

An Evaluation Of New Solar Energy Opportunities For REITs

By **Michelle Jewett, Jeffrey Bruns and Matthew McDonald** (November 1, 2022)

Real estate investment trusts face a number of challenges to efficiently invest in solar energy, in part because of their inability to access certain tax benefits historically available to incentivize the ownership and operation of renewable energy facilities.[1]

These challenges come despite strong interest from REITs and their investors in utilizing renewable energy and the tremendous amount of land and rooftop space REITs own that could be a location for solar facilities.

As a result, REITs have been slower to develop properties utilizing solar and other renewable energy technologies than otherwise might have been expected.

Although REITs are a very attractive investment vehicle in light of their unique tax treatment and ability to raise capital, their deployment of capital in developing properties generating renewable energy has been limited.

The Inflation Reduction Act, which was signed into law on Aug. 16, includes a number of tax provisions intended to further incentivize the development and use of renewable energy.[2]

Included in the IRA was a provision extending the investment tax credit,[3] or for solar energy and allowing the transfer of the ITC. The IRA contained an accompanying change that could benefit REITs interested in owning distributed solar facilities.[4]

As discussed in greater detail below, while these changes should make it meaningfully more efficient for REITs to directly own and lease real estate with solar systems, questions remain about how these provisions will operate in practice.

Moreover, the IRA does not change existing limitations on REITs' ability to actually own and operate utility scale renewable energy facilities. Consequently, so-called solar REITs likely are not viable under current law.

In addition, there are limitations on the ability of REITs to utilize other tax incentives available to owners of renewable energy facilities, such as accelerated depreciation, that remain unchanged.

Limitations REITs Have Historically Faced

REITs are subject to a favorable tax regime pursuant to which they are not subject to federal income tax if they satisfy a number of technical requirements with respect to their organization, income, assets and distributions.

However, limitations on the amount of income a REIT can generate from sources other than



Michelle Jewett



Jeffrey Bruns



Matthew McDonald

real estate — the income test — and the value of assets a REIT can own other than real estate — the asset test — have made it difficult for a REIT to own a solar facility.

REITs historically have been able to claim only a limited percentage of the ITC. Moreover, REITs can only use the ITC to offset taxable income, but REITs typically operate so as to have no taxable income. The following is a discussion of how solar facilities have traditionally been treated for purposes of the REIT requirements.

Income Test

In general, the income test requires that at least 75% of a REIT's gross income for each taxable year be derived from real estate sources — e.g., rents from real property, interest on loans secured by real property, and gains from the sale of real property — and that at least 95% of a REIT's gross income for each taxable year be derived from the foregoing sources and certain types of passive income such as dividends, interest, and gain from the sale of securities.

The foregoing limitations significantly limit the type of income that a REIT can derive in connection with a solar facility. U.S. Department of the Treasury regulations addressing the circumstances in which REITs can own solar facilities that are qualifying REIT assets suggest that a REIT can own a building with solar panels, rent space in the building to tenants and charge tenants rents that take into account the benefit of the power supplied to the building.

There is an implication that the rental income derived should be qualifying REIT income. However, the IRS has not issued clear guidance providing that income from the foregoing situation is qualifying REIT income, although Treasury regulations providing clarifications with respect to the income test have been rumored to be released soon.

Note that if a REIT sells electricity to third parties, the income derived by the REIT from electricity sales clearly will not be qualifying income for either income test and could be subject to a 100% tax on income from prohibited transactions if the electricity were characterized as inventory.

One technical issue is whether charging a tenant rent based in part on the tenant's reduction in costs for electricity would be viewed as rent from real property. Arguably, this component of the rent is attributable to electricity generation with respect to the electricity provided by the REIT to the tenants.

Nevertheless, the IRS has ruled that furnishing of heat, light and water may be directly provided by the REIT.[5] The IRS has also ruled that where a REIT provided that fixed rent that includes the cost of electricity charged to its tenants in connection with lease of space in a data center is rent from real property.[6]

In addition, the IRS has concluded that income derived by a REIT from its generation and furnishing of electricity and steam to its tenants will qualify as rents from real property.[7]

Accordingly, it seems as though sufficient precedent exists for the IRS to treat amounts charged to tenants for electricity generated from a distributed solar facility as rents from real property, but it would be important to have implementing guidance from the Treasury Department and IRS that clarifies this.

