 19, 2006, a publicly-traded REIT, Hospitality Properties Trust (NYSE: HPT), announced a $1.9 billion acquisition of TravelCenters of America (TravelCenters), an operator of travel centers (truck stops) at 162 sites in 40 states and Ontario, Canada. An integral part of the acquisition was a transfer of Travel Centers's operating business (including a lease of the 162 sites) to a newly-formed operating company (TA) to be distributed as a dividend to HPT's shareholders. The leases were described by HPT to have a number of security features such as one long-term lease for all properties and all-or-none renewal options. The planned spin-off was completed in January 2007 when the shares of TA (AMEX:TA) were distributed to HPT shareholders (see a recent prospectus for TA at http://www.sec.gov/Archives/edgar/data/1378453/000104746907005275/a2178666z424b1.htm). *See* Diagram A for a diagram of the TravelCenters acquisition. An important threshold for the REIT-ability of travel centers (and gas stations: see Getty Realty, Inc., NYSE Arca: GTY, a gas station REIT) is the real property status of underground storage tanks. Counsel to Hospitality Properties Trust was able to opine (without a PLR on which to rely) that underground storage tanks "should" constitute real estate assets, rather than personal property, for purposes of the various REIT qualification tests.

2. In May, 2006, another publicly-traded REIT, Spirit Finance Corporation acquired 178 real estate properties of ShopKo stores, Inc. (ShopKo) by acquiring all of the common stock of ShopKo (Spirit Finance has since undergone a going-private transaction). In connection with the acquisition, Spirit Finance entered into a triple-net, master lease agreements with an operating company (which Spirit Finance did not acquire) that would continue to manage the

existing operations of the retail store operations and all related corporate functions. Both of these examples underscore the value of the REIT structure in providing a means efficiently to finance/acquire qualifying real property assets while ceding operational risk and control to third parties, most importantly for businesses, such as electric transmission, where the value of the qualifying real property is the predominate portion of enterprise value (presumably each of the acquired TravelCenters and Shopko entities continued as QRSs of their respective REITs).

3. In some cases, publicly-traded companies have been able to effect conversions to REIT status. Conversions have occurred in the timber business, the 2005 conversion by Potlatch being the most notable in this sector (see http://www.sec.gov/Archives/edgar/data/1338749/000119312506002718/d424b3.htm), and in the property development sector, the conversion by Catellus Development Corp. being a notable example (see http://www.sec.gov/Archives/edgar/data/1228862/000089843003003402/d424b3.htm). *See* Diagram B for a diagram of the Potlatch conversion transactions and Diagram C for a diagram of the Catellus conversion. The Potlatch filing details, among other things, the process by which its Board of Directors made the decision to convert and the advice of Potlatch's investment bankers concerning the conversion. The Potlatch conversion was enabled by a significant use of a TRS as the repository for Potlatch's fourteen manufacturing facilities.

4. Another example of a REIT conversion is the May, 1998 conversion of Vencor, Inc. (now named Ventas, Inc., NYSE:VTR) into a REIT as it spun-off to its shareholders (via a taxable dividend) shares in Vencor Healthcare, Inc., (now named Kindred Healthcare, Inc., NYSE:KND), the operator/lessee of the real estate assets (hospitals and nursing centers) retained by the REIT. The spin-off proxy statement can be accessed as follows: http://www.sec.gov/Archives/edgar/data/740260/0000950130-98-001437.txt After a rocky start (the operating company filed for chapter 11 reorganization within 18 months of the spin-offs), both the REIT and the operating company remain actively engaged in their respective businesses and have each grown beyond their starting points in May, 1998.

5. Longview Fibre Company is another timber company that took action to convert to REIT status. Longview was acquired by Brookfield Asset Management, Inc., before the final REIT conversion steps were completed. http://www.sec.gov/Archives/edgar/data/60302/000119312507052587/ddefm14a.htm A portion of Longview now comprises one of the Brookfield Infrastructure MLP investments (see Endnote 17). Following is a link to an S-3 registration statement filed (but not used) by Longview relating to debt and equity offerings to be made to fund the requisite earnings and profits distribution and otherwise to recapitalize Longview as a REIT. http://www.sec.gov/Archives/edgar/data/60302/000119312506040256/ds3asr.htm

6. Possible spin-offs of REITs by C corporations were facilitated by a June 2001 revenue ruling, Rev. Rul. 2001-29, 2001-1 C.B. 1348, but little (if anything) has occurred. Rev. Rul. 2001-29 provides that a self-managed REIT will be considered to be engaged in an active trade or business under Code section 355.

7. The recent acquisition of Florida East Coast Industries, Inc., (http://www.sec.gov/Archives/edgar/data/1360951/000119312507135588/ddefm14a.htm) hints at a possible future railroad REIT: the acquisition price was paid, in part, by the target making a complete distribution of its accumulated but undistributed earnings and profits. A necessary step

for a conversion to REIT status is a cleansing of earnings and profits. The acquiring entity, Fortress Investment Group, also acquired Rail America, Inc., a collection of short-line railroads. The total acquisition cost exceeds $4.5 billion. Given that Fortress Investment Group was also a principal backer of Global Signal, Inc., the cell tower REIT, a railroad REIT seems to be a natural exit strategy.

Endnote 15. 1940 Act Considerations. 1. The REIT/UPREIT structure implicates the Investment Company Act of 1940 (the "1940 Act"). A requirement to register a transmission REIT as an investment company under the 1940 Act would add significant complexity and administrative burden and cost to an already complex structure. Accordingly, the optimal structure for a transmission REIT is one that avoids investment company act status. The 1940 Act is implicated only by a structure where the operating partnership (OP) entity has, or may have, partners other than the REIT and wholly-owned subsidiaries of the REIT. Under section 3(a)(1) of the 1940 Act a company is not an investment company if the only securities it owns are securities of a "majority-owned subsidiary". The 1940 Act defines a majority-owned subsidiary of a person as a company 50% or more of the outstanding voting securities of which are owned by such person, or by another company which is a majority-owned subsidiary of such person. The 1940 Act further defines voting securities as any security presently entitling the owner or holder thereof to vote for the election of the directors of a company. The REIT will need to be a general partner in the OP but it need not be the only general partner. The REIT will need, however, to have, and use, the right to be active in the management and operations of the UPREIT and in all major decisions affecting the partnership (and, possibly, the unilateral right to declare a default under and terminate the lease). The total number of general partners in the UPREIT should be limited to five and fewer. Limited partners in the UPREIT may have significant participating rights on fundamental decisions.

2. In the event that the OP were to be organized as a general partnership, each general partner would (in order to avoid 1940 Act status) appoint a member to a management committee to which management authority would be delegated. Unanimous action by the management committee would be required for certain specified actions:

- the liquidation, dissolution or winding up of the OP or making any bankruptcy filing;
- the issuance, incurrence, assumption or guarantee of any indebtedness or the pledge of any of the OP's assets;
- filing or resolving a rate case proceeding under the Federal Power Act;
- any amendment of the OP partnership agreement;
- any distributions to the OP 's partners, other than the distributions of available cash to be made at least quarterly as described below;
- the admission of any person as a partner (other than a permitted transferee of a partner) or the issuance of any partnership interests or other equity interests of the OP;
- the redemption, repurchase or other acquisition of interests in the OP;

- the disposition of substantially all of the assets of the OP or any portion of such assets with a value exceeding a specified dollar threshold;
- any merger or consolidation of the OP with another person or any conversion or reorganization of the OP; and
- entering into any activity or business that may generate income that is not "good" income for REIT purposes.

Both of the El Paso Pipeline and the Williams Pipeline gas transmission MLPs (prospectuses linked at *footnote 4* to the Conduit PLR) use the same approach to solving the issue presented by the 1940 Act where the MLP will own less than 50% of the gas transmission systems.

Endnote 16. Section 318 Attribution Rules. "Rents" for purposes of Section 856 excludes rent from related parties, generally defined as rent received, directly or indirectly, by the REIT from any corporation in which the REIT owns 10% or more, taking into account the Section 318 attribution rules, as modified. *See footnote 7.* Two relevant attribution rules are, generally, (1) the operating partnership is treated as owning whatever any of its 25% partners own and (2) the REIT (assuming it is treated as a corporation for purposes of the attribution rules) owns whatever its 10% shareholders own. Thus, if a parent of the tenant of the REIT/UPREIT owned 25% or more of an UPREIT, the UPREIT would be treated as owning 100% of the tenant and thus the REIT would indirectly own more than 10% of the tenant, making the rents received from such tenant related party rents. Second, if such parent owned 10% or more of the REIT, the REIT would be treated as owning 100% of the tenant, and the rent paid by the tenant to the REIT would be related party rents. For purposes of the attribution rules, an option, including conversion rights, to acquire stock is treated as ownership of such stock. However, the IRS has privately ruled (in the context of Section 302 regarding stock redemptions) in PLR 9341019 that stock appreciation rights (SARs) are not options for purposes of the Section 318 attribution rules. The ruling held that the right to a cash payment equal to the excess of the fair market value of one share of common stock on the date of the exercise of the SAR over a stated value, entitling the holder to cash payments only and no right to obtain the relevant share of stock, was not an "option" on such stock for purposes of Section 318.

Endnote 17. Land: Own v. Lease. 1. Most electric transmission is sited on owned land rather than on leased land or on easements. Generally speaking, gas and oil pipelines are sited on leased land or on easements. The reason for this dichotomy is probably no more complex than the difference between overhead facilities (and the characteristics of transmitted electrical energy) and underground facilities (and the fact that the transmitted quantities flow within the pipe).

2. An electric transmission system entails a great deal of owned land (the recent divestiture by Consumers Energy of its electric transmission system, but only with an easement over the land, is an exception: see item 3 below in this Endnote 17). Generally speaking, land and certain land improvements are not entitled to a depreciation allowance under section 167(a) of the Code. Whether or not particular improvements to land are entitled to depreciation allowance can be a function of both the nature of the underlying entitlement to land (ownership, lease, easement or license) and the relationship to structures or improvements on the land and/or activities on the land. See the authorities cited at footnote 2 to Annex I) related to logging roads.

See Rev. Rul. 2001-60 which addresses land preparation costs incurred in connection with golf course greens and Rev. Rul. 72-96, 1972-1 C.B. 66 (land preparation costs for a reservoir that would be retired contemporaneously with an electric generating plant are depreciable). See also Asset Class 00.3 under Rev. Proc. 87-56, 1987-2 C.B. 674 (as clarified and modified by Rev. Proc. 88-22, 1988-1 C.B. 785): Asset class 00.3, Land Improvements, includes improvements directly to or added to land, whether the improvements are section 1245 property or section 1250 property, *provided the improvements are depreciable* (emphasis supplied). Examples of the assets might include sidewalks, roads, canals, waterways, drainage facilities, sewers (not including municipal sewers in Class 51), wharves and docks, bridges, fences, landscaping shrubbery, or radio and televisions transmitting towers. Asset class 00.3 does not include land improvements that are explicitly included in any other class, and buildings and structural components as defined in § 1.48-1(e) of the regulations.

3. The FERC has been faced with two situations in the past where an entity transferring transmission assets retained certain important residual interests. American Transmission Systems, Inc. ("ATSI"), the transmission subsidiary owned by certain of the First Energy operating companies, owns the bulk of the tangible transmission assets (lines, transformers, substations, generator tie lines, etc.) but leases the land, licenses and easements underlying the owned assets. First Energy Operating Companies, 89 FERC ¶61,090 (October 27, 1999) (Docket No. EC99-53-000). Michigan Electric Transmission Company ("METC"), the transmission subsidiary created by Consumers Energy Company, owns the tangible transmission assets and leases the underlying land, licenses and easements. Consumers Energy Company, 94 FERC ¶ 61,018 (January 10, 2001) (Docket No. EC01-4-000). See also Docket Nos. EC02-23 and ER02-320 and orders dated February 13, 2002 and March 29, 2002, 98 FERC ¶ 61,142 and 98 FERC ¶ 61,368 (both of which involve further ordered modifications to Consumers' retained interests). *The final and accepted form of the Consumers easement is NewYork\12048* (a related operating agreement is New York\13577) [copies available on request]. Unlike the First Energy Operating Companies, Consumers Energy reserved to itself the right to use the land and facilities for itself or a third party for "compatible uses" not inconsistent with METC's use. As part of its approval order (94 FERC ¶ 61,018), the FERC directed that "[Consumers Energy] may not use its easement rights with [METC] to interfere with the provision of open access transmission service under the OATT." Open access requirements include the obligation to expand or modify the transmission system when necessary to accommodate transmission service requests.

Endnote 18. Election-Out, Undivided Interests, etc. 1. Annex C excerpts the Treasury Regulations on electing-out (items 1 through 4), Rev. Rul. 82-61 (item 5) and certain additional material. Annex C also excerpts the limited use property provisions of the advance ruling guidelines (*see Endnote 8*). The provisions of advance ruling guidelines that address non-severable improvements and limited use property do not apply to property that could itself be separately leased in a transaction eligible for an advance ruling under Rev. Proc. 2001-28 (see Annex C, § 4.04 ("Investment by Lessee") and § 5.02 ("Limited Use Property")).

2. Undivided ownership regimes are common in the electric generation and transmission sector: examples include the three-unit Palo Verde Nuclear Generating Station in Arizona and the four-unit Colstrip Generating Plant in Montana (the related Colstrip Transmission System is the subject of a separate undivided ownership interest regime). Undivided ownership regimes are less common in the oil and gas sector. The Trans-Alaska

Pipeline (TAPS) is held under an undivided interest regime: BP Pipeline (Alaska), Inc., (46.9263%); Phillips TransAlaska, Inc. (26.7953%); ExxonMobil Pipeline Company (20.3378%); Williams Alaska Pipeline Co. (3.0845%); Amerada Hess Pipeline Corp. (1.5000%); and Unocal Pipeline Company (1.3561%). The pipeline is operated on behalf of the TAPS owners by Alyeska Pipeline Service Company.

3. In addition to election-out-of subchapter K, there is another line of authority that addresses the circumstance of real property held by unrelated persons as tenants-in-common. In Revenue Ruling 75-374, 1975-2 C.B. 261, the Service concluded that a two-person co-ownership of an apartment building that was rented to tenants did not constitute a partnership for federal tax purposes. The co-owners employed an agent to manage the apartments on their behalf. The ruling concluded that the agent's activities in providing customary services to tenants, although imputed to the co-owners, was not sufficiently extensive to cause the co-ownership to be characterized as a partnership.

4. In Revenue Procedure 2002-22, 2002-1 C.B. 733, the Service provided certain conditions under which it would consider a request for a ruling that an undivided fractional interest in rental real property is not an interest in a business entity for federal tax purposes. Among other requirements in Rev. Proc. 2002-22, unanimity among co-owners is required for significant decisions. Section 6.05 of Rev. Proc. 2002-22 provides, in part, that the co-owners must retain the right to approve the hiring of any manager, the sale or other disposition of the Property, any leases of a portion or all of the Property, or the creation or modification of a blanket lien. Any sale, lease, or re-lease of a portion or all of the Property, any negotiation or renegotiation of indebtedness secured by a blanket lien, the hiring of any manager, or the negotiation of any management contract (or any extension or renewal of such contract) must be by unanimous approval of the co-owners. A recent private letter ruling under Rev. Proc. 2002-22, PLR 200625009, illustrates the operation of Rev. Proc. 2002-22 in a particular instance.

5. In Revenue Ruling 79-77, 1979-1 C.B. 448, the Service concluded that the transfer of a commercial office building subject to a net lease to a trust having three individuals as beneficiaries was a trust for federal tax purposes and not a business entity. In Revenue Ruling 2004-86, 2004-2 C.B. 191, the Service concluded that a Delaware statutory trust (DST) with multiple beneficiaries that owned rental real property did not constitute a partnership for federal tax purposes even though the trust was concluded to be an entity separate from its owners.

6. The possible importance of election-out and/or tenant-in-common formats is the ability of a REIT to own rental property in the form of an undivided interest in the property which can be subject of a separate lease for REIT purposes thereby avoiding having to analyze the other co-owners and their activities (most importantly, do the other co-owners also lease their interests via "good" REIT leases or do they, for example, use their own undivided interests in their trade or business?). The answer to a question still needs to be analyzed: can an election-out" partnership be completely ignored for REIT purposes (in particular, must an election-out partnership nonetheless be analyzed as though it were an UPREIT under Treas. Reg. 1.856-3(g)). The REIT regulations do not contain a counterpart of the following provision from the like-kind exchange regulations: section 1.1031(a)(1) provides that "[a]n interest in a partnership that has in effect a valid election under section 761(a) to be excluded from the application of all of subchapter K is treated as an interest in each of the assets of the partnership and not as an interest in a partnership for purposes of section 1031(a)(2)(D) and paragraph (a)(1)(iv) of this section."

The uncertainty arises because section 7701(a)(2) defines the term "partnership" for all purposes of the Code, whereas the election-out procedure under section 761(a) by its terms applies to the partnership rules of subchapter K. Thus, an organization satisfying the partnership definition under sections 7701(a)(2) and 761(a), but electing out of Subchapter K under section 761(a), may arguably continue to be treated as a partnership for non-Subchapter K purposes (REITs are under Subchapter M). The answer to the REIT-held undivided ownership interest issue may well lie in the analysis employed in Rev. Ruling 82-61, 1982-13 (excerpted at item 5 in Annex C) which held that where a lessor owns an undivided interest and the lessee possesses the property jointly with the other co-owner (a co-owner that is not a lessor), the partnership comprised by the lessee and the other co-owner only. In other words, Rev. Rul. 82-61 states that a lessor of an undivided interest in property is not a partner of either its lessee or any other co-owner. An inquiry of Treasury and/or a PLR request is warranted before a REIT acquires an undivided interest in a property as to which election-out of subchapter K is available under section 761(a).

7. On a creditors' rights note, the power accorded to a debtor-in-possession to sell the entirety of property in which only an undivided or other partial interest is held is a power that may not be exercised as to property "used in the production, transmission, or distribution, for sale, of electric energy or of natural or synthetic gas for heat, light or power," Bankruptcy Code, section 363(h)(4).

Endnote 19. <u>REIT Sale/Leaseback</u>. Entertainment Properties Trust (NYSE: EPR) is an example of a REIT that was created to serve as the owner/lessor of a number of movie theaters acquired by the REIT in a sale and leaseback transaction with American MultiCinema, Inc. ("<u>AMC</u>"). Upon its IPO in 1997, EPR received 100% of its revenues from AMC; ten years later the percentage dropped to 51% due to EPR's continued expansion beyond its original core holdings. See http://www.sec.gov/Archives/edgar/data/1045450/0001047469-97-005530.txt for EPR's 1997 IPO prospectus and see http://www.sec.gov/Archives/edgar/data/1045450/000095013707015303/c19199bfe424b5.htm for EPR's most recent equity offering.

Endnote 20. <u>Possible Steam REIT</u>. *Following is a conceptual piece describing a possible REIT which may or may not pass muster with Treasury: this Endnote is intended to probe the outer limits of energy infrastructure REITs.*

I. <u>Hypothetical:</u> (1) A REIT proposes to own the totality of a coal-fired or nuclear electric generation station (other than (i) the turbine/generator sets, and, (ii) (A) in the case of a coal-fired unit, the coal procurement, stockpiling, handling and preparation property, and, (B) in the case of a nuclear generating, the nuclear fuel). (2) The REIT (i) leases space to the owner of the turbine/generator sets, (ii) supplies all steam needs and other utilities and (iii) processes all by-products (ash, emissions, hot water (<u>i.e.</u>, the REIT provides cooling services), etc.). (3) The lessee operates its turbine/generator sets and owns all power and energy. (4) The lessee pays a fixed rent (escalating by an inflation index) <u>plus</u> a steam charge <u>plus</u> a by-product processing fee. (5) The generating station (other than the excluded assets and functions) is operated for the REIT by an independent contractor from whom the REIT does not derive or receive any income.

II. <u>Discussion</u>: (1) For purposes of the 95% and 75% income tests applicable to REITs (<u>see</u> R.20 to R.30, pp. E-8 to E-11), "rents from real property" includes charges for services customarily furnished or rendered in connection with the rental of real property," section

85b(d)(1)(B). The regulations, § 1.856-4(b)(1), expand on the concept as follows: "Services furnished to the tenants of a particular building will be considered as customary if, in the geographic market in which the building is located, tenants in buildings which are of a similar class (such as luxury apartment buildings) are customarily provided with the service. The furnishing of water, heat, light, and air-conditioning, the cleaning of windows, public entrances, exits, and lobbies, the performance or general maintenance and of janitorial and cleaning services, the collection of trash, and the furnishing of elevator services, telephone answering services, incidental storage space, laundry equipment, watchman or guard services, parking facilities, and swimming pools facilities are examples of services which are customarily furnished to the tenants of a particular class of buildings in many geographic marketing areas. Where it is customary, in a particular geographic marketing area, to furnish electricity or other utilities to tenants in buildings of a particular class, the submetering of such utilities to tenants in such buildings will be considered a customary service. . . . The service must be furnished through an independent contractor from whom the trust does not derive or receive and income." (2) Assume that the generating station is in a "geographic market" where buildings of a "similar class" (are power plants in a class by themselves? are industrial/manufacturing facilities in the same "class" as power plants?) have tenants who are provided with utilities such as process steam (not just steam for heat) and services such as waste removal (what is emissions processing if not "taking out the garbage?"): does this REIT fly? In the regard, consider the private letter ruling obtained by DuPont Fabros Technology (described at *Endnote 9* above, at *Endnote 26* below and at R.24 to R.27, pp. E-9 and E-10).

Endnote 21. Possible Renewables REIT. *Following is a conceptual piece describing a possible REIT which, even though it might not pass muster with Treasury, is designed to not probe the outer limits of energy infrastructure REITs.*

I. Hypothetical: (1) A REIT proposes to own (i) geothermal facilities (excluding the turbine generators); (2) roof-mounted solar energy facilities, and (3) wind farms (real estate (fee or leasehold), fences, roadways, on-site power collection systems, etc., but excluding the turbines, the towers on which the turbines are mounted and the pads on which the towers are affixed) (2) The REIT leases what it owns to one or more unrelated lessees who operate the leased assets in conjunction with what the lessee owns (turbine generators, wind turbines, etc.) to produce electricity (or heat, cooling or hot water, in the case of solar facilities). (3) The leases are designed to meet all applicable REIT requirements.

II. Additional Background. Certain wind farms are entitled to substantial production tax credits (PTCs) for electricity produced from certain qualifying facilities, including wind turbines, section 45. The PTCs are available to the owner of the qualifying facility. Rev. Rul. 94-31, 1994-1 C.B. 16 determined that, for purposes of the PTCs from wind resources, the facility is the wind turbine (blades, mechanical gear box, mechanism for control and communication and the housing capsule/nacelle), together with the tower on which the wind turbine is mounted and the pad on which the tower is situated. Rev. Rul. 94-31 describes a wind farm as being comprised by an array of wind turbines, towers, pads, transformers, roadways, fencing, on-site power collection systems, and monitoring and meteorological equipment. The term "facility" is narrow in comparison to the array of assets which together comprise an operating wind farm (PLR 200334031). Leasing, rather than owning, the underlying land does not interfere with the availability of the PTCs. PLRs 200142018, 200609001, 200609002 and 200620004. In Rev. Proc. 2007-65 (as revised by IRS Announcement 2007-112, Internal

Revenue Bulletin 2007-50, December 10, 2007) announced a safe harbor concerning partnership allocations of PTCs in connection with wind farms.

III. Discussion: (1) See footnote 18 for a discussion of the REIT-ability of geothermal assets. (2) See PLR 2000-41024 (addressing rooftop platforms used in connection with wireless communications): http://www.irs.gov/pub/irs-wd/0041024.pdf. (3) See Rev. Rul. 75-424 (referenced in the PLR at B.5, pages 12 and 13) which addresses tower structures. (4) In light of Rev. Proc. 2007-65 (see the preceding paragraph), a REIT structure for the REIT-able assets (with such assets being leased to the partnership that owns and operates the facility for PTC purposes) would make the investor minimum investment hurdle easier to clear since the operating partnership would hold a substantial portion of the wind farm assets under lease. None of the PTCs should attach to the assets owned by the REIT. (5) A renewable REIT should be enormously attractive to the equity capital markets with the combination of "green" investments and more predictable yield (arising from the fixed rents).

Endnote 22. Possible LNG REIT. *Following is a conceptual piece describing a possible REIT that may or may not pass muster with Treasury. As with the Endnote on a possible steam REIT (see Endnote 20), this Endnote is intended to probe the outer limits of energy infrastructure REITs.*

1. To date, there has been only one MLP that owns a liquefied natural gas (LNG) receiving/storage terminal: Cheniere Energy Partners, L.P. (AMEX: CQP) (the IPO prospectus is at http://www.sec.gov/Archives/edgar/data/1383650/000119312507059924/d424b4.htm). Work to date shows significant promise in the REIT-ability of the bulk of an LNG receiving terminal thus opening the LNG sector to REIT structures. Pipelines, tank farms, and marine receiving facilities fit squarely within the category of inherently permanent structures and structural components. These assets (together with land, land rights and land improvements) comprise the preponderance of the all-in costs of an LNG receiving facility. The standard industry contracts governing capacity allocations at an LNG facility – so-called firm commitment terminal use agreements (TUAs) – have already a number of characteristics in common with triple-net leases. An LNG REIT could complement an LNG MLP and might supplant the MLP as the preferred means of access to the public capital markets. If a storage tank were determined to be real property, rights to use storage could themselves rise to the level of being "interests in real property" even if the agreement creating the right to use was not a lease as such. ("Vaporization" services provided by the operator of the LNG facility (directly or via a taxable REIT subsidiary) would need to be separately analyzed.) Treas. Reg. 1.856-3(c) provides that the term "interests in real property" includes timeshare interests that represent undivided fractional fee interests, or undivided leasehold interest, in real property, and that entitle the holders of the interests to the use and enjoyment of the property for a specified period of time each year. PLR 200052031 addresses time shares as short as one week up to a stated number of years. Time share concepts are applicable to storage facilities but have little immediate relevance for transmission and distribution systems. See also the cold storage PLR (200428019) discussed at paragraph 2 of *Endnote 6* above and the public storage REITs noted at footnote 11 to the Conduit PLR. *What is an LNG tank farm if not the functional equivalent of a cold-storage warehouse?*

2. The primary cold storage PLR is 199904019, released February 1, 1999, and addresses the status for REIT purposes of cold storage warehouses and central refrigeration systems. The PLR relies on the total energy system revenue ruling (Rev. Rul. 73-425, 1973-2

C.B. 222, described below; also relied on in the Dupont Fabros PLR, *Endnote 26*), the microwave transmission asset revenue ruling (summarized at paragraph B.5 of the annotated PLR to which these Endnotes are appended) and revenue ruling 80-151 and the Whiteco factors (see Annex H). PLR 199904019 states "Although not conclusive, cases classifying property as either real property or personal property for purposes of the investment tax credit under former section 38 (repealed by the Tax Reform Act of 1986, P.L. 99-514) are instructive in determining whether assets constitute real estate assets. The classification of property for purposes of the investment tax credit is analogous to such determinations for REIT purposes. In fact, the legislative history underlying the investment tax credit describes "assets accessory to a business" eligible for credit largely the same as section 1.856-3(d) describes "assets accessory to the operation of a business" that are not considered real estate assets for REIT purposes[8]. See S. Rept. No. 1881, 87th Cong., 2d Sess. (1962), 1962-3 C.B. 716, 722". PLR 199904019 continues: "Corporation's cold storage warehouses are constructed to remain permanently in place, cannot be readily moved, are unlikely to be moved, and are not intended to be moved. Therefore they are inherently permanent structures. See Whiteco, Rev. Rul. 80-151, and Rev. Rul. 71-220. Inherently permanent structures are real property, and the term "real estate assets" means real property. Section 1.856-3. The systems are designed and intended to be permanent. Although comprised of components that individually can be removed, the components are rarely if ever removed because they are part of a system. The systems are permanently affixed and functionally related to their associated warehouses. Moving all or part of the systems would be extremely difficult and would be extremely difficult and would likely affect their function. Therefore, the systems are structural components of the warehouses, which are inherently permanent structures. See Rev. Rul. 73-425 and Loda. Under section 1.856-3, real property includes items that are structural components of a permanent structure. Furthermore, the warehouses and systems are not used in a manufacturing or production process and are not the functional equivalent of any item cited in the regulations under section 856 or the legislative history of the investment tax credit as an example of an accessory to the operation of a business".

3. PLR 199904019 describes Rev. Rul. 73-425 as follows: "Rev. Rul. 73-425, 1973-2 C.B. 222, considers whether a mortgage secured by a shopping center and its total energy

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[8] 1962 Legislative history: "Section 38 property (defined in sec. 48(a)) is the only property (either new or used) which is treated as "qualified investment." Except for the exclusions noted below, all tangible personal property qualifies as section 38 property. Except for buildings and their structural components, real property which is used as an integral part of manufacturing, production or extraction or of furnishing transportation, communications, electrical energy, gas, water or sewage disposal services also qualifies as section 38 property. This is also true of real property (other than buildings and structural components) used for research or storage facilities with respect to any of the above categories. Tangible personal property is not intended to be defined narrowly here, nor to necessarily follow the rules of State law. It is intended that assets accessory to a business such as grocery store counters, printing presses, individual air-conditioning units, etc., even though fixtures under local law, are to qualify for the credit. Similarly, assets of a mechanical nature, even though located outside a building, such as gasoline pumps, are to qualify for the credit. Real property (other than buildings and structural components) which qualifies as integral parts of categories referred to above includes such assets as blast furnaces, oil and gas pipelines, railroad track and signals, and fences used in connection with raising cattle."

system is an obligation secured by real property. A total energy system is a self-contained facility for the production of all the electricity, stem or hot water, and refrigeration needs of associated commercial or industrial buildings, building complexes, shopping centers, apartment complexes and community developments. The system may be permanently installed in the building, attached to the building, or its may be a separate structure nearby. The principal components consist of electric generators powered by turbines or reciprocating engines, waste heat boilers, heat exchangers, gas-fired boilers, and cooling units. In addition, each facility includes fuel storage tanks, control and sensor equipment, electrical substations, and air handling equipment for heat, hot water, and ventilation. It also includes ducts, pipes, conduits, wiring, and other associated parts, machinery and equipment. The revenue ruling holds, in part, that a mortgage secured by the building and the system is a real estate asset, regardless of whether the system is housed in the building it serves or is housed in a separate structure apart from the building it serves. This is because the interest in a structural component is included with an interest held in a building or inherently permanent structure to which the structural component is functionally related."

Endnote 23. Goodwill; Assemblage Valuation. 1. Goodwill. A recent PLR, 200726002, addresses goodwill in the context of REIT income requirements and concludes that, upon the sale of a REIT's business, goodwill gain will be treated for REIT income tests as being derived proportionately from the same source as the gain recognized on the sale to which the goodwill gain relates[9]. The PLR does not address the issue of a goodwill in the context of the REIT asset tests but the logic of the PLR would seem equally applicable to the analysis of acquisition-related goodwill in the context of REIT acquisitions of assets that may include goodwill.

2. Valuation. "Assemblage" valuation is a short–form reference to the "across-the-fence (ATF) times corridor-factor (CF) methodology for valuing corridors. While not without its critics, the ATF x's CF methodology is in wide spread use in valuing corridors such as railways for purchase accounting exercises under generally accepted accounting principles (GAAP). The corridor\assemblage valuation methodology was first posited in a 1978 article by John P. Doleman and Charles F. Seymour entitled "Valuation of Transportation/Communication Corridors", *The Appraisal Journal* for October 1978, pp. 509-522. The methodology was later re-visited by Charles Seymour in "The Continuing Evolution of Corridor Appraising (Back to Basics)," *Right of Way*, May/June 2002, p. 12-20. Seymour defines a corridor as "a long, narrow strip of land or real property rights for which the highest and best use it to provide an economic or social benefit by connecting the endpoints, and sometimes serving intermediate points along the way, " p.14. Seymour recommends that appraisers should first estimate ATF value by examining typical properties in the vicinity of the corridor and "then apply an "enhancement factor" or EF (later renamed a "Corridor Factor") derived from other corridor sales in relation to their EF's on the date of sale." For additional background, compare David R. Bolton and Kent Alan Sick, "Valuation of Utility Corridors: Proper Methodology for Appraising Property Rights," http://www.boltonandbaer.com/downloads/articleValuation.pdf., (the "corridor

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[9] A bit of forensic work discloses that the forward cash merger transaction which is the subject of PLR 200726002 is General Electric Capital's February 2007 acquisition of TruStreet Properties, Inc., (NYSE:TSY). The related acquisition proxy statement http://www.sec.gov/Archives/edgar/data/1032462/000119312507002309/ddefm14a.htm sheds additional light on the facts and circumstances surrounding the goodwill PLR.

valuation method (CVM)" is "the most appropriate method to use when valuing properties that obviously have a highest and best use of easement corridor"), with Charles P. Buccaria and Robert G. Kuhs, "Fiber Optic Communication Corridor Right of Way Valuation Methodology (A Summary Resulting from Telecommunications Corridor Right of Way Market Observations," The Appraisal Journal, April 2002, pp. 136-147 (reprint available at www.catc.ca.gov/committees/airspace/Item_8a_Fiber%20Update%20-%20.pdf-) ("Purchasers or sellers of assembled telecommunications or pipeline corridors do not generally use ATF").

3. REIT involving distribution and/or transmission facilities will entail issues concerning the role and valuenation of municipal/governmental franchises. Franchises run the gamut from allowing access to public rights-of way for the placement of distribution facilities to agreements that grant exclusivity of service within defined geographic areas. From the perspective of structuring a distribution REIT, it is desirable (if franchises are to be included as part of the REITs assets) that the municipal/governmental franchises be included as integral to the real property. Section 197 of the Code may be helpful in this analysis: excluded from amortizable section 197 intangibles are "any interest in land," section 197(e)(2), The regulations state that interests in land include easements and other similar rights. "An interest in land does not include an airport landing or takeoff right, a regulated airline route or a franchise to provide catite service. The cost of acquiring a license, permit or other land improvement right, such as a building construction or use permit, is to be taken into account in the same manner as the underlying improvement." Tres. Reg. 1.197-2(c)(3).

Endnote 24. Section 1031 Opportunities. 1. Section 1031(a) of the Code provides an exception from the general rule requiring the recognition of gain or loss upon the sale or exchange of property. Under section 1031(a)(1), no gain or loss is recognized if property held for productive use in a trade or business or for investment is exchanged solely for property of a like kind to be held either for productive use in a trade or business or for investment. For purposes of section 1031, the regulations provide general guidance as to the meaning of "like kind" in the case of exchanges of real property, section 1031(a)-1(b), and detailed guidance for exchanges of personal property, section 1.103(a)-2. The guidance as to real property is broad: "the words like kind have reference to the nature or character of the property, and not to its grade or quality. . . The fact that any real estate involved is improved or unimproved is not material, for that fact relates only to the grade or quality of the property and not to its kind or class." An example is also given, section 1.1031(a)-1(c): no gain or loss is recognized if "(2) a taxpayer who is not a dealer in real estate exchanges city real estate for a ranch or a farm, or exchanges a leasehold of a fee with 30 years or more to run for real estate, or exchanges improved real estate for unimproved real estate. . . "

2. With respect to REITs, applicable regulations expressly provide that local law definitions will not be controlling for purposes of determining the meaning of "real property" for REIT purposes. Section 1.856-3(d). The like-kind exchange (LKE) regulations, private letter rulings and decisional law, takes a different approach: local law definitions are paramount in assessing whether particular property is real or personal for section 1031 purposes. In determining the proper classification of property as real or personal for purposes of Section 1031 and the like-kind exchange rules, it is well settled that state law must be considered. For example, in Rev. Rul. 55-749, 1955-2 C.B. 295, the Service held that where, under applicable state law, water rights are considered real property rights, the exchange of perpetual water rights for a fee interest in land constitutes a non-taxable exchange of like-kind property under Section

1031(a). See, generally, K. Alton and B. Borden, *Section 1031 Alchemy: Transforming Personal Tangible and Intangible Property into Real Property* http://www.chadbarr.com/uploads_chadbarr/alton-borden-tax-alchemy.pdf. See Non-Docketed Service Advice Review 2004-4101 for a situation involving an exchange of pipelines within a single state (the pipelines were said to be personal property under the laws of the state in question). Does section 1031 character change as a pipeline crosses state lines? Compare Colonial Pipeline Co. v. State Dep't of Assessments and Taxation, 371 Md. 16, 39, 806 A.2d 648, (2002) ("the pipeline system should be classified as personal property, a "trade fixture", for Maryland property tax purposes") and Tenn. Code. Ann. § 65-5-101(8)(G) (classifying pipelines as real property for tax purposes: in effect, over-ruling a Tennessee appeals court decision to the contrary).

3. A couple of infrastructure revenue rulings are of note: Rev. Rul. 72-549, 1972-2 C.B. 472 provides that an easement and right-of-way granted to an electric power company are properties of like-kind to both real property with nominal improvements and real property improved with an apartment building (Rev. Rul. 72-549 has been cited for this proposition as recently as 2006 in PLR 200651025), and Rev. Rul. 73-120, 1973-1 C.B. 369 provides that water distribution utility assets are like-kind to an apartment building because both are fee interests in real property).

4. Southern Union Company (NYSE:SUG) has been a significant user of Section 1031 exchanges in the gas infrastructure area: it exchanged gas distribution public utility assets for both interstate gas transmission assets and for gas gathering and related assets. On audit, Southern Union was able to sustain 70% of the claimed income tax deferral associated with the exchanges. It cannot be determined from Southern Union's 1934 Act filings whether or not the subject assets were treated by Southern Union as real property or personal property for section 1031 purposes.

5. Inland Real Estate Exchange Corporation has a very active section 1031 like-kind exchange program using both the TIC and Rev. Rul. 2004-86 DST formats. The tenant-in-common (TIC) and Rev. Rul. 2004-86 Delaware statutory trust (DST) formats are explained in items 4 and 5 to Endnote 18 above. See pages 28-57 at http://www.sec.gov/Archives/edgar/data/1307748/000110465907076831/a07-26267_1424b3.htm for an overview.

6. The Behringer Harvard REITs have been active in the tenant-in-common (TIC), undivided interest business and have an active program where, subject to the Rev. Rul. 2002-22 guidelines, a REIT owns anchoring undivided interests in buildings with other undivided interests being held by individuals who acquire the interests in section 1031 like-kind exchanges (see Endnote 24 for more on section 1031 opportunities). See http://www.sec.gov/Archives/edgar/data/1176373/000118811204000637/t8k.txt for a description of a particular TIC structure and see pages 68-69 at http://www.sec.gov/Archives/edgar/data/1387061/000110465907089931/a07-12529_3s11a.htm for a more detailed description of the Behringer Harvard section 1031 TIC activities.

7. Energy infrastructure assets such as specific electric and gas transmission lines are ideally suite to undivided interest/TIC co-ownership structures and, therefore, lend themselves to inclusion in section 1031 exchange programs (particularly, programs designed to

meet the needs of utilities and energy companies seeking to complete like-kind exchange transactions under section 1031). The UPREIT operating partnership could lease the undivided interests under a master lease and thereafter sublease the interests. The UPREIT operating partnership could negotiate a purchase option giving it the right to acquire the tenancy-in-common interests at a later time in exchange for partnership units in the operating partnership under section 721 of the Code (relating to non-recognition of gain or loss on contribution to a partnership). Since many energy infrastructure assets are, or can be, held as undivided ownership interests (with an ability for any resulting partnership to elect-out of subchapter k, *see Endnote 18*), section 1031 exchange opportunities will be enhanced because section 1031(a), and implementing regulations, give effect to the election-out by treating the undivided interest as an asset and not an interest in a partnership.

8. In the context of an exchange of buildings, the section 1245 depreciation recapture rules can cause problems where the property being exchanged (the relinquished property) has been subjected to rigorous cost segregation studies (with the result that significant portions of a buildings value are depreciated as personal property) and the exchange property has less in the way of section 1245 property. The long and the short of it is that gain can be recognized in an otherwise good section 1031 transaction to the extent of the "excess" (i.e., non-carry over) section 1245 property. Section 1245(d); Reg. § 1.1245-(6)(b). With respect to energy infrastructure, the section 1245 recapture issue arising from a section 1031 exchange should be greatly reduced (if not completely eliminated) due to the provisions of section 1245 which sweep into the ambit of section 1245 property all tangible property, whether personal property or otherwise (but not including a building or its structure components) used as an integral part of manufacturing, production or extraction or of furnishing transportation, communications, electrical energy, gas, water, or sewage disposal services …," section 1245(a)(3)(B)(1)[10]. All other things being equal, section 1031 exchange transactions involving energy infrastructure assets should be easier to arrange than with buildings where section 1245 recapture components may differ from building to building.

Endnote 25. TRS Ownership of Generation: 1. In the expected case, ownership of electric generation will not be a design/implementation issue for a transmission/distribution REIT. There may, however, be situations where a utility is analyzing possible conversion to a REIT or where a utility holding company is considering the possible spin-off of a subsidiary that is predominantly a "wires" and/or "pipes" company. Minor amounts of generation may be involved. While a REIT may not own generation, a TRS may (albeit subject to the limitations on the overall size of TRSs in relation to the REIT, *see Endnote 6*). REITs can own directly limited amounts of electric generation dedicated to tenant use. See Rev. Rul. 73-425, 1973-2 C.B. 222 and PLR 2007752012 discussed in *Endnote 9* above.

2. The acquisition by Ventas, Inc. (NYSE:VTR) of Sunrise REIT provides a template for TRS ownership of operating assets such that the parent REIT was able to retain (rather than relinquish to third-party lessees) the net operating income (NOI) associated with the

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[10] Also includes facilities for the bulk storage of fungible commodities (including commodities in a liquid or gaseous state), section 1245(a)(3)(B)(3), and storage facilities (not including a building or its structural components) used in connection with the distribution of petroleum or any primary product of petroleum, section 1245(a)(3)(C).

TRS'd operating assets. Rather than acquire the Sunrise health care facilities in Ventas REIT operating partnership (Ventas is an UPREIT) and lease them out, Ventas chose instead to acquire the facilities via taxable REIT subsidiaries (TRs) and have unrelated parties manage the facilities pursuant to long-term management contracts. In this manner, Ventas believes that it was able to retain the upside of ownership of the facilities (albeit subject to an additional layer of tax at the TRS level on taxable net income arising from the facilities).

Endnote 26. Dupont Fabros PLR. 1. On December 28, 2007, Treasury released a PLR dated September 6, 2007, PLR 200752012 http://www.irs.gov/pub/irs-wd/0752012.pdf, with significant implications for infrastructure REITs. Usually, a PLR cannot be tied to the requesting party; but, in the case of PLR 200752012, the PLR can be tied with certainty to DuPont Fabros Technology, Inc. (NYSE:DFT), the wholesale data center REIT that went public in October, 2007. The IPO prospectus (the IPO prospectus is linked at *footnote 21* to the Conduit PLR) provides a detailed description of DFT's operations as a REIT that are only hinted at in the PLR. Two aspects of the PLR are notable: first, the PLR describes a fixed base rent plus operating expense reimbursement with the operating expense reimbursement being subject to reduction if the REIT does not provide (i) an uninterruptible, stable source of power to the tenant's space, or (ii) does not maintain an environment within the tenant's space at a specified temperature and humidity range. Second, structural components of the buildings include an "electrical distribution and redundancy system" designed "to provide an uninterrupted power supply to the property through redundancy." *The PLR notes that the system are "designed and constructed to remain permanently in place." The PLR concludes that "[a]lthough the Buildings and structures help to facilitate the technology businesses of tenants that occupy such buildings, the buildings and structural components themselves are not assets accessory to the operation of a business like the examples set forth in section 1.856-3(d)."*

2. The IPO prospectus (linked at footnote 21 to the Conduit PLR) and a recent quarterly report on Form 10-Q for DFT show that operating expense reimbursement approximates one-third of monthly tenant payments thereby effectively shifting to the landlord the risk of failure to maintain uninterruptible and stable power, temperature and humidity. This is a novel rent provision in that substantial direct landlord costs can go unreimbursed in the event that the landlord fails to provide promised redundancy and environment stability.

3. The improvements described as an "electrical distribution and redundancy system" include, in the case of one location, (i) 32 diesel-powered emergency generators each rated at 2,250 kW capacity and (ii) 32 rotary powered uninterruptible power supply (UPS) systems with 1300 kW of critical output. The DFT buildings are designed to N+3/N+4 redundancy and display a remarkable level of landlord support for tenant operations (surpassing by a significant degree, for example, landlord support activities for cold-storage warehouses).

Endnote 27. Self-Advised/Self--Managed. 1. Tony M. Edwards, Senior Vice President and General Counsel of the National Association of Real Estate Trusts (NAREIT) has described the concepts of self-advised and self-managed as follows (in a letter dated July 11, 2005 to the Singapore Monetary Authority): "As noted below, the listed U.S. REIT industry has moved to more of a self-advised/self-managed model over the past 20 years. Although these terms are sometimes used interchangeably, as described below, there is a difference between them. A self-**advised** REIT has its own employees who devote all of their time to the REIT just like the employees of any other publicly traded company. An externally-advised REIT typically hires a

separate business entity, which can be an investment manager, bank or insurance company or an affiliate of these entities, to supervise the ongoing entity-level operations of the REIT in exchange for an advisory fee. Such advisory services include, for example, making decisions or recommendations to buy or sell a property, declare dividends, raise capital, or hire on-site managers or other employees, in all cases subject to the oversight of the company's board of directors or trustees. An externally-advised REIT can have employees as well, but it subcontracts with an outside entity for supervisory services . . . An externally-**managed** REIT typically is a REIT that uses outside entities (called "independent contractors") to provide on-site services to tenants at its properties. A self-managed REIT provides these services through its own employees. This definition applies to "equity REITs," which are REITs that own real estate (rather than "mortgage REITs", REITs that own mortgages). In the U.S., the Congress has permitted REITs to be self-managed since 1986, and the majority of listed REITs are internally managed. Although there is no legal requirement that a REIT be self-advised, the capital markets tend to prefer that listed REITs be self-advised. Accordingly, about 90% of the publicly traded REITs that are NAREIT members (and an even higher number of listed equity REITs) are self-advised. This number represents approximately 97% of listed REITs by market capitalization. Most non-traded REITs appear to be externally advised and managed."

2. Both the recent DuPont Fabros Technology IPO (prospectus linked at *footnote 21* to the Conduit PLR) and Douglas Emmett, Inc. (NYSE:DEI), a REIT which completed its $1.46 billion IPO in the fourth quarter of 2006 are good examples of self-advised, self-managed REITs. Following is a link to the Douglas Emmett IPO prospectus. http://www.sec.gov/Archives/edgar/data/1364250/000104746906013093/a2173975z424b4.htm

3. A recent IPO for an externally managed and advised REIT is Care Investment Trust, Inc. (NYSE:CRE), a real estate investment and finance company formed principally to invest in health-care related commercial mortgage debt and real estate. External management and advice is by a subsidiary of CITGroup, Inc. Hospitality Properties Trust (NYSE:HPT) and its recently spun-off lessee, TravelCenters of America LLC (Amex:TA), share external management via Boston-based REIT Management, LLC (HPT and TA are mentioned above at *Endnote 14*).

4. A recent REIT offering that is 1934 Act-registered but not exchange traded is Wells Timberland REIT, Inc., an externally advised, externally-managed REIT. See http://www.wellsref.com/wellspdf/Timber_Prospectus_And_Subdoc.pdf. Hines Real Estate Investment Trust, Inc., is another example. See http://hinesreit.myhines.com/reit/resources/documents/2007/Prospectus_4-07.pdf.

5. DCT Industrial Trust Inc. (NYSE:DCT), is a REIT that became a publicly listed company on the New York Stock Exchange (prior to the transaction it was 1934 Act registered but was not a company listed for trading on an exchange) in connection with its October 2006 "internalization" transaction (i.e., a transaction whereby its external advisor contributed to its economic and other interests to the UPREIT operating partnership in exchange for limited partnership interests) http://www.sec.gov/Archives/edgar/data/1170991/000119312506184484/ddefm14a.htm. Proxy material provided to REIT unitholders in connection with DCT's listing discloses that, as of the end of September 2006, 96 of the 100 largest listed equity REITs, measured by market capitalization, were self-advised.

