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It still ain't easy being green – for a REIT

A discussion of selected tax developments and considerations

Deloitte Center for Energy Solutions

Numerous federal incentives have been enacted to accelerate capital investment in renewable energy and conservation technologies including the production tax credit, the investment tax credit, bonus depreciation, Internal Revenue Code (IRC) Section 179D expense deductions, and cash grants. The "greening" trend continues to accelerate, as many states have adopted a variety of renewable portfolio standards which require or promote minimum thresholds of power generation from renewable sources. Several states have also adopted renewable energy certificate (REC) programs creating an open market for certificates that can be traded among multiple parties. The purchaser of a REC can claim the benefits associated with producing energy from renewable sources. The seller obtains a source of revenue which can provide financing for these capital-intensive projects.

In our previous publication, *The Changing Environment of R&R (REITs and Renewables)*[1], we addressed the difficulties real estate investment trusts (REITs) encounter in taking advantage of the emerging framework of tax incentives seeking to stimulate investment in renewable energy. We explored why their unique tax status and applicable regulatory regime, prevented REITs from being able to utilize these incentives in the same manner as non-REIT commercial property owners, thus placing them at a significant market disadvantage.

As owners of millions of square feet of commercial real estate, REITs could potentially be significant consumers of energy from renewable sources. Furthermore, they may also be a significant source of capital for renewable energy development. In this point of view, we will return to the analysis in our prior publication of the interplay between REITs and energy-related incentives and then explore the emerging and evolving landscape of REIT requirements and these valuable energy incentives. We will use solar renewables as a focal point for the discussion to explore the use of REITs as a vehicle to finance capital investment into renewables while leveraging the REITs' status as an entity with a single level of tax and an increasingly popular form of investment, both public and private.

Federal investment tax credit and cash grants

A taxpayer purchasing qualifying energy property may receive a credit against their federal income tax liability of between 10 percent and 30 percent, depending on the type of qualifying investment. Qualifying investments include renewable energy investments, such as solar and small wind property, if placed in service before 2017.[2] For a REIT, these credits continue to be of limited use as, in general, a REIT only incurs a federal income tax liability to the extent it fails to distribute all of its taxable income.

The IRC Section 1603 cash grant program[3] was enacted to provide an alternative subsidy for investment in renewables. This program provides a reimbursement to eligible applicants for a portion of the cost of qualifying property equal to 30 percent of its investment in certain renewable energy properties.[4] In general, in order to qualify under this program, construction of the qualifying solar property must have begun before 2011 and must be placed in service before 2017.[5] As with tax credits, however, a REIT is only able to obtain a grant to the extent it incurs a federal tax liability due to its failure to distribute all its taxable income.

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[1] http://www.deloitte.com/assets/Dcom-UnitedStates/Local%20Assets/Documents/FSI/us_re_changingenviroment%20of%20RR_280910.pdf

[2] Placed in service date requirements are specific and vary by type of renewable energy property. Solar and small wind or other IRC Section 48 property must be placed in service before 2017 to receive a 30 percent tax credit. IRC Section 45 property must be placed in service before 2013 in the case of wind property and before 2014 for biomass and other qualifying property.

[3] Enacted as part of the American Recovery and Reinvestment Act of 2009.

[4] While the IRC Section 1603 Cash Grant program was in place, cash grants could be received in lieu of the investment tax credit.

[5] The cash grant program has placed in service date requirements that conform to the incentive tax credit, with a "safe harbor" for a minimum amount of construction to have begun before the end of 2011.

Federal IRC Section 179D

IRC Section 179D provides a good example of the complexity of the tax issues related to installing energy-efficient systems. A commercial building owner can claim a deduction equal to $1.80 per square foot for energy-efficient property placed in service between January 1, 2006, and December 31, 2013, for property located in the United States. Certification requirements must be met in order to qualify for the deduction. For this purpose, energy-efficient property includes interior lighting systems, heating, cooling, ventilation, hot water systems, or the building envelope, but solar panels do not qualify within the definition of energy-efficient property, thereby causing a certain amount of confusion.

IRC Section 179D also illustrates some of the tax issues specifically affecting REITs embarking on sustainable energy programs. REIT dividend levels are often set to market requirements as opposed to simply managing taxable income. Accordingly, the deduction may not be a significant incentive to a REIT that must maintain a certain dividend level. In addition, an important nuance may cancel the benefit of the deduction for the REIT's shareholders. A distribution from a REIT is treated as a dividend to the extent of its "earnings and profits," but the deduction under IRC Section 179D does not reduce earnings and profits, and as a consequence, the shareholders do not receive the benefit of the deduction since the amount of the distribution treated as a dividend is not reduced.