It is also unclear whether income derived by a REIT from the sale of incentives such as

renewable energy certificates, which essentially provide the recipient with the right to receive cash payments in lieu of a credit, is qualifying REIT income.

The IRS concluded that 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.[8]

It is possible that the same analysis would apply to economic incentives for renewable energy investments that can be sold. However, such incentives typically focus on electricity generation, and therefore may be viewed as not being intrinsically related to the REIT's real estate.

Accordingly, absent clarifying legislation such as the IRA or Treasury regulations, the treatment of any sale of a tax incentive for purposes of the income test is uncertain.

The Asset Test

The asset test generally requires that at least 75% of the value of a REIT's total assets at the end of each calendar quarter consist of real estate assets — e.g., interests in real property and loans secured by real property — cash and cash items, and government securities.

In addition, although a REIT is limited in its ability to own securities of corporations, up to 20% of the value of a REIT's total assets at the end of each calendar quarter may consist of securities of a taxable REIT subsidiary, or TRS.

In part because of uncertainty surrounding the degree to which solar facilities satisfy the asset test, many REITs historically have owned their solar facilities through TRS structures, which present their own challenges with respect to solar facility ownership and operation and use of ITCs.

Treasury regulations that contain a definition of "real property" for REIT purposes provide some guidance with respect to when solar facilities will constitute qualifying REIT assets.[9]

In general, solar systems that primarily serve buildings that they are adjacent to or mounted to will be treated as qualifying REIT assets, whereas larger, utility-scale solar facilities are effectively not eligible. The Treasury regulations contain two examples to illustrate the application of these rules to solar energy facilities.

Example 8 in the Treasury regulations[10] analyzes a solar energy site that includes land, photovoltaic modules, mounts, and an exit wire. In the example, electricity produced by the photovoltaic modules is transmitted to an electrical power grid through which the electricity is distributed for sale to third parties.

The example concludes that both the exit wire and the mounts are treated as inherently permanent structures, i.e., qualifying REIT assets, but that the photovoltaic modules serve an active function — converting solar energy into electricity — because the electricity is supplied to third parties, and therefore do not qualify as inherently permanent structures, i.e., good REIT assets.

Example 9 in the Treasury regulations[11] analyzes a similar solar energy site, except that the solar energy site is mounted on land adjacent to an office building owned by the REIT.

The example assumes that, although the tenant occasionally transfers excess electricity produced by the solar energy site assets to a utility company, the solar energy site assets are designed and intended to produce electricity only to serve the office building.

The example concludes that the solar energy site assets are a structural component of the office building, and that this conclusion would not change if, instead of the solar energy site assets, solar shingles were used as the roof of the office building.

This example appears to acknowledge that, as a result of net metering, the system will at times serve an active function, but seems to permit that only if the transfers are occasional.

It is not clear how that actually applies given that there are periods of the year where solar systems typically generate excess electricity and other periods where electricity needs to be drawn for the grid.

The Treasury regulations also do not address the treatment of a variety of components of solar systems and solar storage systems as qualifying REIT assets. This is of importance where the entire facility is not treated as a qualifying REIT asset.

With respect to sales of incentives, one aspect of uncertainty is whether the right to receive an incentive should be disregarded in determining whether a taxpayer satisfies the asset tests.

REIT Use of ITCs

REITs are subject to additional limitations in terms of their ability to use ITCs.

As an initial premise, to the extent that REITs do not have income that is subject to tax because they satisfy annual distribution requirements, the ITC is of no value to a REIT itself. In addition, Section 50(d)(1) of the Internal Revenue Code of 1986, as amended, specifies that rules similar to the rules of former Section 46(e) will apply for purposes of determining limitations on the ability of certain taxpayers to claim the ITC.

Former Section 46(e)(1)(B) of the code provided that, in general, in the case of a REIT, a qualified investment in an ITC-eligible facility is limited to the REIT's ratable share of such qualified investment. The ratable share is a ratio, the numerator of which is its taxable income and the denominator of which is its taxable income computed without regard to the deduction for dividends paid.