6. MLPs, because of the role of the general partner, are (using REIT terminology) externally-advised and externally managed. A few MLPs depart from the standard model (that of a limited partnership) and are organized as limited liability companies with a single class of voting securities: Copano Energy, L.L.C. (NASDAQ:CPNO) and Linn Energy, L.L.C. (NASDAQ:LINE). One MLP is in the process of converting from the standard MLP format to a structure involving MarkWest Energy Partners (NYSE:MWE) a single class of voting securities. http://www.sec.gov/Archives/edgar/data/1166036/000104746908000143/a2181899z424b3.htm

Endnote 28. Income Tax Allowance (ITA) in Rates.[11] 1. In May 2005, FERC issued a statement of general policy, permitting a pipeline to include in cost-of-service computations an income tax allowance provided that an entity or individual has an actual or potential income tax liability on income from the pipeline's public utility assets. Whether a pipeline's owners have such actual or potential income tax liability will be reviewed by FERC on a case-by-case basis. 111 FERC ¶ 61,139 (May 30, 2005). In June 2005 FERC applied its new policy and granted a partnership owning an oil pipeline an income tax allowance when establishing rates. 111 FERC ¶ 61,334 (June 1, 2005). That decision, applying the new policy to the particular oil pipeline, was appealed to the United States Court of Appeals for the District of Columbia Circuit, or the D.C. Circuit. The D.C. Circuit, by order issued May 29, 2007, denied the appeal and upheld FERC's new tax allowance policy as applied in the decision involving the oil pipeline on all points subject to the appeal. 487 F.3d 945 (D.C. Cir. 2007).

2. On December 8, 2006, FERC issued an order in an interstate oil pipeline proceeding addressing its income tax allowance policy, noting that the tax deferral features of a publicly traded partnership may cause some investors to receive, for some indeterminate duration, cash distributions in excess of their taxable income, which FERC characterized as a "tax savings." FERC stated that it is concerned that this creates an opportunity for those investors to earn an additional return, funded by ratepayers. Responding to this concern, FERC chose to adjust the pipeline's equity rate of return downward based on the percentage by which the publicly traded partnership's cash flow exceeded taxable income. 117 FERC ¶ 61,285 (December 8, 2006). On February 7, 2007, the pipeline asked FERC to reconsider this ruling. On March 9, 2007, FERC granted rehearing for further consideration of its December 8, 2006 order. The rehearing request is pending before the FERC.

3. On December 26, 2007 FERC issued a further order in certain of the same dockets in which it had issued its December 8, 2006 order. The December 26, 2007 order, 121 FERC ¶ 61,240, clarifies certain aspects of the implementation of the FERC's Income Tax Allowance Policy.

4. In an effort to provide some guidance and to obtain further public comment on FERC's policies concerning return on equity determinations, on July 19, 2007, FERC issued its Proposed Proxy Policy Statement, Composition of Proxy Groups for Determining Gas and Oil Pipeline Return on Equity. 120 FERC ¶ 61,108 (July 19, 2007). In the Proposed Proxy Policy

[11] Pages D-5 to D-7 of Annex D is a detailed chronology of the FERC's policy on income tax allowances in rates for flow-through entities such as MLPs. Annex G are excerpts from the December 8, 2006 order and the December 26, 2007 order referenced in items 2 and 3 of this Endnote 28.

Statement, FERC proposes to permit inclusion of publicly traded partnerships in the proxy group analysis relating to return on equity determinations in rate proceedings, provided that the analysis be limited to actual publicly traded partnership distributions capped at the level of the pipeline's earnings and that evidence be provided in the form of multiyear analysis of past earnings demonstrating a publicly traded partnership's ability to provide stable earnings over time. FERC has not yet adopted a final Proxy Policy Statement.

5. In a decision issued shortly after FERC issued its Proposed Proxy Policy Statement, the D.C. Circuit, 496 F.3d 695 (D.C.Cir. August 7, 2007), vacated FERC's orders in proceedings involving *High Island Offshore System*, 110 FERC ¶ 61,403 (January 24, 2005) and *Petal Gas Storage*, 106 FERC ¶ 61,325 (March 30, 2004). The Court determined that FERC had failed to adequately reflect risks of interstate pipeline operations both in populating the proxy group (from which a range of equity returns was determined) with entities the record indicated had lower risk, while excluding publicly traded partnerships primarily engaged in interstate pipeline operations, and in the placement of the pipeline under review in each proceeding within that range of equity returns. Although the Court accepted for the sake of argument FERC's rationale for excluding publicly traded partnerships from the proxy group (i.e., publicly traded partnership distributions may exceed earnings) it observed this proposition was "not self-evident."

6. FERC has indicated that they will consider favorably requests to convene a technical conference to address issues particular to REITs insofar as its Income Tax Allowance Policy is concerned. Bracewell & Giuliani and Merrill Lynch intend to file such a request after the date on which requests for rehearing of the FERC's December 28, 2007 order, 121 FERC ¶ 61,240 are due---the December 28, 2007 order clarified aspects of the December 8, 2006 order noted in item 2 of this Endnote 28. The December 28, 2007 order did not resolve the pending rehearing request of the December 8, 2006 order.

Endnote 29. Private REITs. 1. One of the REIT qualification requirements (the "5/50 rule") is that no more than 50% of the ownership of a REIT may be held by five or fewer individuals (as defined in the Code to include specific tax-exempt entities), sections 856(a)(6) and 856(h). In determining the number of stockholders of a REIT for purposes of the 5/50 rule, generally, and stock held by tax-exempt employer's pension or profit sharing trust which qualifies under section 401(a) of the Code and which is exempt from tax under section 501(a) will be treated as held directly by its beneficiaries in proportion to their interests in the trust, section 856(h)(3). A similar rule does not apply to other types of tax-exempt entities (such as tax-exempt registered investment companies, RICs).

2. Where the general partner in an investment fund is part of a public company, possible consolidation of the fund in the financial statements of the public company will be a significant issue. Consolidation for GAPP purposes has a number of results – combined financial statements reflect the assets, liabilities, revenues, expenses and cash flows of consolidated funds on a gross basis rather than only reflecting only the value of the general partner/sponsor's investments in the funds. In addition, all management fees and incentive income earned by the general partner/sponsor from the funds are eliminated in the consolidation of the funds and are instead reflected in financial statements as an increase in the shall of net income from the funds allocated to the general partner/sponsor. In June 2005, the Emerging Issues Task Force reached a consensus on EITF 04-5, "Determining Whether a General Partner,

or the General Partners as a Group, Controls a Limited Partnership or Similar Entity When the Limited Partners Have Certain Rights." EITF 04-5 states that a sole general partner is presumed to control a limited partnership (or similar entity) and should consolidate the limited partnership unless one of the following two conditions exist: (1) the limited partners possess substantive kick-out rights, or (2) the limited partners possess substantive participating rights. A kick-out right is defined as the substantive ability to remove the sole general partner without cause or otherwise dissolve (liquidate) the limited partnership. Substantive participating rights are when the limited partners have the substantive right to participate in certain financial and operating decisions of the limited partnership that are made in the ordinary course of business. The consensus guidance in EITF 04-5 is effective for all agreements entered into or modified after June 29, 2005. Where limited partners have kick-out rights, it is easier to conclude that a partnership is a real estate operating company (REOC) for ERISA purposes (*see Endnote 30*) but kick-out rights may complicate change-of-control analyses for regulatory purposes (particularly where a regulatory approval is a condition to consummating a change-of-control).

3. Public REITs have emerged as significant managers of institutional private equity. For example, in the industrial and shopping center sectors over the 18-month period ending June 30, 2007, public REITs raised in excess of $11.6 billion of institutional private equity versus approximately $2.7 billion in REIT common stock offerings. Christopher Vallace, "Public REITs as Managers of Private Equity," Institute for Fiduciary Education (IFE) occasional paper. http://www.ifecorp.com/applications/DocumentLibraryManager/upload/M3907.pdf Management of institutional private equity (particularly tax-exempt equity investors) shows substantial promise for both MLPs and public energy infrastructure REITs as a source of significant earnings and capital for new projects. Utilization of a private REIT structure will be central to the marshalling tax-exempt institutional investor funds.

4. Detailed descriptions of most REIT private equity investment transactions are hard to come by. One of the more detailed descriptions of a particular transaction is an institutional discretionary investment fund established by AnalonBay Communities, Inc. (NYSE Arca: AVB) in March, 2005. In addition to a description of the fund in its 1934 Act reports, a copy of the partnership agreement for the fund, AvalonBay Value Added Fund, L.P. (the"AVB Fund"), was included as an exhibit (exhibit 10.1) to AVB's second quarter 2005 10-Q. http://www.sec.gov/Archives/edgar/data/915912/000095013305001991/w08520exv10w1.htm. The AVB Fund, was structured as an UPREIT operating partnership that achieved GAAP deconsolidation under EITF 04-5 (via standard kick-out right provisions). In addition to its 15.2% equity interest in the AVB Fund, (funded pro rata with the institutional investors.), AVB was entitled to receive asset management fees, property management fees and redevelopment fees, as well as a promoted interest if certain thresholds are met. A further structural aspect of the AVB Fund was the use of a 70% limited partner entity, organized as a REIT, through which the bulk of the private investment was made (AVB, the 5% general partner, acquired the balance of its investment as shares in the limited partner REIT entity). A non-UBTI sensitive investor, Public School Employee's Retirement Board (Pa), invested directly in the AVB Fund as a limited partner. The AVB Fund was authorized to use leveraged financings up to 65% on a portfolio basis. The AVB Fund was also designed to meet ERISA requirements for a real estate operating company (REOC), *see* Endnote 30 below. Reference to the linked limited partnership agreement provides insights into a number of more or less standard terms for public REIT managed private equity.

5. A good overview of issues and REIT structural alternative at the intersection of the Investment Company Act of 1940, UBTI and ERISA plan asset regulations (Endnote 30) in the area of private fund investments is an October 3, 2006 article in the New York Law Journal, J.M. Morgan, S.G. Tomlinson and T.J. Tracey, "Tax Exempts Challenge Private Fund Sponsors" (must early accessed via the website resources of the Chicago-based law firm of Kirkland & Ellis (search word "REITs").

Endnote 30. Plan Asset Considerations (ERISA). 1. A prohibited transaction may occur if a REITs assets are deemed to be assets of the investing ERISA Plans and disqualified persons directly or indirectly deal with such assets. In certain circumstances where an ERISA Plan holds an interest in an entity, the assets of the entity are deemed to be ERISA Plan assets (the "look-through rule"). Under those circumstances, any person that exercises authority or control with respect to the management or disposition of the assets is an ERISA Plan fiduciary. ERISA Plan assets are not defined in ERISA or the Code, but the United States Department of Labor ("DOL") has issued regulations, effective March 13, 1987, that outline the circumstances under which an ERISA Plan's interest in an entity will be subject to the look-through rule.

2. DOL regulations, 29 C.F.R. Part 2510 (the plan asset regulations), apply only to the purchase by an ERISA Plan of an "equity interest" in an entity, such as stock of a REIT. However, the Department of Labor regulations provide an exception to the look-through rule for equity interests that are "publicly-offered securities." See item 3 of this Endnote 30. The DOL regulations also provide exceptions to the look-through rule for equity interests in certain types of entities, including any entity which qualifies as either a "real estate operating company" (a "REOC") or a "venture capital operating company" (a "VCOC"). See items 4 through 8 of this Endnote 30 for more on REOCs. Lastly, under the plan asset regulations, an investment fund (such as a private REIT) is deemed to own ERISA "plan assets" if the aggregate participation by "benefit plan investors" in the fund is significant, unless the fund qualifies as a VCOC or a REOC. See item 9 below.

3. Under the DOL regulations, a "publicly-offered security" is a security that is: (i) freely transferable; (ii) part of a class of securities that is widely-held; and (iii) either part of a class of securities that is registered under section 12(b) or 12(g) of the Exchange Act or sold to an ERISA Plan as part of an offering of securities to the public pursuant to an effective registration statement under the Securities Act so long as the class of securities of which such security is a part is timely registered under the Exchange Act after the end of the fiscal year of the issuer during which the offering of such securities to the public occurred. Whether a security is considered "freely transferable" depends on the facts and circumstances of each case. Under the DOL regulations, if the security is part of an offering in which the minimum investment is $10,000 or less, then any restriction on or prohibition against any transfer or assignment of such security for the purposes of preventing a termination or reclassification of the entity for federal or state tax purposes will not ordinarily prevent the security from being considered freely transferable. Additionally, limitations or restrictions on the transfer or assignment of a security which are created or imposed by persons other than the issuer of the security or persons acting for or on behalf of the issuer will ordinarily not prevent the security from being considered freely transferable. A class of securities is considered "widely-held" if it is a class of securities that is owned by 100 or more investors independent of the issuer and of one another.

4. Under the DOL regulations, a REOC is defined as an entity which on certain testing dates has at least 50% of its assets (other than short-term investments pending long-term commitment or distribution to investors), valued at cost, invested in real estate which is managed or developed and with respect to which the entity has the right to substantially participate directly in the management or development activities and which, in the ordinary course of its business, is engaged directly in real estate management or development activities. 29 C.F.R. § 2510.3-101(e). A VCOC is defined as an entity which, on certain testing dates, has at least 50% of its assets (other than short-term investments pending long-term commitment or distribution to investors), valued at cost, invested in one or more operating companies with respect to which the entity has management rights and which, in the ordinary course of its business, actually exercises its management rights with respect to one or more of the operating companies in which it invests. 29 C.F.R. § 2510.3-101(d)

5. The differences between a REOC and a VCOC are significant: an investment in a REOC by an ERISA plan entails a significantly lesser degree of management involvement than a similar investment in a VOCC. DOL's plan asset regulations provide examples of "good" and "bad" REOCs and VOCCs, 29 C.F.R. § 2510.3-101(j): examples (2) though (6) relate to VOCCs and examples (7), (8) and (9) relate to REOCs. Example (7) addresses a circumstance where a REIT and a REOC can be expected to exist in tandem. Example (7) describes an ERISA plan investment in a limited partnership that holds buildings "subject to long-term leases under which substantially all management and maintenance activities with respect to the property of the lessee." Example (7) says the partnership described is <u>not</u> a REOC: the partnership is not engaged in the management or management of real estate" merely because it assumes the risks of ownership if income-producing real property." Example (7) is a hurdle for structuring ERISA plan investments in energy infrastructure <u>via</u> the private REIT/REOC model.

6. DOL's plan asset regulations do not defined real estate and no interpretive guidance is available. For the first energy infrastructure investment fund using the private REIT/REOC model, a meeting with DOL is warranted. DOL regulations provide a means to obtain written guidance: ERISA Procedure 76-1 for ERISA Advisory Opinions. The 1986 amendments to ERISA in the Consolidated Budget Reconciliation Act of 1986 (COBRA), Pub. Law 99-272, included a provision, section 11018 (not codified), that excluded from the scope of DOL plan asset regulations a real estate entity described in such section (29 C.F.R. § 2510.3-101(k)(2)). Section 11018 defines "real asset" and "interest in real property" by adopting a number of the key phrases in the comparable definitions for REIT purposes, sections 856(c)(5)(B) and (C) thus providing a basis for the DOL to give significant weight to section 856 precedent (including implementing regulations and revenue rulings).

7. Where a private REIT/REOC plans to invest in an undivided interest in an operating asset, section 2510.3-101(g) of the plan asset regulations is implicated: "where a plan jointly owns properly with others, or where the value of a plan's equity interest in an entity relates solely to identified property of the entity, such property shall be treated as the sole property of a separate entity." The implications of this section for undivided ownership interests in assets that have a clearly defined capacity entitlement (and where the co-owners have elected-out of subchapter k) is not immediately apparent.

8. An analysis of public information concerning placement by Fortress Investment Group LLC (NYSE: FIG) of railroad holdings into its network of private funds indicates that Fortress likely reached the conclusion that a railroad can be a REOC.

9. Participation by benefit plan investors is "significant" if 25% or more of the value of any class of equity interests in an investment fund is held by benefit plan investors. 29 C.F.R. § 2510.3-101(f). Investments by governmental, foreign and church plans will not count against the 25%.

Endnote 31. Two Rate Making Considerations. 1. Ratemaking is beyond the scope of this presentation, but two threshold matters are worth addressing: first, an asset that is fully depreciated for rate making purposes no longer generates revenues providing a recovery of, and earnings, on the investment in rate base (although management fees are sometimes available for fully depreciated assets, see items 2 through 7 of this Endnote). Second, absent extraordinary circumstances, rate base does not increase to reflect acquisition premiums (see items 8 and 9 of this Endnote).

2. Traditionally, FERC has followed the formula set out in *Tarpon Transmission Co.*, 57 FERC ¶ 61,371 (1991) to evaluate requests for management fees. In *Tarpon* FERC concluded that a management fee was appropriate since "Tarpon's investment in its transmission plant is now fully depreciated." 57 FERC at 62,240. FERC reasoned that "the fee is an operator's fee to compensate Tarpon's owners for the risks of continuing to operate the pipeline and to provide incentive for efficient operations. While Tarpon's owners receive salaries for the daily management of the pipeline, they continue to have an entrepreneurial interest in the pipeline. Absent an owner's fee, they would have only limited incentives to manage the operations of the pipeline on an efficient basis, because the actual return on equity is so small once Tarpon's gas transmission plant has been depreciated. Under these circumstances a modest management fee is a more effective means of encouraging efficiency than an occasional regulatory proceeding, particularly if the pipeline exceeds its throughput projection." *Id.*

3. FERC cited this precedent in *High Island Offshore*, 110 FERC 61,043 (2005) *(HIOS), orders on reh'g,* 112 FERC 61,050, 113 FERC ¶ 61,280 (2005*), reversed and remanded in part sub. nom. on separate grounds, Petal Gas Storage* LLC v. FERC, 496 F.3d 695 (D.C. Cir. 2007). There, HIOS had a negative rate base due to the original cost of its gas plant being almost fully depreciated (from original cost of $385,510,921 only $13,405,796 of net plant remained). Once the deferred tax revenue and negative salvage revenue that HIOS had collected through its past rates were subtracted from its net plant, HIOS was left with negative rate base. FERC determined that a management fee was appropriate since HIOS had no traditional rate base on which to earn a return, and explained that approving rates that would only recover HIOS' projected costs of continuing to operate the pipeline without any allowance for earning a profit would leave HIOS' owners with only limited incentives to manage the operations of the pipeline in an efficient manner. 110 FERC at 61,151. "Giving HIOS an opportunity to earn a modest profit through a management fee should be an effective means of encouraging efficient operations, including reduced costs and increasing throughput and maintaining needed transportation facilities." *Id.*

4. FERC also granted a management fee in *Natural Gas Pipeline Co. of America*, 105 FERC ¶ 61,383 (2003), where Panther Interstate Pipeline Energy, LLC (Panther) purchased

fully-depreciated facilities from NGPA. FERC stated simply that because the facilities Panther would acquire were fully depreciated, a management fee was appropriate.

5. FERC has disallowed management fees at least twice. In *Northwest Pipeline Corp.*, 87 FERC ¶ 61,227 (1999), Northwest proposed to modify compressor facilities to expand its transport service capacity. Regarding its cost of service proposal, depreciation expense was proposed to be based on a fifteen-year depreciation ratio. At the sixteenth year, Northwest proposed a management fee of $145,999 to replace costs lost through the "depreciating-out of rate base." FERC denied this proposal, stating that "with a properly designed depreciation rate, Northwest would have no need of a management fee. Although the Commission has permitted management fees in situations where a pipeline's rate base is close to zero (citing to *Tarpon*), Northwest has a long history of rate base additions that more than compensate for its increasing depreciation reserve." *Id.* at 61,290.

6. In *Stingray Pipeline Co*., 98 FERC ¶ 63,004 (2002), Stingray had filed revised tariff sheets including a management fee, due to Stingray's calculation that at the end of the test period its facilities would be approximately 85 percent depreciated. In reviewing the proposal, FERC noted that while in *Tarpon*, it had allowed a management fee for fully-depreciated facilities, Stingray's facilities would not be fully depreciated, and set for hearing the issue of whether a management fee could be permitted in such a case. 85 FERC ¶ 61,455 (1998). The ALJ's initial decision said that "in order to demonstrate a need for the management fee …, a company (especially one not fully depreciated) would need to show significant detrimental financial circumstances, through no fault of its own, inhibiting the company's ability to manage its operations."

7. In one of the few electric power cases dealing with management fees, in *Connecticut Jet Power LLC*, 105 FERC ¶ 61,096 (2003), FERC denied a management fee to Connecticut Jet for its peaking units, since Connecticut Jet's only explanation for requesting the fee was that Commission precedent permits such a fee. FERC determined that since Connecticut Jet included administration and general expenses in its fixed costs, which are intended to cover all administrative and general costs including management fees, and since Connecticut Jet had not supported a management fee over and above these expenses, Connecticut Jet's fixed costs could not include a management fee.

8. In another electric power case, *Norwalk Power, LLC*, 120 FERC ¶ 61,048 at PP 39-42 (2007), Norwalk filed a proposed unexecuted Reliability Must Run Agreement (RMR Agreement) between itself, NRG Power Marketing Inc. (as Norwalk's agent) and the Independent System Operator New England, Inc. (ISO-NE), for two Norwalk generating units. Norwalk proposed to include a management fee in its cost-of-service, basing the request on its statement that the units were fully depreciated for rate base purposes, and the management fee provides an incentive to operate the units efficiently. FERC rejected the proposal, explaining that Norwalk's argument for the inclusion of a management fee failed to recognize the underlying rationale behind the use of RMR agreements. FERC stated that the purpose of an RMR agreement is not to encourage efficient operation of a particular facility, but to serve as a tool of last resort—a function fundamentally different than "traditional" cost-of-service agreements. FERC considered this last resort standard to be inconsistent with the proposed recovery of a management fee, and concluded that the fixed payments provided under an RMR agreement allow generators the ability to recover their cost of continued operation, thereby ensuring that

these units will be available to provide needed reliability service to ISO-NE customers. Thus, FERC concluded, an additional incentive payment was not needed to make such units economically viable.

9. Under Commission policy, rate recovery of an acquisition adjustment in traditional cost-based requirements rates is allowed only if the acquisition is prudent and provides measurable, demonstrable benefits to ratepayers. *Duquesne Light Holdings, Inc., et al.*, 117 FERC ¶ 61,326 at P 42, n. 47 (2006) (citing *Minnesota Power & Light Co.*, 43 FERC ¶ 61,104, at 61,342, *reh'g denied*, 43 FERC ¶ 61,502 (1988); *Duke Energy Moss Landing, LLC*, 83 FERC ¶ 61,318, at 62,304 (1998) (*Duke Energy*); *PSEG Power Connecticut*, 110 FERC ¶ 61,020 at P 32 (2005); *Suffolk County Electrical Agency*, 102 FERC ¶ 63,037 at P 31 (ALJ Decision) (2003)). In *Duke Energy*, FERC stated that while its usual approach to dealing with traditional requirements rates has been to restrict rate base to the original cost of the facility, an approach reflecting a presumption that the cost that ratepayers should bear is the cost to construct the unit, even if its market value later increases, "nonetheless [it] has permitted the inclusion of acquisition adjustments in rate base for requirements rates if a utility can show that the investment decision is prudent and if it can demonstrate that the acquisition provides measurable benefits to ratepayers. 83 FERC at 62,304.

Endnote 32. Pipeline Capacity Leases. 1. An increasing number of gas pipeline expansions involve significant pipeline capacity leases. For example, the Midcontinent Express pipeline, a new 502-mile natural gas pipeline system proposed by two MLPs, Kinder Morgan Energy Partners, L.P. (NYSE:KMP) and Energy Transfer Partners, L.P. (NYSE:ETP), will include the reservation via a renewable pipeline capacity lease of substantial intrastate capacity. The capacity lease can be accessed via the FERC's electronic docket: Docket No. CP08-6-000, Exhibit Z-3 (part of FERC accession number 20071009-4001) http://elibrary.ferc.gov/idmws/common/downloadOpen.asp?downloadfile=20071009%2D4011%2818073235%29%2Epdf&folder=11902232&fileid=11474073&trial=1. A number of recent FERC orders have approved pipeline capacity leases: Gulf South Pipeline Company, LP, 120 FERC ¶ 62,291 (2007) (Docket No. CP07-110-000); Gulf South Pipeline Company, LP, 119 FERC ¶ 61,281 (2007); Rockies Express Pipeline LLC, 119 FERC ¶ 61,069 (2007) (Docket No. CP-06-423-000); and Texas Gas Transmission, LLC, 113 FERC ¶ 61,185 (2007) (Docket No. CP-05-408-000). The leases typically involve an undivided percentage ownership interest in the subject line (see the Midcontinent Express pipeline lease referenced above) or a stated daily capacity in a particular line (without expressing a percentage ownership equivalent: an example can be found at FERC Docket No. CP08-16-000, Exhibit U – this docket also included the purchase and sale of a line segment expressed as an undivided ownership percentage).

2. The FERC approach to pipeline leases is to view them differently from transportation agreements under rate contracts. The FERC views a lease of interstate pipeline as the acquisition of a property interest that the lessee acquires in the capacity of a lessor's pipeline. To enter into a lease agreement, the lessee generally needs to be (or become) a natural gas company under the Natural Gas Act and needs section 7(c) authorization to acquire the capacity. Similarly, the lessor needs FERC authority to abandon by lease the subject capacity. In the view of the FERC, once capacity is acquired by lease, the lessee in essence owns that capacity and that capacity is subject to the lessee's tariff. Gulf South Pipeline, LP, 120 FERC, ¶ 61,291, paras. 35 to 42 (2007). The lessor, while it may remain the operator of the pipeline system, has, in the view of FERC, no longer any rights to use the leased capacity.

3. Material available on the FERC's electronic docket, FERRIS, does not state why a pipeline capacity lease was selected by the parties in lieu of a sale of an undivided ownership interest (whether expressed as a percentage or periodic throughout). A brief review shows capacity leases being more often selected for older assets. Since a lease is not an event that causes gain to be recognized for Federal income tax purposes, by a lessor, it is not surprising that assets that have been more fully depreciated for tax purposes would come down in favor of a long term lease over a direct sale. Regulatory reasons are also important: if an intrastate pipeline leases an undivided interest to an interstate pipeline, the lessor pipeline remains intrastate and unregulated by FERC. Also, the lease of an undivided interest enables a pipeline to offer the equivalent of firm capacity on a limited basis without offering firm (i.e., non-interruptible) capacity generally (this last fact pattern is the subject of pending protests in FERC Docket CP08-6-000 involving the Midcontinent Express pipeline mentioned above).

Endnote 33. Brookfield Infrastructure MLP Spin-off. Brookfield Infrastructure Partners, L.P., http://www.sec.gov/Archives/edgar/data/1406234/000090956707001635/o38887bexv12w1.htm,, is a hybrid MLP that will be subject to taxation as a partnership under U.S. law upon its being spun-off by its parent. Brookfield Infrastructure is notable in that its initial assets will be a combination of timber interests, both U.S. and non-U.S., and non-U.S. electric transmission interests. The interests will be structured as investments that will seek to rely on subsection of section 7701(d)(1) other than (C) ("real property rents") or (E) (income or gains under mineral/natural resource).

Endnote 34. IRS Circular 230 Disclosure. ***To ensure compliance with requirements imposed by the IRS, the reader is informed that any tax advice contained in this communication was not intended or written to be used, and cannot be used, for the purpose of (i) avoiding tax-related penalties under the Internal Revenue Code or (ii) promoting, marketing or recommending to another party any tax-related matters(s) addressed herein.***

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ACQUISITION OF TRAVELCENTERS OF AMERICA

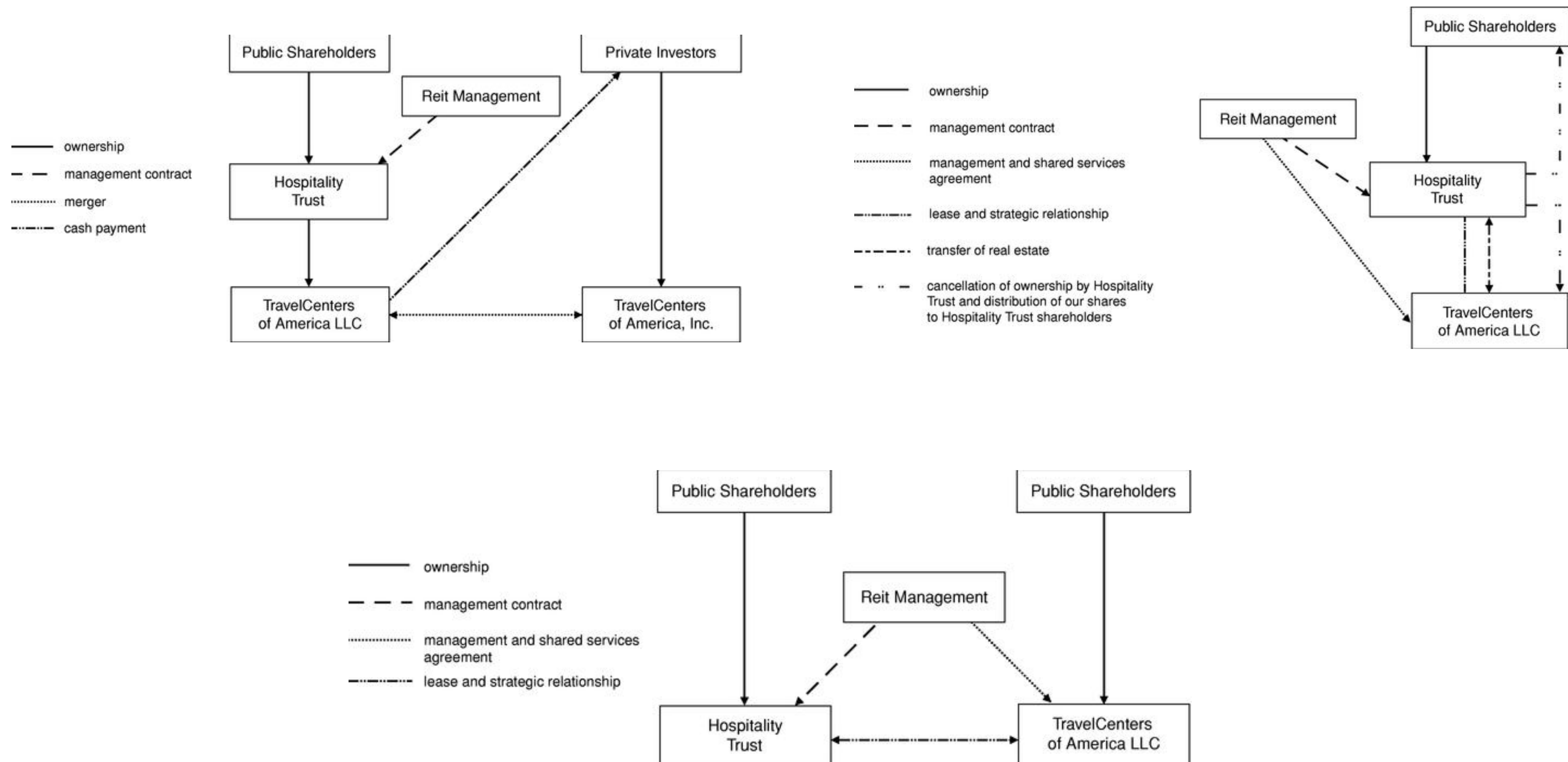

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DIAGRAM A

THE POTLATCH CONVERSION TRANSACTIONS

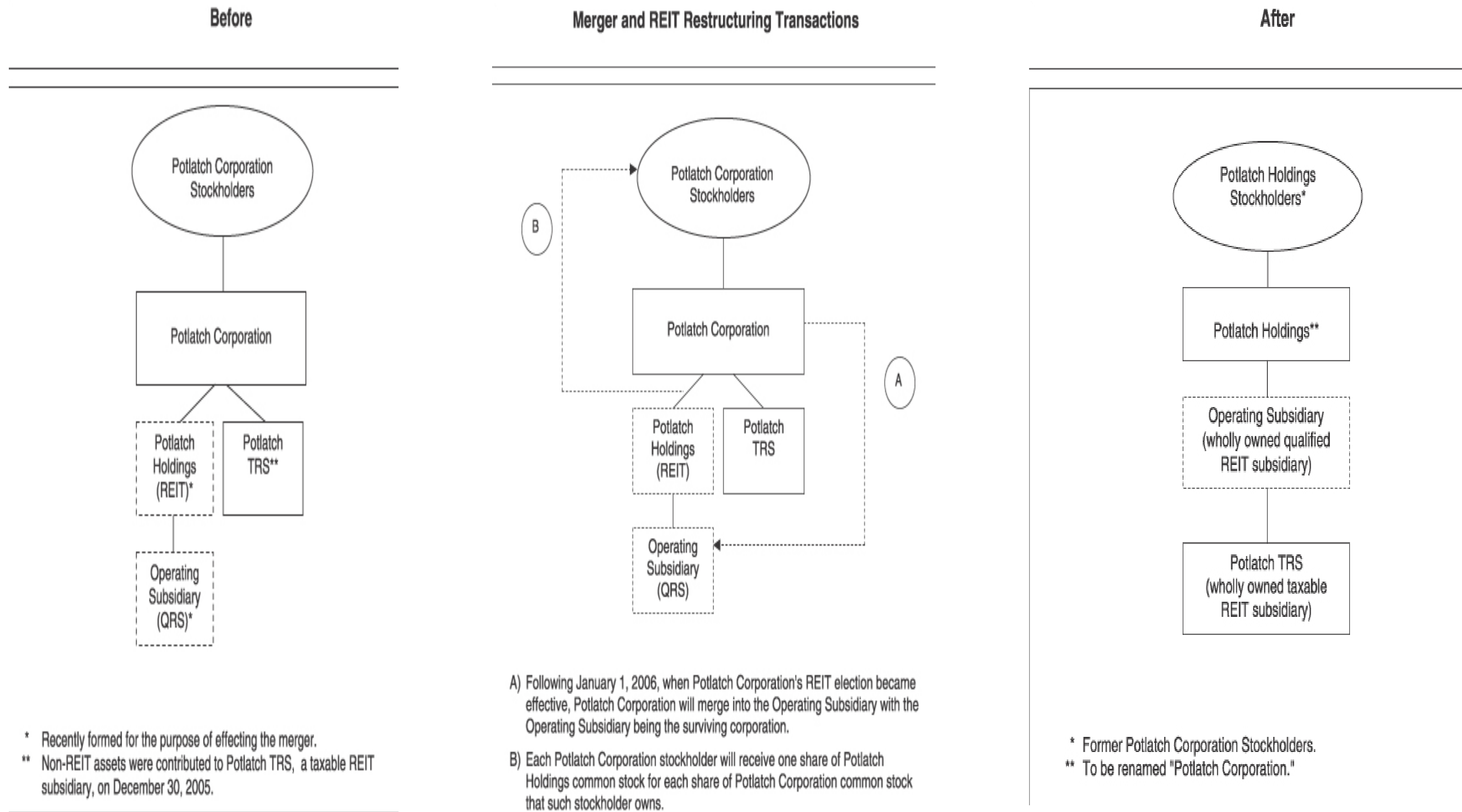
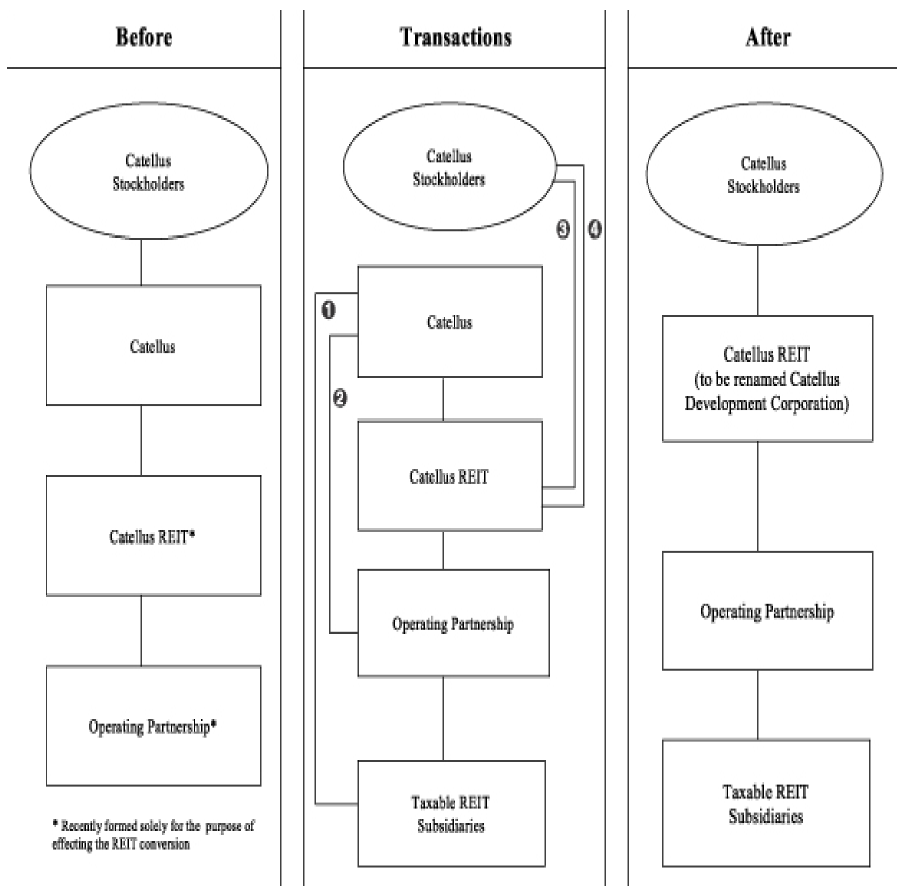


DIAGRAM B

CATELLUS REIT CONVERSION (2004)



1. Catellus contributes certain assets to one or more wholly owned subsidiaries which will become taxable REIT subsidiaries following the REIT conversion.
2. Catellus merges with and into Operating Partnership (UPREIT).
3. Catellus shareholders receive one share of Catellus REIT common stock for each share of Catellus common stock they own.
4. Catellus REIT distributes special E&P distribution to its stockholders. E&P distribution of both cash and/or shares as elected by the shareholder (subject to $100 million aggregate cash) structured to be a taxable distribution.

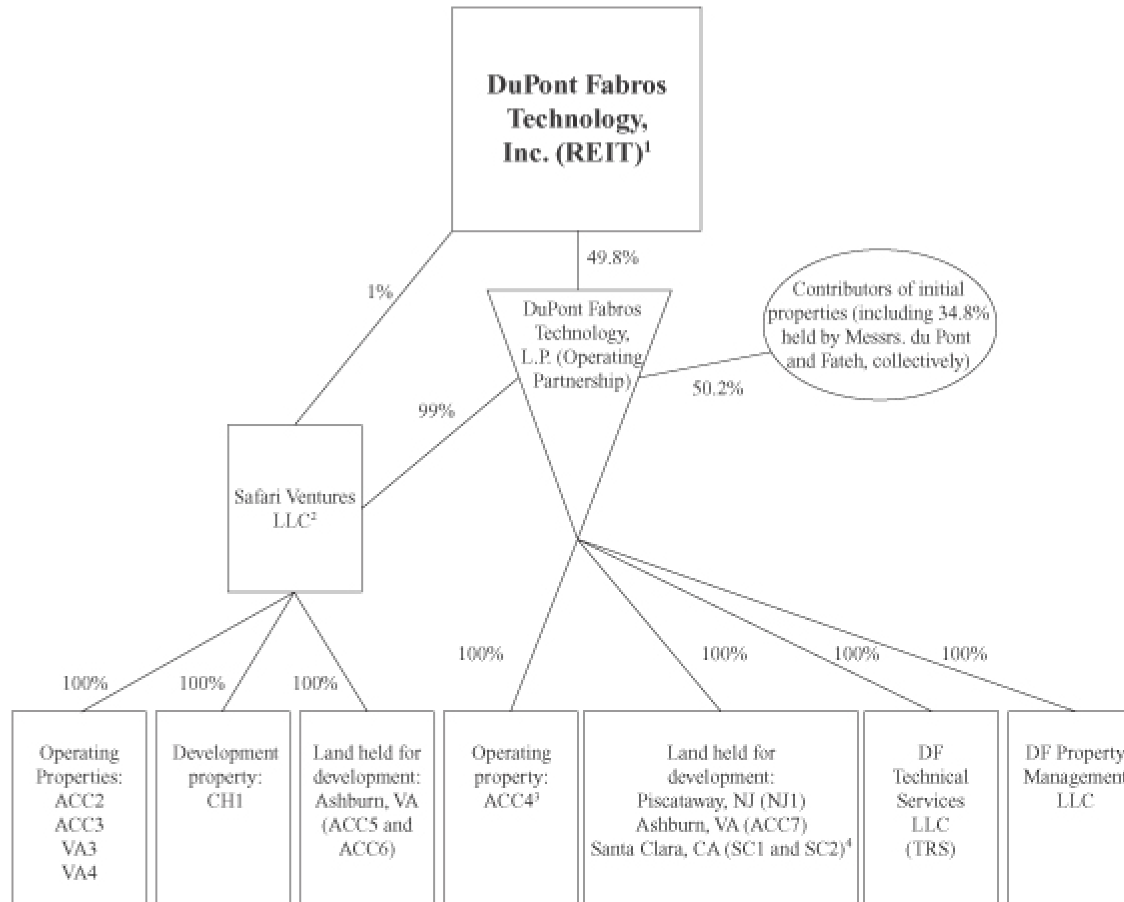


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DIAGRAM D

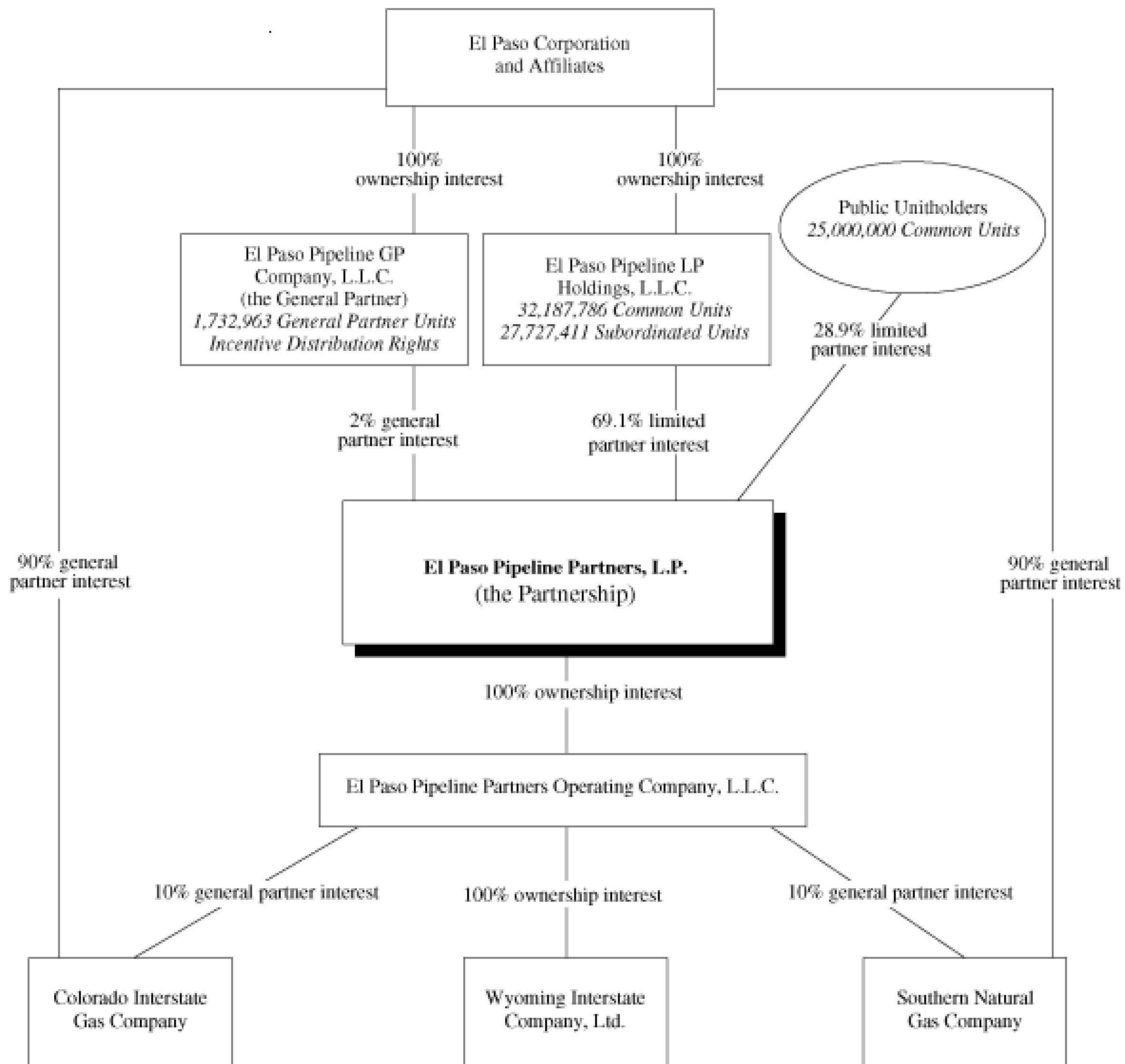

DIAGRAM E

REIT ENERGY INFRASTRUCTURE INVESTMENT VIA PRIVATE EQUITY (NON-REOC)

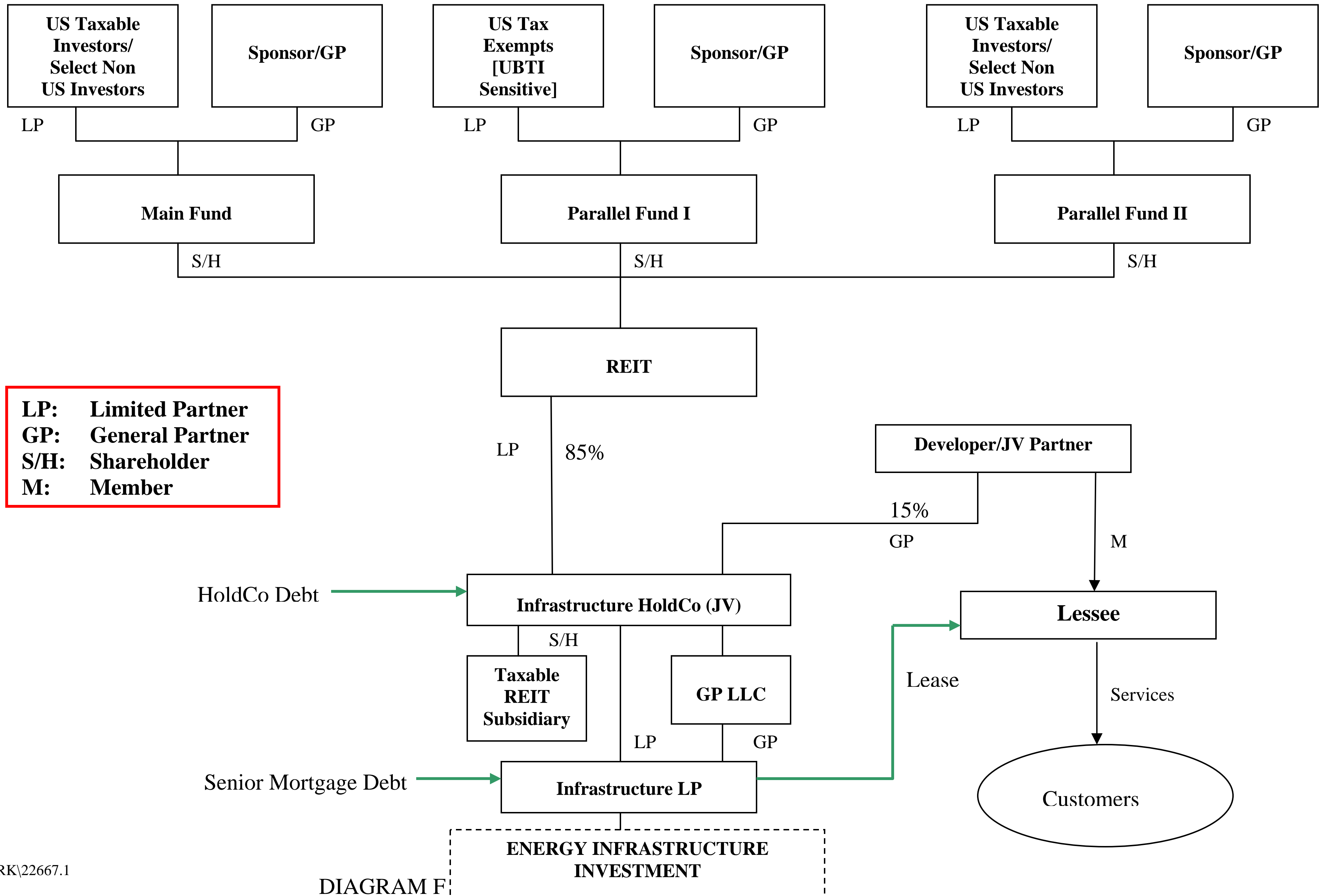

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DIAGRAM F

Annex A

COMMUNICATION TOWERS LEASE TRANSACTION
BETWEEN SPRINT NEXTEL (LESSOR) AND
GLOBAL SIGNAL (LESSEE)

A. Introductory Note: The following transaction description is derived from (i) filings made under the Securities Exchange Act of 1934 by Sprint Nextel Corporation ("SNC") and Global Signal, Inc. ("GSI"), (ii) certain rating agency write-ups of the GSI commercial mortgage pass-through transaction described below and (iii) number crunching exercises.