Legislative changes may be necessary for REITs to benefit from federal incentives

Industry groups have supported numerous proposals seeking to modify the existing incentive regimes to benefit REITs. Some examples of these proposals include:

- Designing a credit useable to a REIT, such as providing a credit against capital gains or allowing the REIT to pass the credit through to tenants
- Creating a refundable energy tax credit that is not reduced even if the REIT makes mandatory distributions (i.e., distributions equal to taxable income)
- Providing clarification that the right to receive a cash grant or energy tax credit qualifies as a real estate asset for REIT testing purposes[6]
- Fixing the conformity issue between taxable income and earnings and profits (highlighted above in the discussion of IRC Section 179D) to allow shareholders to benefit from the deduction

Emerging revenue-generating programs and associated REIT implications

In *The Changing Environment of R&R*, we examined the broad emergence of direct incentive payments or renewable portfolio standards designed to encourage investment in the generation of renewable energy. Revenue streams obtained from the receipt of direct incentive payments or from the sale of renewable energy certificates provide economic support in addition to the federal tax credits. These performance-based incentives (PBIs) are generally received when renewable energy enters the grid, but can be sold and purchased separately from the power.

[6] In order to qualify as a REIT, an entity must satisfy various income and asset tests. Among these tests, at least 75 percent of the value of a REIT's total assets must consist of "real estate assets", cash and cash items, and government securities at the end of each calendar quarter. There is no direct guidance as to how the right to receive grants or credits would be treated in this computation.

The Internal Revenue Service (IRS) has not provided guidance on the REIT tax treatment of income from PBIs. As there is no direct authority to treat this income as qualified REIT income, some have concluded it is non-qualifying or "bad income."[7] But given the breadth of these programs at the federal and state levels and the potential role of real estate owners in leveraging billions of square feet of real estate (e.g., roof and/or land) to generate energy, it is important to analyze this further to determine the level of support for treating PBIs as qualifying income and energy property as real estate.

Citing the legislative history underlying the tax treatment of REITs, the IRS has indicated Congress' concern in enacting this requirement was to prevent a REIT from engaging in the active conduct of a trade or business. In certain cases, the IRS has concluded the transactions were not inconsistent with the purpose of the REIT requirements and therefore, income from the transactions could be disregarded in determining whether the REIT satisfied the income tests. For example, in separate private letter rulings (PLR), the IRS concluded income derived from refundable state tax credits for the remediation and development of contaminated real estate would not be considered in determining whether the taxpayer satisfied the REIT income tests and that the right to receive the credit payment should be disregarded in determining whether the taxpayer had met the asset test (PLR 200614024, 200916014 and 200528004). Although PBIs are incentives separate from those delivered through current tax regimes, the analysis of their impact on REIT qualification should be the same, at least to the extent the energy system is related primarily to the real estate and its tenants.

Treasury authority to treat income as qualifying or excludable

In 2008, Congress specifically granted the Treasury general authority to determine what type of income would be treated as qualifying income or to exclude the income entirely for purposes of REIT testing. Given the growth in numbers of credits and incentives in the area of renewable energy, including credit exchanges, the Treasury could potentially exercise its discretion to permit REITs and their shareholders to benefit from these incentives.

Structural approaches to date

Historically REITs have been owners of commercial real estate, such as office buildings, warehouses, or multifamily housing properties. In recent years, there has been significant discussion surrounding whether a REIT, with its access to public capital, and a single level of taxation, might provide the solution to the next wave of low-cost financing needed to broadly encourage investment in solar electricity. In *The Changing Environment of R&R*, we provided two possible approaches, both of which remain viable today, to a REITs investment in solar panels. These are shown on the following page.