For this purpose, the REIT's taxable income is determined without regard to any deduction for capital gains dividends and by excluding any net capital gain. This limitation further limits the ability of a REIT to use ITCs, and also prevents REITs from being suitable partners in tax equity structures.

Existing Structures That REITs Use to Invest in Solar Energy

There are several structures that REITs utilize to invest in solar energy. In each case, there are limitations on the ability of the REIT to benefit from the tax incentives available for solar energy. We describe some of these structures below.

Lease of Land or Roof Space

Some REITs lease land or roof space to unrelated third parties that install solar systems and

sell the electricity generated to off-takers. The third-party operator is entitled to claim the ITC and other tax benefits associated with ownership of the solar system.

While the tax benefits may be implicitly factored into the rent payments, the REIT is not able to capture the full economic benefit associated with the incentives.

Structure Described in Treasury Regulations

Some REITs install and directly own rooftop or adjacent solar systems, and charge rents to their tenants that take into account the energy savings recognized by the tenants as a result of the electricity generated by the solar system.

REITs using these structures generally are not able to utilize the ITC in light of having little to no taxable income. They also face some challenges in terms of appropriately factoring the energy savings into the rents charged.

In addition, the solar assets generally constitute a very small percentage of their overall assets in light of the potential uncertainties surrounding qualification of the income as rents from real property and the assets as being qualifying real estate assets in light of net metering.

TRS Structure

Most frequently, REITs employ a structure where they lease land or rooftop space to a TRS. The TRS owns and operates the solar system, and pays rent to the REIT for the leased real estate. The TRS can claim the ITC and use it to offset other taxable income.

This potentially allows meaningful utilization of the ITC and other tax incentives by the TRS. However, the structure comes with the cost of the TRS being subject to tax on income derived from the sale of electricity.

The structure also contains some potential REIT qualification risks. Because the value of a TRS must be less than 20% of the value of a REIT's assets, there are limitations on the degree to which a TRS can own and operate solar assets.

With respect to the real estate leased to a TRS, a limited rental exception provides that amounts paid to a REIT by its TRS are excluded from rents from real property by reason of the TRS being related to the REIT if, with respect to any property, less than 90% of the leased space of the property is rented to persons other than the REIT's TRSs and other related persons.

Depending on the asset classes in which the REIT invests, e.g., industrial or self-storage, this could be a meaningful risk given the square footage of the roof relative to the rest of the space. In addition, the REIT needs to charge rent that is substantially comparable to the rent paid by other tenants of the REIT property for comparable space.

Loans Secured by Real Property

A somewhat different model involving loans to the sponsor of renewable energy projects has been employed by REITs. In this structure, the REIT makes a mezzanine loan to a sponsor of a renewable energy project.

The loan is secured by either the sponsor's interest in a tax equity partnership that owns a

renewable energy facility or the underlying facility itself. Although a technical analysis of the basis for this structure is beyond the scope of this discussion, there is at least one public REIT that utilizes this strategy.

Changes With the IRA

As noted above, the IRA includes a provision that allows certain taxpayers, including REITs, to elect to transfer — essentially sell — the ITC to an unrelated taxpayer in exchange for cash.

That provision specifies that the amount received by the seller is not includible in gross income, and there is nothing that suggests that the income exclusion is limited to certain purposes.

The IRA also includes a provision that would turn off the ITC limitation in the case of a REIT that elects to transfer the ITC allowed with respect to a solar facility, in which case the purchaser would not be subject to a limitation based on a percentage of the REIT's taxable income.

Taken together, these changes may make it possible for a REIT to own a solar facility other than through a TRS and benefit from the ITC by selling the credit to a third party. The following is a summary of the potential ways in which REITs can benefit from the changes made by the IRA.

Implications for REITs

Income Test

If a REIT elects to transfer the ITC allowed with respect to a solar facility, the amount received from the sale of the ITC is not includible in the REIT's gross income. Thus, it appears that amounts realized from the sale of solar ITCs would not be taken into account for purposes of the income test.

Assuming that the REIT's tenants consume the electricity generated by the solar facility, that there is no income from the sale of environmental attributes such as RECs, and that there is limited energy distributed to the grid through net metering, it seems likely that REIT would not have any income from the solar facility itself that is not qualifying for purposes of the income test.