B. Brief Description (SNC 1934 Act Reports)

1. In May 2005, SNC closed a transaction with GSI under which GSI acquired exclusive rights to lease or operate 6,553 communications towers owned by SNC for a negotiated lease term, which is the greater of the remaining term of the underlying ground leases (approximately 17 years in 2005), or up to 32 years (assuming successful renegotiation of the underlying ground leases at the end of their current lease terms). SPN has subleased space on approximately 6,342 (96.7% of the 6,553 leased towers) of the towers from GSI for a minimum of ten years (from 2005). Monthly rental is $1400 per tower per month or an aggregate monthly rental approximating $9 million ($108 million annually). The monthly rental increases at a rate of 3% per year (resulting in an average annual rental over the minimum ten-year term of approximately $124 million). The net present value of the SNI sub-lease payments range over the minimum 10-year sublease term from $804 million (using an 8% semi-annual discount rate) to $932 million (a 5% discount rate).

2. SPN maintains ownership of the towers, and continues to reflect the towers on its consolidated balance sheet. SPN did not treat the transaction as a sale and leaseback for accounting (GAAP) purposes. Nor did SPN treat the transaction as a sale for Federal income tax purposes; the transaction documents clearly envision a true lease for tax purposes.[1]

3. At closing, SPN received proceeds of approximately $1.2 billion, which were recorded as rental income – communications towers (a non current liability) on SPN's consolidated balance sheet. The deferred income is being recognized as a reduction of lease expense relating to tower operating costs on a straight-line basis over approximately 17 years from 2005 (the remaining terms of the underlying ground leases). SPN accounted for the $1.2 billion as cash flow from operating (and not financing) activities. It is notable that the aggregate sub-lease rentals payable by SNI ($1.24 billion) effectively repays (without regard to the time value of money) the $1.2 billion prepaid rent over the ten-year minimum term of the sublease.[2]

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[1] Among other things, the thirty-two year lease term indicates that the appraiser determined the towers to have an economic useful life of at least 40 years: a conclusion that seems warranted for bare towers (i.e., towers without regard to the communication and other equipment attached to them).

[2] Upon certain significant and continuing SNC defaults, GSI can acquire title to the leased towers for a nominal additional consideration. This remedy gives support for the

4. Presumably, transaction efficiency would have been significantly eroded were the $1.2 billion rent prepayment to have been taxable as ordinary income to SNI in the year of receipt. A review of the transaction documentation reveals that the transaction was structured to make maximum usage of section 467 of the Internal Revenue Code (Section 467). In general terms, where a lease provides for substantial prepaid rent (among other rent structures such as uneven or deferred rent) the transaction is restructured for tax purposes so that the bulk of the prepayment is treated as an interest-bearing loan from the lessee (GSI in this case) to the lessor (SNI).[3] The result of Section 467 is that the lessor's taxable income is spreadout over the term of the lease. The lessor has a combination of cash (the pre-paid rent from year one), an annual taxable income item equal to allocated rent and an annual deduction item equal to interest on the deemed loan. The lessee has a combination of an annual deduction equal to the allocated rent and a partially off-setting taxable income item equal to the interest it is deemed to have received in the Section 467 loan to its lessors.

5. Page A-5 is a tabular presentation of the $1.2 billion rent prepayment under the section 467 regulations. Descriptions of the eight columns for the years within the thirty-two year lease term are as follows:

Column	Description
1	The $1.2 billion rent prepayment
2	This is a mechanical process: rent can vary between 90% and 110% of average rent and the allocations will be respected in applying the section 467 regulations. Average rent is $37.5 million, 90% of which is $33.75 million and 110% of which is $41.25 million. The model uniformly pushes the higher rent payments to the later years consistently with maximizing the deferral of rent income recognition by the lessor.[4]
3	Proportional rent for each period is the allocated rent for such period multiplied by a fraction. The fraction is the present value of the cash rents ($1.2 billion paid on day one) divided by the present value of the allocated rents (using a discount rate, as specified in the section 467 regulations

inference that the parties believed the present value of the towers to approximate the $1.2 billion amount of the pre-paid rent.

[3] Loan proceeds do not constitute taxable income. While partial section 467 loan structures are common in sale and leaseback financing transactions, it is unusual to see a transaction involving a 100 per cent rent prepayment. It is interesting to note that neither SNI nor GSI was the beneficiary of an indemnification provision that would protect their respective economic positions in the event there was a structural flaw with the 100% section 467 loan structure or if the structure did not otherwise hold up as expected if audited by the IRS.

[4] The section 467 regulations allow a variance between 85% and 115% of average rents if the lease involves property that is more than 90% "real estate" (as defined for purposes of the REIT regulations). Maximum use of a 85/115 structure will significantly increase the opportunity to defer further rental income recognition by the lessor.

equal to 110% of the applicable federal rate: 5.32% in the example given).

4-7 The columns show the manner in which the measure of the rent prepayment is calculated for purposes of inclusion as an interest deduction item for the lessor as an interest income item for the lessee (the bulk of the rent prepayment being treated as a loan by the lessee to the lessor).

8 This is the net amount of rental income to the lessor each period; the lessee has a corresponding stream of net deductions over the lease term.

C. Brief Description (GSI 1935 Act Reports):

1. SNC lessor entities are constituted as a series of bankruptcy–remote, special purpose Delaware limited liability companies. The GSI lessee entity is similarly constituted.

2. The master lease and sublease arrangement terminates in 2037. There are no contractual renewal options. The upfront payment of $1.2 billion is only payment for right to lease/operate towers. The lessee entity has assumed all ground leases underlying the towers. The lessee is obligated to pay all tower operating costs as well as an agreed annual payment of $13.3 million (escalating by 3% a year throughout the 32 year lease term) for personal and real property taxes attributable to the subject towers. An important financial measure for a lessee is the net present value (NPV) of its minimum lease payments. The $1.2 billion rent prepayment can be analyzed as a prepayment by the lessee of the net present value of the aggregate of minimum lease payments.[5] Under this analysis, equivalent annual cash rents for 32 years range as follows:

Semi-Annual Discount Rate	Annual Rent
5%	$75.6 million
6	84.8
7	94.4
8	104.4
9	114.9
10	125.2

[5] This analysis disregards two important items: first, the flip-side of Section 467 (*see B.4 above*) is that the lessee cannot deduct the entirety of the remt prepayment in the year made; and, second, its annual rent deduction for tax purposes from income is offset by the amount of interest it is deemed to have received under the section 467 loan.

It is notable that through a 10% discount rate, the average sub-lease rentals from SPN "cover" the rental implicit in a $1.2 billion NPV of rent; at lower discount rates, the sublease rentals exceed the implicit rentals due to SNI (for example, using a discount rate of 6%, "excess" sublease rentals aggregate approximately $390 million over the ten-year minimum sublease term)

3. During the one year period prior to the 2037 expiration, GSI may purchase all (but not less than all) of the then remaining leased towers for $2.3 billion.[6] As of transaction closing, the NPV of the $2.3 billion ranged from $254.4 million (discounting semi-annually at 7.00%) to $87 million (discounting semi-annually at 10.50%).[7]

4. GSI accounted for the transaction with SNC as a capital lease "in reflection of the substantive similarity to an acquisition". The primary driver for capital lease treatment was the very substantial upfront rent prepayment.

5. After the ten year minimum term, SNC may terminate the sublease at any or all leased towers, provided that if a minimum of one year notice is not given as to a tower, there is an automatic five year renewal for such tower. In addition, SNC may terminate the sublease as to any or all towers on the 15th, 20th, 25th or 30th anniversary of the May 27, 2005 closing date.

6. GSI initially funded the $1.2 billion prepayment from the proceeds of an $850 million secured bridge loan and equity offerings of $433.4 million. In February 2006, GSI refinanced the bridge loan from the proceeds of a $1.55 billion commercial mortgage pass-through obligation ("CMO") transaction that also refinanced secured loans relating to other GSI mortgage loans. The CMOs are interest-only for five years and mature in February 2011 and have a weighted average fixed rate per year of approximately 5.7%. The issuer of the CMOs, Global Signal Trust III, issued that involved no fewer than seven (7) layers of subordination thereby garnering AAA ratings (Standard & Poor's and Fitch) on $702.4 million (45.3%) of the $1.55 billion total. Fitch (but not S&P) awarded AAA to the $132.2 million of second tier certificates and BBB or above ratings to a total of 87.8% of the $1.55 billion (first through fifth levels of repayment priority).

7. A technical discussion of the Section 467 loan follows at pages A-6 to A-8.

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[6] $2.3 billion was determined, by appraisal, to be expected aggregate fair market value of the leased towers on May 27, 2037, the purchase option exercise date.

[7] Other data points (NPV/discount rate): $137.5 million (9.00%); $187.0 million (8.00%); $347 million (6.00%); and $473.6 million (5.00%).

Example: Tax Analysis of Section 467 Loan

Year	Cash Rent [1]	Allocated Rent [2]	Proportional Rent	(Prepaid) / Deferred Rent [Debt Service on 467 Loan] [4]	Interest @ 5.32% on 467 Loan [5]	Change in 467 Loan Balance Principal [6]	467 Loan Balance [7]	Allocated Rent and Interest [8]
		"90/110" Allocation to [1]	[2] * 2.189	[3] - [1]	[7] (prior period) * 5.32%	[4] + [5]	[7] (prior period) + [6]	[3] + [5]
1	$1,200,000,000	$33,750,000	$73,866,556	($1,126,133,444)	($63,840,000)	($1,189,973,444)	($1,189,973,444)	$10,026,556
2		$33,750,000	$73,866,556	$73,866,556	($63,306,587)	$10,559,969	($1,179,413,476)	$10,559,969
3		$33,750,000	$73,866,556	$73,866,556	($62,744,797)	$11,121,759	($1,168,291,717)	$11,121,759
4		$33,750,000	$73,866,556	$73,866,556	($62,153,119)	$11,713,437	($1,156,578,280)	$11,713,437
5		$33,750,000	$73,866,556	$73,866,556	($61,529,965)	$12,336,591	($1,144,241,689)	$12,336,591
6		$33,750,000	$73,866,556	$73,866,556	($60,873,658)	$12,992,898	($1,131,248,791)	$12,992,898
7		$33,750,000	$73,866,556	$73,866,556	($60,182,436)	$13,684,120	($1,117,564,671)	$13,684,120
8		$33,750,000	$73,866,556	$73,866,556	($59,454,440)	$14,412,115	($1,103,152,555)	$14,412,115
9		$33,750,000	$73,866,556	$73,866,556	($58,687,716)	$15,178,840	($1,087,973,715)	$15,178,840
10		$33,750,000	$73,866,556	$73,866,556	($57,880,202)	$15,986,354	($1,071,987,361)	$15,986,354
11		$33,750,000	$73,866,556	$73,866,556	($57,029,728)	$16,836,828	($1,055,150,533)	$16,836,828
12		$33,750,000	$73,866,556	$73,866,556	($56,134,008)	$17,732,547	($1,037,417,985)	$17,732,547
13		$33,750,000	$73,866,556	$73,866,556	($55,190,637)	$18,675,919	($1,018,742,066)	$18,675,919
14		$33,750,000	$73,866,556	$73,866,556	($54,197,078)	$19,669,478	($999,072,588)	$19,669,478
15		$33,750,000	$73,866,556	$73,866,556	($53,150,662)	$20,715,894	($978,356,694)	$20,715,894
16		$33,750,000	$73,866,556	$73,866,556	($52,048,576)	$21,817,980	($956,538,715)	$21,817,980
17		$41,250,000	$90,281,346	$90,281,346	($50,887,860)	$39,393,486	($917,145,228)	$39,393,486
18		$41,250,000	$90,281,346	$90,281,346	($48,792,126)	$41,489,220	($875,656,008)	$41,489,220
19		$41,250,000	$90,281,346	$90,281,346	($46,584,900)	$43,696,446	($831,959,562)	$43,696,446
20		$41,250,000	$90,281,346	$90,281,346	($44,260,249)	$46,021,097	($785,938,465)	$46,021,097
21		$41,250,000	$90,281,346	$90,281,346	($41,811,926)	$48,469,420	($737,469,045)	$48,469,420
22		$41,250,000	$90,281,346	$90,281,346	($39,233,353)	$51,047,993	($686,421,052)	$51,047,993
23		$41,250,000	$90,281,346	$90,281,346	($36,517,600)	$53,763,746	($632,657,306)	$53,763,746
24		$41,250,000	$90,281,346	$90,281,346	($33,657,369)	$56,623,977	($576,033,329)	$56,623,977
25		$41,250,000	$90,281,346	$90,281,346	($30,644,973)	$59,636,373	($516,396,956)	$59,636,373
26		$41,250,000	$90,281,346	$90,281,346	($27,472,318)	$62,809,028	($453,587,928)	$62,809,028
27		$41,250,000	$90,281,346	$90,281,346	($24,130,878)	$66,150,468	($387,437,459)	$66,150,468
28		$41,250,000	$90,281,346	$90,281,346	($20,611,673)	$69,669,673	($317,767,786)	$69,669,673
29		$41,250,000	$90,281,346	$90,281,346	($16,905,246)	$73,376,100	($244,391,686)	$73,376,100
30		$41,250,000	$90,281,346	$90,281,346	($13,001,638)	$77,279,708	($167,111,978)	$77,279,708
31		$41,250,000	$90,281,346	$90,281,346	($8,890,357)	$81,390,989	($85,720,989)	$81,390,989
32		$41,250,000	$90,281,346	$90,281,346	($4,560,357)	$85,720,989	($0)	$85,720,989
Total	**$1,200,000,000**	**$1,200,000,000**	**$2,626,366,430**	**$1,426,366,430**	**($1,426,366,430)**	**($0)**		**$1,200,000,000**

PV @ 5.32% of Cash Rent	**$1,200,000,000**
PV @ 5.32% of Allocated Rent	**$548,286,021**
Ratio of PVs	**2.189**

5.32%

TECHNICAL DISCUSSION OF THE SECTION 467 LOAN

1. Under the final Section 467 regulations, Section 467 applies to any rental agreement with increasing or decreasing rent that exceeds certain limits, as well as any rental agreement with deferred or prepaid rents. It is important to establish that the rent structure being considered for a proposed transaction is not subject to constant rental accrual under Section 467.

   - Specifically, if the allocated rent is within the rules of the 90-110 safe harbor described in the final regulations, constant rental accrual should not apply and the allocations should be respected.

   - The lessor's income from each allocated rent is fractioned by proportional rent, an overall measure of deferral or prepayment of the rent.

   - Furthermore, the lessor's income from scheduled rental allocations is decreased or increased by interest expense and income, respectively, from the 467 loan that is deemed to result from the prepayment and deferral of rent.

2. This discussion provides the background of how the final regulations are applied in reaching the conclusions stated above and in analyzing the "467 loan" alternative rent structures. As the steps are traced to the safe harbor, proportional rent calculation, and 467 loan application, the relevant references to the Section 467 final regulations are listed.

3. <u>90-110 Safe Harbor</u>: It must first be established that the allocated rents do not cause the agreement to be subject to constant rental accrual.

   - A rental agreement with increasing rents or deferred or prepaid rents is treated as a Section 467 rental agreement (1.467-1(c)(1)).

   - The three month rent holiday that is allowed by the final regulations is disregarded in the determination of increasing or decreasing rent (1.467-1(c)(2)(B)).

   - A Section 467 agreement may specifically allocate fixed rent to the rental periods of the lease term (1.467-1(c)(2)(A)).

   - Section 467 rent includes the fixed rent for any rental period (1.467-1(d)(1)).

   - The fixed rent for a rental period includes the proportional rental accrual (1.467-1(d)(2)(ii)).

   - A Section 467 rental agreement is subject to constant rental accrual if it is a disqualified leaseback or long-term agreement (1-467-3(a)). A rental agreement that has increasing or decreasing rent is not a disqualified leaseback if tax avoidance is not a principal purpose for providing the increasing or decreasing rent (1-467-3(b)(1)(i)). A safe harbor for these purposes is meeting the uneven

rent test described in 1.467-3(c)(4)(i), under which the 90-110 test is applied to allocated rent.

4. Compliance of the allocated rents with the 90-110 safe harbor clears the first hurdle in establishing an acceptable structure.

5. Proportional Rent: The calculation of proportional rent results in a fraction that is an overall measure of prepayment or deferral. The fraction is applied to each allocated rent.

    - Proportional rent is used for the fixed rent for each rental period if the Section 467 rental agreement is not a disqualified leaseback and adequate interest on fixed rent is not provided (1.467-2(a)).

    - Proportional rent for each period is the allocated rent for such period, multiplied by a fraction. The fraction is the present value of the rents payable under the agreement divided by the present value of the rents allocated under the agreement (1.467-2(c)(1)).

    - The present values are computed as of the first day of the first rental period in the lease term, using a discount rate of 110% of the applicable Federal rate (1.467-2(d)).

    If a rental agreement has prepaid rent, the proportional rent calculation will result in a number that is greater than 1. Each allocated rent will be increased by this factor. Conversely, an agreement with deferral will produce a proportioning factor that is less than 1, reducing each allocated rent.

    Note that the proportional rent calculation will not affect compliance with 90-110, since each allocated rent is multiplied by the constant proportioning factor.

6. 467 Loan: The final step in the structuring process is the inclusion of an ongoing measure of prepayment or deferral. This measure takes the form of the 467 loan, which can have either a positive or negative balance at various points in time (1.467-4(a)). When the balance is positive (representing a deferral of rent), the lessor has interest income from a deemed loan to the lessee. When the balance is negative (representing a prepayment of rent), the lessor has interest expense from the deemed loan from the lessee.

7. More specifically:

    - If a Section 467 rental agreement does not provide adequate interest (through either having no deferred or prepaid rent or by stating an interest rate), then a 467 loan arises under 1.467-4(b); if rent is prepaid, the lessor has interest expense on the 467 loan, and if rent is deferred, the lessor has interest income.

- The 467 loan balance is the sum of prior rent accruals, plus prior interest income of the lessor, less prior interest expense and rent paid (1.467-4(b)). A positive balance will result when accruals exceed payments (rent deferrals from the lessor's view); a negative balance will occur when payments exceed accruals (rent prepayment from the lessor's view).

- The interest rate on the 467 loan, for agreements that have proportional rent, is prescribed as 110% of the applicable Federal rate (1.467-4(c)(2)).

SIDE-BY-SIDE COMPARISON OF REAL ESTATE INVESTMENT TRUSTS (REITs) AND MASTER LIMITED PARTNERSHIPS (MLPs)

TOPIC	REITs	MLPs
1. Basis for Single Layer of Taxation	• Subchapter M of the Code. • Generally, no federal income tax is paid by a REIT because REITs may deduct dividends paid to shareholders; amounts distributed are generally taxable to the shareholders as ordinary income. • A REIT cannot pass losses through to its shareholders.	• Subchapter K of the Code concerning the taxation of partnerships and section 7704 of the Code relating to certain publicly-traded partnerships. • An MLP does not pay any federal income tax. Instead, each partner is required to report on his income tax return its share of income, gains, losses and deductions without regard to whether or not corresponding cash distributions are received by the partner. An MLP is a "pass-through" entity of the type recognized in the FERC's ITA Policy.
2. Qualifying Income	• Among sources of qualifying income for REITs are rents from real property. • Electric transmission systems have been determined to comprise real estate for REIT purposes that can be leased by a REIT to an unrelated tenant to produce rents from real property.	• Source of qualifying income is "rents from real property" (as defined for purposes of the REIT provisions). ***In other words, an MLP can invest in electric transmission and distribution properties only if (as is the case with REITs) the property is leased to a party unrelated to the MLP.*** • The preponderance of MLPs operate in the energy sector deriving more than 90% of their qualifying income from "income and gains from the exploration, development, mining or production, processing, refining, transportation (including pipelines transporting gas, oil or products there), or the marketing of any mineral or natural resource (including fertilizer, geothermal energy and timber)".

TOPIC	REITs	MLPs
3. Distributions: Accompanying Form/ Timing of Forms/ State Tax Filings	Shareholders will receive a single tax reporting statement (on Form 1099) and will only be required to file income tax returns in states in which they would ordinarily file.	MLP unit holders receive a statement of partnership items (on Schedule K-1) from each MLP owned and may be required to file income tax returns in each state in which the MLP generates income. MLP's distribute Schedule K-1 tax reports in mid-March, potentially delaying an investor's tax reporting process.
4. Response to FERC Policy	Not applicable.	In response to the FERC's ITA Policy, MLP IPOs that include FERC-regulated oil and gas assets have imposed a limitation on holders: only "Eligible Holders" may be initial purchasers of MLP units and only "Eligible Holders" will be entitled to receive distributions or be allocated income or loss by the MLP. SEP, WMZ and EPB take this approach. "Eligible Holders" are (i) individuals or entities subject to U.S. federal income taxation on income generated by the MLP, or (ii) if the unitholder is not subject to U.S. federal income taxation on such income, (for example, a Flow-Through regulated investment company (RIC)[1] or a partnership), all of the entity's owners are subject to U.S. federal income taxation on income generated by the MLP. ***A Taxable RIC would be an Eligible Holder under clause (i).***
5. Holding Company Structure[2]	The REIT's operations are conducted through an entity organized as a partnership for state law purposes (a so-called "umbrella partnership" or "UPREIT"). The UPREIT may be wholly or partially owned by the REIT; if wholly-owned by the REIT, the UPREIT is disregarded for federal income tax purposes. With an electric transmission REIT, the REIT would be a holding company and the UPREIT would be the public utility for purposes of the Federal Power Act and regulations thereunder.	An MLP typically employs a three-tier structure: (i) the MLP that is the publicly-traded entity: (ii) an operating partnership/limited liability company that owns assets and conducts operations; and, (iii) when the MLP owns (indirectly), partial interests in assets or businesses, the lower-tier entities that own/operate such assets or businesses.

[1] Discussed at footnote 3 below (p. B-4).

[2] Both REITs and MLPs are designed to enable access to the public capital markets. While so-called "private" REITs and MLPs (i.e., REITs and MLPs that are not subject to periodic disclosure obligations under the Securities Exchange Act of 1934, the "'34 Act") exist, this presentation does not attempt to address private REITs or private MLPs. The REITs and MLPs discussed in this presentation are assumed to be '34 Act registrants. The holding company in either a REIT structure or an MLP structure that includes jurisdictional facilities under the Federal Power Act will be a holding company subject to FERC regulations concerning holding companies including

TOPIC	REITs	MLPs
6. Governance: Board of Directors	• Board must have a majority of directors who are independent under NYSE Arc rules. • Where a REIT is externally managed, the external manager/advisor has significant involvement (typically under long term contract) in day-to-day operations that can (but need not) put significant limitations around the authority of a Board of Directors to direct the management and policies of the REIT.	Under NYSE Arca and American Stock Exchange (AMEX) rules, an MLP is treated as a "controlled corporation". While a controlled corporation is not required to have a majority of independent directors (MLPs typically do not have a majority of independent directors), the board of directors/managers of general partner of the MLP must at least have a three-member audit committee all of whose members must be independent.
7. Governance: Voting Rights	Each holder has one vote for the election of directors and on other matters as mandated by the state statute under which the REIT is organized.	The general partner manages and operates the MLP. Unlike the holders of common stock in a corporation, an MLP unit holder votes only on limited on matters affecting the MLP. Unit holders have no right to elect the general partner or the directors/managers of the general partner on an annual or other continuing basis. The general partner of an MLP typically may not be removed except by vote of the holders of at least 66-2/3% of outstanding MLP units (including those held by the general partner and its affiliates). Consequently, the general partner typically cannot be involuntarily removed.
8. Minimum/Maximum Number of Holders	A REIT may have no fewer than 100 shareholders. Ownership limitations designed to prevent a REIT from being closely held in violation of the Code's REIT provisions are typically implemented and usually restrict the number/value of shares that any shareholder can own to 9.9% or some lesser percentage. The purpose is to ensure compliance with the so-called "five-fifty" rule of the Code which prohibits five or fewer individuals from owning in the aggregate 50% of the value of the shares of the REIT during the last half of the REIT's taxable year.	There is no applicable minimum or maximum.

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the obligation to provide the FERC with copies of any Schedule 13D, Schedule 13G and Form 13F, at the same time and on the same basis, as filed with the SEC, 18 C.F.R. § 33.1(c)(4)(2007).

TOPIC	REITs	MLPs
9. Distributions: Required	To maintain qualification as a REIT, a REIT generally is required to distribute to its shareholders each year in an amount at least equal to 90% of its taxable income (other than net capital gains). To the extent that a REIT does not distribute all of its taxable income, the REIT is subject to tax thereon at regular ordinary and capital gain corporate tax rates.	No distributions are required in order to maintain tax status.
10.. Distributions: Tax Impact	Shareholders tax on REIT distributions should not exceed cash received from the REIT for any taxable year assuming no consent dividends.	Cash distributions should exceed taxable income allocations. Additional and tax distributions may be mandated.
11. Investment Company Act Considerations	REITs typically conduct operations so as not to become subject to SEC regulation as an investment company under the Investment Company Act of 1940 (the "40 Act"). REITs that fail to avoid investment company status become subject to a number of restrictions (for example, prohibitions on affiliate transactions) but a REIT would nonetheless retain its tax status as a REIT under the Code.	MLPs typically conduct operations so as not to become subject to regulation as an investment company under the 1940 Act. Both the WMZ and EPB IPOs disclose and discuss structural aspects that create a heightened risk that the MLP may be deemed to be an investment company under the 1940 Act. An MLP that is, or becomes, an investment company is prevented from qualifying as a partnership for federal income tax purposes in which case it would be treated as a corporation and taxed as such (unless the MLP could claim the special flow-through tax status available to flow-through RICs (see footnote 3 below).

TOPIC	REITs	MLPs
12. General partner incentive rights	Nothing comparable for a self-managed REIT. An externally-managed REIT will often confer incentive rights on the investment manager/advisor.	The general partner is typically eligible to receive incentive distributions if the general partner operates the business in a manner that results in distributions paid per common unit surpassing specified target levels. As the general partner increases cash distributions to the limited partners, the general partner receives an increasingly higher percentage of the incremental cash distributions. A common arrangement provides that the general partner can reach a tier where it receives 50% of every incremental dollar paid to unitholders.
13. Holders: Regulated Investment Companies (RICs).[3]	Regulated Investment Companies (RICs) can generally invest in REITs and not have adverse consequences from the receipt of REIT distributions or the nature of a REIT's investments or activities.	In 2004 RICs received authority to hold interests in MLPs in significant amounts, but the statute was unable to address the requirement that RICs, as MLP holder, have to file state tax returns in each state where the MLP does business.

[3] There are two types of RICs (often called mutual funds) that are relevant for purposes of this presentation: (i) RICs that have irrevocably elected to qualify as "regulated investment companies" under the Internal Revenue Code (Flow-Through RICs); and (ii) RICs that have not elected to qualify as such under the Internal Revenue Code (Taxable RICs). A Flow-Through RIC does not pay an entity-level tax on its amounts paid to its investors.). A Flow-Through RIC must distribute at least 90% of its net investment income as taxable dividends (there is no requirement that capital gains be distributed). A Flow-Through RIC pays federal income taxes solely on any part (up to 10%) of investment income retained, and on retained capital gains. The preponderance of RICs are Flow-Through RICs. Taxable RICs are rare but have come to occupy increasing importance in the MLP investment community. Kayne Anderson MLP Company (NYSE Arca: KYN) is an example of a Taxable RIC that invests at least 85% of its assets in energy-related MLPs and their affiliates and in other midstream energy companies. KYN does not view Taxable status as a negative because of KYN's expectation that the cash flow that it receives from its MLP investments will exceed the taxable income allocated to KYN by the MLPs. As of May 31, 2007, KYN held in excess of $2.2 billion of MLP investments. Tortoise Energy Capital Corporation (NYSE Arca: TYY) is another example of a large Taxable RIC focusing on MLPs and their affiliates in the energy infrastructure sector. KYN, TYY and other MLP-focused Taxable RICs occupy a space created by the inefficiency of MLPs when it comes to institutional investors. Following is an excerpt from KYN's IPO prospectus: "[t]here are adverse consequences of MLP ownership for many institutional investors, including the generation of non-qualifying income for regulated investment companies…. Further, because MLPs generate unrelated business taxable income (UBTI), they are typically not held by tax-exempt investors such as pension plans, endowments, employee benefit plans, or individual retirement accounts. Also, income and gains from MLPs are subject to the Foreign Investment in Real Property Tax Act (FIRPTA), limiting the investment by non-U.S. investors in the sector. As a result, MLPs are held predominantly by taxable U.S. retail investors. Further, due to the limited public market float for MLP common units and tax-reporting burdens and complexities associated with MLP investments, MLPs appeal only to a segment of such retail investors. Due to this limited, retail-oriented focus, the market for MLPs can experience inefficiencies which can be exploited by a knowledgeable investor." REITs do not exhibit the type of inefficiencies that can be exploited by Taxable RICs.

TOPIC	REITs	MLPs
14. Holders: retirement accounts and other tax exempt investors (Unrelated Business Taxable Income (UBTI) issues)	Common stock dividends are generally excluded from treatment as UBTI. Accordingly, tax-exempt investors (including pension plans, employee benefit plans and individual retirement accounts) will not have UBTI upon receipt of REIT dividends.	A tax-exempt limited partner's allocable share of MLP income is generally treated as UBTI.
15. Holders: foreign investors	Any distributions made with respect to a REIT interest held by a foreign person in a "domestically controlled REIT' (any REIT in which less than 50% of its interests are held by foreign persons) are statutorily excepted from the FIRPTA withholding rules.	Section 1446 of the Code requires withholding on distributions to foreign persons. If these withholding rules are observed, then no withholding is required under FIRPTA. Otherwise, withholding under FIRPTA can also apply if 50% or more of the MLP's assets are US real property.
16. Tax Rates on Distributions to Individuals	With limited exceptions, dividends received from REITs are not eligible for taxation at preferential income tax rates (15% maximum federal rate through 2010) for qualified dividends received by individuals from taxable C corporations.	Unitholders subject to tax at rates determined by the nature of the income generated by the MLP.
17. Market Valuation	Although REIT indices have fallen considerably over the past several months in response to residential mortgage turmoil, REITs have remained an attractive investment to retail and institutional investors. As an asset class, REITs have historically traded at an average yield premium of 100 basis points to long-dated treasuries with low correlation to the market, making them effective from a portfolio diversification standpoint. Compared to other yield vehicles, REITs benefit from the fact that they are required by construct to pay at least 90% of their taxable income in the form of dividends, creating a more certain yield. For these reasons, REITs have traded at a 50-250 basis point valuation premium to MLPs over the past 5 years.	MLP's are attractive to retail and institutional investors given their current undervaluation relative to their risk profile, largely driven by their structural/tax complexity. While there is a growing institutional participation in the MLP asset class (for example, via Taxable RICs described at footnote 3 above), there remains a significant lack of broad-based institutional participation in the MLP asset class due to significant barriers to entry including limitations on mutual fund (RIC) ownership and UBTI generation for tax-exempt institutions. Market undervaluation relative to risk profile means higher yields are needed to attract new investment, higher yields that will eventually come to characterize the pool of proxy companies that are used in discounted cash flow (DCF) analyses to set return on equity (ROE) for regulated companies.

ELECTION OUT OF SUBCHAPTER K

1. Certain unincorporated organizations may be excluded from the provisions of subchapter K of Chapter 1 of the Code (the partnership tax provisions) including an organization that is availed of

> "(ii) for the joint production, extraction, or use of property, but not for the purpose of selling services or property produced or extracted. The members of such organization must be able to compute their income without the necessity of computing partnership taxable income."

§ 1.761-2(a)(1).

2. The applicable provisions of the regulations provide further detail on joint-use arrangements:

> "(3) *Operating agreements*. Where the participants in the joint production, extraction, or use of property:
>
> > (i) Own the property as coowners, either in fee or under lease or other form of contract granting exclusive operating rights[1], and
> >
> > (ii) Reserve the right separately to take in kind or dispose of their shares of any property produced, extracted, or used[2], and
> >
> > (iii) Do not jointly sell services or the property produced or extracted, although each separate participant may delegate authority to sell his share of the property produced or extracted for the time being for his account,

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[1] The joint operating agreement may constitute an entity under state law – a non-corporate entity such as a limited liability company (LLC), a limited partnership, a limited liability partnership or a business/statutory trust – but the participants in the entity must own directly (or indirectly through a disregarded entity) interests in the subject property. An LLC that owns its property may not elect out of subchapter K. In PLR 200305026 Treasury concluded that a limited partnership where members owned only an interest in the partnership (and not the property owned by the partnership) was not entitled to elect-out. Field Service Advice (FSA) 199923017 (June 11, 1999) states that generally "the Service does not allow entities formed under a state's partnership or limited partnership laws to elect out of subchapter K" since the partners do not have the right to take their share of the property (both as a matter of law and pursuant to their agreement). FSA 2002216005 (April 19, 2002) states that co-ownership is determined under state law, not by definition of a co-tenancy, but rather by reference to each party's rights in the property as specified in a lease or other contract between the parties.

[2] Clause (ii) has been determined to be inapplicable where the joint use property in question provides a service (such as transportation). See item 6 below, page C-4.

> but not for a period of time in excess of the minimum needs of the industry, and in no event for more than 1 year,

then such group may be excluded from the application of the provisions of subchapter K under the rules set forth in paragraph (b) of this section. However, the preceding sentence does not apply to any unincorporated organization one of whose principal purposes is, cycling, manufacturing, or processing for persons who are not members of the organization."

§ 1.761-2(a)(3).

3. Absent a formal election by the unincorporated organization, an election-out can be implied from the arrangements of the organization:

"(ii) If an unincorporated organization described in subparagraphs (1) and either (2) or (3) of paragraph (a) of this section does not make the election provided in section 761(a) in the manner prescribed by subdivision (i) of this subparagraph, it shall nevertheless be deemed to have made the election if it can be shown from all the surrounding facts and circumstances that it was the intention of the members of such organization at the time of its formation to secure exclusion from all of subchapter K beginning with the first taxable year of the organization. Although the following facts are not exclusive, either one of such facts may indicate the requisite intent:

> (a) At the time of the formation of the organization there is an agreement among the members that the organization be excluded from subchapter K beginning with the first taxable year of the organization, or
>
> (b) the members of the organization owning substantially all of the capital interests report their respective shares of the items of income, deductions, and credits of the organization on their respective returns (making such elections as to individual items as may be appropriate) in a manner consistent with the exclusion of the organization from subchapter K beginning with the first taxable year of the organization."

§ 1.761-2(b)(2)(ii).

4. The regulations also provided guidance when an organization is treated as an entity separate from its owners for Federal tax purposes:

"(2) *Certain joint undertakings give rise to entities for federal tax purposes*. A joint venture or other contractual arrangement may create a separate entity for federal tax purposed if the participants carry on a trade, business, financial operation, or venture and divide the profits therefrom. For example, a separate entity exists for federal tax purposes if co-owners of an apartment building lease space and in addition provide services to the occupants either directly or through an agent. Nevertheless, a joint undertaking merely to share expenses does not

create a separate entity for federal tax purposes. For example, if two or more persons jointly construct a ditch merely to drain surface water from their properties, they have not created a separate entity for federal tax purposes. Similarly, mere co-ownership of property that is maintained, kept in repair, and rented or leased does not constitute a separate entity for federal tax purposes. For example, if an individual owner, or tenants in common, of farm property lease it to a farmer for a cash rental or a share of the crops, they do not necessarily create a separate entity for federal tax purposes."

§ 301.7701-1(a)(2).

5. Rev. Rul. 82-61, 1982-1 C.B. 13 (1982) addresses a jointly-owned electric generating facility involving three parties: a 50% owner (X), a 50% owner (Y) which leases its 50% interest to a lessee, and the lessee (Z). X and Z are party to an operating agreement concerning operation, cost-sharing (50-50) and entitlement to output (50-50) [except that fuel costs are born in relation to power scheduled and produced].

Rev. Rul. 82-61 made a number of determinations:

- As to whether an undivided interest in an electric generating facility constitutes 'limited use property' as defined in rev. Proc. 76-30, this depends on whether the undivided interest in the facility can be disposed of or used by a party other than the lessee or whether the use of the facility is limited to the lessee. Thus, a determination must be made whether a party other than the lessee can operate the facility and, further, whether the other party can dispose of the electricity produced by the facility on a commercially feasible basis.

- The facts in this revenue ruling are analogous to those in Example (6) of section 5 of Rev. Proc. 76-30[3], in which the Service indicated that an electric generating facility, under the circumstances described in the example, did not constitute 'limited use property.' The only significant difference is that instead of the entire facility being leased, as in Example (6) of Rev. Proc. 76-30, the lease in this revenue ruling involves an undivided interest in the facility. This difference does not, under the circumstances of this revenue ruling, cause the undivided interest in the facility under lease to become 'limited use property' because: (1) at the end of the lease between Y and Z, Y will continue to hold an undivided interest in the facility with a substantial remaining useful life that will entitle is to a ratable share of the electrical capacity of the facility; (2) Y will hold an undivided interest in the coal lease capable of supplying the facility with coal for the remaining useful life of the facility; and (3) Y can dispose of the electricity produced by the facility on a commercially feasible basis because of the transmission system to the power grid. These factors insure that Y can dispose of or lease its undivided interest in the facility to utilities other than Z, and that these other utilities can operate and dispose of the electricity produced on a commercially feasible basis.

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[3] Same as example (f) of Section 5.02 of Rev. Proc. 2001-28 (see page C-4).

- X and Y are a partnership, but can elect out:

  "Section 1.761-2(a) of the regulations provides that for the participants to elect under section 761(a) of the Code to be excluded from the provisions of subchapter K, they must own the property 'as coowners either in fee or under lease or other form of contract granting exclusive operating rights.' ***The regulation does not require that the participants own any specific or equal ownership interest in the venture's property. Rather, the regulation only requires that the coowners have joint possession of the exclusive operating rights in the facility. Thus, irrespective of the legal characterization of the participants' interest, the interests will qualify under section 1.761-2(a) so long as the participants have exclusive operating rights to the property***. [emphasis supplied]"

- The term of the partnership between X and Z is the term of the lease to Z.

- X and Y are <u>not</u> partners in a partnership (so long as the lease to Z remains in effect): X and Y are "mere coowners of an electric generating facility."

  "Although both Y and X are owners of the generating facility, Y is entitled to a fixed dollar amount each year under the lease. Under the operating agreement, Y has no control over the operation of the generating facility and has no right to share in any power generated by the facility during the term of the lease and operating agreement. Y has no obligation to pay the costs of operation or maintenance of the generating facility. Y was not held out to be a participant in the operation of the facility."

6. General Counsel Memorandum (GCM) 38025, 07/20/1979, addressed an unincorporated organization that owns and operates a pipeline system. The GCM concludes that an unincorporated organization that produces transportation services can elect-out (the issue arose because § 1.761-2(a)(3)(ii) references the parties' shares of "property produced, extracted, or used": clause (iii) helpfully begins "do not jointly sell services or the property produced or extracted."

7. Field Service Advisory No. 2002-05023, Issued February 1, 2002 addressed an electric generating plant (Y) joint operating agreement as follows:

"In applying the three-part test of section 1.761-2(a)(3) to Y, the owners appear to satisfy the first two prongs. The Y Ownership Agreement executed by B and D states that B and D own Y as tenants in common and that each participant reserves the right to take in kind or dispose of their shares of power produced. However, the Ownership Agreement also states that excess power not needed by B or D shall be pooled and offered for sale, with each owner credited a proportionate share of the revenue from the sale. This provision likely violates the requirement under section 1.761-2(a)(3) that the co-owners do not jointly sell the property produced. Thus, regardless of whether or not B and D actually elected out of subchapter K, it seems unlikely that they were eligible to do so."

EXCERPTS FROM REV. PROC. 2001-28 AND REV. PROC. 2001-29.

4.04 Investment by Lessee. (Rev. Proc. 2001-28)

(1) *Permitted Investments*. Except as otherwise specifically provided in paragraphs (2) and (3) below, no part of the cost of the property or the cost of improvements, modifications, or additions to the property ("Improvements"), may be furnished by any member of the Lessee Group. *Property that could itself be separately leased in a transaction eligible for an advance ruling under this revenue procedure does not constitute an Improvement* [emphasis supplied]. For example, assume X leases a chemical plant from Y. Assume further, that after the plant is placed in service, X wishes to erect and own additional tanks that will be used to store the output of the plant. Although the tanks will be used in conjunction with X's plant, they constitute separate items of property that could be used in conjunction with other facilities and therefore do not constitute limited use property under section 5.02 of this revenue procedure. If a third party owned the tanks, it could lease them to X in a transaction eligible for an advance ruling. Thus, the tanks do not constitute an Improvement.

(2) *Severable Improvements*. A member of the Lessee Group may furnish amounts to pay for the cost of an Improvement that is owned by a member of the Lessee Group, and is readily removable without causing material damage to the leased property ("Severable Improvement"), provided that such Improvement is not subject to a contract or option for purchase or sale between the lessor and any member of the Lessee Group at a price other than fair market value at the time of such purchase or sale. At the commencement of the term of the lese, a Severable Improvement to the leased property must not be required in order to render the leased property complete for its intended use by the lessee. However, property will be considered to be complete even though the lessee may add as Severable Improvements ancillary items of equipment of a kind that customarily are selected and furnished by purchasers or lessee may add as Severable improvements ancillary items of equipment of a kind that customarily are selected and furnished by purchasers or lessees of property of the kind subject to the lease. Thus, for example, to the extent an item of equipment such as the boiler for a leased, steam powered vessel otherwise constituted a Severable improvement, the vessel would not, for purposes of this section, be considered complete without the boiler. On the other hand, a leased airplane would he considered complete without items of equipment such as aviation electronics and a leased vessel would be considered complete without such ancillary items such as radar, lines, or readily removable fittings, and will be eligible for an advance ruling even though such items of equipment are to be added by the lessee.

(3) *Nonseverable Improvements*. A member of the Lessee Group may furnish amounts to pay for the cost of Improvements that are not readily removable without causing material damage to the property ("Nonseverable Improvements") if they are described in subparagraph (a) below and the conditions of subparagraph (h) are met.

(a) A Nonseverable Improvement is described in this subparagraph if either:

(i) it is furnished in order to comply with health, safety, or environmental standards of any government or governmental authority having relevant

jurisdiction (or any industry-wide standard recognized by such government or governmental authority):

(ii) it does not increase the productivity (or capacity) of the leased property to more than 125 percent of its productivity (or capacity) when first placed in service, or modify the leased property for a materially different use. For this purpose, separate units that are subject to one lease (*e.g.*, ten boxcars subject to one lease) are each considered "the leased property;" or

(iii) the cost of the Nonseverable Improvement, when added to the cost of Nonseverable Improvements that previously have been made to the property (other than those described in subparagraph (i) above) does not exceed 10 percent of the cost of the property. For purposes of this subparagraph, the cost of a Nonseverable Improvement will be considered to be the actual cost multiplied by a fraction, the numerator of which is the Implicit Price Deflator for Fixed Nonresidential Investment (published by the Department of Commerce in the Survey of Current Business) for the year in which the property was placed in service, and the denominator of which is the Implicit Price Deflator for Fixed Nonresidential Investment for the year in which the Improvement is made. ***As indicated in section 4.04(5) of this revenue procedure, ordinary maintenance and repair does not constitute an Improvement*** [emphasis supplied].

(b) The following conditions must be satisfied:

(i) At the commencement of the term of the lease, a Nonseverable Improvement must not be required in order to complete the property for its intended use by the lessee;

(ii) The Nonseverable Improvement must not cause the leased property to become limited use property within the meaning of section 5.02 of this revenue procedure; and

(iii) The furnishing of the cost of the Nonseverable Improvement must not constitute an equity investment by a member of the Lessee Group in the property. For this purpose, the lessee's right to use the Improvement during the lease term in which such improvement is made does not constitute an equity investment in the property. The furnishing of such cost will be considered an equity investment in the property if a member of the Lessee Group may receive compensation, directly or indirectly, for its interest in such Nonseverable Improvement. A member of the Lessee Group will be regarded as having made an equity investment in the property if, for example:

- the lessor is obligated to purchase the Nonseverable Improvement or reimburse a member of the Lessee Group for the cost or the fair market value of the No severable Improvement;

- any option price or renewal rental rate to a member of the Lessee Group is adjusted downward to reflect any portion of the cost or fair market value of the Nonseverable Improvement; or

- the lessor obligated to share with a member of the Lessee Group a portion of the proceeds of any sale or lease of the property to a third party.

(4) *Cost Overruns and Modifications*. If the cost of property exceeds the estimate on which the lease was based, the lease may provide for adjustments of rent to compensate the lessor for such additional cost.

(5) *Maintenance and Repair*. If the lease requires the lessee to maintain and keen the property in good repair during the term of the lease, ordinary maintenance and repairs performed by a member of the Lessee Group will not constitute an Improvement.

5.02 *Limited Use Property*. (Rev. Proc. 2001-28).

(1) *In General*. Section 4.01(3) of this revenue procedure requires the lessor to represent and demonstrate certain facts relating to the estimated fair market value and estimated remaining useful life of the property at the end of the lease term. This requirement is intended, in part, to assure that the purported lessor has not transferred the use of the property to the purported lessee for substantially its entire useful life. In the case of such "limited use" property, at the end of the lease term there will probably be no potential lessees or buyers other than members of the Lessee Group. As a result, the lessor of limited use property will probably sell or rent the property to a member of the Lessee Group, thus enabling the Lessee Group to enjoy the benefits of the use or ownership of the property for substantially its entire useful life. See Rev. Rul. 55-541, 1955-2 C.B. 19, for an example of a transaction in which property was determined to be leased for substantially its entire useful life and the conclusion that such a transaction transfers equitable ownership. Accordingly, the Service will not issue advance rulings concerning whether certain transactions purporting to be leases of property are, in fact, leases for federal income tax purposes when the property is limited use property.

(2) *Examples*. The following examples illustrate the types of property the Service considers to be limited use property, and the types of property the Service does not consider to be limited use property.

(a) X builds a masonry smokestack attached to a masonry warehouse building owned by Y, and leases the smokestack to Y for use as an addition to the heating system of the warehouse. The lease term is 15 years; the smokestack has a useful life of 25 years, and the warehouse has a remaining useful life of 25 years. It would not be commercially feasible to disassemble the smokestack at the end of the lease term and reconstruct it at a new location. The smokestack is considered to be limited use property.

(b) X builds a complete chemical production facility on land owned by Y and leases the facility to Y, a manufacturer of chemicals. The lease term is 24 years, and the facility has a useful life of 30 years. The land is leased to X pursuant to a ground

lease for a term of 30 years. The technical "know-how" and trade secrets Y possesses are necessary elements in the commercial operation of the facility. At the time the lease is entered into, no person who is not a member of the lessee group possesses the technical "know-how" and trade secrets necessary for the commercial operation of the facility. The taxpayers submit to the Service the written opinion of a qualified expert stating it is probable that by the expiration of the lease term of the facility third parties who are potential purchasers or lessees of the facility will have independently developed such "know how" and trade secrets. The facility is considered to be limited use property. In reaching this conclusion, the Service will not take into account such expert opinion because such opinions are too speculative for advance ruling purposes.

(c) The facts are the same as in example (b) except X has an option, exercisable at the end of the lease term of the facility, to purchase from Y the "know how" and trade secrets necessary for the commercial operation of the facility, and it would be commercially feasible at the end of such lease term for X to exercise the option and operate the facility itself. The facility is not considered to be limited use property.

(d) The facts are the same as in example (b) except it would be commercially feasible for the lessor at the end of the lease term to make certain structural modifications of the facility that n would make the facility capable of being used by persons not possessing any special technical "know-how" or trade secrets. Furthermore, if such modifications were made, it would be commercially feasible, at the end of the lease term, for a person who is not a member of the lessee group to purchase or lease the facility from X. The facility is not considered to be limited use property.

(e) X builds an electrical generating plant on land owned by Y and leases the plant to Y. The lease term is 40 years, and the plant has an estimated useful life of 50 years. The land is leased to X pursuant to a ground lease for a term of 50 years. The plant is adjacent to a fuel source that it is estimated will last for at least 50 years. Access to this fuel source is necessary for the commercial operation of the plant, and Y has recently obtained the contractual night to acquire all fuel produced from the source for 50 years. Y will use the plant to produce and generate electrical power for sale to a city located 500 miles away. The plant is synchronized into a power grid that makes the sale of electrical power to a number of potential markets commercially feasible. It would not be commercially feasible to disassemble the plant and reconstruct it at a new location. The electrical generating plant is considered to be limited use property because access to the fuel source held exclusively by Y is necessary for the commercial operation of the plant.