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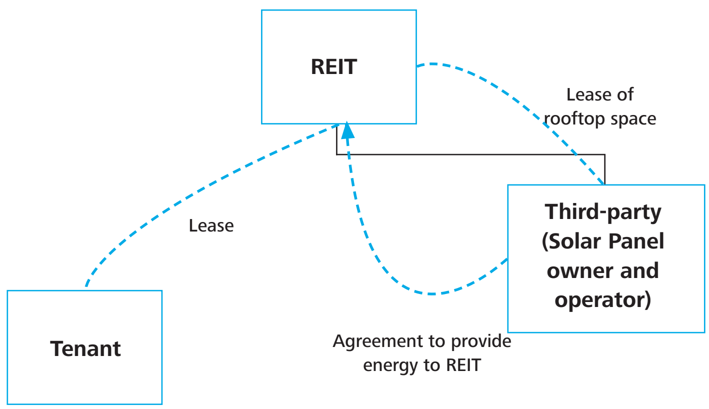
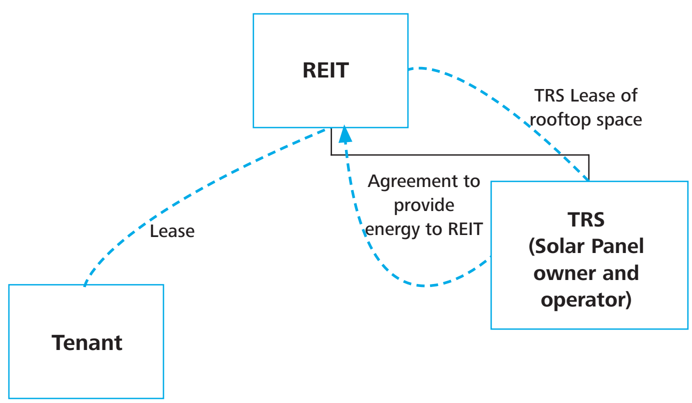
[7] In addition to other requirements imposed for REIT qualification, REITS must also satisfy two gross income tests annually, a "95% test" and a "75% test". At least 75 percent of its gross income must be derived from certain sources including rents from real property, interest on real property mortgages, gains on dispositions of real property not held for sale to customers in the ordinary course of business, and certain other specified sources. At least 95 percent of its gross income must be derived from these sources or from non-real estate dividends and interest and certain other specified sources. Accordingly, no more than five percent of a REIT's gross income may be derived from sources other than those described above. This five percent is commonly referred to as a REIT's "bad income bucket".

Scenario 1 – Third-party owner of solar panels



Pricing of rooftop lease would consider economic benefits derived by Third-party owner/operator of solar panel

Scenario 2 – The taxable REIT subsidiary (TRS) owner



- Transfer pricing considerations in pricing lease and energy
- Possible benefits to TRS through credits/incentives/grants
- Management contained and controlled by REIT
- Compliance with related party rent rules and "limited rental exception" is assumed but would require monitoring

Renewable energy property as "real property"

One of the challenges presented with respect to incorporating renewable energy projects into a REIT structure is whether the renewable energy infrastructure may qualify as "real estate assets" for REIT purposes. Section 1.856-3(d) of the Treasury regulations defines real property as "land or improvements thereon, such as buildings" or "other inherently permanent structures" not "accessory to the operation of a business." There has been significant case law and PLRs interpreting the latter phrase. In General Counsel Memorandum 33996, the IRS concluded property is accessory to the operation of a business if it is in the nature of machinery or equipment, regardless of how actively or passively it functions. In reaching this conclusion, the IRS relied on language from IRC Section 179, which contains the definition of tangible personal property. The application of this reasoning with respect to passive machinery or equipment could lead to the conclusion that renewable energy production property, such as wiring, modules, and mounting structure on solar plants, should be excluded from the definition of real property.

The IRS, however, has excluded certain types of machinery or equipment from the category of "asset accessory to the operation of a business" and classified those types of properties as "real property" for REIT purposes. For example, in Revenue Rule 73-424, the IRS concluded a permanently installed total energy system that provided for production of all the electricity, steam, hot water, or refrigeration for the building was an inherently permanent structure even though the system contained items of machinery and equipment such as turbine-driven generators. In a separate PLR, the IRS concluded the physical space on a building rooftop, together with the right to use the space, qualified as real estate property. In addition, billboards and signs attached to the roofs or walls are also considered real estate assets for REIT qualification purposes.

Recent development

The IRS has continued the trend of expanding the definition of real property for REIT purposes. In PLR 201323016 (July 30, 2012), the IRS ruled the taxpayer's interests in certain structural improvements constituted "real estate assets" for purposes of REIT requirements and ruled the taxpayer's interest income from the financing of structural improvements qualified as interest on obligations secured by mortgages on real property or interests in real property, thus satisfying the "income test" for a REIT. The "structural improvements" to which the ruling relates included a photovoltaic array located on the roof of, or adjacent to, the building. It is important to note the structural improvements were used solely in energy production for the use of the building or facility and were considered by the IRS to constitute structural components of the building. This ruling falls short of classifying the solar panels as real estate in the context of a business selling electricity to third parties. The extent to which renewable energy infrastructure will qualify as real property is still an open question and subject to review and scrutiny by the IRS.

Will REITs ever be green?

Even in an environment rife with limitations, the greening of REITs continues, from traditional rooftop leases, to financing renewables in transactions secured by real estate, to purchasing and leasing the land underneath solar projects. It remains to be seen whether three years from now we are writing again to list the challenges facing a REIT seeking to invest in renewables or to applaud a wave of significant investment into renewables.

Learn More

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