(f) The facts are the same as in example (e) except X has an option, exercisable at the end of the lease term of the plant, to acquire from Y the contractual right to acquire all fuel produced from the fuel source for the 14-year period commencing at the end of such lease term. It would be commercially feasible at the end of

such lease term for X to exercise this option. Furthermore, it would be commercially feasible, at the end of such lease term, for a person who is not a member of the lessee group to purchase the contractual right to the fuel from X for an amount equal to the option price and purchase or lease the plant from X. The plant is not considered to be limited use property.

4.08 ***Other Considerations: Limited Use Property.*** (Rev. Proc. 2001-29)

(1) Indicate whether the Property is expected to be useful or usable by the lessor at the end of the lease term and capable of continued leasing or transfer to any party. If such a representation is made, demonstrate its commercial feasibility.

(2) Indicate whether the Property would be useful or usable at the end of the lease term by a party other than a member of the Lessee Group, and if so, describe such use.

(3) Indicate whether the Property needs to be dismantled, disconnected, or removed from any site on which it was placed or installed in order for possession thereof to be returned to the lessor at the end of the lease term. If so:

(a) Indicate whether and how such dismantling, disconnection, or removal will affect the value of the Property for the purpose for which it was originally intended to be used, and

(b) Demonstrate the commercial feasibility of reassembling, reconnecting, or installing the Property at another location.

Talking Points: Tax Allowance for an Electric Transmission Real Estate Investment Trust

The Internal Revenue Service in June issued a private letter ruling (PLR 2007 25015) that certain energy infrastructure, including electric transmission and distribution systems, qualify as real estate assets. The ruling allows these assets to be owned through either a publicly traded real estate investment trust (REIT) or a master limited partnership (MLP). The qualifying criterion for both is that earnings must be derived from rents on real property. Both MLPs and REITs benefit from avoiding the double taxation of a C-corporation — the typical form of organization for vertically integrated electric utilities — though they do so in very different ways, as explained below. By eliminating double taxation, a REIT or an MLP could lower transmission charges to ratepayers and advance other federal regulatory objectives. [1]

The potential utility ratepayer benefits from the REIT structure are much greater than from an MLP for reasons explained in this paper. These incremental benefits to ratepayers offered by the REIT, combined with the fundamental legal differences between a REIT and an MLP, should cause the Federal Energy Regulatory Commission (FERC) to regulate the REIT for purposes of income tax allowance (ITA) differently from how it has come to regulate the ITA of natural gas and oil pipeline MLPs.[2]

For an MLP, FERC currently permits an ITA in rates to the extent its partners have an actual or potential tax liability with respect to their allocable share of the MLP's taxable income. Regardless of whether this methodology makes sense in the context of an MLP, doing so in the context of a transmission REIT eliminates an integrated utility's incentive to transfer transmission assets to a REIT as well as an investor's incentive to acquire those assets through a REIT. For reasons explained below, a transmission REIT should be treated as a taxable C-corporation for purposes of the ITA as opposed to how an MLP is currently treated. The tax savings (as well as the lower cost of capital of a REIT) can then be shared between investors and ratepayers in the form of higher earnings and lower rates, respectively.

Differences between MLPs and REITs

Despite certain similarities, a REIT and an MLP are fundamentally different business organizations,[3] and are treated differently for purposes of federal income taxation. An MLP is a limited liability partnership, not a corporation. From a tax perspective, an MLP is a pass-through entity; it does not pay entity-level federal or state income tax. Instead, an MLP reports on a Schedule K-1 to each unit holder its pro rata share of partnership earnings and losses, which is taxed at the holder's applicable combined income tax rate.

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[1] For example, transferring ownership of transmission to a REIT or MLP could be used to promote the independent operation or control of the transmission system, as more fully explained below.

[2] A Regulatory Chronology of Oil and Natural Gas Pipeline MLPs is presented in below, pp. D-5 to D-6.

[3] The differences are detailed in the Side-by-Side Comparison in Annex B.

An MLP is a publicly traded partnership, created by an act of Congress to own, operate, and develop assets in the energy and natural resource sectors. Income derived from these activities is considered Qualifying Income for tax purposes and is also referred to as Active Business Income. In order for a partnership to qualify as an MLP, 90% of its income must be Qualifying Income. Another source of Qualifying Income for an MLP is rent from real property, although very few MLPs rely on rents from real property as a primary source of Qualifying Income. Some investors such as pension funds, foreigners, and tax-exempts cannot invest in assets from which they earn Active Business Income because that income could constitute either Unrelated Business Taxable Income (UBTI) for tax-exempt investors (and would be taxable to them) or Effectively Connected Income (ECI) for foreign investors (which would subject them to US taxation).

In contrast to an MLP, a REIT is organized as a corporation or business trust. For a corporation or business trust to qualify as a REIT, it must earn "passive" rental income, have more than 100 investors, and distribute a minimum of 90% of its income to shareholders in the form of dividends. A REIT is taxed as a C-corporation. It is therefore a separate taxable entity that pays corporate level tax on the income it retains. However, unlike a C-corporation, a REIT is entitled to a deduction for dividends that it pays to its shareholders. As a result, few REITs pay income tax. Dividends are taxed to the shareholders who receive them. Those dividends are not entitled to the preferential 15 percent dividend rate, but rather are taxed as ordinary income to the REIT shareholder.

The ownership and reporting of dividends from a REIT is administratively easier for investors than is an MLP. REIT investors receive a Form 1099, just as an owner of C-corporation common stock who receives dividend payments. Unlike MLP earnings, REIT dividends are not UBTI or ECI to any class of investor. Therefore, the ownership of REIT shares and the receipt of REIT dividends appeal to a greater spectrum of investors than do MLP units.

These differences between a REIT and an MLP determine the profile of their respective investors and, ultimately, their relative strength as investment vehicles for transmission infrastructure.

REITs More Easily Attract Large Institutional Investors

A REIT has access to a base of institutional investors that are largely inaccessible to an MLP. Without the enhanced liquidity from institutional ownership, MLP units trade at a relative discount compared to REIT shares. For this reason, lessors of real property have historically chosen the REIT over the MLP form of organization for owning and leasing real property.

Regulated Investment Companies (RIC) under Subchapter M of the Internal Revenue Code, including mutual funds, are impeded from investing in an MLP, but not in a REIT. This is the case because:

- No more than 25% of RIC's total assets in MLPs; no more than 10% in any single MLP.

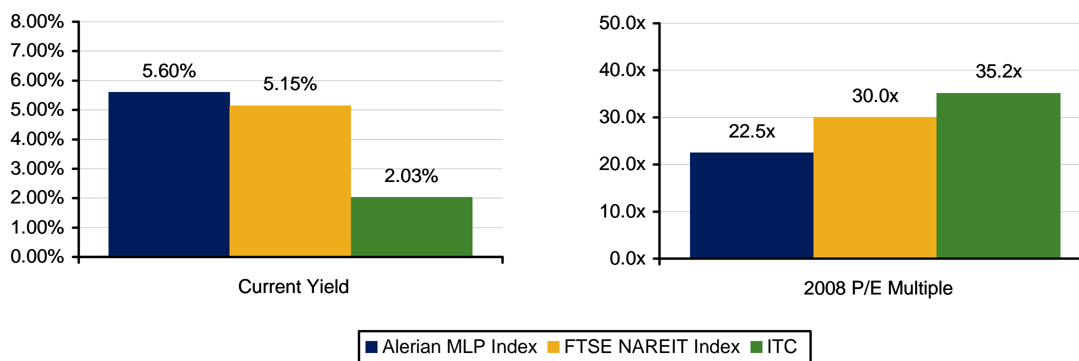
- Form 1099 must be issued by January 31 for a calendar-year REIT, while an MLP issues its K-1 much later in the year. This timing discrepancy between issuance of RIC 1099 and MLP Form K-1 can force restatement of RIC earnings and penalties.

- Unlike MLP earnings, REIT dividends do not give rise to UBTI or ECI to any class of investor.

For these reasons, an MLP is less attractive than a REIT to a large base of institutional investors; an MLP is therefore forced to rely on a smaller universe of individual investors.[4] In contrast, a REIT enjoys greater participation from institutional investors and benefits from enhanced liquidity and a lower cost of capital, which is explained further below.

Illiquid Market for MLP Units Requires Higher Pay Out than for REIT Shares

In order to retain status as a REIT, the REIT must distribute annually no less than 90 percent of its earning. Neither utilities (organized as C-corporations) nor MLPs are subject to a comparable dividend or distribution requirement. For this reason, as shown in this chart below, a REIT enjoy relatively high multiples in relation to an MLP and a relatively lower cost of capital. Conversely, the high cost of capital and distribution expectations of partners in an MLP causes the MLP to distribute not only earnings but also cash flow sheltered by depreciation, which complicates their use as comparables in discounted cash flow analyses that regulators use to set equity returns for natural gas and oil pipeline MLPs.



A REIT Better Facilitates Key Policy Objectives

Operation of a REIT is more independent and transparent than is the operation of an MLP. REIT shareholders have voting and control rights, including the periodic election of

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[4] As a consequence, MLPs such as Kinder Morgan Management and Enbridge Management have been forced to resort to cumbersome "I-shares" — pay-in-kind limited partner unit equivalents — in which institutional investor can invest. Because these securities make no current cash distribution they are difficult to use within proxy groups for setting regulated equity returns using discounted cash flow analysis

directors, a majority of whom are independent, which limited partners in an MLP do not enjoy. The greater independence and transparency of a REIT will facilitate the formation of independent regional transmission organizations in ways that an MLP cannot.

Income Tax Allowance for an Electric Transmission REIT

Were FERC to require that ratepayers receive all of the tax savings that accrue from the change from taxable C-corporation to transmission REIT, as its treatment of MLPs effectively does, then the transmission REIT becomes untenable and the ratepayer will receive none of the benefits of a transmission REIT. This is the case for two reasons:

- The administrative burden of monitoring the tax status of investors in the REIT would be infeasible in the absence of restricting eligible investors to actual or potential taxpayers as MLPs have come to do;

- Restricting eligible investors to actual or potential taxpayers and enforcing that restriction would defeat the foremost benefit of converting from a C-corporation to a REIT — the REIT's ability to attract a large base of institutional investors whose investments will lower the cost of capital to the REIT and its ratepayers.

This combination of outcomes from applying MLP ITA policy to REITs dictates strongly in favor of setting a REIT's ITA in the same way the ITA is set for a taxable C-corporation. The tax savings that accrue from the REIT's avoidance of the entity level taxation (through its ability to distribute dividends and take a tax deduction) can then be shared between investors and ratepayers in the form of higher earnings and lower rates.

Income Tax Allowances In Rates and Proxy Groups

1986	•	Initial public offering (IPO) for Buckeye Pipe Line Company, L.P. See Buckeye Pipe Line Company L.P., 44 FERC ¶ 61,066 (1988). First MLP for a major interstate oil pipeline.
1987	•	A qualifying income test is first imposed on publicly traded partnerships (PTPs) when section 7704 of the Internal Revenue Code became effective. Partnership status for Federal income tax purposes for PTPs was sharply limited. PTP status remained for MLPs then existing or thereafter created with 90% or more of income secured from (i) natural resource/mineral activities or (ii) rents from real property.
1993	•	IPO for Northern Border Partners, L.P. (September 23, 1993). First MLP for a major interstate natural gas pipeline system: a 70% general partner interest in the Northern Border gas pipeline.[1] Northern Border is now named "Oneok Partners, L.P."
1995	•	The Lakehead Policy: Lakehead Pipe Line Co., 71 FERC ¶ 61,138, pp. 62,313-315 (1995). In this decision, the FERC allowed an oil pipeline publicly traded partnership to include in its cost-of-service an income tax allowance to the extent that its unitholders were corporations subject to income tax.
1999	•	Lakehead Policy applied: SFPP, L.P., 85 FERC ¶ 61,022 (1999).
2004	•	Inclusion of MLPs in proxy groups: Petal Gas Storage, L.L.C., 106 FERC ¶ 61,325 (March 30, 2004).
	•	Lakehead Policy vacated: BP West Coast Products, LLC v. FERC, 374 F.3d 1263 (D.C. Cir. July 20, 2004).
2005	•	Inclusion of MLPs in proxy groups: High Island Offshore Sys., L.L.C. (HiOS), 110 FERC ¶ 61,043 (January 24, 2005).
	•	Policy Statement, Income Taxes in Rates, 111 FERC ¶ 61,139 (May 30, 2005) (the "Income Tax Policy").
	•	Policy Statement applied: SFPP, L.P., 111 FERC ¶ 61,334 (June 1, 2005). In the Policy Statement and the order on remand in SFPP, L.P., the FERC stated it would permit pipelines to include in cost-of-service a tax allowance to reflect actual or potential tax liability on their public utility income

[1] The other 30% is owned by an MLP that underwent its IPO in 1999: TC Pipelines, L.P.

attributable to all partnership or limited liability company interests, if the ultimate owner of the interest has an actual or potential income tax liability on such income. Whether or not a pipeline's owners have such actual or potential) income tax liability would be determined by FERC on a case-by-case basis.

- Boardwalk Pipeline Partners, L.P.: IPO for parent of Texas Gas Transmission and Gulf South Pipeline natural gas pipeline systems: ***Common units available only to Eligible Holders*** (individual or entities subject to U.S. federal income taxation on MLP income or entities not subject to taxation so long as all of entity's owners are subject to such taxation) (November 8, 2005).

- First significant case-specific review of income tax allowance (ITA) policy: ITA policy reaffirmed and pipeline ordered to provide certain evidence necessary to determine ITA. SFPP, L.P., 113 FERC ¶ 61,227 (December 16, 2005).

2006

- FERC issues another order addressing ITA in rates. SFPP, L.P., 117 FERC ¶ 61,285 (December 8, 2006). ***Annex G hereto, pages G-1 to G-8, is an excerpt from the December 8, 2006 order which discusses in detail implementation of the Income Tax Policy.***

- The December 8, 2006 order also addressed (in paragraphs 20 through 48 of the order) cost of equity and allowed rate of return. Among other things, FERC orders a downward adjustment to rate of return (ROE) to extent partnership cash flow exceeds taxable income. In this order, the FERC refined its income tax allowance policy, and notably raised a new issue regarding the implication of the policy statement for publicly traded partnerships. It noted that the tax deferral features of a publicly traded partnership may cause some investors to receive, for some indeterminate duration, cash distributions in excess of their taxable income, which the FERC characterized as a "tax savings." The FERC stated that it is concerned that this created an opportunity for those investors to earn an additional return, funded by ratepayers. Responding to this concern, the FERC chose to adjust the pipeline's equity rate of return downward based on the percentage by which the publicly traded partnership's cash flow exceeded taxable income.

2007

- Motion to reconsider December 8, 2006 order and motions for rehearing in Docket OR96-2-012, et al. (February 7, 2007).

- Order granting rehearing for further consideration of December 8, 2006 order (March 9, 2007).

- D.C. Circuit upholds ITA policy and December 16, 2005 implementation order, Exxon Mobil Oil Corp. v. FERC, 487 F.3d 945 (D.C. Cir. May 24,

2007).

- Proposed Policy Statement, Composition of Proxy Groups for Determining Gas and Oil Pipeline Return on Equity, 120 FERC ¶ 61,068 (July 19, 2007) [Docket PL07-2]: include MLPs in proxy groups but constrain observed rate of return (ROE) by GAAP net income. The proposed policy statement would permit the inclusion of master limited partnership (MLPs) in the proxy group for purposes of calculating allowed returns on equity under the Discounted Cash Flow (DCF) analysis, a change from its prior view that MLPs had not been shown to be appropriate for such inclusion. Specifically, the FERC proposes that MLPs may be included in the proxy group provided that the DCF analysis recognizes as distributions only the pipeline's reported earnings, and not other sources of cash flow subject to distribution. According to the proposed policy statement, under the DCF analysis, the return on equity is calculated by adding the dividend or distribution yield (dividends divided by share/unit price) to the projected future growth rate of dividends or distributions (weighted one third for long-term growth of the economy as a whole and two-thirds short term growth as determined by analysts' five-year forecasts for the pipeline). This change would only impact maximum allowed recourse tariff rates in the course of a rate case proceeding to adjust those rates. The determination of which MLPs should be included will be made on a case by case basis, after a review of whether an MLP's earnings have been stable over a multi-year period. The FERC proposes to apply the final policy statement to all natural gas rate cases that have not completed the hearing phase as of the date the FERC issues the final policy statement.

- Petal Gas and HiOS orders (March 30, 2004 and January 24, 2005, respectively) over-turned on proxy group issue. Petal Gas Storage, L.L.C. v. FERC, 496 F.3d 695 (D.C. Cir. August 7, 2007).

- El Paso Pipeline Partners, L.P.: IPO for parent of 10% interest in each of Colorado Interstate and Southern Natural Gas natural gas transmission systems (November 15, 2007): ***common units available only to Eligible Holders***.

- Order on rehearing, remand, compliance and tariff filings [Docket OR96-2, et al.] in which, among other things, the FERC clarified its methodology for determining whether a partnership or other passthrough entity may be afforded an income tax allowance, 121 FERC ¶ 61,240 (December 26, 2007) *Annex G, pages G-10 to G-29 contain an excerpt from the December 26, 2007 order discussing implementation of the Income Tax Policy.* In the December 26, 2007 order, the FERC stated that it would not address (in the subject dockets) whether it is appropriate to include MLPs in the proxy group used to determine a regulated entity's cost of capital. (in other words, the matters raised in the February 7, 2007 requests for rehearing of the December 8, 2006 order remain pending, in particular the downward

adjustment in equity rate of return to reflect "tax savings").

2008

- Williams Pipeline Partners, L.P.: pending IPO for parent of 25% interest in Northwest Pipeline natural gas transmission system (January 17, 2008): ***common units available only to Eligible Holders***.

- NiSource Energy Partners, L.P.: pending IPO for parent of Columbia Gulf gas pipeline system (___________ __, 2008): common units available only to Eligible Holders (purchase option at lowest of holder's purchase price and market price of units held by non-Eligible Holders).

DUPONT FABROS TECHNOLOGY, INC.
FEDERAL INCOME TAX CONSIDERATIONS[1]

[R.1] The following is a summary of the material federal income tax consequences relating to the acquisition, holding, and disposition of our common stock. For purposes of this section under the heading "Federal Income Tax Considerations," references to "DuPont Fabros Technology," "we," "our," and "us" mean only DuPont Fabros Technology, Inc., and not its subsidiaries, except as otherwise indicated. This summary is based upon the Code, the regulations promulgated by the U.S. Treasury Department, rulings and other administrative pronouncements issued by the IRS, and judicial decisions, all as currently in effect, and all of which are subject to differing interpretations or to change, possibly with retroactive effect. XYZ LLP has acted as our special tax counsel, has reviewed this summary, and is of the opinion that the discussion contained herein fairly summarizes the federal income tax consequences that are likely to be material to a holder of shares of our common stock. However, we cannot assure you that the IRS would not assert, or that a court would not sustain, a position contrary to any of the tax consequences described below. Except as otherwise indicated, no advanced ruling has been or will be sought from the IRS regarding any matter discussed in this prospectus. This summary also assumes that we and our subsidiaries and affiliated entities will operate in accordance with our applicable organizational documents or partnership agreements. This discussion is for your general information only and is not tax advice. It does not purport to address all aspects of federal income taxation that may be relevant to you in light of your particular investment circumstances, or if you are a type of investor subject to special tax rules, such as:

- an insurance company;
- a financial institution, broker, or dealer;
- a regulated investment company or a REIT;
- a holder who received our stock through the exercise of employee stock options or otherwise as compensation;
- a person holding our stock as part of a "straddle," "hedge," "conversion transaction," "synthetic security," or other integrated investment;
- a person holding our stock indirectly through other vehicles, such as partnerships, trusts, or other pass-through entities;
- a tax-exempt organization; and
- a foreign investor.

[1] R.79 to R.93 below are excerpted from the Douglas Emmet, Inc. IPO prospectus dated October 23, 2006.

[R.2] This summary assumes that you will hold our common stock as a capital asset, which generally means as property held for investment. The federal income tax treatment of holders of our stock depends in some instances on determinations of fact and interpretations of complex provisions of federal income tax law for which no clear precedent or authority may be available. In addition, the tax consequences of holding our common stock to any particular stockholder will depend on the stockholder's particular tax circumstances. You are urged to consult your tax advisor regarding the specific tax consequences (including the federal, state, local, and foreign tax consequences) to you in light of your particular investment or tax circumstances of acquiring, holding, exchanging, or otherwise disposing of our common stock.

Taxation of DuPont Fabros Technology

[R.3] We intend to elect to be taxed as a REIT commencing with our taxable year ending December 31, 2007. We believe that we are organized and will operate in such a manner as to qualify for taxation as a REIT, and intend to continue to operate in such a manner.

[R.4] The law firm of XYZ LLP has acted as our special tax counsel in connection with our election to be taxed as a REIT. We expect to receive an opinion of XYZ LLP to the effect that we are organized in conformity with the requirements for qualification and taxation as a REIT under the Code, and that our proposed method of operation will enable us to meet the requirements for qualification and taxation as a REIT. It must be emphasized that the opinion of XYZ LLP will, if issued, be based on various factual assumptions relating to our organization and operation, and is conditioned upon factual representations and covenants made by our management regarding our organization, assets, and the past, present, and future conduct of our business operations and our ability to rely on the private letter ruling issued to us by the IRS. See "—Income Tests." While we intend to operate so that we will qualify as a REIT, given the highly complex nature of the rules governing REITs, the ongoing importance of factual determinations, and the possibility of future changes in our circumstances, no assurance can be given by XYZ LLP or us that we will so qualify for any particular year. The opinion of XYZ LLP, a copy of which will be filed as an exhibit to the registration statement of which this prospectus is a part, will be expressed as of the date issued, and will not cover subsequent periods. Opinions of counsel impose no obligation to advise us or the holders of our common stock of any subsequent change in the matters stated, represented or assumed, or of any subsequent change in the applicable law. You should be aware that opinions of counsel are not binding on the IRS, and we cannot assure you that the IRS will not challenge the conclusions set forth in such opinions.

[R.5] Qualification and taxation as a REIT depends on our ability to meet, on a continuing basis, through actual operating results, asset ownership, distribution levels, and diversity of stock ownership, various qualification requirements imposed on REITs by the Code, compliance with which will not be reviewed by special tax counsel. In addition, our compliance with the REIT income and quarterly asset requirements also depends upon our ability to successfully manage the composition of our income and assets on an ongoing basis, which may not be reviewed by special tax counsel. Our ability to qualify as a REIT also requires that we satisfy certain asset tests, some of which depend upon the fair market values of assets directly or indirectly owned by us. Such values may not be susceptible to a precise determination. We have received, as described more fully under "—Income Tests," a private letter ruling from the IRS substantially

to the effect that our buildings (including the structural components) will be treated as real property for purposes of the gross income tests and the asset tests and that certain services that we will provide directly to our tenants will not cause any amounts received from our tenants to fail to be treated as qualifying rents from real property for purposes of the gross income tests. We have not received, and do not expect to seek, a private letter ruling from the IRS on any other issue. Accordingly, we cannot assure you that the actual results of our operations for any taxable year satisfy such requirements for qualification and taxation as a REIT.

Taxation of REITs in General

[R.6] As indicated above, qualification and taxation as a REIT depends upon our ability to meet, on a continuing basis, various qualification requirements imposed upon REITs by the Code. The material qualification requirements are summarized below under "—Requirements for Qualification—General." While we intend to operate so that we qualify as a REIT, we cannot assure you that the IRS will not challenge our qualification, or that we will be able to operate in accordance with the REIT requirements in the future. See "—Failure to Qualify."

[R.7] Provided that we qualify as a REIT, we will generally be entitled to a deduction for dividends that we pay and therefore will not be subject to federal corporate income tax on our net income that is currently distributed to our stockholders. This deduction for dividends paid substantially eliminates the "double taxation" of corporate income (i.e., taxation at both the corporate and stockholder levels) that generally results from an investment in a corporation. Thus, income generated by a REIT and distributed to its stockholders generally is taxed only at the stockholder level upon the distribution of that income.

[R.8] The Jobs and Growth Tax Relief Reconciliation Act of 2003 (the "2003 Act") and the Tax Increase Prevention and Reconciliation Act of 2005 reduced the rate at which stockholders taxed at individual rates are taxed on corporate dividends from a maximum of 38.6% to a maximum of 15% (the latter of which is the same as the rate for long-term capital gains) for the years 2003 through 2010. With limited exceptions, however, dividends received by stockholders from us, or from other entities that are taxed as REITs, are generally not eligible for the reduced rates, and will continue to be taxed at rates applicable to ordinary income, which is currently taxed at a maximum rate of 35%. See "Taxation of Stockholders—Taxation of Taxable Domestic Stockholders—Distributions."

[R.9] Net operating losses, foreign tax credits and other tax attributes of a REIT generally do not pass through to the stockholders of the REIT, subject to special rules for certain items such as capital gains recognized by REITs. See "Taxation of Stockholders."

[R.10] If we qualify as a REIT, we will nonetheless be subject to federal tax in the following circumstances:

[R.11] We will generally be taxed at regular corporate rates on any income, including net capital gains, that we do not distribute during or within a specified time period after the calendar year in which such income is earned.

- of 100% of such net income. We intend to conduct our operations so that no asset owned by us or any of our pass-through subsidiaries will be treated as inventory or property held for sale to customers, and that a sale or other disposition of any such asset will not be made in our ordinary course of our business. Whether property is held "primarily for sale to customers in the ordinary course of a trade or business" depends, however, on the particular facts and circumstances. We cannot assure you that any property in which we hold a direct or indirect interest will not be treated as inventory or property held for sale to customers, or that we will comply with certain safe-harbor provisions of the Code that would prevent such treatment.

- If we elect to treat property that we acquire in connection with a foreclosure of a mortgage loan or certain leasehold terminations as "foreclosure property," we may avoid the 100% tax on net income from "prohibited transactions," but such net income from the sale or other disposition of such foreclosure property will be subject to corporate income tax at the highest applicable rate, which is currently 35%. We do not anticipate receiving any income from foreclosure property.

- We may elect to retain and pay income tax on our net long-term capital gain. In that case, a U.S. stockholder would be taxed on its proportionate share of our undistributed long-term capital gain (to the extent that we make a timely designation of such gain to the stockholder) and would receive a credit or refund for its proportionate share of the tax we paid.

- If we should fail to satisfy either the 75% gross income test or the 95% gross income test, as discussed below, but nonetheless maintain our qualification as a REIT because we satisfy the reporting requirements described in Section 856(c)(6) of the Code and our failure of such test or tests is due to reasonable cause and not due to willful neglect, we will be subject to a tax equal to 100% of the greater of the amount of gross income by which we fail either the 75% gross income test or the 95% gross income test, multiplied by a fraction which is our taxable income over our gross income determined with certain modifications.

- Similarly, if we should fail to satisfy any of the asset tests (other than a de minimis failure of the 5% and 10% asset tests described below), but nonetheless maintain our qualification as a REIT because we satisfy our reporting and disposition requirements in Section 856(c)(7) of the Code and our failure to satisfy test or tests is due to reasonable cause and not due to willful neglect, we will be subject to a tax equal to the greater of $50,000 or the amount of net income generated by the assets that caused the failure multiplied by the highest corporate tax rate.

- If we should fail to meet certain minimum distribution requirements during any calendar year, which is an amount equal to or greater than the sum of (1) 85% of our REIT ordinary income for such year, (2) 95% of our REIT capital gain net income for such year, and (3) any such taxable income from prior periods that is

undistributed, we would be subject to an excise tax at the rate of 4% on the excess of the required distribution over the sum of (a) the amounts actually distributed, plus (b) retained amounts on which income tax is paid at the corporate level.

- If we fail to satisfy one or more requirements for REIT qualification, other than the gross income tests and asset tests, we will be required to pay a penalty of $50,000 for each such failure.

- We may be required to pay monetary penalties to the IRS in certain circumstances, including if we fail to meet record keeping requirements intended to monitor our compliance with rules relating to the composition of a REIT's stockholders, as described below in "—Requirements for Qualification—General."

- A 100% tax may be imposed with respect to items of income and expense that are directly or constructively paid between a REIT and a taxable REIT subsidiary if and to the extent that the IRS establishes that such items were not based on market rates.

- If we acquire appreciated assets from a corporation taxable under subchapter C, i.e., a corporation that is not a REIT, in a transaction in which the adjusted tax basis of the assets in our hands is determined by reference to the adjusted tax basis of the assets in the hands of the subchapter C corporation, we may be subject to tax on such appreciation at the highest corporate income tax rate then applicable if we subsequently recognize gain on a disposition of any of such assets during the ten-year period following their acquisition from the subchapter C corporation.

- One of our subsidiaries is a TRS, the earnings of which will be subject to federal corporate income tax.

[R.12] In addition, we and our subsidiaries may be subject to a variety of taxes, including payroll taxes and state, local, and foreign income, property, and other taxes on their assets and operations. We could also be subject to tax in situations and on transactions not presently contemplated.

Requirements for Qualification—General

[R.13] The Code defines a REIT as a corporation, trust or association:

1. that is managed by one or more trustees or directors;

2. the beneficial ownership of which is evidenced by transferable shares, or by transferable certificates of beneficial interest;

3. that would be taxable as a domestic corporation but for the special Code provisions applicable to REITs;

4. that is neither a financial institution nor an insurance company subject to specific provisions of the Code;

5. the beneficial ownership of which is held by 100 or more persons;

6. in which, during the last half of each taxable year, not more than 50% in value of the outstanding stock is owned, directly or indirectly, by five or fewer "individuals" (as defined in the Code to include specified tax-exempt entities); and

7. that meets other tests described below, including with respect to the nature of its income and assets.

[R.14] The Code provides that conditions (1) through (4) must be met during the entire taxable year, and that condition (5) must be met during at least 335 days of a taxable year of 12 months, or during a proportionate part of a shorter taxable year. Conditions (5) and (6) do not apply until after the first taxable year for which an election is made to be taxable as a REIT. Our amended and restated certificate of incorporation provides restrictions regarding transfers of its shares, which are intended to assist us in satisfying the share ownership requirements described in conditions (5) and (6) above.

[R.15] To monitor compliance with the share ownership requirements, we are generally required to maintain records regarding the actual ownership of our shares. To do so, we must demand written statements each year from the record holders of significant percentages of our stock in which the record holders are to disclose the actual owners of the shares, i.e., the persons required to include in gross income the dividends paid by us. A list of those persons failing or refusing to comply with this demand must be maintained as part of our records. Failure to comply with these record keeping requirements could subject us to monetary penalties. A stockholder that fails or refuses to comply with the demand is required by Treasury regulations to submit a statement with its tax return disclosing the actual ownership of the shares and other information.

[R.16] In addition, a corporation generally may not elect to become a REIT unless its taxable year is the calendar year. We satisfy this requirement. The Code provides relief from violations of the REIT gross income requirements, as described below under "—Income Tests," if a violation is due to reasonable cause and not willful neglect, and other requirements are met, including the payment of a penalty tax that is based upon the magnitude of the violation. In addition, the Code extends similar relief from violations of the REIT asset requirements (see "—Asset Tests" below) and other REIT requirements, if the violation is due to reasonable cause and not willful neglect, and other conditions are met, including the payment of a penalty tax that may be based upon the magnitude of the violation. If we fail to satisfy any of the various REIT requirements, we cannot assure you that these relief provisions would be available to enable us to maintain our qualification as a REIT, and, if available, the amount of any resultant penalty tax could be substantial.

Effect of Subsidiary Entities

[R.17] *Ownership of Partnership Interests*. In the case of a REIT that is a partner in a partnership or other entity taxable as a partnership for federal income tax purposes, such as our OP, Treasury regulations provide that the REIT is deemed to own its proportionate share of the partnership's assets (subject to special rules relating to the 10% asset test described below) and to earn its proportionate share of the partnership's income for purposes of the asset and gross income tests applicable to REITs as described below. Similarly, the assets and gross income of the partnership are deemed to retain the same character in the hands of the REIT. Thus, our proportionate share of the assets, liabilities, and items of income in the OP will be treated as our assets, liabilities, and items of income for purposes of applying the REIT requirements described below. A summary of certain rules governing the federal income taxation of partnerships and their partners is provided below in "Tax Aspects of Investments in the OP."

[R.18] *Disregarded Subsidiaries*. If a REIT owns a corporate subsidiary that is a "qualified REIT subsidiary," that subsidiary is generally disregarded for federal income tax purposes, and all assets, liabilities, and items of income, deduction, and credit of the subsidiary are treated as assets, liabilities, and items of income, deduction, and credit of the REIT itself, including for purposes of the gross income and asset tests applicable to REITs as summarized below. A qualified REIT subsidiary is any corporation, other than a TRS as described below, that is wholly owned by a REIT, or by one or more disregarded subsidiaries of the REIT, or by a combination of the two. Other entities that are wholly owned by a REIT, including single member limited liability companies, are also generally disregarded as separate entities for federal income tax purposes, including for purposes of the REIT income and asset tests. Disregarded subsidiaries, along with partnerships in which we hold an equity interest, are sometimes referred to herein as "pass-through subsidiaries." In the event that a disregarded subsidiary of ours ceases to be wholly owned—for example, if any equity interest in the subsidiary is acquired by a person other than us or another disregarded subsidiary of ours—the subsidiary's separate existence would no longer be disregarded for federal income tax purposes. Instead, it would have multiple owners and would be treated as either a partnership or a taxable corporation. Such an event could, depending on the circumstances, adversely affect our ability to satisfy the various asset and gross income requirements applicable to REITs, including the requirement that REITs generally may not own, directly or indirectly, more than 10% of the securities of another corporation. See "—Asset Tests" and "—Income Tests."

[R.19] *Taxable Subsidiaries*. REITs, in general, may jointly elect with a subsidiary corporation, whether or not wholly owned, to treat the subsidiary corporation as a TRS of the REIT. The separate existence of a TRS or other taxable corporation, unlike a disregarded subsidiary as discussed above, is not ignored for federal income tax purposes. Accordingly, such an entity would generally be subject to corporate income tax on its earnings, which may reduce the cash flow generated by us and our subsidiaries in the aggregate, and our ability to make distributions to our stockholders. A parent REIT is not treated as holding the assets of a taxable subsidiary corporation or as receiving any income that the subsidiary earns. Rather, the stock issued by the subsidiary is an asset in the hands of the parent REIT, and the REIT recognizes as income, the dividends, if any, that it receives from the subsidiary. This treatment can affect the income and asset test calculations that apply to the REIT, as described below. A TRS may be used by the parent REIT to indirectly undertake activities that the REIT rules might otherwise preclude the parent REIT from doing directly or through pass-through subsidiaries (for example activities that

give rise to certain categories of income such as management fees). A TRS, however, may not directly or indirectly operate or manage a hotel or lodging facility or provide rights to any brand name under which any hotel or healthcare facility in operation. A TRS will pay income tax at regular corporate rates on any income that it earns. In addition, the TRS rules limit the deductibility of interest paid or accrued by a TRS and its parent REIT to assure that the TRS is subject to an appropriate level of corporate taxation. Further, the rules impose a 100% excise tax on transactions between a TRS and its parent REIT or the REIT's tenants that are not conducted on an arm's length basis. We may engage in activities indirectly through a TRS as necessary or convenient to avoid obtaining the benefit of income or service that would jeopardize our REIT status if we engaged in the activities directly. We will initially have one TRS, DF Technical Services, LLC.

Income Tests

[R.20] In order to qualify and maintain our qualification as a REIT, we must satisfy annually two gross income requirements. First, at least 95% of our gross income for each taxable year, but excluding gross income from "prohibited transactions" and certain hedging transactions, must be derived from: (1) dividends; (2) interest; (3) rents from real property (i.e., income that qualifies under the 75% test described below); (4) gain from the sale or other disposition of stock, securities, and real property (including interests in real property and interests in mortgages on real property) which is not described in Section 1221(a)(1) of the Code; (5) abatements and refunds of taxes on real property; (6) income and gain derived from foreclosure property; (7) amounts (other than amounts determined in whole or in part on the income or profits of any person) received or accrued as consideration for entering into agreements (i) to make loans secured by mortgages on real property or on interests in real property or (ii) to purchase or lease real property (including interests in real property and interests in mortgages on real property); and (8) gain from the sale or other disposition of a real estate asset which is not a prohibited transaction solely by reason of Section 857(b)(6) of the Code.

[R.21] Second, at least 75% of our gross income for each taxable year must be derived from: (1) rents from real property; (2) interest on obligations secured by mortgages on real property or on interests in real property; (3) gain from the sale or other disposition of real property (including interests in real property and interests in mortgages on real property) which is not property described in Section 1221(a)(1) of the Code; (4) dividends or other distributions on, and gain (other than gain from "prohibited transactions") from the sale or other disposition of, transferable shares (or transferable certificates of beneficial interest) in other REITs which meet the requirements of this part; (5) abatements and refunds of taxes on real property; (6) income and gain derived from foreclosure property; (7) amounts (other than amounts determined in whole or in part on the income or profits of any person) received or accrued as consideration for entering into agreements (i) to make loans secured by mortgages on real property or on interests in real property or (ii) to purchase or lease real property (including interests in real property an interests in real property); (8) gain from the sale or disposition of a real estate asset which is not a prohibited transaction solely by reason of Section 857(b)(6) of the Code; and (9) qualified temporary investment income.

[R.22] Income described under the 95% or 75% gross income test above is referred to as "Good REIT Income."

[R.23] Rents received by us will qualify as "rents from real property" in satisfying the gross income requirements described above, only if several conditions, including the following, are met. If rent is partly attributable to personal property leased in connection with a lease of real property, the portion of the total rent that is attributable to the personal property will not qualify as "rents from real property" if it constitutes more than 15% of the total rent received under the lease ("Non-Qualifying Rent").

[R.24] A significant portion of the value of our properties is attributable to structural components related to the provision of electricity, heating ventilation and air conditioning, humidification regulation, security and fire protection, and telecommunication services. We have received a private letter ruling from the IRS holding, among other things, that our buildings, including the structural components, constitute real property for purposes of the gross income tests and asset tests. Based on that ruling and our review of our properties, we have determined that rent attributable to personal property is not Non-Qualifying Rent with respect to any particular lease. If, despite the private letter ruling, the IRS were to determine that structural components at our properties constituted personal property rather than real property, a significant portion of our rent would constitute Non-Qualifying Rent and we would fail to satisfy the 75% and 95% gross income tests. We are entitled to rely upon that private letter ruling only to the extent that we did not misstate or omit a material fact in the ruling request we submitted to the IRS and that we operate in the future in accordance with the facts described in that request. Moreover, the IRS, in its sole discretion, may decide to revoke the private letter ruling. Accordingly, no complete assurance can be provided that the IRS will not successfully assert that rent attributable to personal property with respect to a particular lease is Non-Qualifying Rent with respect to such lease.

[R.25] Moreover, for rents received to qualify as "rents from real property," the REIT generally must not furnish or render services to the tenants of such property, other than through an "independent contractor" from which the REIT derives no revenues and that satisfies certain other requirements. We and our affiliates are permitted, however, to perform only services that are "usually or customarily rendered" in connection with the rental of space for occupancy and are not otherwise considered rendered to the occupant of the property. In addition, we and our affiliates may directly or indirectly provide non-customary services to tenants of our properties without disqualifying all of the rent from the property if the payment for such services does not exceed 1% of the total gross income from the property. For purposes of this test, the income received from such non-customary services is deemed to be at least 150% of the direct cost of providing the services. Furthermore, we are generally permitted to provide services to tenants or others through a TRS without disqualifying the rental income received from tenants for purposes of the REIT income requirements.

[R.26] The private letter ruling we received from the IRS held that certain services that we will provide to our tenants directly would not prevent the rent received from those properties as constituting rents from real property. The private letter ruling specifically addressed services related to utilities; controlled humidity; security; fire protection; common area maintenance (including cleaning and maintenance of public areas, landscaping, and pest control); management, operation and maintenance, and repair of the major building systems and components of the data system buildings (including structural components); parking for tenants and their visitors (including reserved and unreserved unattended parking); and

telecommunication infrastructure to allow tenants to connect to third-party telecommunication providers. The private letter ruling was based, in part, on our representation that those services are customarily rendered in connection with the rental of comparable buildings in the geographic market in which our buildings are located. Our ability to rely upon the private letter ruling is dependent on the accuracy of that representation and on our not misstating or omitting another material fact in the ruling request we submitted to the IRS. If, despite the private letter ruling, the IRS were to determine that services we directly provide at our properties were not "usually and customarily rendered" in connection with the rental of real property, the rent from our property would not constitute Good Income and we would likely fail to satisfy the 95% and 75% gross income tests. We intend to provide any services that are not "usually and customarily rendered" in connection with the rental of real property through our TRS or through an "independent contractor." In addition, we generally may not, and will not, charge rent that is based in whole or in part on the income or profits of any person, except for rents that are based on a percentage of the tenant's gross receipts or sales.

[R.27] The rents at our properties are based on the square footage leased to the tenants and other factors (including the power available for use by the tenants). Tenants are entitled to reduce the management fee paid to us if we do not provide an uninterruptible, stable source of power to the tenants' space or do not maintain an environment within the tenants' space at specified temperatures or humidity ranges. Although the fixed rent at our properties is determined, in part, on the amount of available power and the management fee paid by our tenants is contingent on our providing the required power and maintaining in the appropriate temperatures and humidity ranges, no portion of the rent we receive is based, in whole or in part, on the income or profits or profits of any person. Also, except in the case of certain rental income from a TRS, rental income will qualify as rents from real property only to the extent that we do not directly or constructively hold a 10% or greater interest, as measured by vote or value, in the tenant's equity. Based on the private letter ruling and our review of our properties and leases, we believe that substantially all of our gross income will be rents from real property.

[R.28] We may indirectly receive distributions from TRSs or other corporations that are not REITs or qualified REIT subsidiaries. These distributions will be classified as dividend income to the extent of the earnings and profits of the distributing corporation. Such distributions will generally constitute qualifying income for purposes of the 95% gross income test, but not under the 75% gross income test. Any dividends received by us from a REIT will be qualifying income in our hands for purposes of both the 95% and 75% income tests.

[R.29] Any income or gain we or our pass-through subsidiaries derive from instruments that hedge certain risks, such as the risk of changes in interest rates, will not be treated as gross income for purposes of the 95% gross income test, and therefore will be disregarded for purposes of this test, provided that specified requirements are met, but generally will constitute non-qualifying income for purposes of the 75% gross income test. Such requirements include that the instrument hedges risks associated with indebtedness issued or to be issued by us or our pass-through subsidiaries incurred to acquire or carry "real estate assets" (as described below under "—Asset Tests"), and that the instrument is properly identified as a hedge, along with the risk that it hedges, within prescribed time periods.

[R.30] If we fail to satisfy one or both of the 75% or 95% gross income tests for any taxable year, we may still qualify as a REIT for the year if we are entitled to relief under applicable provisions of the Code. These relief provisions will be generally available if: (i) our failure to meet these tests was due to reasonable cause and not due to willful neglect, and (ii) following our identification of the failure to meet the 75% or 95% gross income test for any taxable year, we file a schedule with the IRS setting forth each item of our gross income for purposes of the 75% or 95% gross income test for such taxable year in accordance with Treasury regulations to be issued. It is not possible to state whether we would be entitled to the benefit of these relief provisions in all circumstances. If these relief provisions are inapplicable to a particular set of circumstances involving us, we will not qualify as a REIT. As discussed above under "—Taxation of REITs in General," even where these relief provisions apply and we retain our REIT status, a tax would be imposed based upon the amount by which we fail to satisfy the particular gross income test.

Asset Tests

[R.31] We, at the close of each calendar quarter, must also satisfy four tests relating to the nature of our assets. First, at least 75% of the value of our total assets must be represented by some combination of "real estate assets," cash, cash items, U.S. government securities, and, under some circumstances, stock or debt instruments purchased with new capital. For this purpose, the term "real estate assets" includes interests in real property, such as land, buildings, leasehold interests in real property, stock of other corporations that qualify as REITs, and some kinds of mortgage-backed securities and mortgage loans. Securities that do not qualify for purposes of this 75% test are subject to the additional asset tests described below, while securities that do qualify for purposes of the 75% asset test are generally not subject to the additional asset tests.

[R.32] Second, of our investments that are not included in the 75% asset class, the value of any one issuer's securities owned by us may not exceed 5% of the value of our total assets.

[R.33] Third, of our investments that are not included in the 75% asset class, we may not own more than 10% of any one issuer's outstanding securities, as measured by either voting power or value. The 5% and 10% asset tests do not apply to securities of TRSs and qualified REIT subsidiaries, and the 10% value test does not apply to "straight debt" having specified characteristics and to certain other securities described below. Solely for the purposes of the 10% value test, the determination of our interest in the assets of an entity treated as a partnership for federal income tax purposes in which we own an interest will be based on our proportionate interest in any securities issued by the partnership, excluding for this purpose certain securities described in the Code.

[R.34] Fourth, the aggregate value of all securities of TRSs held by a REIT may not exceed 20% of the value of the REIT's total assets.

[R.35] Notwithstanding the general rule, as noted above, that for purposes of the REIT income and asset tests, a REIT is treated as owning its share of the underlying assets of a subsidiary partnership, if a REIT holds indebtedness issued by a partnership, the indebtedness will be subject to, and may cause a violation of, the asset tests, unless it is a qualifying mortgage asset, satisfies the rules for "straight debt," satisfies other conditions described below, or is sufficiently

small so as not to otherwise cause an asset test violation. Similarly, although stock of another REIT is a qualifying asset for purposes of the REIT asset tests, non-mortgage debt held by us that is issued by another REIT is not a qualifying asset, except for the 10% value test.

[R.36] Certain relief provisions are available to REITs that fail to satisfy the asset requirements. One such provision allows a REIT which fails one or more of the asset requirements (other than de minimis violations of the 5% and 10% asset tests as described below) to nevertheless maintain its REIT qualification if (a) it provides the IRS with a description of each asset causing the failure, (b) the failure is due to reasonable cause and not willful neglect, (c) the REIT pays a tax equal to the greater of (i) $50,000 per failure, and (ii) the product of the net income generated by the assets that caused the failure multiplied by the highest applicable corporate tax rate (currently 35%), and (d) the REIT either disposes of the assets causing the failure within 6 months after the last day of the quarter in which it identifies the failure, or otherwise satisfies the relevant asset tests within that time frame.

[R.37] In the case of de minimis violations of the 10% and 5% asset tests, a REIT may maintain its qualification if (a) the value of the assets causing the violation does not exceed the lesser of 1% of the REIT's total assets, and $10,000,000, and (b) the REIT either disposes of the assets causing the failure within 6 months after the last day of the quarter in which it identifies the failure, or the relevant tests are otherwise satisfied within that time frame.

[R.38] Certain securities will not cause a violation of the 10% value test described above. Such securities include instruments that constitute "straight debt," which does not include securities having certain contingency features. A security will not qualify as "straight debt" where a REIT (or a controlled taxable REIT subsidiary of the REIT) owns other securities of the issuer of that security that do not qualify as straight debt, unless the value of those other securities constitute, in the aggregate, 1% or less of the total value of that issuer's outstanding securities. In addition to straight debt, certain other securities will not violate the 10% value test. Such securities include (a) any loan made to an individual or an estate, (b) certain rental agreements in which one or more payments are to be made in subsequent years (other than agreements between a REIT and certain persons related to the REIT), (c) any obligation to pay rents from real property, (d) securities issued by governmental entities that are not dependent in whole or in part on the profits of (or payments made by) a non-governmental entity, (e) any security issued by another REIT, and (f) any debt instrument issued by a partnership if the partnership's income is of a nature that it would satisfy the 75% gross income test described above under "—Income Tests." In applying the 10% value test, a debt security issued by a partnership to a REIT is not taken into account to the extent, if any, of the REIT's proportionate equity interest in that partnership.

[R.39] We believe that our holdings of assets will comply, and will continue to comply, with the foregoing REIT asset requirements, and we intend to monitor compliance on an ongoing basis. As described above in "—Income Tests," we have received a ruling from the IRS holding that our buildings (including certain structural components) will constitute real property for purposes of the asset tests. No independent appraisals have been obtained, however, to support our conclusions as to the value of our total assets, or the value of any particular security or securities. Moreover, we cannot assure you that the IRS will not contend that any of our assets or our interests in the securities violate the REIT asset laws.

[R.40] If we should fail to satisfy the asset tests at the end of a calendar quarter, such a failure would not cause us to lose our REIT status if we (1) satisfied the asset tests at the close of the preceding calendar quarter and (2) the discrepancy between the value of our assets and the asset test requirements was not wholly or partly caused by an acquisition of non-qualifying assets, but instead arose from changes in the market value of our assets. If the condition described in (2) were not satisfied, we still could avoid disqualification by eliminating any discrepancy within 30 days after the close of the calendar quarter in which it arose or by making use of relief provisions described below.

Annual Distribution Requirements

[R.41] In order to qualify as a REIT, we are required to distribute dividends, other than capital gain dividends, to our stockholders in an amount at least equal to:

(a) the sum of

(i) 90% of our "REIT taxable income" (computed without regard to our deduction for dividends paid and net capital gains); and

(ii) 90% of the (after tax) net income, if any, from foreclosure property (as described below); minus

(b) the sum of specified items of non-cash income.

[R.42] Distributions must be paid in the taxable year to which they relate, or in the following taxable year if they are declared in October, November, or December of the taxable year, are payable to stockholders of record on a specified date in any such month, and are actually paid before the end of January of the following year. Such distributions are treated as both paid by us and received by each stockholder on December 31 of the year in which they are declared. In addition, a distribution for a taxable year may be declared before we timely file our tax return for the year and if paid with or before the first regular dividend payment after such declaration, provided such payment is made during the 12-month period following the close of such taxable year. In order for distributions to be counted for this purpose, and to give rise to a tax deduction by us, they must not be "preferential dividends." A dividend is not a preferential dividend if it is pro rata among all outstanding shares of stock within a particular class, and is in accordance with the preferences among different classes of stock as set forth in our organizational documents.

[R.43] To the extent that we distribute at least 90%, but less than 100%, of our "REIT taxable income," as adjusted, we will be subject to tax at ordinary corporate tax rates on the retained portion. We may elect to retain, rather than distribute, our net long-term capital gains and pay tax on such gains. In this case, we could elect to have our stockholders include their proportionate share of such undistributed long-term capital gains in income, and to receive a corresponding credit for their share of the tax paid by us. Stockholders of ours would then increase the adjusted basis of their DuPont Fabros stock by the difference between the designated amounts included in their long-term capital gains and the tax deemed paid with respect to their shares. To the extent that a REIT has available net operating losses carried forward from prior tax years, such losses may reduce the amount of distributions that it must make in order to comply with the REIT

distribution requirements. Such losses, however, will generally not affect the character, in the hands of stockholders, of any distributions that are actually made by the REIT, which are generally taxable to stockholders to the extent that the REIT has current or accumulated earnings and profits. See "Taxation of Stockholders—Taxation of Taxable Domestic Stockholders—Distributions."

[R.44] If we should fail to distribute during each calendar year at least the sum of (1) 85% of our REIT ordinary income for such year, (2) 95% of our REIT capital gain net income for such year, and (3) any undistributed taxable income from prior periods, we would be subject to a 4% excise tax on the excess of such required distribution over the sum of (a) the amounts actually distributed and (b) the amounts of income retained on which we have paid corporate income tax. We intend to make timely distributions so that we are not subject to the 4% excise tax. It is possible that we, from time to time, may not have sufficient cash to meet the distribution requirements due to timing differences between (1) the actual receipt of cash, including receipt of distributions from our subsidiaries, and (2) our inclusion of items in income for federal income tax purposes. In the event that such timing differences occur, in order to meet the distribution requirements, it might be necessary to arrange for short-term, or possibly long-term, borrowings, or to pay dividends in the form of taxable in-kind distributions of property. We may be able to rectify a failure to meet the distribution requirements for a year by paying "deficiency dividends" to stockholders in a later year, which may be included in our deduction for dividends paid for the earlier year. In this case, we may be able to avoid losing our REIT status or being taxed on amounts distributed as deficiency dividends. However, we will be required to pay interest and a penalty based on the amount of any deduction taken for deficiency dividends.

Failure to Qualify

[R.45] Specified cure provisions are available to us in the event we discover a violation of a provision of the Code that would result in our failure to qualify as a REIT. Except with respect to violations of the REIT income tests and asset tests (for which the cure provisions are described above), and provided the violation is due to reasonable cause and not due to willful neglect, these cure provisions generally impose a $50,000 penalty for each violation in lieu of a loss of REIT status. If we fail to qualify for taxation as a REIT in any taxable year, and the relief provisions of the Code do not apply, we would be subject to tax, including any applicable alternative minimum tax, on our taxable income at regular corporate rates. Distributions to stockholders in any year in which we are not a REIT would not be deductible by us, nor would they be required to be made. In this situation, to the extent of current and accumulated earnings and profits, all distributions to stockholders that are individuals will generally be taxable at a rate of 15% (through 2010), and, subject to limitations of the Code, corporate distributees may be eligible for the dividends received deduction. Unless we are entitled to relief under specific statutory provisions, we would also be disqualified from re-electing to be taxed as a REIT for the four taxable years following the year during which qualification was lost. It is not possible to state whether, in all circumstances, we would be entitled to this statutory relief.

Prohibited Transactions

[R.46] Net income derived from a prohibited transaction is subject to a 100% tax. The term "prohibited transaction" generally includes a sale or other disposition of property (other than

foreclosure property) that is held primarily for sale to customers in the ordinary course of a trade or business. We intend to conduct our operations so that no asset owned by us or our pass-through subsidiaries will be held for sale to customers, and that a sale of any such asset will not be in the ordinary course of our business. Whether property is held "primarily for sale to customers in the ordinary course of a trade or business" depends, however, on the particular facts and circumstances. We cannot assure you that any property we sell will not be treated as property held for sale to customers, or that we can comply with certain safe-harbor provisions of the Code that would prevent the imposition of the 100% excise tax. The 100% tax does not apply to gains from the sale of property that is held through a TRS or other taxable corporation, although such income will be subject to tax in the hands of that corporation at regular corporate tax rates.

Hedging Transactions

[R.47] We and our subsidiaries may from time to time enter into hedging transactions with respect to interest rate exposure on one or more of our assets or liabilities. Any such hedging transactions could take a variety of forms, including the use of derivative instruments such as interest rate swap contracts, interest rate cap or floor contracts, futures or forward contracts, and options. Any income from such instruments, or gain from the disposition of such instruments, would not be qualifying income for purposes of the REIT 75% gross income test.

[R.48] Income of a REIT, including income from a pass-through subsidiary, arising from "clearly identified" hedging transactions that are entered into to manage the risk of interest rate or price changes or currency fluctuations with respect to borrowings, including gain from the disposition of such hedging transactions, to the extent the hedging transactions hedge indebtedness incurred, or to be incurred, by the REIT to acquire or carry real estate assets, are not treated as gross income for purposes of the 95% REIT income test, and, are therefore disregarded for such test. In general, for a hedging transaction to be "clearly identified," (a) it must be identified as a hedging transaction before the end of the day on which it is acquired or entered into, and (b) the items or risks being hedged must be identified "substantially contemporaneously" with entering into the hedging transaction (generally, not more than 35 days after entering into the hedging transaction). To the extent that we hedge with other types of financial instruments or in other situations, the resultant income will generally be treated as income that does not qualify under the 95% or 75% income tests.

[R.49] We intend to structure any hedging transactions in a manner that does not jeopardize our status as a REIT. We may conduct some or all of our hedging activities through a TRS or other corporate entity, the income from which may be subject to federal income tax, rather than participating in the arrangements directly or through pass-through subsidiaries. However, we cannot assure you that our hedging activities will not give rise to income that would adversely affect our ability to satisfy the REIT qualification requirements.

Tax Aspects of Investments in the OP

General

[R.50] We will hold substantially all of our real estate assets through a single OP that holds pass-through subsidiaries. In general, an entity classified as a partnership (or a disregarded entity) for federal income tax purposes is a "pass-through" entity that is not subject to federal income tax. Rather, partners or members are allocated their proportionate shares of the items of income, gain, loss, deduction, and credit of the entity, and are potentially subject to tax on these items, without regard to whether the partners or members receive a distribution from the entity. Thus, we would include in our income our proportionate share of these income items for purposes of the various REIT income tests and in the computation of our REIT taxable income. Moreover, for purposes of the REIT asset tests, we would include our proportionate share of the assets held by the OP. Consequently, to the extent that we hold an equity interest in the OP, the OP's assets and operations may affect our ability to qualify as a REIT.

Entity Classification

[R.51] Our investment in our OP involves special tax considerations, including the possibility of a challenge by the IRS of the tax status of such partnership. If the IRS were to successfully treat the OP as an association or publicly traded partnership taxable as a corporation for federal income tax purposes, the OP would be subject to an entity-level tax on its income. In such a situation, the character of our assets and items of our gross income would change and could preclude us from satisfying the REIT asset tests or the gross income tests as discussed in "Taxation of DuPont Fabros Technology—Asset Tests" and "—Income Tests," and in turn could prevent us from qualifying as a REIT unless we are eligible for relief from the violation pursuant to relief provisions described above. See "Taxation of DuPont Fabros Technology—Failure to Qualify," above, for a discussion of the effect of our failure to meet these tests for a taxable year, and of the relief provisions. In addition, any change in the status of the OP for tax purposes could be treated as a taxable event, in which case we could have taxable income that is subject to the REIT distribution requirements without receiving any cash.

Tax Allocations with Respect to Partnership Properties

[R.52] Under the Code and the Treasury regulations, income, gain, loss, and deduction attributable to appreciated or depreciated property that is contributed to a partnership in exchange for an interest in the partnership must be allocated for tax purposes in a manner such that the contributing partner is charged with, or benefits from, the unrealized gain or unrealized loss associated with the property at the time of the contribution. The amount of the unrealized gain or unrealized loss is generally equal to the difference between the fair market value of the contributed property at the time of contribution, and the adjusted tax basis of such property at the time of contribution (a "book-tax difference"). Such allocations are solely for federal income tax purposes and do not affect other economic or legal arrangements among the partners. These rules may apply to a contribution of property by us to an OP. To the extent that the OP acquires appreciated (or depreciated) properties by way of capital contributions from its partners, allocations would need to be made in a manner consistent with these requirements. Where a partner contributes cash to a partnership at a time at which the partnership holds appreciated (or depreciated) property, the Treasury regulations provide for a similar allocation of these items to the other (i.e. non-contributing) partners. These rules may apply to the contribution by us to the OP of the cash proceeds received in offerings of our stock. As a result, members, including us, could be allocated greater or lesser amounts of depreciation and taxable income in respect of the

OP's properties than would be the case if all of the OP's assets (including any contributed assets) had a tax basis equal to their fair market values at the time of any contributions to the OP. This could cause us to recognize taxable income in excess of cash flow from the OP, which might adversely affect our ability to comply with the REIT distribution requirements discussed above.

[R.53] The OP will use the "traditional method" under Section 704(c) of the Code with respect to the original contributed properties. As a result of the OP's use of the traditional method, our tax depreciation deductions attributable to those properties may be lower, and gain on sale of such property may be higher, than they would have been if our OP had acquired those properties for cash. If we receive lower tax depreciation deductions from the contributed properties, we would recognize increased taxable income, which could increase the annual distributions that we are required to make under the federal income tax rules applicable to REITs or cause a higher portion of our distributions to be treated as taxable dividend income, instead of a tax-free return of capital or a capital gain. See "—Taxation of Stockholders."

Sale of Properties

[R.54] Our share of any gain realized by our OP or any other subsidiary partnership or limited liability company on the sale of any property held as inventory or primarily for sale to customers in the ordinary course of business will be treated as income from a prohibited transaction that is subject to a 100% excise tax. See "Taxation of DuPont Fabros Technology—Taxation of REITs in General" and "Taxation of DuPont Fabros Technology—Prohibited Transactions." Under existing law, whether property is held as inventory or primarily for sale to customers in the ordinary course of a trade or business depends upon all of the facts and circumstances of the particular transaction. Our OP and our other subsidiary partnerships and limited liability companies generally intend to hold their interests in properties for investment with a view to long-term appreciation, to engage in the business of acquiring, developing, owning, operating, financing and leasing the properties, and to make occasional sales of the properties, including peripheral land, as are consistent with our investment objectives.

Taxation of Stockholders

Taxation of Taxable Domestic Stockholders

[R.55] *Distributions.* Provided that we qualify as a REIT, distributions made to our taxable domestic stockholders out of current or accumulated earnings and profits, and not designated as capital gain dividends, will generally be taken into account by them as ordinary income and will not be eligible for the dividends received deduction for corporations. With limited exceptions, dividends received from REITs are not eligible for taxation at the preferential income tax rates (15% maximum federal rate through 2010) for qualified dividends received by stockholders taxed at individual rates from taxable C corporations and certain foreign corporations. Such stockholders, however, are taxed at the preferential rates on certain out-of-the-ordinary dividends designated by and received from REITs. These are dividends attributable to (1) income retained by the REIT in the prior taxable year on which the REIT was subject to corporate level income tax (less the amount of tax), (2) dividends received by the REIT from TRSs or other taxable C corporations, or (3) income in the prior taxable year from the sales of "built-in gain" property

acquired by the REIT from C corporations in carryover basis transactions (less the amount of corporate tax on such income).

[R.56] Distributions from us that are designated as capital gain dividends will generally be taxed to stockholders as long-term capital gains, to the extent that they do not exceed our actual net capital gain for the taxable year, without regard to the period for which the stockholder has held its stock. A similar treatment will apply to long-term capital gains retained by us, to the extent that we elect the application of provisions of the Code that treat stockholders of a REIT as having received, for federal income tax purposes, undistributed capital gains of the REIT, while passing through to stockholders a corresponding credit for taxes paid by the REIT on such retained capital gains. Corporate stockholders may be required to treat up to 20% of some capital gain dividends as ordinary income. Long-term capital gains are generally taxable at maximum federal rates of 15% (through 2010) in the case of stockholders who are taxed at individual rates, and 35% in the case of stockholders that are corporations. Capital gains attributable to the sale of depreciable real property held for more than 12 months are subject to a 25% maximum federal income tax rate for taxpayers who are individuals, to the extent of previously claimed depreciation deductions.

[R.57] In determining the extent to which a distribution constitutes a dividend for tax purposes, our earnings and profits generally will be allocated first to distributions with respect to preferred stock, none of which is currently issued and outstanding, and then to common stock. If we have net capital gains and designate some or all of our distributions as capital gain dividends to that extent, the capital gain dividends will be allocated among different classes of stock in proportion to the allocation of earnings and profits as described above.

[R.58] Distributions in excess of current and accumulated earnings and profits will not be taxable to a stockholder to the extent that they do not exceed the adjusted basis of the stockholder's shares in respect of which the distributions were made, but rather, will reduce the adjusted basis of these shares. To the extent that such distributions exceed the adjusted basis of a stockholder's shares, they will be included in income as long-term capital gain, or short-term capital gain if the shares have been held for one year or less. In addition, any dividend we declare in October, November, or December of any year and payable to a stockholder of record on a specified date in any such month will be treated as both paid by DuPont Fabros and received by the stockholder on December 31 of such year, provided that the dividend is actually paid by us before the end of January of the following calendar year.

[R.59] *Dispositions of DuPont Fabros Stock*. In general, a domestic stockholder will realize gain or loss upon the sale, redemption, or other taxable disposition of our stock in an amount equal to the difference between the sum of the fair market value of any property received and the amount of cash received in such disposition, and the stockholder's adjusted tax basis in the stock at the time of the disposition. In general, a stockholder's tax basis will equal the stockholder's acquisition cost, increased by the excess of net capital gains deemed distributed to the stockholder (discussed above), less tax deemed paid on it, and reduced by returns of capital. In general, capital gains recognized by stockholders taxed at individual rates upon the sale or disposition of shares of our stock will be subject to a maximum federal income tax rate of 15% (through 2010) if the stock is held for more than 12 months, and will be taxed at ordinary income rates (of up to 35% through 2010) if stock is held for 12 months or less. Gains recognized by

stockholders that are corporations are subject to federal income tax at a maximum rate of 35%, whether or not classified as long-term capital gains. Capital losses recognized by a stockholder upon the disposition of stock held for more than one year at the time of disposition will be considered long-term capital losses, and are generally available only to offset capital gain income of the stockholder but not ordinary income (except in the case of individuals, who may offset up to $3,000 of ordinary income each year). In addition, any loss upon a sale or exchange of shares of stock by a stockholder who has held the shares for six months or less, after applying holding period rules, will be treated as a long-term capital loss to the extent of distributions received from us that are required to be treated by the stockholder as long-term capital gain.

[R.60] If an investor recognizes a loss upon a subsequent sale or other disposition of our stock in an amount that exceeds a prescribed threshold, it is possible that the provisions of recently adopted Treasury regulations involving "reportable transactions" could apply, with a resulting requirement to separately disclose the loss generating transaction to the IRS. While these regulations are directed towards "tax shelters," they are written broadly and apply to transactions that would not typically be considered tax shelters. In addition significant penalties are imposed by the Code for failure to comply with these requirements. You should consult your tax advisor concerning any possible disclosure obligation with respect to the receipt or disposition of our stock, or transactions that might be undertaken directly or indirectly by us. Moreover, you should be aware that we and other participants in the transactions involving us (including their advisors) might be subject to disclosure or other requirements pursuant to these regulations.

[R.61] *Passive Activity Losses and Investment Interest Limitations.* Distributions made by us and gain arising from the sale or exchange by a domestic stockholder of our stock will not be treated as passive activity income. As a result, stockholders will not be able to apply any "passive losses" against income or gain relating to our stock. Distributions made by us, to the extent they do not constitute return of capital, generally will be treated as investment income for purposes of computing the investment interest limitation.

Taxation of Foreign Stockholders

[R.62] The following is a summary of certain federal income and estate tax consequences of the ownership and disposition of our common stock applicable to non-U.S. holders of our common stock. A "non-U.S. holder" is any person other than:

(a) a citizen or resident of the United States;

(b) a corporation created or organized in the United States or under the laws of the United States, or of any state thereof, or the District of Columbia;

(c) an estate, the income of which is includable in gross income for federal income tax purposes regardless of its source; or

(d) a trust if a United States court is able to exercise primary supervision over the administration of such trust and one or more United States fiduciaries have the authority to control all substantial decisions of the trust.

[R.63] The discussion is based on current law and is for general information only. It addresses only selected, and not all, aspects of federal income and estate taxation.

[R.64] *Ordinary Dividends*. The portion of dividends received by non-U.S. holders payable out of our earnings and profits which are not attributable to our capital gains and which are not effectively connected with a U.S. trade or business of the non-U.S. holder will be subject to U.S. withholding tax at the rate of 30%, unless reduced by an income tax treaty.

[R.65] In general, non-U.S. holders will not be considered to be engaged in a U.S. trade or business solely as a result of their ownership of our stock. In cases where the dividend income from a non-U.S. holder's investment in our stock is, or is treated as, effectively connected with the non-U.S. holder's conduct of a U.S. trade or business, the non-U.S. holder generally will be subject to U.S. tax at graduated rates, in the same manner as domestic stockholders are taxed with respect to such dividends, such income must generally be reported on a U.S. income tax return filed by or on behalf of the non-U.S. holder, and the income may also be subject to the 30% branch profits tax in the case of a non-U.S. holder that is a corporation.

[R.66] *Non-Dividend Distributions.* Unless our stock constitutes a U.S. real property interest (a "USRPI"), distributions by us which are not dividends out of our earnings and profits will not be subject to U.S. income tax. If it cannot be determined at the time at which a distribution is made whether or not the distribution will exceed current and accumulated earnings and profits, the distribution will be subject to withholding at the rate applicable to dividends. However, the non-U.S. holder may seek a refund from the IRS of any amounts withheld if it is subsequently determined that the distribution was, in fact, in excess of our current and accumulated earnings and profits. If our stock constitutes a USRPI, as described below, distributions by us in excess of the sum of our earnings and profits plus the stockholder's basis in its DuPont Fabros stock will be treated as gain from the sale or exchange of such stock and be taxed under the Foreign Investment in Real Property Tax Act of 1980 ("FIRPTA") at the rate of tax, including any applicable capital gains rates, that would apply to a domestic stockholder of the same type (for example, an individual or a corporation, as the case may be). The collection of the tax will be enforced by a creditable withholding at a rate of 10% of the amount by which the distribution exceeds the stockholder's share of our earnings and profits.

[R.67] *Capital Gain Dividends.* Under FIRPTA, a distribution made by us to a non-U.S. holder, to the extent attributable to gains from dispositions of USRPIs held by us directly, lower-tier REITs, or through pass-through subsidiaries ("USRPI capital gains"), will, except as discussed below, be considered effectively connected with a U.S. trade or business of the non-U.S. holder and will be subject to U.S. income tax at the rates applicable to U.S. individuals or corporations, without regard to whether the distribution is designated as a capital gain dividend. In addition, we will be required to withhold tax equal to 35% of the amount of dividends to the extent we could designate such dividends as a capital gain dividend. Distributions subject to FIRPTA may also be subject to a 30% branch profits tax in the hands of a non-U.S. holder that is a corporation. A distribution is not a USRPI capital gain if we held the underlying asset solely as a creditor.

[R.68] A capital gain dividend by us that would otherwise have been treated as a USRPI capital gain will not be so treated or be subject to FIRPTA, will generally not be treated as income that is effectively connected with a U.S. trade or business, and will instead be treated the same as an

ordinary dividend from us (see "—Taxation of Foreign Stockholders—Ordinary Dividends"), provided that (1) the capital gain dividend is received with respect to a class of stock that is regularly traded on an established securities market located in the United States, and (2) the recipient non-U.S. holder does not own more than 5% of that class of stock at any time during the one-year period ending on the date on which the capital gain dividend is received. We expect that our common stock will be treated as regularly traded on an established securities market following this offering.

[R.69] *Dispositions of DuPont Fabros Stock.* Unless our stock constitutes a USRPI, a sale of the stock by a non-U.S. holder generally will not be subject to U.S. taxation under FIRPTA. The stock will be treated as a USRPI if 50% or more of all of our assets (which, solely for FIRPTA purposes, includes our worldwide real property and other assets used in our trade or business) throughout a prescribed testing period consist of interests in real property located within the United States, excluding, for this purpose, interests in real property solely in a capacity as a creditor. Even if the foregoing test is met, our stock nonetheless will not constitute a USRPI if we are a "domestically controlled qualified investment entity." A domestically controlled qualified investment entity includes a REIT in which, at all times during a specified testing period, less than 50% in value of its shares is held directly or indirectly by non-U.S. holders. We cannot assure you that we will be a domestically controlled qualified investment entity.

[R.70] In the event that we do not constitute a domestically controlled qualified investment entity, a non-U.S. holder's sale or other disposition of our stock nonetheless will generally not be subject to tax under FIRPTA as a sale of a USRPI, provided that (1) the stock owned is of a class that is "regularly traded," as defined by applicable Treasury regulations, on an established securities market, and (2) the selling non-U.S. holder held 5% or less of our outstanding stock of that class at all times during a specified testing period. As noted above, we believe that our common stock will be treated as regularly traded on an established securities market following this offering.

[R.71] If gain on the sale of our stock were subject to taxation under FIRPTA, the non-U.S. holder would be subject to the same treatment as a U.S. stockholder with respect to such gain, subject to applicable alternative minimum tax and a special alternative minimum tax in the case of non-resident alien individuals, and the purchaser of the stock could be required to withhold 10% of the purchase price and remit such amount to the IRS.

[R.72] Gain from the sale of our stock that would not otherwise be subject to FIRPTA will nonetheless be taxable in the United States to a non-U.S. holder in two cases: (1) if the non-U.S. holder's investment in our stock is effectively connected with a U.S. trade or business conducted by such non-U.S. holder, the non-U.S. holder will be subject to the same treatment as a U.S. stockholder with respect to such gain, or (2) if the non-U.S. holder is a nonresident alien individual who was present in the United States for 183 days or more during the taxable year and has a "tax home" in the United States, the nonresident alien individual will be subject to a 30% tax on the individual's capital gain. In addition, even if we are a domestically controlled qualified investment entity, upon disposition of our stock (subject to the 5% exception applicable to "regularly traded" stock described above), a non-U.S. holder may be treated as having gain from the sale or exchange of a USRPI if the non-U.S. holder (1) disposes of our common stock within a 30-day period preceding the ex-dividend date of a distribution, any portion of which, but

for the disposition, would have been treated as gain from the sale or exchange of a USRPI and (2) acquires, or enters into a contract or option to acquire, other shares of our common stock within 30 days after such ex-dividend date.

[R.73] *Estate Tax.* DuPont Fabros stock owned or treated as owned by an individual who is not a citizen or resident (as specially defined for federal estate tax purposes) of the United States at the time of death will be includable in the individual's gross estate for federal estate tax purposes, unless an applicable estate tax treaty provides otherwise, and may therefore be subject to federal estate tax.

Taxation of Tax-Exempt Stockholders

[R.74] Tax-exempt entities, including qualified employee pension and profit sharing trusts and individual retirement accounts, generally are exempt from federal income taxation. However, they are subject to taxation on their unrelated business taxable income ("UBTI"). Provided that (1) a tax-exempt stockholder has not held our stock as "debt financed property" within the meaning of the Code (i.e. where the acquisition or holding of the property is financed through a borrowing by the tax-exempt stockholder), and (2) our stock is not otherwise used in an unrelated trade or business, distributions from us and income from the sale of our stock should not give rise to UBTI to a tax-exempt stockholder.

[R.75] Tax-exempt stockholders that are social clubs, voluntary employee benefit associations, supplemental unemployment benefit trusts, and qualified group legal services plans exempt from federal income taxation under sections 501(c)(7), (c)(9), (c)(17) and (c)(20) of the Code, respectively, are subject to different UBTI rules, which generally will require them to characterize distributions from us as UBTI.

[R.76] In certain circumstances, a pension trust that owns more than 10% of our stock could be required to treat a percentage of the dividends from us as UBTI, if we are a "pension-held REIT." We will not be a pension-held REIT unless either (1) one pension trust owns more than 25% of the value of our stock, or (2) a group of pension trusts, each individually holding more than 10% of the value of our stock, collectively owns more than 50% of such stock. Certain restrictions on ownership and transfer of our stock should generally prevent a tax-exempt entity from owning more than 10% of the value of our stock, or our becoming a pension-held REIT.

Other Tax Considerations

Legislative or Other Actions Affecting REITs

[R.77] The rules dealing with federal income taxation are constantly under review by persons involved in the legislative process and by the IRS and the U.S. Treasury Department. We cannot give you any assurances as to whether, or in what form, any proposals affecting REITs or their stockholders will be enacted. Changes to the federal tax laws and interpretations thereof could adversely affect an investment in our stock.

State, Local and Foreign Taxes

[R.78] We and our subsidiaries and stockholders may be subject to state, local or foreign taxation in various jurisdictions, including those in which it or they transact business, own property or reside. We own properties located in a number of jurisdictions, and may be required to file tax returns in some or all of those jurisdictions. The state, local or foreign tax treatment of us and our stockholders may not conform to the federal income tax treatment discussed above. We will pay foreign property taxes, and dispositions of foreign property or operations involving, or investments in, foreign property may give rise to foreign income or other tax liability in amounts that could be substantial. Any foreign taxes incurred by us do not pass through to stockholders as a credit against their federal income tax liability. Prospective investors should consult their tax advisors regarding the application and effect of state, local and foreign income and other tax laws on an investment in stock or other securities of ours.

ERISA Considerations

[R.79] The Employee Retirement Income Security Act of 1974, as amended ("ERISA"), and the Code impose certain restrictions on (a) employee benefit plans (as defined in Section 3(3) of ERISA), (b) plans described in section 4975(e)(1) of the Code, including individual retirement accounts or Keogh plans, (c) any entities whose underlying assets include plan assets by reason of a plan's investment in such entities (each a "Plan") and (d) persons who have certain specified relationships to such Plans ("Parties-in-Interest" under ERISA and "Disqualified Persons" under the Code). Moreover, based on the reasoning of the United States Supreme Court in John Hancock Life Ins. Co. v. Harris Trust and Sav. Bank, 510 U.S. 86 (1993), an insurance company's general account may be deemed to include assets of the Plans investing in the general account (e.g., through the purchase of an annuity contract), and the insurance company might be treated as a Party-in-Interest with respect to a Plan by virtue of such investment. ERISA also imposes certain duties on persons who are fiduciaries of Plans subject to ERISA and prohibits certain transactions between such a Plan and Parties-in-Interest or Disqualified Persons with respect to such Plans.

[R.80] The United States Department of Labor (the "DOL") has issued a regulation (29 C.F.R. § 2510.3-101) concerning the definition of what constitutes the assets of a Plan (the "Plan Asset Regulations"). These regulations provide that, as a general rule, the underlying assets and properties of corporations, partnerships, trusts and certain other entities in which a Plan purchases an "equity interest" will be deemed for purposes of ERISA to be assets of the investing Plan unless certain exceptions apply. The Plan Asset Regulations define an "equity interest" as any interest in an entity other than an instrument that is treated as indebtedness under applicable local law and which has no substantial equity features. The shares of our common stock offered hereby, or REIT Shares, should be treated as "equity interests" for purposes of the Plan Asset Regulations.

[R.81] The Plan Asset Regulations provide exceptions to the look-through rule for equity interests in some types of entities, including any entity which qualifies as either a "real estate operating company" or a "venture capital operating company." Under the Plan Asset Regulations, a "real estate operating company" is defined as an entity which on testing dates has at least 50% of its assets, other than short-term investments pending long-term commitment or distribution to investors, valued at cost:

- invested in real estate which is managed or developed and with respect to which the entity has the right to substantially participate directly in the management or development activities; and

- which, in the ordinary course of its business, is engaged directly in real estate management or development activities.

[R.82] According to those same regulations, a "venture capital operating company" is defined as an entity that on testing dates has at least 50% of its assets, other than short-term investments pending long-term commitment or distribution to investors, valued at cost invested in one or more operating companies with respect to which the entity has management rights; and that, in the ordinary course of its business, actually exercises its management rights with respect to one or more of the operating companies in which it invests.

[R.83] Another exception under the Plan Asset Regulations applies to "publicly offered securities," which are defines as securities that are:

- freely transferable;

- part of a class of securities that is widely held; and

- either part of a class of securities that is registered under section 12(b) or 12(g) of the Exchange Act, or sold to a Plan as part of an offering of securities to the public pursuant to an effective registration statement under the Securities Act, and the class of securities of which this security is a part is registered under the Exchange Act within 120 days, or longer if allowed by the SEC, after the end of the fiscal year of the issuer during which this offering of these securities to the public occurred.

[R.84] Whether a security is considered "freely transferable" depends on the facts and circumstances of each case. Under the Plan Asset Regulations, if the security is part of an offering in which the minimum investment is $10,000 or less, then any restriction on or prohibition against any transfer or assignment of the security for the purposes of preventing a termination or reclassification of the entity for federal or state tax purposes or which would violate any state or federal statute, regulation, court order, judicial decree, or rule of law will not ordinarily prevent the security from being considered freely transferable. Additionally, limitations or restrictions on the transfer or assignment of a security that are created or imposed by persons other than the issuer of the security or persons acting for or on behalf of the issuer will ordinarily not prevent the security from being considered freely transferable.

[R.85] A class of securities is considered "widely held" if it is a class of securities that is owned by 100 or more investors independent of the issuer and of one another. A security will not fail to be "widely held" because the number of independent investors falls below 100 subsequent to the initial public offering as a result of events beyond the issuer's control.

[R.86] We expect that the REIT Shares will meet the criteria of the publicly offered securities exception to the look-through rule. First, the REIT Shares should be considered to be freely

transferable, as the minimum investment will be less than $10,000 and the only restrictions upon transfer of the REIT Shares are those generally permitted under the Plan Asset Regulations, those required under federal tax laws to maintain the REIT's status as a REIT, resale restrictions under applicable federal securities laws with respect to securities not purchased pursuant to a registered public offering and those owned by officers, directors and other affiliates, and voluntary restrictions agreed to by a selling stockholder regarding volume limitations.

[R.87] Second, we expect (although we cannot confirm) that the REIT Shares will be held by 100 or more investors and that at least 100 or more of these investors will be independent of the REIT and of one another.

[R.88] Third, the shares of the REIT's common stock will be part of an offering of securities to the public pursuant to an effective registration statement under the Securities Act and the common stock will be registered under the Exchange Act.

[R.89] If, however, none of the exceptions under the Plan Asset Regulations were applicable to the REIT and the REIT were deemed to hold Plan assets subject to ERISA or Section 4975 of the Code, such Plan assets would include an undivided interest in the assets held in the REIT. In such event, such assets and the persons providing services with respect to such assets would be subject to the fiduciary responsibility provisions of Title I of ERISA and the prohibited transaction provisions of ERISA and Section 4975 of the Code.

[R.90] In addition, if the assets held in the REIT were treated as Plan assets, certain of the activities of the REIT could be deemed to constitute a transaction prohibited under Title I of ERISA or Section 4975 of the Code (e.g., the extension of credit between a Plan and a Party in Interest or Disqualified Person). Such transactions may, however, be subject to a statutory or administrative exemptions such as Prohibited Transaction Class Exemption ("PTCE") 84-14, which exempts certain transactions effected on behalf of a Plan by a "qualified professional asset manager."

[R.91] Each Plan fiduciary should consult with its counsel with respect to the potential applicability of ERISA and the Code to such investment or similar rules that may apply to Plans not subject to ERISA or Code Section 4975, such as governmental plans, church plans or plans maintained outside of the United States. Each Plan fiduciary should also determine on its own whether any exceptions or exemptions are applicable (including the publicly offered securities exception) and whether all conditions of any such exceptions or exemptions have been satisfied.

[R.92] Moreover, each Plan fiduciary should determine whether, under the general fiduciary standards of investment prudence and diversification, participation in the formation transactions is appropriate for the Plan, taking into account the overall investment policy of the Plan and the composition of the Plan's investment portfolio.

[R.93] This Statement is in no respect a representation that any of the transactions contemplated herein meet all relevant legal requirements with respect to investments by Plans generally or that any such transaction is appropriate for any particular Plan.

EL PASO PIPELINE PARTNERS, L.P.
MATERIAL TAX CONSEQUENCES

[M.1] This section is a discussion of the material tax considerations that may be relevant to prospective unitholders who are individual citizens or residents of the United States and, unless otherwise noted in the following discussion, is the opinion of ABC LLP, counsel to our general partner and us, insofar as it relates to matters of United States federal income tax law and legal conclusions with respect to those matters. This section is based upon current provisions of the Internal Revenue Code, existing and proposed regulations and current administrative rulings and court decisions, all of which are subject to change. Later changes in these authorities may cause the tax consequences to vary substantially from the consequences described below. Unless the context otherwise requires, references in this section to "us" or "we" are references to El Paso Pipeline Partners, L.P. and our operating company.

[M.2] The following discussion does not address all federal income tax matters affecting us or the unitholders. Moreover, the discussion focuses on unitholders who are individual citizens or residents of the United States and has only limited application to corporations, estates, trusts, nonresident aliens or other unitholders subject to specialized tax treatment, such as tax-exempt institutions, foreign persons, individual retirement accounts (IRAs), real estate investment trusts (REITs), employee benefit plans or mutual funds. Accordingly, we urge each prospective unitholder to consult, and depend on, his own tax advisor in analyzing the federal, state, local and foreign tax consequences particular to him of the ownership or disposition of the common units.

[M.3] All statements as to matters of law and legal conclusions, but not as to factual matters, contained in this section, unless otherwise noted, are the opinion of ABC LLP and are based on the accuracy of the representations made by us and our general partner.

[M.4] No ruling has been or will be requested from the IRS regarding any matter affecting us or prospective unitholders. Instead, we will rely on opinions and advice of ABC LLP. Unlike a ruling, an opinion of counsel represents only that counsel's best legal judgment and does not bind the IRS or the courts. Accordingly, the opinions and statements made in this discussion may not be sustained by a court if contested by the IRS. Any contest of this sort with the IRS may materially and adversely impact the market for the common units and the prices at which the common units trade. In addition, the costs of any contest with the IRS, principally legal, accounting and related fees, will result in a reduction in cash available to pay distributions to our unitholders and our general partner and thus will be borne indirectly by our unitholders and our general partner. Furthermore, the tax treatment of us, or of an investment in us, may be significantly modified by future legislative or administrative changes or court decisions. Any modifications may or may not be retroactively applied.

[M.5] For the reasons described below, ABC LLP has not rendered an opinion with respect to the following specific federal income tax issues:

- the treatment of a unitholder whose common units are loaned to a short seller to cover a short sale of common units (please read "— Tax Consequences of Unit Ownership — Treatment of Short Sales");

- whether our monthly convention for allocating taxable income and losses is permitted by existing Treasury Regulations (please read "— Disposition of Common Units — Allocations Between Transferors and Transferees"); and
- whether our method for depreciating Section 743 adjustments is sustainable in certain cases (please read "— Tax Consequences of Unit Ownership — Section 754 Election" and "— Uniformity of Units").

Partnership Status

[M.6] A partnership is not a taxable entity and incurs no federal income tax liability. Instead, each partner of a partnership is required to take into account his share of items of income, gain, loss and deduction of the partnership in computing his federal income tax liability, regardless of whether cash distributions are made to him by the partnership. Distributions by a partnership to a partner are generally not taxable to the partner unless the amount of cash distributed is in excess of the partner's adjusted basis in his partnership interest.

[M.7] Section 7704 of the Internal Revenue Code provides that publicly traded partnerships will, as a general rule, be taxed as corporations. However, an exception, referred to as the "Qualifying Income Exception," exists with respect to publicly traded partnerships of which 90% or more of the gross income for every taxable year consists of "qualifying income." Qualifying income includes income and gains derived from the transportation, storage and processing of crude oil, natural gas and products thereof. Other types of qualifying income include interest (other than from a financial business), dividends, gains from the sale of real property and gains from the sale or other disposition of capital assets held for the production of income that otherwise constitutes qualifying income. We estimate that less than 6% of our current gross income is not qualifying income; however, this estimate could change from time to time. Based on and subject to this estimate, the factual representations made by us and our general partner and a review of the applicable legal authorities, ABC LLP is of the opinion that at least 90% of our current gross income constitutes qualifying income. The portion of our income that is qualifying income can change from time to time.

[M.8] No ruling has been or will be sought from the IRS and the IRS has made no determination as to our status for federal income tax purposes or whether our operations generate "qualifying income" under Section 7704 of the Internal Revenue Code. Instead, we will rely on the opinion of ABC LLP on such matters. It is the opinion of ABC LLP that, based upon the Internal Revenue Code, its regulations, published revenue rulings and court decisions and the representations described below, we will be classified as a partnership and the operating company will be disregarded as an entity separate from us for federal income tax purposes.

[M.9] In rendering its opinion, ABC LLP has relied on factual representations made by us and our general partner. The representations made by us and our general partner upon which ABC LLP has relied include:

(a) Neither we nor our operating company have elected nor will elect to be treated as a corporation; and

(b) For each taxable year, more than 90% of our gross income will be income that ABC LLP has opined or will opine is “qualifying income” within the meaning of Section 7704(d) of the Internal Revenue Code.

[M.10] If we fail to meet the Qualifying Income Exception, other than a failure that is determined by the IRS to be inadvertent and that is cured within a reasonable time after discovery, we will be treated as if we had transferred all of our assets, subject to liabilities, to a newly formed corporation, on the first day of the year in which we fail to meet the Qualifying Income Exception, in return for stock in that corporation, and then distributed that stock to the unitholders in liquidation of their interests in us. This deemed contribution and liquidation should be tax-free to unitholders and us except to the extent that our liabilities exceed the tax bases of our assets at that time. Thereafter, we would be treated as a corporation for federal income tax purposes.

[M.11] If we were taxable as a corporation in any taxable year, either as a result of a failure to meet the Qualifying Income Exception or otherwise, our items of income, gain, loss and deduction would be reflected only on our tax return rather than being passed through to the unitholders, and our net income would be taxed to us at corporate rates. In addition, any distribution made to a unitholder would be treated as either taxable dividend income, to the extent of our current or accumulated earnings and profits, or, in the absence of earnings and profits, a nontaxable return of capital, to the extent of the unitholder’s tax basis in his common units, or taxable capital gain, after the unitholder’s tax basis in his common units is reduced to zero. Accordingly, taxation as a corporation would result in a material reduction in a unitholder’s cash flow and after-tax return and thus would likely result in a substantial reduction of the value of the units.

[M.12] The discussion below is based on ABC LLP’s opinion that we will be classified as a partnership for federal income tax purposes.

Limited Partner Status

[M.13] Unitholders who have become limited partners of El Paso Pipeline Partners, L.P. will be treated as partners of El Paso Pipeline Partners, L.P. for federal income tax purposes. Also, unitholders whose common units are held in street name or by a nominee and who have the right to direct the nominee in the exercise of all substantive rights attendant to the ownership of their common units will be treated as partners of El Paso Pipeline Partners, L.P. for federal income tax purposes.

[M.14] A beneficial owner of common units whose units have been transferred to a short seller to complete a short sale would appear to lose his status as a partner with respect to those units for federal income tax purposes. Please read “— Tax Consequences of Unit Ownership — Treatment of Short Sales.”

[M.15] Items of our income, gain, loss or deduction are not reportable by a unitholder who is not a partner for federal income tax purposes, and any cash distributions received by a unitholder who is not a partner for federal income tax purposes would therefore be fully taxable as ordinary income. These holders are urged to consult their own tax advisors with respect to their status as

partners in El Paso Pipeline Partners, L.P. for federal income tax purposes. The references to "unitholders" in the discussion that follows are to persons who are treated as partners in El Paso Pipeline Partners, L.P. for federal income tax purposes.

Tax Consequences of Unit Ownership

[M.16] *Flow-Through of Taxable Income*. We will not pay any federal income tax. Instead, each unitholder will be required to report on his income tax return his share of our income, gains, losses and deductions without regard to whether corresponding cash distributions are received by him. Consequently, we may allocate income to a unitholder even if he has not received a cash distribution. Each unitholder will be required to include in income his allocable share of our income, gains, losses and deductions for our taxable year or years ending with or within his taxable year. Our taxable year ends on December 31.

[M.17] *Treatment of Distributions.* Distributions by us to a unitholder generally will not be taxable to the unitholder for federal income tax purposes to the extent of his tax basis in his common units immediately before the distribution. Our cash distributions in excess of a unitholder's tax basis in his common units generally will be considered to be gain from the sale or exchange of the common units, taxable in accordance with the rules described under "—Disposition of Common Units" below. Any reduction in a unitholder's share of our liabilities for which no partner, including our general partner, bears the economic risk of loss, known as "non-recourse liabilities," will be treated as a distribution of cash to that unitholder. To the extent our distributions cause a unitholder's "at risk" amount to be less than zero at the end of any taxable year, the unitholder must recapture any losses deducted in previous years. Please read "—Limitations on Deductibility of Losses."

[M.18] A decrease in a unitholder's percentage interest in us because of our issuance of additional common units will decrease his share of our non-recourse liabilities, and thus will result in a corresponding deemed distribution of cash, which may constitute a non-pro rata distribution. A non-pro rata distribution of money or property may result in ordinary income to a unitholder, regardless of his tax basis in his common units, if the distribution reduces the unitholder's share of our "unrealized receivables," including depreciation recapture, and/or substantially appreciated "inventory items," both as defined in Section 751 of the Internal Revenue Code, and collectively, "Section 751 Assets." To that extent, he will be treated as having been distributed his proportionate share of the Section 751 Assets and having then exchanged those assets with us in return for the non-pro rata portion of the actual distribution made to him. This latter deemed exchange will generally result in the unitholder's realization of ordinary income, which will equal the excess of the non-pro rata portion of that distribution over the unitholder's tax basis for the share of Section 751 Assets deemed relinquished in the exchange.

[M.19] *Ratio of Taxable Income to Distributions.* We estimate that a purchaser of common units in this offering who owns those common units from the date of closing of this offering through the record date for distributions for the period ending December 31, 2010, will be allocated, on a cumulative basis, an amount of federal taxable income for that period that will be 20% or less of the cash distributed to the unitholder with respect to that period. Thereafter, we anticipate that the ratio of allocable taxable income to cash distributions to the unitholders will increase. These

estimates are based upon the assumption that gross income from operations will approximate the amount required to make the minimum quarterly distribution on all units and other assumptions with respect to capital expenditures, cash flow and anticipated cash distributions. These estimates and assumptions are subject to, among other things, numerous business, economic, regulatory, legislative, competitive and political uncertainties beyond our control. Further, the estimates are based on current tax law and tax reporting positions that we will adopt and with which the IRS could disagree. Accordingly, we cannot assure you that these estimates will prove to be correct. The actual percentage of distributions that will constitute taxable income could be higher or lower, and any differences could be material and could materially affect the value of the common units.

[M.20] *Basis of Common Units.* A unitholder's initial tax basis for his common units will be the amount he paid for the common units plus his share of our non-recourse liabilities. That basis will be increased by his share of our income and by any increases in his share of our non-recourse liabilities. That basis generally will be decreased, but not below zero, by distributions from us, by the unitholder's share of our losses, by any decreases in his share of our non-recourse liabilities and by his share of our expenditures that are not deductible in computing taxable income and are not required to be capitalized. A unitholder will have no share of our debt that is recourse to our general partner, but will have a share, generally based on his share of profits, of our non-recourse liabilities. Please read "— Disposition of Common Units — Recognition of Gain or Loss."

[M.21] *Limitations on Deductibility of Losses.* The deduction by a unitholder of his share of our losses will be limited to the tax basis in his units and, in the case of an individual unitholder or a corporate unitholder, if more than 50% of the value of the corporate unitholder's stock is owned directly or indirectly by or for five or fewer individuals or some tax-exempt organizations, to the amount for which the unitholder is considered to be "at risk" with respect to our activities, if that amount is less than his tax basis. A unitholder must recapture losses deducted in previous years to the extent that distributions cause his at risk amount to be less than zero at the end of any taxable year. Losses disallowed to a unitholder or recaptured as a result of these limitations will carry forward and will be allowable as a deduction in a later year to the extent that his tax basis or at risk amount, whichever is the limiting factor, is subsequently increased. Upon the taxable disposition of a unit, any gain recognized by a unitholder can be offset by losses that were previously suspended by the at risk limitation but may not be offset by losses suspended by the basis limitation. Any excess loss above that gain previously suspended by the at risk or basis limitations is no longer utilizable.

[M.22] In general, a unitholder will be at risk to the extent of the tax basis of his units, excluding any portion of that basis attributable to his share of our non-recourse liabilities, reduced by (i) any portion of that basis representing amounts other than were protected against loss because of a guarantee, stop-loss agreement or other similar arrangement and (ii) any amount of money he borrows to acquire or hold his units, if the lender of those borrowed funds owns an interest in us, is related to the unitholder or can look only to the units for repayment. A unitholder's at risk amount will increase or decrease as the tax basis of the unitholder's units increases or decreases, other than tax basis increases or decreases attributable to increases or decreases in his share of our non-recourse liabilities.

[M.23] The passive loss limitations generally provide that individuals, estates, trusts and some closely-held corporations and personal service corporations are permitted to deduct losses from passive activities, which are generally trade or business activities in which the taxpayer does not materially participate, only to the extent of the taxpayer's income from those passive activities. The passive loss limitations are applied separately with respect to each publicly traded partnership. Consequently, any passive losses we generate will only be available to offset our passive income generated in the future and will not be available to offset income from other passive activities or investments, including our investments or investments in other publicly traded partnerships, or a unitholder's salary or active business income. Passive losses that are not deductible because they exceed a unitholder's share of income we generate may be deducted in full when the unitholder disposes of his entire investment in us in a fully taxable transaction with an unrelated party. The passive activity loss limitations are applied after other applicable limitations on deductions, including the at risk rules and the basis limitation.

[M.24] A unitholder's share of our net income may be offset by any of our suspended passive losses, but it may not be offset by any other current or carryover losses from other passive activities, including those attributable to other publicly traded partnerships.

[M.25] *Limitations on Interest Deductions.* The deductibility of a non-corporate taxpayer's "investment interest expense" is generally limited to the amount of that taxpayer's "net investment income." Investment interest expense includes:

- interest on indebtedness properly allocable to property held for investment;
- our interest expense attributed to portfolio income; and
- the portion of interest expense incurred to purchase or carry an interest in a passive activity to the extent attributable to portfolio income.

[M.26] The computation of a unitholder's investment interest expense will take into account interest on any margin account borrowing or other loan incurred to purchase or carry a unit. Net investment income includes gross income from property held for investment and amounts treated as portfolio income under the passive loss rules, less deductible expenses, other than interest, directly connected with the production of investment income, but generally does not include gains attributable to the disposition of property held for investment. The IRS has indicated that net passive income earned by a publicly traded partnership will be treated as investment income to its unitholders. In addition, the unitholder's share of our portfolio income will be treated as investment income.

[M.27] *Entity-Level Collections.* If we are required or elect under applicable law to pay any federal, state, local or foreign income tax on behalf of any unitholder or our general partner or any former unitholder, we are authorized to pay those taxes from our funds. That payment, if made, will be treated as a distribution of cash to the partner on whose behalf the payment was made. If the payment is made on behalf of a person whose identity cannot be determined, we are authorized to treat the payment as a distribution to all current unitholders. We are authorized to amend the partnership agreement in the manner necessary to maintain uniformity of intrinsic tax characteristics of units and to adjust later distributions, so that after giving effect to these

distributions, the priority and characterization of distributions otherwise applicable under the partnership agreement is maintained as nearly as is practicable. Payments by us as described above could give rise to an overpayment of tax on behalf of an individual unitholder in which event the unitholder would be required to file a claim in order to obtain a credit or refund.

[M.28] *Allocation of Income, Gain, Loss and Deduction.* In general, if we have a net profit, our items of income, gain, loss and deduction will be allocated among our general partner and the unitholders in accordance with their percentage interests in us. At any time that distributions are made to the common units in excess of distributions to the subordinated units, or incentive distributions are made to our general partner, gross income will be allocated to the recipients to the extent of these distributions. If we have a net loss for the entire year, that loss will be allocated first to our general partner and the unitholders in accordance with their percentage interests in us to the extent of their positive capital accounts and, second, to our general partner.

[M.29] Specified items of our income, gain, loss and deduction will be allocated under Section 704(c) of the Internal Revenue Code to account for the difference between the tax basis and fair market value of our assets at the time of an offering, referred to in this discussion as "Contributed Property." These allocations are required to eliminate the difference between a partner's "book" capital account, credited with the fair market value of Contributed Property, and the "tax" capital account, credited with the tax basis of Contributed Property, referred to in this discussion as the "Book-Tax Disparity." The effect of these allocations to a unitholder purchasing common units in this offering will be essentially the same as if the tax basis of Contributed Property was equal to its fair market value at the time of this offering. In the event we issue additional common units or engage in certain other transactions in the future, "reverse Section 704(c) allocations," similar to the Section 704(c) allocations described above, will be made to all partners, including purchasers of common units in this offering, to account for the difference, at the time of the future transaction, between the "book" basis for purposes of maintaining capital accounts and the fair market value of all property held by us at the time of the future transaction. In addition, items of recapture income will be allocated to the extent possible to the unitholder who was allocated the deduction giving rise to the treatment of that gain as recapture income in order to minimize the recognition of ordinary income by other unitholders. Finally, although we do not expect that our operations will result in the creation of negative capital accounts, if negative capital accounts nevertheless result, items of our income and gain will be allocated in an amount and manner to eliminate the negative balance as quickly as possible.

[M.30] An allocation of items of our income, gain, loss or deduction, other than an allocation required by Section 704(c), will generally be given effect for federal income tax purposes in determining a partner's share of an item of income, gain, loss or deduction only if the allocation has substantial economic effect. In any other case, a partner's share of an item will be determined on the basis of his interest in us, which will be determined by taking into account all the facts and circumstances, including:

- his relative contributions to us;
- the interests of all the partners in profits and losses;

- the interest of all the partners in cash flow; and
- the rights of all the partners to distributions of capital upon liquidation.

[M.31] ABC LLP is of the opinion that, with the exception of the issues described in "— Tax Consequences of Unit Ownership — Section 754 Election," "— Uniformity of Units" and "— Disposition of Common Units — Allocations Between Transferors and Transferees," allocations under our partnership agreement will be given effect for federal income tax purposes in determining a partner's share of an item of income, gain, loss or deduction.

[M.32] *Treatment of Short Sales.* A unitholder whose units are loaned to a "short seller" to cover a short sale of units may be considered as having disposed of those units. If so, he would no longer be a partner for tax purposes with respect to those units during the period of the loan and may recognize gain or loss from the disposition. As a result, during this period:

- any of our income, gain, loss or deduction with respect to those units would not be reportable by the unitholder;
- any cash distributions received by the unitholder as to those units would be fully taxable; and
- all of these distributions would appear to be ordinary income.

[M.33] ABC LLP has not rendered an opinion regarding the treatment of a unitholder where common units are loaned to a short seller to cover a short sale of common units; therefore, unitholders desiring to assure their status as partners and avoid the risk of gain recognition from a loan to a short seller are urged to modify any applicable brokerage account agreements to prohibit their brokers from loaning their units. The IRS has announced that it is studying issues relating to the tax treatment of short sales of partnership interests. Please also read "— Disposition of Common Units — Recognition of Gain or Loss."

[M.34] *Alternative Minimum Tax.* Each unitholder will be required to take into account his distributive share of any items of our income, gain, loss or deduction for purposes of the alternative minimum tax. The current minimum tax rate for non-corporate taxpayers is 26% on the first $175,000 of alternative minimum taxable income in excess of the exemption amount and 28% on any additional alternative minimum taxable income. Prospective unitholders are urged to consult with their tax advisors as to the impact of an investment in units on their liability for the alternative minimum tax.

[M.35] *Tax Rates.* In general, the highest effective United States federal income tax rate for individuals is currently 35% and the maximum United States federal income tax rate for net capital gains of an individual is currently 15% if the asset disposed of was a capital asset held for more than twelve months at the time of disposition.

[M.36] *Section 754 Election.* We will make the election permitted by Section 754 of the Internal Revenue Code. That election is irrevocable without the consent of the IRS. The election will generally permit us to adjust a common unit purchaser's tax basis in our assets ("inside basis")

under Section 743(b) of the Internal Revenue Code to reflect his purchase price. This election does not apply to a person who purchases common units directly from us. The Section 743(b) adjustment belongs to the purchaser and not to other unitholders. For purposes of this discussion, a unitholder's inside basis in our assets will be considered to have two components: (1) his share of our tax basis in our assets ("common basis") and (2) his Section 743(b) adjustment to that basis.

[M.37] Treasury Regulations under Section 743 of the Internal Revenue Code require, if the remedial allocation method is adopted (which we will adopt), a portion of the Section 743(b) adjustment that is attributable to recovery property under Section 168 of the Internal Revenue Code to be depreciated over the remaining cost recovery period for the property's unamortized Book-Tax Disparity. Under Treasury Regulation Section 1.167(c)-1(a)(6), a Section 743(b) adjustment attributable to property subject to depreciation under Section 167 of the Internal Revenue Code, rather than cost recovery deductions under Section 168, is generally required to be depreciated using either the straight-line method or the 150% declining balance method. Under our partnership agreement, our general partner is authorized to take a position to preserve the uniformity of units even if that position is not consistent with these Treasury Regulations. Please read "— Uniformity of Units."

[M.38] Although ABC LLP is unable to opine as to the validity of this approach because there is no clear authority on this issue, we intend to depreciate the portion of a Section 743(b) adjustment attributable to unrealized appreciation in the value of Contributed Property, to the extent of any unamortized Book-Tax Disparity, using a rate of depreciation or amortization derived from the depreciation or amortization method and useful life applied to the unamortized Book-Tax Disparity of the property, or treat that portion as non-amortizable to the extent attributable to property which is not amortizable. This method is consistent with the regulations under Section 743 of the Internal Revenue Code but is arguably inconsistent with Treasury Regulation Section 1.167(c)-1(a)(6), which is not expected to directly apply to a material portion of our assets. To the extent this Section 743(b) adjustment is attributable to appreciation in value in excess of the unamortized Book-Tax Disparity, we will apply the rules described in the Treasury Regulations and legislative history. If we determine that this position cannot reasonably be taken, we may take a depreciation or amortization position under which all purchasers acquiring units in the same month would receive depreciation or amortization, whether attributable to common basis or a Section 743(b) adjustment, based upon the same applicable rate as if they had purchased a direct interest in our assets. This kind of aggregate approach may result in lower annual depreciation or amortization deductions than would otherwise be allowable to some unitholders. Please read "— Uniformity of Units."

[M.39] A Section 754 election is advantageous if the transferee's tax basis in his units is higher than the units' share of the aggregate tax basis of our assets immediately prior to the transfer. In that case, as a result of the election, the transferee would have, among other items, a greater amount of depreciation deductions and his share of any gain or loss on a sale of our assets would be less. Conversely, a Section 754 election is disadvantageous if the transferee's tax basis in his units is lower than those units' share of the aggregate tax basis of our assets immediately prior to the transfer. Thus, the fair market value of the units may be affected either favorably or unfavorably by the election. A basis adjustment is required regardless of whether a Section 754 election is made in the case of a transfer of an interest in us if we have a substantial built-in loss

immediately after the transfer, or if we distribute property and have a substantial basis reduction. Generally a basis reduction or a built-in loss is substantial if it exceeds $250,000.

[M.40] The calculations involved in the Section 754 election are complex and will be made on the basis of assumptions as to the value of our assets and other matters. For example, the allocation of the Section 743(b) adjustment among our assets must be made in accordance with the Internal Revenue Code. The IRS could seek to reallocate some or all of any Section 743(b) adjustment we allocated to our tangible assets to goodwill instead. Goodwill, an intangible asset, is generally either nonamortizable or amortizable over a longer period of time or under a less accelerated method than our tangible assets. We cannot assure you that the determinations we make will not be successfully challenged by the IRS and that the deductions resulting from them will not be reduced or disallowed altogether. Should the IRS require a different basis adjustment to be made, and should, in our opinion, the expense of compliance exceed the benefit of the election, we may seek permission from the IRS to revoke our Section 754 election. If permission is granted, a subsequent purchaser of units may be allocated more income than he would have been allocated had the election not been revoked.

Tax Treatment of Operations

[M.41] *Accounting Method and Taxable Year.* We use the year ending December 31 as our taxable year and the accrual method of accounting for federal income tax purposes. Each unitholder will be required to include in income his share of our income, gain, loss and deduction for our taxable year or years ending within or with his taxable year. In addition, a unitholder who has a taxable year different than our taxable year and who disposes of all of his units following the close of our taxable year but before the close of his taxable year must include his share of our income, gain, loss and deduction in income for his taxable year, with the result that he will be required to include in income for his taxable year his share of more than one year of our income, gain, loss and deduction. Please read "— Disposition of Common Units — Allocations Between Transferors and Transferees."

[M.42] *Initial Tax Basis, Depreciation and Amortization.* We use the tax basis of our assets for purposes of computing depreciation and cost recovery deductions and, ultimately, gain or loss on the disposition of these assets. The federal income tax burden associated with the difference between the fair market value of our assets and their tax basis immediately prior to this offering will be borne by our general partner and its affiliates. Please read "— Tax Consequences of Unit Ownership — Allocation of Income, Gain, Loss and Deduction."

[M.43] To the extent allowable, we may elect to use the depreciation and cost recovery methods that will result in the largest deductions being taken in the early years after assets are placed in-service. Property we subsequently acquire or construct may be depreciated using accelerated methods permitted by the Internal Revenue Code.

[M.44] If we dispose of depreciable property by sale, foreclosure or otherwise, all or a portion of any gain, determined by reference to the amount of depreciation previously deducted and the nature of the property, may be subject to the recapture rules and taxed as ordinary income rather than capital gain. Similarly, a unitholder who has taken cost recovery or depreciation deductions with respect to property we own will likely be required to recapture some or all of those

deductions as ordinary income upon a sale of his interest in us. Please read "— Tax Consequences of Unit Ownership — Allocation of Income, Gain, Loss and Deduction" and "— Disposition of Common Units — Recognition of Gain or Loss."

[M.45] The costs incurred in selling our units (called "syndication expenses") must be capitalized and cannot be deducted currently, ratably or upon our termination. There are uncertainties regarding the classification of costs as organization expenses, which we may be able to amortize, and as syndication expenses, which we may not amortize. The underwriting discounts and commissions we incur will be treated as syndication expenses.

[M.46] *Valuation and Tax Basis of Our Properties.* The federal income tax consequences of the ownership and disposition of units will depend in part on our estimates of the relative fair market values, and the tax bases, of our assets. Although we may from time to time consult with professional appraisers regarding valuation matters, we will make many of the relative fair market value estimates ourselves. These estimates and determinations of basis are subject to challenge and will not be binding on the IRS or the courts. If the estimates of fair market value or basis are later found to be incorrect, the character and amount of items of income, gain, loss or deductions previously reported by unitholders might change, and unitholders might be required to adjust their tax liability for prior years and incur interest and penalties with respect to those adjustments.

Disposition of Common Units

[M.47] *Recognition of Gain or Loss.* Gain or loss will be recognized on a sale of units equal to the difference between the unitholder's amount realized and the unitholder's tax basis for the units sold. A unitholder's amount realized will be measured by the sum of the cash or the fair market value of other property received by him plus his share of our non-recourse liabilities attributable to the common units sold. Because the amount realized includes a unitholder's share of our non-recourse liabilities, the gain recognized on the sale of units could result in a tax liability in excess of any cash received from the sale.

[M.48] Prior distributions from us in excess of cumulative net taxable income for a common unit that decreased a unitholder's tax basis in that common unit will, in effect, become taxable income if the common unit is sold at a price greater than the unitholder's tax basis in that common unit, even if the price received is less than his original cost.

[M.49] Except as noted below, gain or loss recognized by a unitholder, other than a "dealer" in units, on the sale or exchange of a unit held for more than one year will generally be taxable as capital gain or loss. Capital gain recognized by an individual on the sale of units held more than twelve months will generally be taxed at a maximum rate of 15%. However, a portion of this gain or loss will be separately computed and taxed as ordinary income or loss under Section 751 of the Internal Revenue Code to the extent attributable to assets giving rise to depreciation recapture or other "unrealized receivables" or to "inventory items" we own. The term "unrealized receivables" includes potential recapture items, including depreciation recapture. Ordinary income attributable to unrealized receivables, inventory items and depreciation recapture may exceed net taxable gain realized on the sale of a unit and may be recognized even if there is a net taxable loss realized on the sale of a unit. Thus, a unitholder may recognize both

ordinary income and a capital loss upon a sale of units. Net capital losses may offset capital gains and no more than $3,000 of ordinary income, in the case of individuals, and may only be used to offset capital gains in the case of corporations.

[M.50] The IRS has ruled that a partner who acquires interests in a partnership in separate transactions must combine those interests and maintain a single adjusted tax basis for all those interests. Upon a sale or other disposition of less than all of those interests, a portion of that tax basis must be allocated to the interests sold using an "equitable apportionment" method. Treasury Regulations under Section 1223 of the Internal Revenue Code allow a selling unitholder who can identify common units transferred with an ascertainable holding period to elect to use the actual holding period of the common units transferred. Thus, according to the ruling, a common unitholder will be unable to select high or low basis common units to sell as would be the case with corporate stock, but, according to the regulations, may designate specific common units sold for purposes of determining the holding period of units transferred. A unitholder electing to use the actual holding period of common units transferred must consistently use that identification method for all subsequent sales or exchanges of common units. A unitholder considering the purchase of additional units or a sale of common units purchased in separate transactions is urged to consult his tax advisor as to the possible consequences of this ruling and application of the regulations.

[M.51] Specific provisions of the Internal Revenue Code affect the taxation of some financial products and securities, including partnership interests, by treating a taxpayer as having sold an "appreciated" partnership interest, one in which gain would be recognized if it were sold, assigned or terminated at its fair market value, if the taxpayer or related persons enter(s) into:

- a short sale;
- an offsetting notional principal contract; or
- a futures or forward contract with respect to the partnership interest or substantially identical property.

[M.52] Moreover, if a taxpayer has previously entered into a short sale, an offsetting notional principal contract or a futures or forward contract with respect to the partnership interest, the taxpayer will be treated as having sold that position if the taxpayer or a related person then acquires the partnership interest or substantially identical property. The Secretary of the Treasury is also authorized to issue regulations that treat a taxpayer that enters into transactions or positions that have substantially the same effect as the preceding transactions as having constructively sold the financial position.

[M.53] *Allocations Between Transferors and Transferees.* In general, our taxable income or loss will be determined annually, will be prorated on a monthly basis and will be subsequently apportioned among the unitholders in proportion to the number of units owned by each of them as of the opening of the applicable exchange on the first business day of the month, which we refer to in this prospectus as the "Allocation Date." However, gain or loss realized on a sale or other disposition of our assets other than in the ordinary course of business will be allocated among the unitholders on the Allocation Date in the month in which that gain or loss is

recognized. As a result, a unitholder transferring units may be allocated income, gain, loss and deduction realized after the date of transfer.

[M.54] The use of this method may not be permitted under existing Treasury Regulations. Accordingly, ABC LLP is unable to opine on the validity of this method of allocating income and deductions between unitholders. We use this method because it is not administratively feasible to make these allocations on a more frequent basis. If this method is not allowed under the Treasury Regulations, or only applies to transfers of less than all of the unitholder's interest, our taxable income or losses might be reallocated among the unitholders. We are authorized to revise our method of allocation between unitholders, as well as among unitholders whose interests vary during a taxable year, to conform to a method permitted under future Treasury Regulations.

[M.55] A unitholder who owns units at any time during a quarter and who disposes of them prior to the record date set for a cash distribution for that quarter will be allocated items of our income, gain, loss and deductions attributable to that quarter but will not be entitled to receive that cash distribution.

[M.56] *Notification Requirements.* A unitholder who sells any of his units, other than through a broker, generally is required to notify us in writing of that sale within 30 days after the sale (or, if earlier, January 15 of the year following the sale). A purchaser of units who purchases units from another unitholder is required to notify us in writing of that purchase within 30 days after the purchase, unless a broker or nominee will satisfy such requirement. We are required to notify the IRS of any such transfers of units and to furnish specified information to the transferor and transferee. Failure to notify us of a transfer of units may, in some cases, lead to the imposition of penalties.

[M.57] *Constructive Termination.* We will be considered to have been terminated for tax purposes if there is a sale or exchange of 50% or more of the total interests in our capital and profits within a twelve-month period. A constructive termination results in the closing of our taxable year for all unitholders. In the case of a unitholder reporting on a taxable year different from our taxable year, the closing of our taxable year may result in more than 12 months of our taxable income or loss being includable in his taxable income for the year of termination. We would be required to make new tax elections after a termination, including a new election under Section 754 of the Internal Revenue Code, and a termination would result in a deferral of our deductions for depreciation. A termination could also result in penalties if we were unable to determine that the termination had occurred. Moreover, a termination might either accelerate the application of, or subject us to, any tax legislation enacted before the termination.

Uniformity of Units

[M.58] Because we cannot match transferors and transferees of units, we must maintain uniformity of the economic and tax characteristics of the units to a purchaser of these units. In the absence of uniformity, we may be unable to completely comply with a number of federal income tax requirements, both statutory and regulatory. A lack of uniformity can result from a literal application of Treasury Regulation Section 1.167(c)-1(a)(6). Any non uniformity could

have a negative impact on the value of the units. Please read "— Tax Consequences of Unit Ownership — Section 754 Election."

[M.59] We intend to depreciate the portion of a Section 743(b) adjustment attributable to unrealized appreciation in the value of Contributed Property, to the extent of any unamortized Book-Tax Disparity, using a rate of depreciation or amortization derived from the depreciation or amortization method and useful life applied to the unamortized Book-Tax Disparity of that property, or treat that portion as nonamortizable, to the extent attributable to property which is not amortizable, consistent with the regulations under Section 743 of the Internal Revenue Code, even though that position may be inconsistent with Treasury Regulation Section 1.167(c)-1(a)(6), which is not expected to directly apply to a material portion of our assets. Please read "— Tax Consequences of Unit Ownership — Section 754 Election." To the extent that the Section 743(b) adjustment is attributable to appreciation in value in excess of the unamortized Book-Tax Disparity, we will apply the rules described in the Treasury Regulations and legislative history. If we determine that this position cannot reasonably be taken, we may adopt a depreciation and amortization position under which all purchasers acquiring units in the same month would receive depreciation and amortization deductions, whether attributable to a common basis or Section 743(b) adjustment, based upon the same applicable rate as if they had purchased a direct interest in our property. If this position is adopted, it may result in lower annual depreciation and amortization deductions than would otherwise be allowable to some unitholders and risk the loss of depreciation and amortization deductions not taken in the year that these deductions are otherwise allowable. This position will not be adopted if we determine that the loss of depreciation and amortization deductions will have a material adverse effect on the unitholders. If we choose not to utilize this aggregate method, we may use any other reasonable depreciation and amortization method to preserve the uniformity of the intrinsic tax characteristics of any units that would not have a material adverse effect on the unitholders. Our counsel, ABC LLP, is unable to opine on the validity of any of these positions. The IRS may challenge any method of depreciating the Section 743(b) adjustment described in this paragraph. If this challenge were sustained, the uniformity of units might be affected, and the gain from the sale of units might be increased without the benefit of additional deductions. We do not believe these allocations will affect any material items of income, gain, loss or deduction. Please read "— Disposition of Common Units — Recognition of Gain or Loss."

Tax-Exempt Organizations and Other Investors

[M.60] Ownership of units by employee benefit plans, other tax-exempt organizations, non-resident aliens, foreign corporations and other foreign persons raises issues unique to those investors and, as described below, may have substantially adverse tax consequences to them. Employee benefit plans and most other organizations exempt from federal income tax, including individual retirement accounts and other retirement plans, are subject to federal income tax on unrelated business taxable income. Virtually all of our income allocated to a unitholder that is a tax-exempt organization will be unrelated business taxable income and will be taxable to them.

[M.61] A regulated investment company or "mutual fund" is required to derive 90% or more of its gross income from certain permitted sources. The American Jobs Creation Act of 2004 generally treats net income from the ownership of publicly traded partnerships as derived from

[M.62] Non-resident aliens and foreign corporations, trusts or estates that own units will be considered to be engaged in business in the United States because of the ownership of units. As a consequence, they will be required to file federal tax returns to report their share of our income, gain, loss or deduction and pay federal income tax at regular rates on their share of our net income or gain. Moreover, under rules applicable to publicly traded partnerships, we will withhold tax at the highest applicable effective tax rate from cash distributions made quarterly to foreign unitholders. Each foreign unitholder must obtain a taxpayer identification number from the IRS and submit that number to our transfer agent on a Form W-8BEN or applicable substitute form in order to obtain credit for these withholding taxes. A change in applicable law may require us to change these procedures.

[M.63] In addition, because a foreign corporation that owns units will be treated as engaged in a United States trade or business, that corporation may be subject to the United States branch profits tax at a rate of 30%, in addition to regular federal income tax, on its share of our income and gain, as adjusted for changes in the foreign corporation's "U.S. net equity," that is effectively connected with the conduct of a United States trade or business. That tax may be reduced or eliminated by an income tax treaty between the United States and the country in which the foreign corporate unitholder is a "qualified resident." In addition, this type of unitholder is subject to special information reporting requirements under Section 6038C of the Internal Revenue Code.

[M.64] Under a ruling of the IRS, a foreign unitholder who sells or otherwise disposes of a unit will be subject to federal income tax on gain realized on the sale or disposition of that unit to the extent that this gain is effectively connected with a United States trade or business of the foreign unitholder. Because a foreign unitholder is considered to be engaged in a trade or business in the United States by virtue of the ownership of the common units, under this ruling, a foreign unitholder who sells or otherwise disposes of a unit generally will be subject to federal income tax on gain realized on the sale or other disposition of the common units. Apart from the ruling, a foreign unitholder will not be taxed or subject to withholding upon the sale or disposition of a unit if he has owned less than 5% in value of the units during the five-year period ending on the date of the disposition and if the units are regularly traded on an established securities market at the time of the sale or disposition.

Administrative Matters

[M.65] *Information Returns and Audit Procedures.* We intend to furnish to each unitholder, within 90 days after the close of each taxable year, specific tax information, including a Schedule K-1, which describes each unitholder's share of our income, gain, loss and deduction for our preceding taxable year. In preparing this information, which will not be reviewed by counsel, we will take various accounting and reporting positions, some of which have been mentioned earlier, to determine each unitholder's share of income, gain, loss and deduction. We cannot assure you that those positions will yield a result that conforms to the requirements of the Internal Revenue Code, Treasury Regulations or administrative interpretations of the IRS. Neither we nor ABC LLP can assure prospective unitholders that the IRS will not successfully contend in court that

those positions are impermissible. Any challenge by the IRS could negatively affect the value of the units.

[M.66] The IRS may audit our federal income tax information returns. Adjustments resulting from an IRS audit may require each unitholder to adjust a prior year's tax liability, and possibly may result in an audit of his return. Any audit of a unitholder's return could result in adjustments not related to our returns as well as those related to our returns.

[M.67] Partnerships generally are treated as separate entities for purposes of federal tax audits, judicial review of administrative adjustments by the IRS and tax settlement proceedings. The tax treatment of partnership items of income, gain, loss and deduction are determined in a partnership proceeding rather than in separate proceedings with the partners. The Internal Revenue Code requires that one partner be designated as the "Tax Matters Partner" for these purposes. The partnership agreement names our general partner as our Tax Matters Partner.

[M.68] The Tax Matters Partner will make some elections on our behalf and on behalf of unitholders. In addition, the Tax Matters Partner can extend the statute of limitations for assessment of tax deficiencies against unitholders for items in our returns. The Tax Matters Partner may bind a unitholder with less than a 1% profits interest in us to a settlement with the IRS unless that unitholder elects, by filing a statement with the IRS, not to give that authority to the Tax Matters Partner. The Tax Matters Partner may seek judicial review, by which all the unitholders are bound, of a final partnership administrative adjustment and, if the Tax Matters Partner fails to seek judicial review, judicial review may be sought by any unitholder having at least a 1% interest in profits or by any group of unitholders having in the aggregate at least a 5% interest in profits. However, only one action for judicial review will go forward, and each unitholder with an interest in the outcome may participate in that action.

[M.69] A unitholder must file a statement with the IRS identifying the treatment of any item on his federal income tax return that is not consistent with the treatment of the item on our return. Intentional or negligent disregard of this consistency requirement may subject a unitholder to substantial penalties.

[M.70] *Nominee Reporting.* Persons who hold an interest in us as a nominee for another person are required to furnish to us:

(a) the name, address and taxpayer identification number of the beneficial owner and the nominee;

(b) a statement regarding whether the beneficial owner is:

1. a person that is not a United States person;

2. a foreign government, an international organization or any wholly owned agency or instrumentality of either of the foregoing; or

3. a tax-exempt entity;

(c) the amount and description of units held, acquired or transferred for the beneficial owner; and

(d) specific information including the dates of acquisitions and transfers, means of acquisitions and transfers, and acquisition cost for purchases, as well as the amount of net proceeds from sales.

[M.71] Brokers and financial institutions are required to furnish additional information, including whether they are United States persons and specific information on units they acquire, hold or transfer for their own account. A penalty of $50 per failure, up to a maximum of $100,000 per calendar year, is imposed by the Internal Revenue Code for failure to report that information to us. The nominee is required to supply the beneficial owner of the units with the information furnished to us.

Accuracy-Related Penalties

[M.72] An additional tax equal to 20% of the amount of any portion of an underpayment of tax that is attributable to one or more specified causes, including negligence or disregard of rules or regulations, substantial understatements of income tax and substantial valuation misstatements, is imposed by the Internal Revenue Code. No penalty will be imposed, however, for any portion of an underpayment if it is shown that there was a reasonable cause for that portion and that the taxpayer acted in good faith regarding that portion.

[M.73] For individuals, a substantial understatement of income tax in any taxable year exists if the amount of the understatement exceeds the greater of 10% of the tax required to be shown on the return for the taxable year or $5,000. The amount of any understatement subject to penalty generally is reduced if any portion is attributable to a position adopted on the return:

(1) for which there is, or was, "substantial authority;" or

(2) as to which there is a reasonable basis if the pertinent facts of that position are adequately disclosed on the return.

[M.74] If any item of income, gain, loss or deduction included in the distributive shares of unitholders might result in that kind of an "understatement" of income for which no "substantial authority" exists, we must disclose the pertinent facts on our return. In addition, we will make a reasonable effort to furnish sufficient information for unitholders to make adequate disclosure on their returns to avoid liability for this penalty. More stringent rules apply to "tax shelters," but we believe we are not a tax shelter.

[M.75] A substantial valuation misstatement exists if the value of any property, or the adjusted basis of any property, claimed on a tax return is 150% or more of the amount determined to be the correct amount of the valuation or adjusted basis. For individuals, no penalty is imposed unless the portion of the underpayment attributable to a substantial valuation misstatement exceeds $5,000. If the valuation claimed on a return is 200% or more than the correct valuation, the penalty imposed increases to 40%.

[M.76] *Reportable Transactions.* If we were to engage in a "reportable transaction," we (and possibly you and others) would be required to make a detailed disclosure of the transaction to the IRS. A transaction may be a reportable transaction based upon any of several factors, including the fact that it is a type of tax avoidance transaction publicly identified by the IRS as a "listed transaction" or a "transaction of interest" or that it produces certain kinds of losses in excess of $2 million in any single year, or $4 million in any combination of six successive tax years. Our participation in a reportable transaction could increase the likelihood that our federal income tax information return (and possibly your tax return) would be audited by the IRS. Please read "—Information Returns and Audit Procedures" above.

[M.77] Moreover, if we were to participate in a reportable transaction with a significant purpose to avoid or evade tax, or in any listed transaction, you may be subject to the following provisions of the American Jobs Creation Act of 2004:

- accuracy-related penalties with a broader scope, significantly narrower exceptions, and potentially greater amounts than described above at "—Accuracy-Related Penalties,"

- for those persons otherwise entitled to deduct interest on federal tax deficiencies, nondeductibility of interest on any resulting tax liability, and

- in the case of a listed transaction, an extended statute of limitations.

We do not expect to engage in any "reportable transactions."

State, Local and Other Tax Considerations

[M.78] In addition to federal income taxes, you likely will be subject to other taxes, such as state and local income taxes, unincorporated business taxes, and estate, inheritance or intangible taxes that may be imposed by the various jurisdictions in which we do business or own property or in which you are a resident. Although an analysis of those various taxes is not presented here, each prospective unitholder should consider their potential impact on his investment in us. We will initially own property or do business in Alabama, Colorado, Florida, Georgia, Kansas, Kentucky, Louisiana, Mississippi, Montana, New Mexico, Oklahoma, South Carolina, Tennessee, Texas, Utah and Wyoming. Each of these states, other than Florida, Texas and Wyoming, currently imposes a personal income tax on individuals. Most of these states also impose an income tax on corporations and other entities. We may also own property or do business in other jurisdictions in the future. Although you may not be required to file a return and pay taxes in some jurisdictions if your income from that jurisdiction falls below the filing and payment requirement, you will be required to file income tax returns and to pay income taxes in many of these jurisdictions in which we do business or own property and may be subject to penalties for failure to comply with those requirements. In some jurisdictions, tax losses may not produce a tax benefit in the year incurred and may not be available to offset income in subsequent taxable years. Some of the jurisdictions may require us, or we may elect, to withhold a percentage of income from amounts to be distributed to a unitholder who is not a resident of the jurisdiction. Withholding, the amount of which may be greater or less than a particular unitholder's income tax liability to the jurisdiction, generally does not relieve a nonresident unitholder from the obligation to file an

income tax return. Amounts withheld will be treated as if distributed to unitholders for purposes of determining the amounts distributed by us. Please read "— Tax Consequences of Unit Ownership — Entity-Level Collections." Based on current law and our estimate of our future operations, our general partner anticipates that any amounts required to be withheld will not be material.

[M.79] It is the responsibility of each unitholder to investigate the legal and tax consequences, under the laws of pertinent jurisdictions, of his investment in us. Accordingly, each prospective unitholder is urged to consult, and depend on, his own tax counsel or other advisor with regard to those matters. Further, it is the responsibility of each unitholder to file all state and local, as well as United States federal tax returns, that may be required of him. ABC LLP has not rendered an opinion on the state, local or foreign tax consequences of an investment in us.

**INVESTMENT IN EL PASO PIPELINE PARTNERS, L.P.
BY EMPLOYEE BENEFIT PLANS**

[M.80] An investment in us by an employee benefit plan is subject to additional considerations because the investments of these plans are subject to the fiduciary responsibility and prohibited transaction provisions of ERISA, and restrictions imposed by Section 4975 of the Internal Revenue Code. For these purposes, the term "employee benefit plan" includes, but is not limited to, qualified pension, profit-sharing and stock bonus plans, Keogh plans, simplified employee pension plans and tax deferred annuities or IRAs established or maintained by an employer or employee organization. Among other things, consideration should be given to:

- whether the investment is prudent under Section 404(a)(1)(B) of ERISA;
- whether in making the investment, that plan will satisfy the diversification requirements of Section 404(a)(l)(C) of ERISA; and
- whether the investment will result in recognition of unrelated business taxable income by the plan and, if so, the potential after-tax investment return.

[M.81] The person with investment discretion with respect to the assets of an employee benefit plan, often called a fiduciary, should determine whether an investment in us is authorized by the appropriate governing instrument and is a proper investment for the plan.

[M.82] Section 406 of ERISA and Section 4975 of the Internal Revenue Code prohibits employee benefit plans, and IRAs that are not considered part of an employee benefit plan, from engaging in specified transactions involving "plan assets" with parties that are "parties in interest" under ERISA or "disqualified persons" under the Internal Revenue Code with respect to the plan.

[M.83] In addition to considering whether the purchase of common units is a prohibited transaction, a fiduciary of an employee benefit plan should consider whether the plan will, by investing in us, be deemed to own an undivided interest in our assets, with the result that our general partner also would be fiduciaries of the plan and our operations would be subject to the

regulatory restrictions of ERISA, including its prohibited transaction rules, as well as the prohibited transaction rules of the Internal Revenue Code.

[M.84] The Department of Labor regulations provide guidance with respect to whether the assets of an entity in which employee benefit plans acquire equity interests would be deemed "plan assets" under some circumstances. Under these regulations, an entity's assets would not be considered to be "plan assets" if, among other things:

- the equity interests acquired by employee benefit plans are publicly offered securities; i.e., the equity interests are widely held by 100 or more investors independent of the issuer and each other, freely transferable and registered under some provisions of the federal securities laws;

- the entity is an "operating company," — i.e., it is primarily engaged in the production or sale of a product or service other than the investment of capital either directly or through a majority owned subsidiary or subsidiaries; or

- there is no significant investment by benefit plan investors, which is defined to mean that less than 25% of the value of each class of equity interest, disregarding some interests held by our general partner, its affiliates, and some other persons, is held by the employee benefit plans referred to above, IRAs and other employee benefit plans not subject to ERISA, including governmental plans.

[M.85] Our assets should not be considered "plan assets" under these regulations because it is expected that the investment will satisfy the requirements in the first bullet point above.

[M.86] Plan fiduciaries contemplating a purchase of common units should consult with their own counsel regarding the consequences under ERISA and the Internal Revenue Code in light of the serious penalties imposed on persons who engage in prohibited transactions or other violations.

Legislative History of Code Section 7701(e)

Deficit Reduction Act of 1984, P.L. 98-369, House Report No. 98-432, Part II, pages 1152-5:

DEFICIT REDUCTION ACT OF 1984

[page 1152]

6. Property Used Under Certain Service Contracts

The committee bill provides for the treatment of property used under a purported service contract arrangement with a tax-exempt entity as used by the tax-exempt entity if the arrangement is more properly characterized as a lease. That provision of the bill applies to contracts under which property is used to provide services to or for the benefit of a tax-exempt entity. The bill creates no inferences regarding the treatment of service contracts under present law. Nor does the bill affect the present-law rules for determining the treatment of management contracts under which a tax-exempt entity performs services with respect to property owned by a taxpayer.

The service contract provisions apply for purposes of the depreciation provisions of the bill and for purposes of the nontaxable use restriction on the investment credit (as modified by the bill). This provision applies to service contracts involving personal property or real property, whether the so-called service provider is the tax owner; or the lessee of the property.

Factors to be considered

In determining whether a transaction structured as a service contract is more properly treated as a lease, the committee bill requires, that all relevant factors be taken into account, including, but not limited to, whether (1) the tax-exempt entity is in physical possession of the property, (2) the tax-exempt entity controls the property; (3) the tax-exempt entity has a significant possessory or economic interest in the property, (4) the service provider bears any risk of substantially diminished receipts or substantially increased expenditures if there is nonperformance under the contract, (5) the service provider uses the property concurrently to provide services to other entities unrelated to the tax-exempt entity, and (6) the total contract price substantially exceeds the rental value of the property for the contract period.

Physical possession

Physical possession of property is indicative of a lease. Under the bill, property that is located on the premises of a tax-exempt entity, or located off the premises but operated by employees of a tax-exempt entity, is viewed as in the physical possession of the entity. However, property is not in the physical possession of a tax-exempt entity merely because the property is located on land leased to the service provider by the tax-exempt entity.

Control of the property

The fact that the tax-exempt entity controls the property is indicative of a lease. Under the bill, a tax-exempt entity is viewed as controlling the property to the extent the entity dictates

or has a contractual right to dictate the manner in which the property is operated, maintained, or improved. Control is not established merely by reason of contractual provisions designed to enable the tax-exempt entity to monitor or ensure the service provider's compliance with performance, safety, pollution control, or other general standards. ***[page 1153]***

Possessory or economic interest

A contract that conveys a significant possessory or economic interest to a tax-exempt entity resembles a lease. Under the bill; the existence of a possessory or economic interest in property is established by facts that show (1) the property's use is likely to be dedicated to the tax-exempt entity for a substantial portion of the useful life of the property, (2) the tax-exempt entity shares the risk that the property will decline in value, (3) the tax-exempt entity shares any appreciation in the value of the property, (4) the tax-exempt entity shares in savings in the property's operating costs, or (5) the tax-exempt entity bears the risk of damage to or loss of the property.

Substantial risk of nonperformance

Under a service contract arrangement, the service provider bears the risk of substantially diminished receipts or substantially increased expenditures if there is nonperformance under the contract by the service provider or any property involved. Under the bill, facts that establish that the service provider does not bear any significant risk of nonperformance are indicative of a lease.

Concurrent use of property

The concurrent use of the property to provide significant services to entities unrelated to the tax-exempt entity is indicative of a service contract.

Rental value of property relative to total contract price

The fact that the total contract price (including expenses to be reimbursed by the tax-exempt entity) substantially exceeds the rental value of the property for the contract period is indicative of a service contract. If the total contract price reflects substantial costs that are attributable to items other than the use of' the property subject to the contract, then the contract more closely resembles a service contract. Conversely, the fact that the total contract price is based principally on recovery of the cost of the property is indicative of a lease. A contract that states charges for services separately from charges for use of' property is indicative of a lease.

Other rules

A contract will be treated as a lease rather than a service contract if the contract more nearly resembles a lease. Although each of the factors in the bill must be considered, a particular factor or factors may be insignificant in the context of any given case. Similarly, because the test for determining whether a service contract should be treated as a lease is inherently factual, the presence or absence of' any single factor. may not be dispositive in every case. For example, even if a tax-exempt entity does not have physical possession of property, the arrangement could still be treated as a. lease after taking all other relevant factors into account. ***[page 1154]***

Examples

The following examples illustrate the application of the service contract provisions of the committee bill. In each of these examples; T is a taxpayer and E is a tax-exempt entity.

Example (1)

E, an agency of the Federal government, desires to obtain the use of a built-to-purpose vessel. A contractor arranges for the construction of the vessel and for the sale of the vessel to T. The contractor then leases the vessel from T, the shipowner, under a long-term bareboat charter. E and the contractor enter into a time charter with respect to the vessel. The time charter provides for the transportation of equipment, cargo, and personnel. Under the time charter, E has the right to designate the port of call and the cargo to be carried. The master, officers, and crew of the vessel are hired by the contractor, subject to E's approval. All officers of the vessel must qualify for a government' "confidential" security clearance. In addition, the master, chief officer, and radio officer must qualify for a government "secret" security clearance. E reserves the right to station 28 permanent government personnel aboard the vessel and to assign up to 100 additional military personnel to the vessel. However, the master of the vessel is under the direction of the contractor as regards navigation and care of the cargo. E also has the right to cause alterations to be made to the vessel: E must make separate payments for "Capital Hire" (computed by reference to the amount required to repay, with interest or a guaranteed return, the debt financing and equity investment of' T) and "Operating Hire" (which covers the cost of operating the vessel and the contractor's profit): Payments of Operating Hire are suspended or reduced when the vessel is not fully available for service. However, E Must continue to pay Capital Hire during such period.

The time charter has an initial term of 5 years. E has the option to extend on similar terms the basic term for one to four successive renewal periods, for a total of 25 years. The useful life of the vessel is in excess of 30 years. E can terminate the time charter for convenience at any time during the renewal periods. Upon a termination for convenience or if E fails to exercise a renewal option; E is required to pay any difference between the proceeds of the sale of the vessel and the "Termination Value" set forth in the time charter. The "Termination Value" is an amount approximating T's unrecovered equity, remaining debt service; and tax liability generated by the vessel's sale: E has the option to purchase the vessel at any tine after the end of the basic 5-year term for the greater of fair market value or Termination Value at the time of purchase. If E purchases the vessel, E can require that the contractor continue to operate the vessel under the same terms as set forth in the time charter. If the vessel is damaged; destroyed, or otherwise lost due to causes beyond the contractor's control, E must pay any difference between Termination Value and any insurance proceeds. Thus, E also bears the risk of damage to or loss of the vessel.

E may be considered the owner of the vessel under the general principles for determining ownership for Federal income tax purposes. If however, T were considered the Owner, under the bill E ***[page 1155]*** would be treated as having a leasehold interest in the property (and .the vessel would be tax-exempt use property. In the latter case; the following facts would serve as the basis for the conclusion that E is treated as having a leasehold interest: (a) E has some control over the vessel in that E can direct that alterations be made, (b) E has a significant possessory

interest because the time charter contemplates that the vessel's use will be dedicated to E for a substantial portion of its useful life, the requirement that Termination Value be paid shifts the risk that the vessel will decline in value to E, and E bears the risk of damage to or loss of the vessel; (c) T does not bear a substantial risk of nonperformance within the meaning of the bill, because payments of Capital Hire continue even if the vessel is unavailable for service, (d) regarding the rental value of the property relative to the total contract price, the test for a service contract is not satisfied since the Capital Hire represents pay merits for the cost of the vessel and the Operating Hire represents separate payments for services, and (e) all other relevant facts and circumstances, including the facts that the vessel was built-to-purpose and the terms of E's purchase option. The facts that the contractor (and not E) has physical possession of the vessel and that there is no concurrent use of the vessel to provide services to other persons are insignificant in the context of this case.

Example (2)

The facts are the same as in example (1) except that (a) E has no right to make alterations to the vessel, (b) E's obligation to pay charter hire is set at a rate per deadweight ton and is subject to the condition that the vessel be in full working order, (c) the time charter has an initial term of 5 years, with an option to renew for one to five one-year periods, for a total of 10 years, (d) T bears the risk of damage to or loss of the vessel, and (e) E has no option to purchase the vessel. In addition, E is not required to pay Termination Value (or any other penalty) if it fails to exercise a renewal option.

On these facts, the time charter will be respected as a service contract under the bill (and the vessel will not be tax-exempt use property). The following facts provide the basis for that conclusion: (a) E has no control: over the vessel, (b) E has no possessory or economic interest in the vessel, (c) the contractor bears a substantial risk of nonperformance; since the contractor will receive no revenues if the vessel is unavailable for service, and (d) the facts do not indicate that any portion of the charter hire is based on the cost: of the vessel.

Example (3)

E, a municipal housing authority, owns Section-8-assisted low income housing projects. E sells the property to T, a partnership of taxable persons. In order to ensure that the purposes of the Section-8 housing program are fulfilled, T retains E to manage the property under a long-term management contract. Under the management contract, E performs many of the managerial and administrative functions that it performed before the sale. However, T exercises a degree of control over E's activities, by virtue of provisions in the management contract that require E to keep ade- ***[page 1156]*** quate records of its operations, to use its best efforts to least the housing units, and to pay net earnings to T within a reasonable time period. For these services, E is compensated by a fee determined on an arm's-length basis. T bears the risk that the property will decline in value and that the property will be damaged or lost. E does not have an option to repurchase the property.

The mere fact that E continues to control the maintenance and operation of the property under a management contract does not provide a basis for treating the contract as a lease under the service contract provision of the bill. However, the bill leaves open the possibility that an

arrangement structured as a management contract could be treated as a lease (under which the tax-exempt entity provides services to third parties for its own benefit) under present law rules. *See McNabb* v. *Commissioner*, 81-1 USTC 9143 (W.D. Wash. 1980) (where an arrangement structured as a management contract was characterized as a lease because the taxpayer did not adequately control the venture and did not bear the risk of loss); *Meagher* v. *Commissioner*, 36 T.C.M. 1091 (1977) (where the court held that an agreement was a management contract and not a lease, applying the same tests discussed in the *McNabb* case).

Example (4)

E, a municipal agency, acquires an industrial park and then leases the facility to T, a taxable person, for a term in excess of 15 years. T substantially rehabilitates the building, and then subleases the improved property to other taxable persons. T retains E to manage the property under a management contract.

T owns the improved portion of the building. The mere fact that E performs services with respect to the entire property under a management contract does not provide a basis for treating the improvements as tax-exempt use property under the service contract provision of the bill. Rather, the status of the management contract, as it relates to the leasehold improvements, is determined under present-law rules.

Example (5)

E, a municipality, and T, a private company, enter into a long-term agreement under which E will be the primary but not the only customer of a local district heating system (the System) that will be constructed, owned, operated, and maintained by T. A local district heating system consists of a pipeline or network which includes or is connected to a central heating source (such as a cogeneration facility or a solid waste resource recovery facility) that furnishes energy for heating through hot water or steam to two or more users for residential, commercial, or industrial heating or processing of steam. The System requires periodic maintenance and repair. The agreement between E and T provides for the distribution of BTUs to building owned by E. 40 to 75 percent of T's investment in the System will be allocable to the cost of pipeline, and the balance will be allocable to the cost of building or retrofitting a heating source. Approximately 97 percent of the pipeline included in the System is located off of E's premises. The only part of the System located on E's premises are pipes (for delivering the energy), meters (to measure E's usage), and heat exchangers. The ***[page 1157]*** in-building investment (attributable to pipes, meters, and heat-exchangers) may, in the case of some of the buildings owned by E, be made by E. In many cases, the only in-building investment made by T will be the cost of a meter. E will make monthly payments to T, determined by the amount of energy E consumes. T will also use much of the System to distribute BTUs to buildings owned by taxable persons in T's service area, under similar contracts.

On these facts, the agreement between E and T will not be treated as a lease. The following facts provide the basis for that conclusion: (a) E has physical possession of, at most, only a nominal part of the System, (b) E does not control the System, (c) T bears a substantial risk of nonperformance in that T will derive revenue from E based solely on the amount of energy E consumes, (d) T concurrently uses the System to provide energy to others, and (e) the

System requires significant servicing by T. The fact that E has an economic or possessory interest in the property is, under the circumstances, outweighed by the other factors.

Example (6)

T, a private company, and E, a Federal governmental agency, enter into a contract under which T will construct and operate a solar energy system (the System). The System will be owned by a group of private investors. The System will be constructed on the roof of a building owned by E. All of the hot water and steam produced by the System will be sold to E under a long-term contract. E must pay a significant penalty if it defaults n the contract. However, T will receive no revenues under the contract unless the System produces energy. T is solely responsible for the operation and maintenance of the Facility. However, because the Facility is substantially maintenance free, the total contract price exceeds the rental value of the Facility by only 5 to 10 percent.

On these facts, the agreement between E and T is treated as a lease (and the System is tax-exempt use property) under the bill. That conclusion is based on the following facts: (a) E has physical possession of the System, (b) E has a possessory or economic interest in the System as the use of the property will be dedicated to E for the property's entire economic life; (c) there is no concurrent use of the property, and (d) the total contract price exceeds the rental value of the property by an insignificant amount. The facts that T controls the property and bears a risk of substantially diminished receipts do not provide a basis for a contrary conclusion because they have little meaning under the circumstances.

Annex G

EXCERPTS FROM FERC ORDERS ON IMPLEMENTATION OF INCOME TAX ALLOWANCE POLICY; EXCERPT ADDRESSING MLPs AND COMPOSITION OF THE PROXY GROUP

Part	Excerpts From	Pages
I	December 8, 2006 Order, 117 FERC ¶ 61,285 (income tax allowance policy), ¶s 49 to 66.	G-1/G-8
II	December 26, 2007 Order, 121 FERC ¶ 61,240 (income tax allowance policy), ¶s 20 to 61.	G-10/G-26
III	December 26, 2007 Order, 121 FERC ¶ 61,240 (MLPs and composition of proxy group), ¶s 89 to 93.	G-27/G-29

I. **Excerpt From SFPP, L.P., 117 FERC ¶ 61,285 (December 8, 2006)[1]: Implementation of FERC's Income Tax Allowance Policy**

49. This section of the order addresses the eligibility of SFPP for an income tax allowance in this proceeding. As explained in the Policy Statement, whether a regulated pass-through entity is eligible for a tax allowance is determined in each proceeding. In each proceeding the Commission requires the regulated entity to establish that its partners have an actual or potential income tax liability on the income generated by the regulated entity. On December 15, 2005, the Commission issued an order establishing certain specific procedures to be followed in the proceedings involving certain of SFPP's East and West Line rates.[2] Since this proceeding involves a related docket and the time frames are similar, the Commission requires SFPP to follow the procedures adopted in the December 2005 order subject to certain clarifications discussed below.

50. The Commission recognizes that the Shipper parties have appealed the Commission's determination that a pass-through entity such as a limited partnership may be afforded an income tax allowance if it conforms to the standards contained in the Policy Statement and in the Commission's more detailed implementing orders.[3] The core of those arguments is that affording a pass-through entity such as a partnership any income tax allowance is inconsistent with the court's remand in BP West Coast. In the Policy Statement and in its June 2005 order the Commission explained in detail why it believes that its conclusion to the contrary is appropriate and is consistent with the Court's remand. There is no need to reprise all of those

[1] ***Footnotes in original are 77 through 106 which correspond to footnotes 2 through 30 in this Part of Annex G.***

[2] December 2005 order at ¶¶ 47-48, 133.

[3] *See ExxonMobil Oil Corporation, et al. v. Federal Energy Regulatory Commission*, U.S.C.A. D.C. No. 04-1102 *et al.*, Initial Brief Filed May 30, 2006.

arguments here and the rationale of those prior orders is incorporated herein. The fact that the Commission's prior rulings on the threshold legal issue are again before the court does not preclude an examination here of whether SFPP has met the required standard. However, whether it has cannot be determined with finality until SFPP makes a compliance filing consistent with the terms of this order and the parties have an opportunity to comment on the specifics of the filing.

51. However, given the pending appeal of the Commission's March 2004 and June 2005 orders, any revised rates approved in this proceeding will be subject to the outcome of the pending appeal of the June 2005 order. Thus, if the Commission's position that pass-through entities may be afforded an income tax allowance is reversed, the rates required here will be revised as of their effective date to reflect that fact. In addition, the Commission will clarify five matters that have been raised in comments on SFPP's March 7, 2006 compliance filing in the related SFPP proceedings. These are: (1) the use of the marginal rather than the effective tax rate; (2) the application of the stand-alone doctrine; (3) the use of presumptions to establish the marginal tax rate; (4) the allocation of income and expenses other than in proportion to ownership; and (5) subsequent filings. This will provide more specific guidance for the compliance filing required by this order and clarify a number of points in the Commission's prior orders addressing the specifics for determining whether any income tax allowance is available in a specific case.

1. **The use of the marginal tax rate**

52. Comments submitted in response to SFPP's March 7, 2006 compliance filing argue that the *Policy Statement* contemplates that the effective, not the marginal, tax rate should be used in determining any income tax allowance.[4] This interpretation is incorrect. While some language in the *Policy Statement* might be construed in this manner, the bulk of the discussion in the *Policy Statement* is to the contrary, as is past Commission practice and court precedent. An interpretation that the effective rather than the marginal tax rate should control is also inconsistent with standard tax nomenclature and with basic financial and tax theory.

53. As was stated over 20 years ago in City of Charlottesville, the income tax allowance designed to compensate the regulated entity for its "tax cost" is "[the] statutory tax rate (which, in the case of regulated utilities, will almost always be the maximum rate)…."[5] This discussion makes it quite clear that the regulated entity's "tax cost" is determined by applying the statutory or marginal rate to the allowed return. Nothing in the Policy Statement compels the contrary and the weight of the Policy Statement text favors the use of the marginal tax rate. For example, at paragraph 37 the Commission refers to the "lower weighted marginal tax rate" of the regulated entity and at paragraph 40 that "all this would do [is] incorporate a presumed marginal income

[4] *See* Protest and Comments of Chevron Products Company, ConnocoPhillips Company, Tosco Corporation, Ultramar Inc., and Valero Marketing and Supply Company (the CVV Group) dated April 21, 2006 in Docket No.OOR92-8-024, *et al.*, at 13, and Testimony of O'Loughlin at 17-18.

[5] *City of Charlottesville* at 1207.

tax rate into the rate structure."[6] In paragraph 41 the Commission does refer to the "income tax status" of the "owning interest" and states that its approach will assure that the rate payers do not pay more than the "actual tax cost" of that interest.[7] However, as the citation from City of Charlottesville makes clear, for over 20 years the concept of "tax cost" has been defined by the statutory (i.e. the marginal rate). Thus, the "income tax status" of the entity is defined by the marginal rate because it is the marginal rate that determines entity's tax liability, or burden, under a graduated income tax. The Policy Statement embodies these income tax nomenclatures and principles. Moreover, in its later orders the Commission made clear that the marginal tax rate was to be used.[8] Arguments to the contrary in comments on SFPP's March 7 compliance filing ignore this consistent interpretation of the Policy Statement.

54. Moreover, given other comments filed in response to SFPP's March 7 compliance filing in the related proceedings, the marginal tax concept warrants some further exploration.[9] The assertion is that it is impossible to determine when a particular dollar of marginal income is received and that only the income received from the MLP should be used in determining the marginal bracket. This is incorrect. Income tax liability increases with taxable income under the graduated income tax structure through a series of brackets that range in the case of individuals from 15 to 35 percent. Income accrues over time during the taxable year and the taxpayer may not know what the actual marginal tax bracket will be until the close of the year. In the case of an individual, the taxpayer first calculates adjusted gross income (which includes all items of income and offsetting items of business and investment costs or loss) and then determines taxable income after, exemptions, deductions and credits that are subtracted for adjusted gross income on page 2 of the Form 1040. The point is that every dollar of income received during the year contributes to adjusted gross income and taxable income and each such dollar is therefore taxed at the marginal rate. As such, the timing of its receipt is irrelevant and it cannot be segregated from all other income received by the taxpayer in a given tax year. For this reason, an informed taxpayer will often project total income to be derived from all sources and the tax. In practice, all taxpayers are required to do so through withholding, or to make estimated quarterly income tax payments if the projected taxable liability is not withheld at the source.

55. As such, every dollar included in adjusted gross income serves to increase taxable income and the possibility of a higher bracket. Dollars of income that are excluded by law, or sheltered through various devices, reduce the possibility of a higher marginal rate. Whether dollars received during the year are included, or are included and offset, in determining adjusted gross income, all have an increment impact and the marginal tax rate applies to each one. Thus, when the Policy Statement says the regulated entity must establish that its partners have an actual or potential income tax on "that" regulated income, it follows that the marginal tax rate for "that" dollar is also the marginal tax rate on all of the partner's income since "that" dollar of income

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[6] *Policy Statement* at ¶¶ 37, 40.

[7] *Id.* at ¶. 41.

[8] December 2005 order at PP 29-32. *See also Trans-Elect NTD Path 15, LLC,* 111 FERC 61,140 (2005), *order on reh'g,* 112 FERC ¶ 61,202; *Trans-Elect NTD Path 15* (113 FERC 61,162 (2005) at ¶¶ 6, 9, *order on reh'g,* 115 FERC 61,047 (2006) at ¶ 4.

[9] April 21, 2006 comments of the CCV Group at 14 and O'Loughlin at 7-8, 17-18 filed in Docket Nos. OR 92-8-000 *et al.* and OR96-2-000, *et al.*

contributes to the marginal rate. To hold otherwise is inconsistent with the financial underpinnings of the tax burden caused by a graduated income tax. Thus, the Commission must look at the partner's total taxable income to determine the marginal tax rate, not just marginal tax rate of the regulated income that is included on the partner's return.[10] For these reasons, the use of a rate other than the partner's marginal rate to determine the income tax allowance of regulated pass-through entity will be rejected.

2. **The stand-alone methodology.**

56. The December 2005 order discussed the Commission's stand-alone method for determining regulated income and the related income tax allowance and concluded that the stand-alone method and the methodology used in that order are consistent.[11] This conclusion is challenged by the comments on SFPP's March 7 compliance.[12] At bottom, the stand-alone method provides that the tax allowance for a regulated entity will be determined by looking at the net income of the regulated entity, but excludes non-jurisdictional income or losses generated by the regulated entity and all the losses and income of any affiliate or the corporate parent. The fact that a jurisdictional operating entity may have losses from other activities that offset its jurisdictional income or that the operating entity's income may be offset by losses on the part of a parent company or an affiliate will not affect the amount of an income tax allowance. Thus, that amount is calculated by determining the marginal tax rate that applies to the regulated income of the entity.[13] *City of Charlottesville* discussed this method in detail and approved it.[14]

57. Again, some further analysis and clarification is required given the comments on SFPP's March 7 compliance filing. First, as discussed, the Commission's approach under the Policy Statement uses all the taxable income of the owning partners to determine the marginal tax rate to be applied to the regulated entity's jurisdictional income. As the Policy Statement discusses, a partnership is a pass-through entity that acts as the collective entity for its individual partner's interest because it has no income tax liability of its own. A partnership's net income is determined at the partnership level, but the actual or potential tax liability of the individual partner is determined by the marginal tax rate burden on the partner's taxable income, which is then imputed and applied to the income of the partnership.

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[10]The income from partnerships is first recorded on Schedule D (income from real estate, farms, partnerships and trusts) and reflects the items of income, loss, and deduction that were included in the partner's Form K-1. This is included on a single line on the first page of the Form 1040 or 1120. It then flows with other items of income (or loss) to adjusted gross income. Taxable income may be further reduced by deductions and exemptions to arrive at taxable income. The marginal tax bracket is applied at this point in the case of individuals. See page 2 of Form 1040.

[11] December 2005 order at ¶¶ 27-28.

[12]April 21, 2006 comments of the CCV Group, O'Loughlin at 11-12 filed in Docket Nos. OR 92-8-000 *et al.* and OR96-2-000, *et al.*

[13] *Id.* at 1207-08.

[14] *City of Charlottesville, passim.*

58. This framework does not defeat the intent of the stand-alone doctrine at the partnership level. All partnerships that are treated as partnerships for tax purposes are required to file a Form 1065 that summarizes income and deductions and discloses the net income of the partnership. A regulated partnership owing and operating jurisdictional assets must apply the stand-alone method and eliminate all non-jurisdictional income and losses from the income reported to the Commission and thus reflect only the net income resulting from jurisdictional items. As was previously discussed, if the partnership does not use straight line depreciation, it must normalize its depreciation accounts just like a corporation. A partner's taxable net income in each year is determined by the net of the income and losses (and credits and deductions) that appear on the partner's return. In the absence of tax deferrals generated by sources other than those of the partnership, the marginal tax rate reflects the partner's "actual" tax "cost" for the year because actual taxes are paid or incurred on the taxable income for that year. The weighted marginal tax rate of all the partners then determines the marginal rate used to determine the partnership's income tax allowance, which is then applied to partnership income to determine the dollar amount of the income tax allowance included in its rates. This reflects partnership tax principles and the stand-alone method is not relevant to that determination.

3. **The use of presumptions to establish the marginal tax rate.**

59. The December 2005 order recognized that in some cases it may be difficult to establish the marginal tax rate of the owning partners because the regulated entity does not have access to its partners' tax returns. This is not a problem when the partnership is owned in wholly by readily identifiable corporate partners, as in *Trans-Elect*. In that case the Commission was able to obtain affidavits with supporting information that established that the projected income of the Subchapter C corporate partners would fall within the 35 percent marginal tax bracket. [15] Similarly, the earlier discussion in this order indicated that the Santa Fe, the corporate partner owning 45.711 percent of the limited partner units, had been allocated some $37,536,795. In this case the marginal tax bracket for Santa Fe, the corporate general partner as well as a holder of limited partnership interests, could be readily determined by including its IRS Form 1060 in the record or from disclosures that may be required under the Security and Exchange Commission's annual reporting requirements. Moreover, since its affiliate is the regulated entity in this proceeding, this disclosure could be required. The marginal tax rate of other Subchapter C owners might also be determined from relatively public sources, such as annual reports or SEC materials that disclose the net taxable income and the total income taxes paid during the test year. However, the relevant information is not reasonably available for individual partners filing a Form 1040 or for corporate partners not affiliated with the regulated entity or whose stock is not publicly issued. Based on this experience, it is not always true, as stated in the *Policy Statement*, that the necessary information is in the exclusive control of the regulated entity.[16]

60. The December 2005 order recognized that it is unreasonable to require a partnership to provide information that it has no means of obtaining and then deny it an income tax

[15] *Trans-Elect,* 113 FERC at ¶¶ 6, 9, 15.
[16] *See Policy Statement* at ¶ 42.

allowance on that basis.[17] In the December 2005 order the Commission adopted a presumption that Subchapter C corporate partners would have a marginal tax rate of 35 percent. Upon reflection, this may be too high in the absence of more proof. In 1995 and 1996, the 35 percent corporate bracket was reached at $335,000, with adjustments to reflect specific surcharges as taxable income increases further.[18] In contrast, the 34 percent corporate bracket was reached at $75,000. While the dollar differences that separate the two brackets can be relatively narrow, if it is not possible to establish that a Subchapter C corporate partner fell in the 35 percent marginal bracket, the 34 percent marginal tax rate will be used. In instant case, if necessary, SFPP will be permitted to submit supporting testimony with its compliance filing since it has the burden in both Complaint and the Rate Filing Proceedings.

61. The December 2005 order also adopted a presumption of a 28 percent marginal tax bracket for individual investors or for fiduciary accounts (such as mutual funds, pensions, and trusts) where the beneficiaries could not be identified because a regulated entity would not have access to their confidential IRS returns. This assured that a tax allowance attributed to unidentified unit holders would be restricted to the 28 percent rather than one derived from the higher brackets. In developing the 28 percent presumption, the Commission concluded, based on the general financial materials in the record, that many pipeline MLPs are registered tax shelters or are intended to function as such,[19] a point that Shippers have vigorously urged. Given this, the Commission concluded that individuals that invest in MLP units most likely have income; otherwise they would have no need for the tax shelter feature of the investment.

62. Given the argument by Shippers that investors in these units have higher levels of income to be sheltered, such higher income will be reflected in adjusted gross income and the taxable income of those partners. Thus, the Commission sought a marginal bracket that would most likely capture income from a partnership because (1) that income will likely be included in adjusted gross income, or (2) the investor would likely have adjusted gross income and taxable income that would reflect at least that marginal tax bracket. For each test year the Commission has reviewed official published Internal Revenue Statistics on the distribution of adjusted gross income and taxable income.[20] These reveal that in 1996,[21] the 28 percent marginal tax bracket

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[17]Assuming that a jurisdictional partnership is eligible for a partnership, denying an income allowance in this manner would be arbitrary and almost certainly confiscatory given a regulated entity is entitled to a reasonable opportunity to recover its costs.

[18] *See* IRS 1995 Instructions for Forms 1120 and 1120-A at 15; IRS 1996 Instructions for Forms 1120 and 1120-A at at13.

[19]Ex. Nos. SEP SFPP-21 at 1-2; SEP ARCO-22 at 4-5; Ex. No. SWST-18 at 43-44; BP West Coast Comments, Attachment A at 10.

[20]Regulatory agencies routinely rely on each others official data in making policy and adjudicatory decisions. For example, the Commission relies on the PPI index produced by the Department of Labor in implementing its annual oil pipeline index adjustments. *See* 18 C.F.R. § 342.3(d)(2) (2006). The Commission does not calculate the index using its own resources. The reliance on IRS statistics here is no different.

[21]*See* IRS 1996 Tax Rate Schedules. For married taxpayers filing jointly the 1996 figures were $40,100 to $96,900. *Id.* In 1995 the comparable range for single taxpayers was $ 23,350 to 56,550 and for married filing jointly was $39,000 to $94,250. *See* IRS 1995 Tax Rate Schedules

covered income between $24,000 and $58,150 for an individual tax payer, and that 85.6 percent of all federal adjusted gross income was reported by taxpayers with adjusted gross income of more than $25,000.[22] Such taxpayers had 61.6 percent of all taxable income, which is the amount taxed after all deductions and credits. As a further check, the Commission reviewed the 1995 and 1996 IRS statistics on the sources of income. Of the income derived from partnerships and Subchapter S corporations reported on all returns, in 1996 97.10 percent was from returns that had more than $25,000 in adjusted gross income, and 97.02 percent in 1995.[23] For adjusted gross incomes in excess of $40,000 the percent was 96.46 percent in 1996 and 94.58 percent in 1995. Since the income from an MLP must be reported as income derived from partnerships, these figures strongly suggest that partnership income is reported and taxes are actually paid or incurred by partners with at least a 28 percent marginal tax bracket. The Shipper parties also argue that investors in MLP receive much of their return from the payment of capital gains taxes, thus avoiding ordinary income taxes. The same IRS statistics for 1996 reveal that of taxable returns reporting capital gains, 93 percent had adjusted gross income of $25,000 or more in 1996 and 90.28 percent in 1995.[24] For adjusted gross incomes in excess of $40,000 the percentage was 87.98 percent in 1996 and 87.32 percent in 1995, again strongly suggesting that taxpayers owning partnership interests are in the 28 percent bracket or higher even allowing for the lower tax rate paid on capital gains.

63. Thus, even if individuals with less than an adjusted gross income of $25,000, or a couple with less than $40,000 in adjusted gross income, had money to invest in MLP units, the IRS statistics support the Commission's conclusion that the 28 percent bracket is a conservative estimate of the marginal tax bracket that would apply to non-corporate investors in SFPP's limited partnership units. While the discussion here speaks in terms of individual tax payers, the Commission (and SFPP) extended the 28 percent marginal tax rate to entities having fiduciary obligations to individuals that cannot be identified. Such entities include mutual funds, various types of trusts, Individual Retirement Accounts and similar devices available individual taxpayers, and pension funds.

4. **The use of allocated income percentages**

The Commission notes that taxpayers do not get any credit for the social security contributions deducted from wages and salaries, which further reduces the cash available for investment after federal, state, and local taxes.

[22] *See* IRS Official Web Site, Tax Stats Page, and SOI Tax Stats - Individual Statistical Tables by Size of Adjusted Gross Income - Table 1.1--1996 Individual Income Tax Returns, Selected Income and Tax Items, by Size and Accumulated Size of Adjusted Gross Income. The same statistics are not available on the IRS public website, but close relationship between 1995 and 1996 income source statistics cited in the next footnote suggest that the relationship of income to adjusted gross income and taxable income would be close.

[23] *See* IRS Official Web Site, Tax Stats Page, SOI Tax Stats - All Returns: Sources of Income, Adjustments, and Tax Items: Table 1.4--1996, All Individual Income Tax Returns: Sources of Income, Adjustments, and Tax Items, by Size of Adjusted Gross Income; Table 1.4--1995, Individual Income Tax Returns, All Returns: Sources of Income, Adjustments, and Tax Items, by Size of Adjusted Gross Income.

[24] Id.

64. The *Policy Statement* contains a relatively generic discussion of partnership law and taxation that assumed items of income, loss, and deduction incurred at the partnership level are allocated to the partners on the basis of their respective partnership interest. Thus, if a partner owns twenty percent of the partnership, that partner would be allocated 20 percent of net income, or if the partnership has a fiscal year loss, 20 percent of that loss.[25] In subsequent filings in the various complaint dockets involving SFPP it became clear that partnerships may allocate items of income, loss, and deduction among the partners in ways that do not reflect their respective partnership interests. Thus, in an extreme example, it is possible to allocate all items of loss and deduction to one category or group of partners, and all income to another. Recognizing this fact, the December 2005 order permitted SFPP to use the percentage of income allocated to each of the partners to determine the weighted marginal tax bracket to be used in calculating any income tax allowance. Some of the comments on the March 7 compliance filing assert that the ownership percentage of units should be used, not the percent of allocated income.[26] This basis for this position is that an allocation of income to the corporate partner, which has a 34 or 35 percent marginal tax rate, increases the weighted income tax allowance if the individual partners are have a collective lower marginal tax rate than the corporate partners.

65. The Commission again concludes that the allocated income percentages should be used. While the *Policy Statement* speaks in terms of an income tax allowance being based on ownership interests,[27] this should not prevent use of the most rational approach to accomplish the *Policy Statement's* goals. Income is the basis upon which an actual or potential income tax liability is based. As such, income establishes the financial cost imposed on the income and capital of the partnership by the partner's actual or potential income tax liability at such time as it is recognized. The purpose of the income tax allowance is to assure the regulated entity has an opportunity to earn its allowed return.[28] This would be defeated if the income tax allowance did not reflect the rate at which the actual or potential income tax liability is or will be incurred. The clear intention of the *Policy Statement* is to follow the weighted marginal income tax rate of the owning partners, and the decision here reflects a practical interpretation of the *Policy Statement* to reflect the realities of some partnership structures.[29] Some implications of this conclusion for the equity cost of capital were discussed earlier in this order.[30]

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[25]See Policy Statement at ¶ 42; cf. Footnote 35.

[26]Comments of the CCV Group at 13-14, O'Loughlin at 4-7.

[27] *Policy Statement* at ¶¶ 1, 13, 26-27, 41-42.

[28] *City of Charlottesville* at 1207; *See also City of Chicago v. FPC*, 385 F.2d 629,623 (D.C. Cir. 1967).

[29] For example, if the corporate and non-corporate partners each own 50 percent of the units, the weighted marginal cost is 31.5 percent (50 percent of 28 = 14 and 50 percent of 35 = 17.5, which when added is a weighted calculation of 31.5 percent).

[30] It is possible for the income allocated to partners to be offset by the reallocation of items of loss and deduction to achieve that purpose, which would result in a deferral of income recognition, and therefore actual taxes, until the deferrals created by the allocation are exhausted. This would present a partnership level deferral issue similar to that discussed earlier in this order.

5. **Conclusions and instructions on income tax allowance issues.**

66. The December 2005 order resulted in a number of additional issues regarding the income tax allowance that might be afforded a regulated pass-through entity. The Commission has addressed several of these in the preceding paragraphs. In making its compliance filing and in preparing an estimated income tax allowance for the test years 1995 and 1996, SFPP must conform to classifications required by the December 2005 order and to the clarifications made in this proceeding. SFPP has already included much of the relevant data for the years 1995 and 1996 in its March 7, 2006 compliance filing in Docket Nos. OR92-8-000 *et al.* and OR96-2-000, *et al.* Subject to the possible modification of the marginal tax rate attributed to corporations, it may utilize the information included in that filing. However, it must show its calculations and identify the source of any data used in the compliance filings and included in any supporting documents. All statements and the filing itself must be supported by affidavits.

However, this particular allocation issue is not present here because only income was reallocated among the partners.

II. **Excerpt From SFPP, L.P., 121 FERC ¶ 61,240 (December 26, 2007)[31]: Implementation of FERC's Income Tax Allowance Policy**

B. Income Tax Allowance Matters

20. The December 2005 Order reiterated the Commission's prior conclusions that it would permit SFPP an income tax allowance to the extent its partners had an actual or potential tax on the jurisdictional income generated by the partnership. The December 2005 Order also directed SFPP to separate its partners into six categories, determine the amount of partnership income allocated to each category, and calculate the income tax allowance based on an actual or presumed marginal tax rate of each category. In particular, the order concluded that it would be difficult to obtain information on the marginal tax rate of an individual tax payer and therefore presumed that such a partner would have a 28 percent marginal tax rate unless it was proven otherwise. Similar instructions were provided for five other categories of partners[32] The December 2005 Order thus provided SFPP an opportunity in its March 7, 2006 compliance filing to justify an income tax allowance factor designed to recover the actual or potential income tax of its partners based on their limited partnership interests in KMEP, the MLP that owns SFPP.

21. SFPP addressed these matters in its March 2006 compliance filing. SFPP also included in its cost of service a state income tax allowance applying the principles used in developing the federal income tax allowance based on the estimated actual or potential income tax allowance of the partners in three states: California, Arizona, and New Mexico. The Protesting Parties' April 2006 comments on SFPP's March 2005 compliance filing challenged the methodology in the December 2005 Order and SFPP's specific calculations on the following grounds: (1) the legal validity of the Commission's Policy Statement; (2) whether an allowance for deferred income taxes (ADIT) was lawful; (3) the definition of an actual or potential income tax allowance, including whether any potential income tax allowance that might be paid by a partner would be at ordinary or capital gains rates; (4) whether any income tax allowance should utilize the marginal or effective tax rate; (5) whether the Commission's approach is consistent with the stand-alone method; (6) whether any income tax liability should be based on the percentage of ownership interests or on the partnership's method for allocating income; (7) the role, if any, of incentive distributions in determining the allowance; (8) whether a state income tax allowance is permissible; and (9) whether SFPP appropriately calculated its proposed state income tax allowance in each of the consolidated dockets. These issues are discussed below in light of ExxonMobil and some recent Commission decisions[33]

1. The Court's Analysis of the *Policy Statement*

22. *ExxonMobil* upheld the Commission's income tax allowance for partnerships in part because partners have the obligation to pay tax on their distributive share of income even

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[31] ***Footnotes in original are 43 through 98 which correspond to footnotes 32 through 87 in this Part of Annex G.***

[32] December 2005 Order at ¶ 30-32, 45.

[33] *Cf.* December 2006 Sepulveda Order, supra, and *Kern River Gas Transmission Company*, 117 FERC ¶ 61,077 (2006) (*Kern River*).

though the partners receive no cash from the partnership to pay the taxes.[34] The court also accepted the formulation that a partnership must establish in individual rate proceedings that a partner has "an actual or potential income tax liability" on partnership income attributed to the partner. However, the court did not address what the phase means because it had no specific example before it. Rather, the court's analysis speaks in terms of an actual or potential income tax liability on the distributive income of the partners. The court also stated that "[W]hile we agree that the orders under review and the policy statement upon which they are based incorporate some troubling elements of the phantom tax we disallowed in *BP West Coast*, FERC has justified its new policy with reasoning sufficient to survive a review."[35] The court further stated that an income tax allowance is permitted: (1) "to the extent that the pipeline's partners – both individual and corporate – paid taxes on income they received from the partnership";[36] (2) "that all partners incur actual or potential income tax liability on the income they receive from the partnership";[37] (3) "to the extent that the pipeline's partners – both individual and corporate – incurred actual or potential tax liability on their distributive share of the partnership income";[38] and (4) "that SFPP will be eligible for a tax allowance only to the extent it can demonstrate – in a rate proceeding – that its partners incur an 'actual or potential' income tax liability on their respective shares of partnership income."[39]

23. The court thus rejected arguments that its prior ruling in *BP West Coast* compelled a conclusion that a jurisdictional partnership could not be afforded in income tax allowance. The court also rejected arguments that a partnership income tax allowance would constitute a phantom cost, holding this was not the case if SFPP could demonstrate that its partners incur an actual or potential income tax liability on their respective shares of partnership income. The court's ruling also effectively rejected Protesting Parties' argument that SFPP may not include an ADIT in its cost of service because, as a partnership, it has no taxable income. Rather, following *ExxonMobil*, the ADIT calculation should use the weighted marginal tax rate of the partners and apply that to any deferrals generated by SFPP's jurisdictional depreciation accounts.

2. <u>Actual or Potential Income Tax Liability</u>

24. Before *ExxonMobil* the Commission's only detailed discussion of the phrase "actual or potential income tax liability" was in the December 2005 Order. That order ultimately concluded that "[i]f a partner is required to file a Form 1040 or Form 1120 return that includes a partnership income or loss, the Commission concludes that such partner has an actual or potential income tax liability for the partnership income."[40] It did so based on the recognition in the *Policy Statement* and pleadings submitted in the fall of 2005 that income tax deferrals resulting from a reduction in a partner's basis are recaptured as ordinary income when the

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[34] *ExxonMobil* at 952, 954.
[35] *Id.* at 948.
[36] *Id.* at 950.
[37] *Id.* at 951.
[38] *Id.*
[39] *Id.* 954.
[40] December 2005 Order at ¶ 28.

partnership unit is sold. As stated in the December 2005 Order, the fundamental difference between the position of SFPP and the Protesting Parties turns on the distinction between a partner that is "subject to" an actual or potential income tax liability and a partner that "has" an actual or potential income tax liability. This difference reflects SFPP's position that (1) a partner that holds a partnership interest over the life of the partnership will eventually pay income tax on all distributions that incorporate an income deferral, and that (2) a participating partner has an obligation to file a income tax return disclosing either positive or negative income that the partnership has in a given year.[41]

25. The Protesting Parties in turn argue that the partner must have positive income from the partnership in a given year, or at least have discernable ordinary taxable income liability in the later years the partner holds a partnership interest. The Protesting Parties' central point is that there is no necessary correlation between the taxable income reported by the partnership on its Form 1065 information return and the cash distributions that are made to the partners in any given year. They correctly assert that the cash distributions may exceed the income attributed to some of the partners and that no taxes will be paid in the year of distribution on the difference between the distributive income allocated to partners for tax purposes and the cash that was distributed to them. Thus, the Protesting Parties' argue that this difference in timing means that some partners may never have an actual or potential income tax liability for their distributive income.[42] For this reason they assert that the definition adopted by the December 2005 Order is too broad as it does not require any quantification of when the "potential income tax liability" will be recognized or the amount. They further assert that there is no assurance that ordinary income will be recognized when a unit with a reduced basis is sold.

26. They contrast the holding of the December 2005 Order with the Commission's conclusion in *Trans-Elect*.[43] In that case, the Commission required the corporate partners to demonstrate that they would have actual or potential income that would place each partner in the 35 percent marginal tax bracket based on the income that would be allocated to each partner. They assert in their comments that the Commission should require SFPP to meet the same standard and that it cannot do so for two reasons. The first is SFPP's inability to identify the tax bracket that should be attributed to publicly held limited partnership interests, i.e., those held by individuals or institutions other than the general partner or entities subject to its control. This first point is discussed below in the context of the use of presumptions to establish the marginal tax rate of the limited partners. The second problem is the difficulty in determining when income will actually be recognized and its character, which is addressed here. SFPP argues in response that the Policy Statement and its own testimony properly recognize that deferred

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[41] *Id.* at P 22-23.

[42] *Id.* *Cf.* Comments of Indicated Shippers *et al.* dated April 21, 2006 at 58-59; Protest and comments of Indicated Shippers dated April 21 at 15-16.

[43] *Trans-Elect NTD Path 15, LLC*, 109 FERC ¶ 61,249 (2004), *order denying reh'g*, 111 FERC ¶ 61,140 (2005), *order denying reh'g,* 112 FERC ¶ 61,200, *order accepting compliance filing*, 113 FERC ¶ 61,162 (2005), *order denying reh'g,* 115 FERC ¶ 61,047 (2006), *order on initial decision*, 117 FERC ¶ 61,214 (2006), *order denying reh'g*, 119 FERC ¶ 61,093 (2007) (*Trans-Elect*).

income and the related income tax liability will be recognized and that this is an issue of timing, not one of whether there will be an eventual liability for any income tax deferrals.

27. On further review, the Commission affirms its prior conclusion that SFPP can establish that a partner has an "actual or potential" income tax liability if the partner is obligated to file a return that recognizes either taxable gain or a loss. The Commission first notes that not all partnership income tax allowance determinations involve such complex issues of deferral. For example, this was not the case in either *Trans-Elect* or *Kern River* since in both cases the regulated entity was controlled by one or more Schedule C corporations. As such, the point at which the tax liability would be incurred and the length and amount of any deferrals could be determined with relative certainty. In practical terms, both cases involved taxes that were "actually paid or incurred," the historical standard under *City of Charlottesville v. FERC*.[44] This is because those Schedule C corporate partners would either recognize taxable distributive income in the test year (*Trans-Elect*),[45] or it was possible to quantify the deferral of the taxable distributive income due to accelerated or bonus depreciation reflected in the rate structure (*Kern River*).[46] Thus, in these two cases the result under the *Policy Statement* was similar to Commission practice before the adoption of its *Lakehead* policy in 1995.[47] This is because prior to *Lakehead* most partnership affiliates were controlled by corporations having a 35 percent income tax, such partnerships had few individual partners, and the Commission treated them as corporate subsidiaries that would be included in a consolidated corporate return.

28. The *Policy Statement* recognized that these simpler affiliate relationships might no longer apply in many cases. Thus, the *Policy Statement* discussed a situation in which one partner will never have an income tax liability because the partner is a non-profit entity, such as the municipal partners of the American Transmission Company, LLC.[48] In that case the income tax allowance would be reduced accordingly.[49] Moreover, footnote 35 of the Policy Statement explained in detail how tax deferrals can occur if distributions to a partner exceed the distributive income allocated to the partner.[50] The phrase "potential income tax liability" implicitly recognized that income tax liability may be deferred if distributions exceed distributive income due to the partnership's internal financial practices, and as such no income would be recognized until the partnership unit was sold and any reduction in the basis was recaptured. However, the *Policy Statement* did not address when recognition would occur and how the present value of tax

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[44] City of Charlottesville, Va. v. FERC, 774 F.2d 1205 (1995) (City of Charlottesville).

[45] *Trans-Elect*, 113 FERC ¶ 61,162 at P 15-16 (2005) and 115 FERC ¶ 61,047 at P 9-10 (2006).

[46] *Kern River* at ¶ 219, 221.

[47] *Lakehead Pipe Line Company, L.P.*, 71 FERC ¶ 61,338 (1995) (Opinion No. 397), *reh'g denied*, 75 FERC ¶ 61,181 (1996) (Opinion No. 397-A) (*Lakehead*).

[48] Policy Statement at ¶ 8-9.

[49] For example, if the were two partners, one with a marginal tax bracket of 35 percent and the other with a marginal tax bracket of zero, the income tax allowance would be based on a 17.5 percent marginal tax rate.

[50] *Policy Statement* at ¶ 37, n. 35.

deferrals would be allocated between the partners and the rate payers. The matters of deferrals and the beneficiary of the present values were left for future determination, as in this case.[51]

29. Even given the postponement of these ultimate issues, footnote 35 of the *Policy Statement* implied that any benefits from tax deferral will flow to the unit holder and not the rate payer under the mechanics of partnership taxation. This result was a departure from the Commission's historical practice of requiring normalization to capture the present value of such deferrals for the rate payers, as in ADIT, or the adjustment to return that the Commission required in the December 2006 Sepulveda Order.[52] As discussed, the matter arises from two common financial practices of MLPs: (1) distributions in excess of earnings, and (2), the allocation of items of income, loss, deduction, and credit in a proportion different from the partner's nominal partnership interests. The genesis of the issue was Congress's enactment of the Tax Reform Act of 1986, which authorized the use of master limited partnerships in energy related businesses, including gas and oil pipelines.[53] While there is no legislative history on this point, the Commission concludes that Congress intended that the partners should benefit from any income tax deferrals. This conclusion reflects the intrinsic characteristics of the tax shelter investment vehicle that resulted from Congress's decision that master limited partnerships should provide incentives for investment in the pipeline industry. Thus, the timing and the certainty of the recapture are matters of tax policy that determine what interests benefit from the present value of tax deferrals that have been resolved by the legislature.

30. At bottom, the Protesting Parties argue that such deferrals create a phantom tax. This conclusion does not necessarily follow since it is the deferral of recognition of the income tax liability that is the basis of a "potential income tax liability." The phrase recognizes that the deferred ordinary income tax liability on distributions will be recognized when the unit is sold and reduction in basis is recaptured. While *BP West Coast* concluded that Congress could not create a regulatory cost that did not otherwise exist in order to encourage investment,[54] the issue here is not the creation of the non-existent cost, but the point at which the regulatory cost legitimized by ExxonMobil must be recognized to meet the "actual or potential income tax liability" standard. It is beyond dispute that a delay in tax recognition will increase the enterprise's return beyond that afforded by a conventional regulatory cost of capital, thus creating incentives for investment as a matter of policy. However, this is not necessarily objectionable. Through basis point adders the Commission has increased the return on equity above that normally generated by the DCF model to encourage investment.[55] Such adders increase the cash flow above that from the normal regulatory return and result in a compounded return over time. Deferred recognition of an income tax liability similarly increases the

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[51] *Id.* at P 42.

[52] December 2006 Sepulveda Order at ¶ 42-48.

[53] Tax Reform Act of 1986, Pub. L. 99-153, 100 Stat. 2085 (1986). Pipeline MLPS were added in 1987. *See* 26 U.S.C. § 7704, Pub. L. 100-203, Title X, § 102119a, 101 Stat. 1330-403 (Dec. 22, 1987).

[54] BP West Coast at 1293.

[55] *See ISO New England, Inc., et al.*, 106 FERC ¶ 61,280 (2004), *order on reh'g*, 109 FERC ¶ 61,147 (2004), *affirmed sub nom. Maine Public Utilities Commission v. FERC*, 454 F.3d 278 (D.C. Cir. 2006).

regulatory return by providing an investment opportunity and the income on the deferred tax payments. Thus, a bonus return increases future value of the equity component and tax deferrals increase the present value of the equity component. Both achieve the same policy goal of creating incentives for investment.

31. The Commission recognizes that there is some risk that recognition may not occur for a substantial period of time if MLP unit holders are investing as long term buy and hold investors. However, the court explicitly recognized the possibility that recognition may be deferred indefinitely in *City of Charlottesville*. The court noted in theory that income generated by a subsidiary might be indefinitely offset by losses generated elsewhere in a corporate structure, but that this in itself was not sufficient to invalidate the Commission's adoption of the stand-alone method for tax calculations rather than continued use of a flow-through methodology allocating the tax savings to the rate payers.[56]

32. This does not mean that one might not imagine conclusions that are closer to the normalization approach the Commission used historically. For example, the Commission might require the jurisdictional entity to establish with a greater degree of certainty the time frame within in which the "potential" income tax liability would be recognized through statistical analysis. All partnership interests and accounts are maintained by computer, and for any interest sold during the test year, KMEP provides the length of the holding period and calculates the basis, any cumulative reduction to basis, the amount of ordinary income recaptured, and the capital gains. Under this approach the pipeline would have to show the percentage of the tax that would likely be recognized by adjusting the deferrals for their present value. The income tax allowance would be reduced by the difference between the nominal income tax liability on the partners, distributive income and the present value of when the deferrals are projected to be recognized. While this approach might address the matter of when a "potential" income tax liability would be recognized with greater specificity, it suffers from a lack of transparency. It might also be inconsistent with the Congressional intent to allocate the present value of income tax deferrals to the partners to encourage investment.

33. Another possible approach is to require net distributive income on the partner's K-1 before permitting an income tax allowance. This would be closer to the approach adopted in *Trans-Elect* because it requires showing of an actual income tax liability on the return. However this conclusion is inconsistent with the general philosophy of the *Policy Statement*, and specifically footnote 35, which anticipated that the present value issue of income tax deferrals would arise in specific cases and would ultimately be awarded to the partners. As such, this approach effectively reads the word "potential" out of the *Policy Statement* since it would require actual recognition of net distributive income in the test year. This approach is also inconsistent with the Congress's purpose in the Tax Reform Act of 1986. Thus, while *Trans-Elect* cautiously required that type of information to assure that the Schedule C corporate partners met the "actual or potential income tax liability" standard, it did not hold that the method used there was the only possible approach that would comply with that standard.

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[56] City of Charlottesville at 1216.

34. Protesting Parties' final criticism is that there is no certainty that gain that will be recognized on the sale of the unit is ordinary income because: (1) the unit may be sold at a loss, and (2) any gain may be characterized as capital gains. On the first point, the prospect of a loss is intrinsic to a traded interest, although one would assume that investors are not seeking losses as the goal of investing in MLP units. On the second point, the Commission recognizes that any gain in excess of the initial purchase price may be taxed as capital gains if the timing of sale qualified for that treatment. That is not the issue here. Similarly, if there are distributions in excess of income, once a partner's basis is reduced to zero, such distributions will be treated as capital gains. However, the investment advisory materials that Indicated Shippers included in the Sepulveda Line proceeding make clear that if the partner's basis is reduced by distributions derived from depreciation or amortization, such reductions will be recaptured as ordinary income when the interest is sold.[57] For these reasons the Commission affirms the conclusion reached in the December 2005 Order that the recognition of ordinary income and the related income tax burden is a timing matter, not a liability issue. Thus, if the partner receives a K-1 and must report distributive ordinary income or loss on the partners' annual income tax return, that partner will have an actual or potential income tax liability.

3. The Use of the Marginal Tax Rate

35. The *Policy Statement* concluded that the income tax allowance for a pass-through entity should be determined through the weighted marginal tax rate of its partners.[58] As discussed in the December 2006 Sepulveda Order, this conclusion is consistent with the stand-alone method that examines the income of a jurisdictional entity and develops a federal income tax allowance based on the statutory, or marginal, tax rate that would apply to that income. As the court noted in *City of Charlottesville*,[59] a corporate tax allowance has almost always been the maximum corporate statutory, or marginal, rate when a corporation is involved.[60] This statement itself presumes that the marginal tax rate is the most appropriate way of measuring the income tax cost of making an investment. This is because investment decisions are made at the margin and the marginal tax rate applied at the end of the tax year will determine how much of the incremental income will be retained by the investor. In light of this basic financial principle the

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[57] *See* the pleadings in Docket No. OR96-2-012 Exs. SEP-ARCO-21 at 2 and SEP ARCO-22 at 4-5; *see also* in Docket No. OR92-8-025 Ex. SWTS-18 at 44. This is consistent with the general premise that available cash consists of net cash from operations plus cash from depreciation and amortization. It is possible that cash may also be distributed from capital gains sales or from capital raised by borrowing or sale of additional units and that this could further reduce the partner's basis. However, all of these are conventional distributions of capital gains or capital contributions and thus do not affect the partnership's operating income, and as such would not result in deferred ordinary income.

[58] *Policy Statement* at ¶ 32, 37, 40.

[59] *City of Charlottesville* at 1207.

[60] This recognizes that investors evaluate the commitment of additional dollars based on the likely after tax return on those dollars. This is no different than the argument whether the additional after tax income from a salary increase is worth the additional work required to obtain the increase. In each case the marginal tax rate determines how much of the incremental investment or the income will be retained.

Commission affirms its prior conclusion in the *Policy Statement*, the December 2005 Order, and the December 2006 Sepulveda Order that the income tax allowance of a pass-through entity will be determined by the weighted marginal tax rate of the owning partners.

36. As was discussed in the December 2006 Sepulveda Order, the difficulty is determining the marginal tax rate of SFPP's partners. A regulated partnership may have partners whose tax returns are confidential. However, attributing a uniform marginal tax rate to all partners would be arbitrary because they are unlikely to all have the same marginal tax rate. Therefore the December 2005 Order held that corporate partners would be presumed to have a marginal tax bracket of 35 percent and non-corporate partners a marginal tax bracket of 28 percent.[61] The December 2006 Sepulveda Order further expanded the rationale for these conclusions, but reduced the corporate marginal tax bracket to 34 percent if the partnership could not establish that the corporate partner had a 35 percent marginal tax bracket in the test year.[62] The Protesting Parties challenge the use of the presumptions in the December 2005 order through their comments on the compliance filing. They argue that the Commission incorrectly interpreted certain Internal Revenue Service (IRS) information, that such information is not entitled to administrative notice, and that the Commission violated due process by depriving them of an opportunity for evaluation and comment. SFPP supports the Commission's conclusions.

37. The Commission affirms its prior conclusions but will modify the December 2005 Order to follow the December 2006 Sepulveda Order. Thus, the marginal tax rate for corporate partners will be 34 percent unless the partnership can demonstrate that a corporate partner has a higher marginal rate. Moreover, in light of the Protesting Parties' critique, the Commission again reviewed official published Internal Revenue Statistics on the distribution of adjusted gross income and taxable income for the 1999, 1997, and 1994 test years.[63] These reveal that in 1999, the 28 percent marginal tax bracket covered income between $25,750 and $62,450 for an individual tax payer, and that 88.8 percent of all federal adjusted gross income was reported by taxpayers with adjusted gross income of more than $25,000[64]. Such taxpayers had 94.7 percent of all taxable income, which is the amount taxed after all deductions and credits.[65] Of the

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[61] December 2005 Order at ¶ 30-32.

[62] December 2006 Sepulveda Order at ¶ 60.

[63] Regulatory agencies routinely rely on each other's official data in making policy and adjudicatory decisions. For example, the Commission relies on the PPI index produced by the Department of Labor in implementing its annual oil pipeline index adjustments. *See* 18 C.F.R. § 342.3(d)(2) (2006). The Commission does not calculate the index itself. The reliance on IRS statistics is the same. The URL for the IRS statistics cited here is http://www.irs.gov/taxstats/indtaxstats/article/0,,id=96981,00.html.

[64] *See* IRS 1999 Tax Rate Schedules. For married taxpayers filing jointly the 1999 figures were $43,050 to $104,050. *Id.* In 1997 the comparable range for single taxpayers was $24,650 to $59,750 and for married filing jointly was $41,200 to $99,600 and in 1994 it was $22,750 to $55,100 for single taxpayers and $38,000 to $91,850 for married taxpayers filing jointly.

[65] *See* IRS Official Web Site, Tax Stats Page, and SOI Tax Stats - Individual Statistical Tables by Size of Adjusted Gross Income: Table 1.1--1999 Individual Income Tax Returns,

income derived from partnerships and Subchapter S corporations reported on all returns, in 1999, 99.4 percent was from returns that had more than $25,000 in adjusted gross income.[66] For adjusted gross incomes in excess of $40,000 the percent was 97.8 percent in 1999. Since the income from an MLP must be reported as income derived from partnerships, these figures strongly suggest that partnership income is reported and taxes are actually paid or incurred by partners with at least a 28 percent marginal tax bracket. The Shipper parties also argue that investors in MLPs receive much of their return from the payment of capital gains taxes, thus avoiding ordinary income taxes. The same IRS statistics for 1999 reveal that of taxable returns reporting capital gains, 98.9 percent had adjusted gross income of at least $25,000, 97.2 percent in 1997, and 96.3 percent in 1994.[67] For adjusted gross incomes in excess of $40,000, the percentage for returns reporting capital gains was 97.0 percent in 1999, 94.6 percent in 1997, and 91.8 percent in 1994.

38. Thus, even if individuals with less than an adjusted gross income of $25,000, or a couple with less than $40,000 in adjusted gross income, had money to invest in MLP units, the IRS statistics support the Commission's conclusion that the 28 percent bracket is a conservative estimate of the marginal tax bracket that would apply to non-corporate investors in SFPP's limited partnership units. While the discussion here speaks in terms of individual tax payers, the Commission (and SFPP) extended the 28 percent marginal tax rate to entities having fiduciary obligations to individuals that cannot be identified. Such entities include mutual funds, various types of trusts, Individual Retirement Accounts and similar devices available to individual taxpayers, and pension funds.

39. Finally, the Commission rejects arguments that Protesting Parties have not had an adequate opportunity to comment on the methodology the Commission has pursued first in the December 2005 Order, then the December 2006 Sepulveda Order, and now in the instant order. Both cases involve the same shipper parties. Moreover, the methodology adopted in the December 2005 Order was critiqued in their comments on SFPP's March 2006 compliance filing[68] and the revised compliance filing affords them another opportunity to address the modifications adopted here. As previously discussed here and in the December 2006 Sepulveda Order, the data upon which the Commission is relying reflects public data of the Internal

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Selected Income and Tax Items, by Size and Accumulated Size of Adjusted Gross Income. The comparable figure for 1997 is 93.3 percent. *See* Table 1.1--1997, Individual Income Tax Returns, All Returns: Sources of Income, Adjustments, and Tax Items, by Size of Adjusted Gross Income.

[66] *See* IRS Official Web Site, Tax Stats Page, SOI Tax Stats - All Returns: Sources of Income, Adjustments, and Tax Items: Table 1.4--1999 All Individual Income Tax Returns: Sources of Income, Adjustments, and Tax Items, by Size of Adjusted Gross Income. The comparable figure for 1997 is 98.9 percent. *See* Table 1.4--1997, Individual Income Tax Returns, All Returns: Sources of Income, Adjustments, and Tax Items, by Size of Adjusted Gross Income; The comparable figure for 1994 is 98.6 percent. Table 1.4--1994, Individual Income Tax Returns, All Returns: Sources of Income, Adjustments, and Tax Items, by Size of Adjusted Gross Income.

[67] *Id.*

[68] Comments of Indicated Shippers, *et al.* at 13; Protest and Comments of CVV Group at 17-18.

Revenue Service and is available to all interested parties on the IRS website for their further review and comment.

4. The Stand-alone Methodology

40. The Protesting Parties assert that the Commission's proposed implementation of the *Policy Statement* departs from the Commission's historical stand-alone method for determining an income tax allowance because: (1) it bases any income tax allowance on the partners', not the partnership's income, and, (2) it does not allow for the fact the marginal tax rate may be influenced by items of income and loss on each partner's return. The first concern was resolved by *ExxonMobil.* The second requires a brief review of the stand-alone method and of *City of Charlottesville, Va. v. FERC*.[69] In the regulatory phase of this latter case the Commission held that the stand-alone method provides that the statutory tax rate would be applied to the subsidiary's income even though that income might be sheltered at the parent company level by losses from other subsidiaries or operations. This occurred because the parent company, Columbia Gas Corporation, had no taxable income for IRS purposes even though it had strong positive cash flows and paid dividends on a regular basis. The losses from gas exploration and drilling, caused mostly by special forms of amortization, were sufficient to offset the income earned by Columbia's gas pipeline operations in all of the years at issue.

41. Thus, under the stand-alone method the Commission did not require the flow-through of the tax savings that might be generated by operations that were external to the "stand-alone" operations of the jurisdictional entity. The court affirmed while acknowledging that it was possible that the parent corporation would never pay any income taxes on the income that was derived from the subsidiary pipeline's operations.[70] Moreover, the court specifically concluded that it was not necessary that there be an actual tax payment in a specific year for application of the stand-alone method to be valid.[71] These principles are equally applicable to partners that may have offsetting losses from sources other than those generated by the regulated partnership or whose other sources of gross income may influence the level of the partner's marginal tax rate.

5. The Role of Income

42. The comments on the compliance filing raise four points regarding the role and definition of income. The first is whether the marginal tax rate should be determined by using ratios of the income allocated to the various partners by the ratios of their nominal partnership interests. The second is that SFPP used the wrong partnership income in determining the weighted marginal tax rate to be applied. The third is that it makes no sense to include the income of those partner's that have negative income on their returns in determining the weighted

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[69] The underlying citations are *Columbia Gas Transmission Co.*, 24 FERC ¶ 61,258 (1983), decided on remand from *City of Charlottesville, Va. v. FERC*, 661 F.2d 945 (D.C. Cir. 1981) (*Charlottesville I*), which reviewed 8 FREC ¶ 61,002 (1979) (*Opinion No. 47*), *order on reh'g,* 9 FERC ¶ 61,355 (1979) (*Opinion No. 47-A*).

[70] *City of Charlottesville* at 1215-16.

[71] *Id.* 1214-15.

marginal tax bracket. A fourth is that an income tax allowance factor is already built into the return derived from the Commission's discounted cash flow method for determining return on equity.

a. Allocation of Income Among the Partners

43. The December 2005 Order concluded that the weighted marginal tax rate should be determined on the basis of how partnership income is allocated, not on the basis of nominal partnership interests. The Protesting Parties argue that this is inconsistent with statements in the Policy Statement that the income tax allowance would be based on the relative weight of the partnership interests.[72] They assert that allocation of income among the partners on a basis other than their nominal partnership interests may result in more income being allocated to a corporate partner that has a higher marginal tax rate than the individual partners. This would increase the weighted marginal tax rate at the expense of the rate payers. SFPP replies that its compliance filing followed the December 2005 Order, that if income is allocated away from one partner, then it is allocated to another partner and total taxable income generated by the partnership remains the same, and that Protesting Parties should have filed a rehearing request on this matter.

44. The Commission affirms its earlier conclusion in the December 2006 Sepulveda Order that the assumption in the *Policy Statement* is that income will be distributed in proportion to the partnership interests, which is often not the case with an MLP.[73] Protesting Parties are correct in their literal reading of the *Policy Statement*, which does speak in terms of the partnership interest, but overlook the point that the *Policy Statement* was speaking of partnerships in general. However, the issue at hand is the imposition of the tax cost to the partners, and through them, the tax burden on the partnership's capital. Thus, if income is allocated to a partner in excess of its nominal partnership interest, that income becomes the partner's distributive income for the purpose of applying the *Policy Statement*. It is that income upon which the partner's income tax liability will be based, and as such it is the income that should be used in determining the weighted marginal tax cost to be applied in developing the partnership's income tax allowance. The Protesting Parties' emphasis on the nominal partnership interests undercuts the purpose of the *Policy Statement* and has no practical application in an MLP context.

b. The Relevant Partnership Income

45. The second issue is what partnership income should be used. In this regard, SFPP developed its marginal tax rates from a profile based on the partnership categories required by the December 2005 Order. It then applied the resulting weighted marginal tax rate to SFPP's net income to determine the dollar amount of SFPP's income tax allowance. The Protesting Parties have several problems with this approach. First, they assert SFPP appears to have "traced" SFFP's income through to KMEP to determine the weighted marginal tax rate and that this is inconsistent with the *Policy Statement*'s emphasis on the income of the regulated entity. Second, they assert that, assuming that income is properly allocated to KMEP's general partner, Kinder

[72] *See* Comments of CVV Group at 16-17.
[73] December 2006 Sepulveda Order at ¶ 64-65.

Morgan Inc. (KMI), this distorts the determination of the tax allowance because so much of KMEP's income comes from entities other than SFPP. Third, they appear to argue that SFPP should not have applied the resulting marginal tax rate to SFPP's jurisdictional income, although this point is not entirely clear. SFPP replies that it followed the Commission's instructions.

46. The Commission affirms certain basic principles discussed in the *Policy Statement* and in the December 2005 Order. First, the proper distributive income to be used in determining the weighted marginal tax cost is that of the partners that ultimately received that income. In this case SFPP has identified those partners as KMEP's limited partners, Santa Fe Pacific Pipelines Inc., KMGP, Inc. via its general partnership interest in OLP-D, an intermediate partnership, and KMGP, Inc., which receives both incentive distributions and distributions from KMEP based on its one percent general partnership interest.[74] The marginal tax rate is properly determined based on the relative amounts of income allocated to these various partners based on their relative shares. Thus, the first step is to sort out how much income flows up through KMEP and how much does not. The second is to make an allocation within KMEP based on the relative share of KMEP income allocated to each of the different categories of KMEP partners since at that level the tax burden incurred is based on the distributive KMEP income made to the KMEP partners.[75] Thus, SFPP applied the proper methodology assuming that allocation among the KMEP partners is based on their relative allocations of KMEP's income. As just discussed, allocation is based on the partner's relative distributive income, not solely on its nominal partnership interest.

47. Second, the fact that KMEP's income may be generated from many different sources is not relevant in the context of a partnership structure for the same reason. In a partnership context it is the partner's distributive income that is used to determine the weighted marginal tax rate. All items of net income (or losses) by various affiliates SFPP controls are consolidated at the KMEP level and it is at that point that distributive income is determined for income tax purposes. That income can be derived from many sources and if the total income is increased, and thereby the marginal tax rate, this follows logically from the use of the partnership structure. SFPP properly used the KMEP partnership income to determine the distributive income of KMEP's partners.

48. Third, once the weighted income tax allowance is determined, SFPP appropriately applied that weighted income tax rate to SFPP's jurisdictional income since that is the income that is being regulated and where the tax cost of the partner must be compensated. The fact that the income generated at the level of the operating entity may be enhanced or offset by income or losses elsewhere by the owning partnership KMEP does not change the marginal tax rate of the partners for the income contributed by all of KMEP's units. Thus, SFPP's net income increases the potential income tax liability of the partners through its contribution to KMEP's income. By applying the weighted marginal tax rate of KMEP and the other owning parties to SFPP jurisdictional income, SFPP was not improperly "tracing" SFPP's income through to KMEP. Rather, it was properly applying the partnership taxation methodology approved in *ExxonMobil*.

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[74] *See* March 2006 Compliance filing, Income Tax Allowance Work Papers, Tab F, Confidential Protected Work Papers, 1999 Sheets, Pages 1 and 2.

[75] *ExxonMobil* at 952, 954, 955.

That methodology modifies the Commission's stand alone method by applying the marginal tax rate of the various partners rather than using the marginal rate on the subsidiary partnership's income as would be the case for a Schedule C corporate subsidiary.[76]

c. The Relevance of Negative Partnership Income

49. The Protesting Parties' third assertion is that it makes no sense to apply the resulting income allocations to SFPP when so many of the partners have, and when in fact most of the partnership categories reflect, negative partnership income. Thus, they conclude that any weighted marginal tax calculation should attribute positive income to the general corporate partner and negative income to the other partnership categories. SFPP replies that this argument fails to recognize that the December 2005 Order held that the weighted marginal tax is to be determined based on the distributive income allocated to partners.

50. Protesting Parties' argument, which focuses on the negative net income that appears on many of the K-1's that KMEP provides its partners, reprises the difference between an "actual and potential" income tax liability previously discussed. There the Commission explained that an income tax liability may be deferred because the partnership income allocated to a partner may be offset by items of depreciation, loss, or credit that may reduce the partner's basis, thus deferring taxable income that would otherwise be recognized in the absence of allocation of items of income, depreciation, or loss among the partners. It is the deferral of income recognition by such allocations that generates the partnership tax shelter element of the tax policy adopted by Congress.

51. *ExxonMobil* appears to recognize this basic fact when it speaks in terms of partners' distributed income.[77] The distributed income is that which shows as income on the partner's K-1 and is not the net income that would be shown on a corporate return. The latter is net of all items of income and all expenses (including depreciation), credit and loss and reflects net taxable income or loss. Partnership tax law provides that distributive income and distributive items of depreciation, loss, or credit are separately stated on the Form K-1 and the partner's return. Given that income tax liability may be deferred until the deferred income is recognized, SFPP properly based its calculations on the distributive income of the partners and determined the weighted marginal income tax rate accordingly. Requiring SFPP to offset positive general partner income with negative limited partner income reads the concept of "potential" income tax liability out of the *Policy Statement* because it would eliminate that deferred income tax component embedded in the word "potential."

d. The Relationship to the DCF Model

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[76] Ironically, if a stand-alone corporate subsidiary were involved, the marginal rate would almost always be 35 percent. Under the Commission's partnership methodology the weighted marginal tax rate of an MLP is likely to be lower because of the lower rate imputed to the publicly traded limited partnership units.

[77] *ExxonMobil* at 952, 954.

52. The Protesting Parties also argue that allowing a pass-through entity an income tax allowance results in a double recovery of income tax cost through the discounted cash flow model the Commission uses to determine the equity cost of capital. They argue that since the dividends used as input to the model have a tax allowance build into them, that an additional tax allowance for the partners double counts the income tax allowance. The Commission disagrees. It is true that the Commission affords corporations an income tax allowance so that the corporation's after-tax income is adequate to support the dividend stream at a pre-tax return satisfactory to the investor. As the *Policy Statement* describes, after the necessary corporate return is determined, the Commission grosses up the return to cover the tax cost, thus assuring that the after-tax corporate return meets the investor's expectations of the corporation.[78] The dividend stream incorporated into the Commission's DCF model reflects the taxes paid at the corporate level prior to the dividend payment and that the income tax allowance compensates for those taxes.

53. However, as the *Policy Statement* also explains, the relevant taxes are not paid by the partnership on the taxable income earned by the partnership, but are paid by partners to the extent that income is recognized on their returns. As *ExxonMobil* recognizes, the taxes on distributive partnership income are due even if there are no distributions made to the partners. The distributions made to the partners represent pre-tax dollars and without the income tax allowance would not equal the first tier after-tax return of a corporation that receives an income tax allowance on the same amount of net income. Thus, if distributions are utilized in the Commission's DCF model, these are not dividends for which a prior income tax allowance has been included in the cost of service, as is done with the corporate model.[79] Rather, the income tax allowance compensates the partners for the tax cost of the distributions they receive and thus equalizes the after-tax cash flows that would be available from a corporation and are used as inputs to the DCF model.[80] Therefore the impact on the DCF model of the income tax allowance is neutral, although there may be an additional return to the partners due to the income tax deferral elements of the partnership. However this is not true for all partnerships and the issue here involves the generic relationship between partnership structures and the Commission's DCF model.

6. <u>The Relevance of Incentive Distributions</u>

54. The Protesting Parties again assert that incentive distributions made to Kinder Morgan General Partners Inc. (KMGP) in its role as general partner should be excluded from the determination of the income tax allowance. Incentive distributions are made under a partnership agreement that provides a larger portion of available cash flow will be distributed to the general

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[78] *Policy Statement* at ¶ 21, note 20, and ¶ 36, 37.

[79] *Cf. ExxonMobil* at 954.

[80] Partners have the benefit of not paying an additional tax on the dividends received. However, the DCF model has never taken this additional level of taxation into account since it is the after-tax return of the first tier entity that is reflected in inputs of the DCF model. The *Policy Statement's* approach is consistent with this approach in that it equalizes the tax impact on the DCF at the first tier level. *See ExxonMobil* at 954-55.

partner with the growth in cash flow available for distribution.[81] This provides an incentive for the general partner to increase the available cash flow. Such distributions may be as much as high as 50 percent of the available cash distributed. Since the general partner normally starts with only a one percent general partnership interest, an incentive distribution equal to 50 percent of available cash flow is significantly different from the general partner's entitlement under its nominal partnership interest and would increase its total distribution to as much as 51 percent. Most MLPs also provide that once the distribution of available cash flow exceeds the general partner's nominal share, the general partner will be allocated income equal to the dollar amount of available cash allocated to it as an incentive distribution.[82] If available cash flow is $30,000 and the general partner is allocated 50 percent of available cash, $15,000 of the partnership's gross operating income will be allocated to the general partnership.

55. Thus, if gross operating income is $20,000, the $15,000 will be deducted from the gross operating income leaving net operating income of $5,000 to be distributed as follows: 99 percent to the limited partners and 1 percent to the general partner through its 1 percent general partnership interest.[83] However, all expenses would still be allocated (and distributed) based on the general and limited partner's nominal partnership interests with the following consequences. First, the distribution of partnership gross income and the related marginal tax rates are: $15,000 to the general partner at 35 percent, $4,950 to the limited partners at 28 percent, and $50 to the general partner at 35 percent. If the income were distributed solely based on the partnership interests, the result would be $19,800 to the limited partners (at 28 percent) and $200 to the general partner (at 35 percent). Clearly the resulting weighting of the marginal tax rate is significantly different if incentive distributions are involved. However, incentive distributions are permitted under limited partnership law and are part of the structure authorized by Congress.

56. Thus, SFPP is correct that if the partnership has gross operating income of $20,000, which is income after inclusion of all revenues and expenses, then $20,000 will be distributed as actual or potentially taxable distributive income. In this regard there was no error in SFPP's March 2006 compliance filing. However, the example stated here should be pursued somewhat further to explain Protesting Parties' concerns. As discussed, distributive net income has been allocated $15,050 to the general partner and $4,950 to the limited partners. However, total distributions were $30,000 allocated as follows: (1) $15,000 to the general partner as an incentive distribution; (2) $150 to the general partner based on its one percent general partner

[81] *See* in Docket No. PL05-5-000, Comments of Indicated Shippers and ExxonMobil dated January 21, 2005, Ex. A, *MLPs: Recognizing the Value of the General Partner*.

[82] *Id.*

[83] This simple example assumes that the partnership had gross revenues of $100,000 and total operating expenses of $80,000, or gross operating income of $20,000. As the example explains, the allocation of cash distributions to the general partner in excess of its nominal partnership interest results in the reduction of gross operating income to a net operating income figure for purposes of determining how the partnership's operating income will be distributed for income tax purposes. It does not change the partnership's income in the sense of revenues that exceed all operating costs, including depreciation. If partnership distributions are in proportion to partnership interests, the partnership's gross operating income and its net operating income for tax purposes are the same.

interest; and (3) $14,850 to the limited partners based on their 99 percent interest. Thus, the general partner is assigned $15,050 in net income and receives $15,150 in distributions, and in practice has an income tax liability on almost all of the cash received. In contrast, the limited partners have net income assigned to them of $4,950 and distributions of $14,850. Thus, the limited partners would pay tax on income of $4,950 and would receive cash of $9,800 on which the limited partners would have no income tax liability. While all of the $20,000 in partnership gross operating income has been recognized, much of the tax burden has been shifted to the general partner.[84] Moreover, it is possible that the limited partners will have negative net taxable income depending on how the allocations are determined and thus that no taxable income may be recognized until the partnership interest is sold.

57. The Protesting Parties also assert that so much of KMEP's income comes from sources other than SFPP that it is inequitable for the regulated entity's tax rate to be influenced by the income that stems from incentive distributions to the general partner. They argue that the amount of income allocated to the general partner is open to manipulation, that incentive distributions provide incentives to maximize the partnership's available cash flow and distributions, at the expense of service quality and pipeline safety. The Commission recognizes that available cash used to make the incentive distributions comes from many sources, but this is a lawful function of a complex MLP structure. Incentive distributions may provide incentives for excessive distributions, but this is not a regulatory income tax allowance matter. Rather, it is a cash management or service issue that is more appropriately addressed in a venue other than a rate proceeding.[85] For these reasons the Commission affirms the conclusions of the December 2005 Order that incentive distributions do not improperly distort the income tax allowance calculation.

58. Finally, Indicated Shippers asserts that incentive distributions are guaranteed income payments and should be treated as an expense that is deducted from KMEP's income. SFPP replies that the Commission held that incentive distributions are appropriate and that the matter should have been raised on rehearing. It argues that the issue of guaranteed payments is imported from Docket No. IS06-230-000 and inappropriately raised here. It also asserts that incentive distributions vary with income and as such are not guaranteed payments. The Commission holds that SFPP correctly argues that the issue of guaranteed payments was not raised at hearing and is inappropriate in the context of a compliance proceeding. In any event, it is clear that incentive distributions are a function of income since income is a major source of

[84] The limited partners will have reduction in basis of $9,850, which one would assume is taxed at capital gains since all of the partnership's gross operating income has been recognized under this example and taxed in the year earned. However, this does not invalidate the Commission's analysis in the Policy Statement since in this example ordinary income of the partnership has been recognized, albeit at a higher marginal tax rate. The general partner is assuming a higher tax burden in exchange for a greater share of available cash, thus leveraging the one percent partnership interest in the example.

[85] *See BP West Coast Products, LLC v. SFPP, L.P.*, 119 FERC ¶ 61,241 (2007), ordering par. A and *ExxonMobil Oil Corporation v. Calnev Pipe Line, LLC, et al.,* 120 FERC ¶ 61,075 (2007); Cf. *BP West Coast Products, LLC et al. v. SFPP, L.P., et al.*, 121 FERC ¶ 61,239 (2007).

such distributions, and of course income is not guaranteed. Moreover, the partnership tax forms included in Indicated Shippers' filing make no mention of guaranteed payments in any part of the relevant forms.[86] Indicated Shippers' argument is specious and is rejected.

7. State Income Tax Allowances

59. The Protesting Parties' April 2006 comments assert that the *Policy Statement* did not authorize SFPP to include in its cost of service a cost element for state income taxes. They further assert that SFPP did not adequately justify the state marginal income tax rate for the income tax allowance included in its March 2006 compliance filing. The first point is without merit. State income taxes are a traditional cost-of-service element. If SFPP establishes that it should receive a federal income tax allowance, it is entitled to a state income tax allowance if its methodology is reasonable.[87]

60. SFPP's method for determining the state income tax allowance was relatively complex and: (1) assumed that SFPP income should be used for determining the state in which the income tax is incurred; (2) estimated what percentage of state income tax payers would fall in the upper brackets under the presumptions established by the Commission for federal taxpayers; (3) determined the state marginal tax rate for three states, Arizona, New Mexico, and California; and, (4) applied that marginal tax rate to SFPP's income derived from those three states based on the allocation provisions of state tax law. The Protesting Parties assert that SFPP has established no logical nexus between the three states that it chose to develop the state weighted marginal tax rate included its compliance filing since the income tax allowance is based on the marginal tax rates of the partners, not SFPP. SFPP replies that the December 2005 Order stated that it is SFPP's income that is relevant and the income upon which the income tax allowance will be determined.

61. The Commission concludes that SFPP has not adequately justified the methodology it proposed for calculating a state income tax allowance. It is true that the dollar amount of the income tax allowance is determined by looking at the dollar amount of the equity return of the regulated firm, in this case SFPP, and by marking up the income to compensate for the marginal tax rate developed under the *Policy Statement*. However, as has been discussed, the weighted marginal tax rate is determined by evaluating the marginal tax rate of KMEP's partners. Thus, the relevant marginal tax rate is the weighted marginal tax rate of all KMEP partners that are required to declare KMEP's income, not SFPP's, in the states where KMEP operates. As the Commission understands it, a partner may be resident in one state and be required to declare all KMEP income in that state. If the KMEP income allocated to a second state is sufficiently high, the same partner may be required to file an income tax return in that second state and then seek a credit in the first state for the income taxed in that second state. The Commission cannot resolve this issue here, but agrees with the Protesting Parties that SFPP must modify its procedure for developing the weighted marginal state income tax rate.

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[86] *See* Comments of Indicated Shippers, *et al.,* Ex. IS-N at 1, 5, 6, 8, 13.
[87] *See Kern River* at 222-23.

III. **Excerpt From SFPP, L.P., 121 FERC ¶ 61,240 (December 26, 2007)[88]: MLPs and composition of proxy group**

D. MLPs and the Composition of the Proxy Group

89. As discussed, the Protesting Parties have raised the so-called *HIOS* cost-of-capital issue in their comments on SFPP's March 2006 compliance filing. At bottom, the *HIOS* issue involves the use of MLPs in a proxy group to determine the equity cost of capital of a jurisdictional entity. As discussed in *HIOS*[89] and *Kern River*,[90] the Commission's concern centered on the fact that MLPs may make cash distributions to their partners in excess of income. The Commission concluded that its current constant dividend discounted cash flow (DCF) model was premised on the payment of dividends based on a corporation's income as well as the reinvestment of retained earnings for future growth. The Commission also concluded that if an MLP's distributions exceeded income, the use of such distributions as the dividend component of the DCF model could double count the depreciation cash flow as a portion of the return to the investor and thus overstate the equity cost of capital.[91] The Commission therefore concluded that if a MLP was to be included in the proxy group to determine a regulated entity's equity cost of capital, it must establish that the MLPs included in the proxy group have distributions that are equivalent to a corporate dividend.

90. The *HIOS* issue was not before the ALJ at the time the Opinion No. 435 Orders issued and in those orders the Commission accepted the use of a proxy group consisting only of oil pipeline master limited partnerships.[92] Thereafter the same group of oil pipeline limited master partnerships was used in the Phase II Proceedings addressed by the March 2004 Order.[93] The ALJ did not even address this issue in the Phase II Proceedings, although he eliminated Kinder Morgan Energy Partnership (KMEP) from the 1999 cost-of-service proxy group on the grounds (1) that it was not proper to include the parent of the regulated entity in the proxy group, and (2) that KMEP's short term growth rate was too high.[94] On review, the December 2005 Order concluded that KMEP could be included in the proxy group and declined to modify the

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[88] ***Footnotes in original are 125 through 138 which correspond to footnotes 89 through 102 in this Part of Annex G.***

[89] *HIOS*, 110 FERC ¶ 61,043 at ¶ 126-27 and 112 FERC ¶ 61,050 at ¶ 53-54 and 62-67.

[90] *Kern River* at ¶ 149-154.

[91] *Id.* at P 224-31

[92] The make up of the proxy group was not raised on appeal of the Opinion No. 435 Orders. Therefore the issue is closed with regard to Docket No. OR92-8-000, *et al.*

[93] In the Remand Proceeding the 1994 six member proxy group consisted of Buckeye Partners, L.P. (Buckeye), Enron Liquids Pipeline, L.P. (Enron), Kaneb Pipe Line Partners, L.P. (Kaneb), Lakehead Pipe Line Partners, L.P. (Lakehead), Santa Fe Pacific Pipeline Partners, L.P. (SFPPP), and Teppco Partners, L.P. (TEPPCO). In the Phase II proceeding, the 1999 test year five member proxy group consisted of Buckeye, Kaneb, Kinder Morgan Energy Partners (KMEP), Enbridge Energy Partners (formerly Lakehead) (Enbridge), and TEPPCO. The difference in the groups also reflects the conversion of Enron Liquids Pipeline to KMEP in 1997 and the latter's purchase of SFPP, L.P. in 1998.

[94] *See* Phase II ID at P 349.

proxy group based on the record before it.[95] While Protesting Parties supported these findings in their December 2004 briefs on exception, even Indicated Shippers concluded in the Phase II Proceeding leading to the December 2005 order held that it was not necessary to address the *HIOS* issue.[96] The other shipper parties and the Commission staff did not to address the matter.

91. It was only in early 2005 that the *HIOS* proxy group issue began to emerge during the tail end of the hearings in the Sepulveda Line proceedings in Docket No. OR96-2-012. Before that the issue was not raised in that proceeding. In fact, the first testimony addressing the appropriateness of using cash distributions in the DCF model issue in detail was that provided by SFPP on December 2004, which did not mention the proxy group issue.[97] Review of that record indicates that prior thereto Mr. O'Loughlin, principal witness for the Complainants, did not address the proxy group issue in any of his prepared testimony, including that filed as late as January 28, 2005.[98] Thus, it is clear that the proxy group issue arose only after the first *HIOS* decision on January 24, 2005,[99] long after the record had closed and over one year after briefs on exception were filed in the Phase II proceeding. It is only in the context of the March 2006 compliance filing that the Protesting Parties now urge the Commission to reject the MLP proxy group used in the Remand and Phase II proceedings, or to reduce SFPP's equity return to the lower end of the range of reasonableness as the ALJ did in the Sepulveda Line proceeding.

92. The Commission affirms its prior conclusion in the December 2005 Order that these proceedings are not the ones to develop a new methodology for addressing rate of return issues involving MLPs or similar pass-through entities. Any changes to the proxy group or modification of the current DCF methodology in Docket No. OR96-2-000 *et al.* would require that the case be remanded due to the lack of a record at hearing. As noted, this MLP issue was specifically disclaimed as relevant in the merits phase of this proceeding. It is not appropriate to raise the issue now in a compliance proceeding unless it was reserved by the Commission, as was the case in the July 2005 Order, or if a court so requires, as was done it the July 2004 and May 2007 remands. Neither exception applies here. The Commission does not find that another remand would be useful given the urgent need to close these proceedings that are between fifteen and twelve years old and the Protestant's urgent desire for the payment of their reparations.

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[95] December 2005 Order at ¶ 67-68.

[96] See Brief Opposing Exceptions of BP West Coast Products LLC, and ExxonMobil Oil Corporation in Docket No. OR96-2-000, *et al*., dated December 17, 2004 at 14.

[97] Prepared Answering Testimony of J. Peter Williamson dated December 10, 2004, Ex. No. SEP SFPP-25 at 4-5. SFPP had alluded to the issue as early as April 4, 1995 in earlier testimony by Dr. Williamson. *See* his Prepared Direct Testimony dated April 4, 1995, Ex. No. 197 in Docket No. OR92-8-000, *et al.*

[98] *See* Prepared Direct Testimony of Matthew P. O'Loughlin dated October 26, 2004, Ex. No. SEP U/CT-1 at 15-16, Answering Testimony of Matthew P. O'Loughlin dated December 10, 2004 at 15, and Prepared Testimony of Matthew P. O'Loughlin dated January 28, 2005, Ex. No. SEP U/TR/T-32 at 30-33.

[99] *HIOS*, 110 FERC ¶ 61,043 (2005).

93. As it is, SFPP's East, West, North, and Oregon Line rates are all subject to challenge in further proceedings.[100] In this regard, the Commission notes that the December 2005 Order stated that "[T]he Commission agrees with the ID that in this proceeding there is no practical alternative to treating distributions as the equivalent of dividends and using distributions in the conventional discounted cash flow (DCF) formula."[101] (Emphasis added). As discussed, the compliance phase here is part of "this proceeding," given the record upon which the December 2005 Order is based. The additional complaints against SFPP's rates provide another opportunity to modify SFPP's rates, if warranted, based on a more recent record. Thus, the issue should be addressed in other proceedings, such the North Line rate case now before the Commission.[102]

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[100] *E.g.* Docket Nos. OR03-5-000, OR05-4-000, and OR05-5-000 (consolidated) (pending complaints against East, West, North, and Oregon Line rates); Docket No. IS05-130-000 (the investigation of newly filed North Line rates in 2005); Docket No. OR96-2-012, *et al.* (complaint against SFPP's Sepulveda Line rates); and Docket No. IS06-283-000 (the investigation of the new East Line rates SFPP filed in 2006).

[101] December 2005 Order at ¶ 77, *citing* Staff's Reply Brief on Exceptions at 13.

[102] *See* Initial Decision in Docket No. IS05-230-000, 116 FERC ¶ 63,059 (2006).

I. Section 38 Property; Section 1245 Property

1. Treas. Reg 1-1245-3. Definition of Section 1245 Property (a) *In General* (1) The term *section 1245 property* means any property… which is or has been property of a character subject to the allowance for depreciation allowed in section 167 and which is either: (i) personal property (within the meaning of paragraph (b) of this section), [or] (ii) property described in section 1245 (a)(3)(B) (see paragraph (c) of this section)…

(b) *Personal property defined*, The term personal property means;

(1) Tangible personal property (as defined in paragraph (c) of § 1.48-1, relating to the definition of section 38 property for purposes of the investment credit), and

(2) Intangible personal property.

(c) *Property described in section 1245(a)(3)(B). (1) The term property described in section 1245(a)(3)(B)* means tangible property of the requisite depreciable character other than personal property (and other than a building and its structural components), but only if there are adjustments reflected in the adjusted basis of the property (within the meaning of paragraph (a)(2) of §1.1245-2) for a period during which such property (or other property);

(i) Was used as an integral part of manufacturing, production, or extraction, or as an integral part of furnishing transportation, communications, electrical energy, gas, water, or sewage disposal services by a person engaged in a trade or business of furnishing any such service, or

(ii) Constituted a research or storage facility used in connection with any of the foregoing activities…

(2) The language used in subparagraph (1) (i) and (ii) of this paragraph shall have the same meaning as when used in paragraph (a) of § 1.48-1, and the terms building and structural components shall have the meanings assigned to those terms in paragraph (e) of §1.48-1.

2. Treas. Reg. §1.48-1(a)

… Except as otherwise provided in this section, the term "section 38 property" means property (1) with respect to which depreciation (or amortization in lieu of depreciation) is allowable to the taxpayer, (2) which has an estimated useful life of 3 years or more (determined as of the time such property is placed in service), and (3) which is (i) tangible personal property, (ii) other tangible property (not including a building and its structural components) but only if such other property is used as an integral part of manufacturing, production, or extraction, or an integral part of furnishing transportation, communications, electrical energy, gas, water, or sewage disposal services by a person engaged in a trade or business of furnishing any such service, or is a research or storage facility used in connection with any of the foregoing activities, (iii) an elevator or escalator which satisfies the conditions of section 48(a)(1)(C), or (iv) in the case of a

qualified rehabilitated building, that portion of the basis which is attributable to qualified rehabilitation expenditures….

3. Treas. Reg. 1.48-1(c)

(c) *Definition of tangible personal property.* If property is tangible personal property it may qualify as section 38 property irrespective of whether it is used as an integral part of an activity (or constitutes a research or storage facility used in connection with such activity) specified in paragraph (a) of this section. Local law shall not be controlling for purposes of determining whether property is or is not "tangible" or "personal". Thus, the fact that under local law property is held to be personal property or tangible property shall not be controlling. Conversely, property may be personal property for purposes of the investment credit even though under local law the property is considered to be a fixture and therefore real property. For purposes of this section, the term "tangible personal property" means any tangible property except land and improvements thereto, such as buildings or other inherently permanent structures (including items which are structural components of such buildings or structures). Thus, buildings, swimming pools, paved parking areas, wharves and docks, bridges, and fences are not tangible personal property. Tangible personal property includes all property (other than structural components) which is contained in or attached to a building. Thus, such property as production machinery, printing presses, transportation and office equipment, refrigerators, grocery counters, testing equipment, display racks and shelves, and open and neon and other signs, which is contained in or attached to a building constitutes tangible personal property for purposes of the credit allowed by section 38. Further, all property which is in the nature of machinery (other than structural components of a building or other inherently permanent structure) shall be considered tangible personal property even though located outside a building. Thus, for example, a gasoline pump, hydraulic car lift, or automatic vending machine, although annexed to the ground, shall be considered tangible personal property.

4. Treas. Reg. 1.48-1(d).

(d) *Other tangible property—(1) In general.* In addition to tangible personal property, any other tangible property (but not including a building and its structural components) used as an integral part of manufacturing, production, or extraction, or as an integral part of furnishing transportation, communication, electrical energy, gas, water, or sewage disposal services by a person engaged in a trade or business of furnishing any such service, or which constitutes a research or storage facility used in connection with any of the foregoing activities, may qualify as section 38 property.

(2) *Manufacturing, production and extraction.* For purposes of the credit allowed by section 38, the terms "manufacturing", "production", and "extraction" include the construction, reconstruction, or making of property out of scrap, salvage, or junk material, as well as from new or raw material, by processing, manipulating, refining, or changing the form of an article, or by combining or assembling two or more articles, and include… the mining of minerals. Thus, section 38 property would include, for example, property used as an integral part of the extracting, processing or refining of metallic or nonmetallic minerals, including oil, gas, rock, marble, or slate; the construction of roads, bridges, or housing…

(3) *Transportation and communications businesses.* Examples of transportation businesses include railroads, airlines, bus companies, shipping or trucking companies, and oil pipeline companies. Examples of communications businesses include telephone or telegraph companies and radio or television broadcasting companies.

(4) *Integral part.* In order to qualify for the credit, property (other than tangible personal property and research or storage facilities used in connection with any of the activities specified in subparagraph (1) of this paragraph) must be used as an integral part of one or more of the activities specified in subparagraph (1) of this paragraph. Property such as pavements, parking areas, inherently permanent advertising displays or inherently permanent outdoor lighting facilities, or swimming pools, although used in the operation of a business, ordinarily is not used as an integral part of any of such specified activities. Property is used as an integral part of one of the specified activities if it is used directly in the activity and is essential to the completeness of the activity. Thus, for example, in determining whether property is used as an integral part of manufacturing, all properties used by the taxpayer in acquiring or transporting raw materials or supplies to the point where the actual processing commences (such as docks, railroad tracks and bridges), or in processing raw materials into the taxpayer's final product, would be considered as property used as an integral part of manufacturing. Specific examples of property which normally would be used as an integral part of one of the specified activities are blast furnaces, oil and gas pipelines, railroad tracks and signals, telephone poles, broadcasting towers, oil derricks, and fences to enclose livestock. Property shall be considered used as an integral part of one of the specified activities if used either by the owner of the property or by the lessee of the property.

(5) *Research or storage facilities.* (i) If property (other than a building and its structural components) constitute a research or storage facility and it is used in connection with an activity specified in subparagraph (1) of this paragraph, such property may qualify as section 38 property even though it is not used as an integral part of such activity… Examples of storage facilities include oil and gas storage tanks and grain storage bins. Although a … storage facility must be used in connection with, for example, a manufacturing process, the taxpayer-owner of such facility need not be engaged in the manufacturing process.

5. Treas. Reg. 1.48-1(e)

(e) *Definition of building and structural components*. – (1) Generally, buildings and structural components thereof do not qualify as section 38 property... The term "building" generally means any structure or edifice enclosing a space within its walls, and usually covered by a roof, the purpose of which is, for example, to provide shelter or housing, or to provide working, office, parking, display, or sales space. The term includes, for example, structures such as apartment houses, factory and office buildings, warehouses, barns, garages, railway or bus stations, and stores. Such term includes any such structure constructed by, or for, a lessee even if such structure must be removed, or ownership of such structure reverts to the lessor, at the termination of the lease. Such term does not include (i) a structure which is essentially an item of machinery or equipment, or (ii) a structure which houses property used as an integral part of an activity specified in section 48(a)(1)(B)(i) if the use of the structure is so closely related to the use of such property that the structure clearly can be expected to be replaced when the property it initially houses is replaced. Factors which indicate that a structure

is closely related to the use of the property it houses include the fact that the structure is specifically designed to provide for the stress and other demands of such property and the fact that the structure could not be economically used for other purposes. Thus, the term "building" does not include such structures as oil and gas storage tanks, grain storage bins, silos, fractionating towers, blast furnaces, basic oxygen furnaces, coke ovens, brick kilns, and coal tipples.[1]

(2) The term "structural components" includes such parts of a building as walls, partitions, floors, and ceilings, as well as any permanent coverings therefore such as paneling or tiling; windows and doors; all components (whether in, on, or adjacent to the building) of a central air conditioning or heating system, including motors, compressors, pipes and ducts; plumbing and plumbing fixtures, such as sinks and bathtubs; electric wiring and lighting fixtures; chimneys; stairs, escalators, and elevators, including all components thereof; sprinkler systems fire escapes; and other components relating to the operation or maintenance of a building. However, the term "structural components" does not include machinery the sole justification for the installation of which is the fact that such machinery is required to meet temperature or humidity requirements which are essential for the operation of other machinery or the processing of materials or foodstuffs. Machinery may meet the "sole justification" test provided by the preceding sentence even though it incidentally provides for the comfort of the employees, or serves, to an insubstantial degree, areas where such temperature or humidity requirements are not essential. For example, an air conditioning and humidification system installed in a textile plant in order to maintain the temperature or humidity within a narrow optimum range which is critical in processing particular types of yarn or cloth is not included within the term "structural components"

II. Inherent Permanency Test and the "Whiteco Factors"

1. Whiteco Industries, Inc. v. Commissioner, 65 T.C. 664 (1975), considered whether outdoor advertising signs constituted tangible personal property eligible for the investment tax credit. In a decision granting the investment tax credit, the court set forth factors to be considered in the determination of whether property is realty or personally.

These factors are:

1) Is the property capable of being moved, and has it in fact been moved?
2) Is the property designed or constructed to remain permanently in place?
3) Are there circumstances that tend to show the expected or intended length of affixation?
4) How substantial a job is removal of the property and how time-consuming is it?
5) How much damage will the property sustain upon its removal?
6) What is the manner of affixation of the property to the land?

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[1] See Rev. Rul. 68-50, 1968-1 C.B. 364 for a description of coal tipples and how they are different from other types of buildings utilized in the coal business.

The Service applied the criteria set forth in Whiteco in Rev. Rul. 80-151, 1980-1 C.B. 7, and concluded that certain outdoor advertising displays are tangible personal property.

2. Revenue Ruling 75-178, 1975-1 C.B 9 outlined several criteria to determine § 1245 property classification. These criteria included (1) whether the asset is movable or removable; (2) how the asset is attached to real property; (3) the design of the asset; and (4) whether the asset bears a load.

3. The classic pronouncement addressing inherent permanency was Whiteco Industries, Inc. v. Commissioner, 65 T.C. 664, 672-673 (1975). The Tax Court, based on an analysis of judicial precedent, developed six questions designed to ascertain whether a particular asset qualifies as tangible personal property. These questions, referred to as the "Whiteco Factors," are:

1) Can the property be moved and has it been moved?
2) Is the property designed or constructed to remain permanently in place?
3) Are there circumstances that show that the property may or will have to be moved?
4) Is the property readily movable?
5) How much damage will the property sustain when it is removed?
6) How is the property affixed to land?

4. Is should also be noted, however, that moveability is not the only determinative factor in measuring inherent permanency. In L.L. Bean, Inc. v Comm., T.C. Memo. 1997-175, aff'd 145 F.3d 53 (1st Cir. 1998), it was determined that, even though the structure could be moved, it was designed to remain permanently in place. Thus, it was determined to be an inherently permanent structure.

5. Rev. Rul. 80-151, 1980-1 C.B. 7:

--IRS acquiesced in Whiteco

--Addresses outdoor advertising displays

- Structure "Y" assemblies are "inherently permanent structures":

- Display frame is bolted to top of steel support column; column is bolted to a steel-reinforced concrete foundation fully embedded in soil to depth of five feet; design specifications are based on 100 mph wind; structures are anticipated to remain in place for an indeterminate number of years; land is subject to renewable one-year leases; "structure-Y type signs have never been moved and the economics of moving such signs make it impractical."; "The economics of constructing, erecting and removing the type [Y-structure] of sign structure requires that careful consideration be given to the long-term availability and viability of the site for advertising purposes." "removal of a structure-Y sign… would be a substantial operation."

Excerpts from Indiana Toll Road Concession and Lease Agreement[1]

1. "Toll Road Assets" means the personal property of the IFA used in connection with operations at the Toll Road set forth on Schedule 2.1(a).

2. "Toll Road Facilities" means any building, structure, facility or other improvement now located or hereinafter erected, constructed or placed on the Toll Road Land.

3. "Toll Road Land" means those parcels of real property legally described in the Title Commitment and any land used for an Expansion contemplated hereunder, including all parcels of real property necessary for Toll Road Operations.

4. "Toll Road Operations" means (i) the operation, management, maintenance, construction, rehabilitation and tolling of the Toll Road and (ii) all other actions relating to the Toll Road or otherwise that are to be performed by or on behalf of the Concessionaire pursuant to this Agreement or the Operating Standards, including all action relating to Vendors.

5. "Toll Road Services" means the services to be provided to the public by the Concessionaire in its capacity as grantee of the Concession under the Agreement.

6. Section 2.1. Grant of Lease. Upon the terms and subject to the conditions of this Agreement, effective at the Time of closing, (a) the Concessionaire shall pay the IFA the exact amount of $3,800,000,000.00 in cash (the "Rent") and (b) the IFA shall (i) demise and lease the Toll Road Land and the Toll Road Facilities to the Concessionaire free and clear of Encumbrances other than Permitted IFA Encumbrances for and during the term (the "Term") commencing on the Closing Date and expiring on the seventy-fifth (75th) anniversary of the Closing Date…, unless terminated earlier as herein provided, (ii) grant the Concessionaire an exclusive franchise and license for and during the Term to provide Toll Road Services, and in connection therewith to operate, manage, maintain, rehabilitate and toll the Toll Road for Highway Purposes and otherwise in accordance with and pursuant to this Agreement, and (iii) assign, transfer and otherwise convey to the Concessionaire or cause the relevant State Agency to assign, transfer, and otherwise convey to the Concessionaire each of the Toll Road Assets and Assigned Toll Road Contracts, and the Concessionaire shall accept each such demise, lease, grant, assignment, transfer and conveyance (collectively, the "Transaction").

7. Section 2.8. Intended Treatment for Federal and State Income Tax Purposes. This Agreement is intended for U.S. federal and state income tax purposes to be a sale of the Toll Road Facilities and Toll Road Assets[2] to the Concessionaire and a grant to the

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[1] Indiana Toll Road Concession and Lease Agreement dated as of April 12, 2006 between the Indiana Finance Authority and ITR Concession Company LLC. http://www.in.gov/ifa/pdfs/4-12-06-Concession-Lease-Agreement.pdf

[2] Note that, as to the Toll Road Land, a "no sale" intent is expressed. This is consistent with the non-depreciable character of land and certain types of improvements to land such as earthwork amelioriation of a permanent character such as clearing for an constructing road beds of permanent roads, land leveling and improvements. As to roads, depreciable land

Concessionaire of an exclusive franchise and license for and during the Term to provide Toll Road Services within the meaning of sections 197(d)(1)(D) and (E) of the Internal Revenue Code of 1986, as amended, and sections 1.197-2(b)(8) and (10) of the Income Tax Regulations thereunder.[3]

8. Section 3.1. Quiet Enjoyment; Present Condition. (a) Quiet Enjoyment. The IFA agrees that if the Concessionaire shall perform all obligations and make all payments as provided hereunder, the Concessionaire shall, at all times during the Term, be entitled to and shall have the quiet possession and enjoyment of the Toll Road and the rights and privileges granted to the Concessionaire hereunder, subject to the provisions contained in this Agreement. The IFA acknowledges and agrees that the quiet possession and enjoyment of the Toll Road includes, without limitation, the IFA, the State or any local, city or county government authority in the State refraining from taking any action with respect to any of the ingress and egress ramps and roadways along the Toll Road that would materially adversely affect Toll Road Operations for an extended period of time …. The IFA and the Concessionaire acknowledge that the Concessionaire's rights to operate the Toll Road as a public highway and charge tolls thereon are subject to the right of the IFA, in accordance with the terms of this Agreement, to monitor compliance with this Agreement to ensure that the Toll Road is used and operated as required by this Agreement.

9. Section 3.2. Toll Road Operations. (a) Use. Except as otherwise specifically provided herein, the Concessionaire shall, at all times during the Term, (i) be responsible for all aspects of the Toll Road Operations, and (ii) cause the Toll Road Operations to be performed in accordance with the provisions of this agreement and applicable Law. The Concessionaire shall, at all time during the Term, cause the Toll Road to be continuously open and operational for use

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improvements would include bridges, trestles, culverts, graveling, or other surfacing, fences, firebreaks (in the case of logging roads), etc. "Toll Road Facilities" as defined seems to encompass both permanent improvements and depreciable improvements. Permanent improvements, while not depreciable, can become amortizable (in this case, over the 75 year lease term) where the owner does not also own the land but has only a leasehold interest. Source materials concerning logging road issues (private ownership of public roads is rare in the United States) will be instructive in considering issues arising in the context of energy infrastructure such as wires and pipes: Appeals, Industry Specialization Program (ISP) Coordinated Issue Paper, Logging Roads—Depreciation and Investment, June 23, 1993; http://www.irs.gov/pub/irs-utl/forest_logging_truck_roads.pdf; Coordinated Issue Paper, Logging Roads—Depreciation and Investment Tax Credit, October 31, 1991 http://www.timbertax.org/publications/irs/isp/logging_roads.asp; Rev. Rul. 88-99, 1988-2 C.B. 33; Rev. Rul. 73-217, 1973-1 C.B. 35 (distinguishing Rev. Rul. 68-281); and Rev. Rul. 68-281, 1968-1 C.B. 22.

[3] "Highway Purposes": means the use of the Toll Road for transportation in a manner consistent with the standard then in general use on Comparable Highways. "Comparable Highways" means a divided four or more lane controlled access interstate highway with interchanges, interstate quality bridges or combition or portion thereof.

by all members of the public for Highway Purposes[4] as a controlled access highway, 24 hours a day, every day, except only for closures specifically permitted under this Agreement or required by applicable Law or as necessary to comply with any other requirement of this Agreement, or pursuant to the Operating Standards or temporary closures required to address emergencies and other similar temporary events.

10. Section 14.1(e). "The development, redevelopment, constructions, maintenance, modification or change in the operation of any existing or new mode of transportation (including a road, street or highway) that results in the reduction of Toll Revenues or in the umber of vehicles using the Toll Road shall not constitute an Adverse Action [defined below]. The opening of a Competing Highway [defined below] shall constitute a Compensation Event with respect to which Concession Compensation shall be payable on or before March 15 in an amount equal to the actual decrease in net income suffered by the Concessionaire during the preceding calendar year as a sole and direct result of the Competing Highway.

"Competing Highway" means any newly-constructed Comparable Highway which is built by or on behalf of the State during the Term and at least twenty (20) continuous miles of which is within ten (10) miles of the Toll Road. In addition, the existing US 20 shall be considered a "Competing Highway" if, on or before the fifty-fifth (55th) anniversary of the Closing Date, it is expanded or improved by or on behalf of the State so that it becomes a Comparable Highway and at least twenty (20) continuous miles of such highway (all of which is within Comparable Highway and none of which was Comparable Highway on the Effective Date) is within (10) miles of the Toll Road. The existing US 20 shall not be considered a "Competing Highway" notwithstanding any future improvement and/or expansion to make it a Comparable Highway so long as the improvement or expansion which makes it otherwise a Competing Highway is not completed prior to the fifty-fifth (55th) anniversary of the Closing Date.

"Concession Compensation" means compensation payable by the IFA to the Concessionaire in order to restore the Concessionaire to the same economic position the Concessionaire would have enjoyed if such Compensation Event had not occurred, which compensation shall equal to the sum of (i) all Losses (including increased operating, capital and

[4] Section 197 of the Code addresses the amortization of certain intangibles. Franchise language is in Section 2.1 (excerpted above) and covenant not to compete language is in Section 14.1 (excerpted below). Section 197 intangibles include "any license, permit or other right granted by a governmental unit or an agency or instrumentality thereof." Code, section 197(d)(1)(D). Also included is "a covenant not to compete (or other arrangement to the extent such arrangement has substantially the same effect as a covenant not to compete) entered into in connection with the acquisition (directly or indirectly) of an interest in a trade or a business, or a substantial portion thereof; Code, section 197(d)(1)(E). "Franchises" are also included, Code, section 197(d)(1)(F). *Section 197 intangibles exclude: any interest in land (section 197(e)(2)), and any interest in an existing lease of tangible property (section 197(e)(5)).* Subleases are to be treated in the same manner as a lease of the underlying property involved, section 197(f)(6). Amortizable section 197 intangibles are to be treated as property which is of a character subject to the allowance for depreciation provided in section 167.

maintenance costs but excluding any costs and expenses that the Concessionaire would otherwise extend or incur in order to comply with this Agreement or in the ordinary course of the performance of the Toll Road Operations or the carrying on of business in the ordinary course) that are reasonably attributable to such Compensation event plus (ii) the losses of the Concessionaire's present and future Toll Road Revenues that are reasonably attributable to such Compensation Event.