However, as discussed above, it would be helpful for the Treasury Department and the IRS to provide guidance to confirm this.

Asset Test

Depending on the solar facility's characteristics and expected use, some or all of the assets comprising the solar facility may qualify as real property for purposes of the asset test.

In particular, if the REIT's tenants consume the electricity generated by the solar facility, it would appear that the solar facility assets should be qualifying based on Example 9 in the Treasury regulations.

With respect to solar facility assets not constituting real property, a typical REIT would own other real estate assets. In that case, the REIT conceivably could limit the overall value of

the solar facility assets that do not qualify as real property to ensure they do not cause the REIT to fail the asset test.

In many cases, the value of a distributed solar facility will be a small fraction of the value of the related real estate, e.g., a rooftop solar system may have a value of less than 5% of the related building.

Although REITs typically do not like to own assets that could cause them to come close to having more than 5% impermissible assets, it may be that the ability to monetize the ITC in a manner that does not adversely affect the Income Tests would incentivize them to manage this risk.

ITC Limitation

As noted above, the ITC limitation would not apply if the REIT elected to sell the ITC. Importantly, however, it appears that the ITC limitation would continue to apply to any ITCs that the REIT does not elect to sell, e.g., because it is not able to sell them.

Because the appropriate ownership structure for solar facilities generally must be determined at the outset of a new project, the marketability of ITCs likely will impact a REIT's determination of the optimal ownership structure for its solar facility assets.

Pricing for ITC Sales

Given that the construct of selling ITCs is new to the industry, it will be interesting to see how the value of ITCs is determined. Buyers will only be incentivized to purchase tax credits if the pricing is something less than the value of the credits.

We would expect there to be a potentially meaningful discount given the risks associated with the facility being eligible for the full amount of the ITC being assigned in terms of eligible basis for the ITC, as well as the complex new regime for determining the applicable percentage of the ITC, e.g., 6% versus 30% or some higher percentage if adder credits are available.

Moreover, a REIT seller may have relatively weaker bargaining power if it tries to find a buyer after it has begun construction on a facility, particularly if the REIT has chosen an ownership structure that would not permit the REIT to utilize unsold ITCs.

The pricing will also take into account the transaction costs associated with documenting the transfers, including potentially complex indemnification provisions, although REITs may be attractive sellers from the perspective of being able to stand behind any indemnities.

Recapture

An interesting aspect of how transfers of the ITCs will work from an operational perspective relates to the rules in connection with the recapture of the ITCs if there is a transfer of the solar facility during the five-year period after a taxpayer places that property in service or such facility otherwise ceases to be property eligible for the ITC.

The ITC recapture rules apply when the relevant property is removed from service or is sold or disposed of during the recapture period.

These rules also apply if a partner in a partnership claiming the ITC transfers its interest in

a partnership to a person that would have caused a reduction in the amount of ITC that is able to be claimed if such person owned an interest in the partnership at the time the property was placed in service after the date (1) that partnership has placed in service the applicable property and (2) that partner has claimed a portion of the ITC generated by such property.

Such consequences are generally borne by the transferring partner, but also could be borne by the nonselling partner to the extent that it has claimed the ITC. If there is a recapture event, the taxpayer has to increase its federal income tax liability in the year of the recapture event by the amount of the recaptured ITC with the applicable percentage of the ITC recaptured, depending on the number of years that have passed since the project has been placed in service.

Under the new ITC transfer rules, it is not clear how the direct sale of the applicable property by a REIT, a transfer of an interest in a partnership owning such property to the extent transferred to a disqualified person, or property ceasing to be in service would affect the purchaser and seller of the ITC.

One would expect that the recapture rules would continue to apply, and that the purchaser would require the REIT to indemnify the purchaser for any losses attributable to a recapture event if the purchaser recognizes the recapture.

However, it is not clear whether the purchaser or seller would bear the tax liability associated with the recapture event. If the REIT recognizes income in connection with a recapture event, it will not receive corresponding cash, which may make it difficult for the REIT to satisfy its distribution requirements.

Issues Related to REIT Ownership of Solar Facilities Not Addressed

Notwithstanding the favorable changes, REITs may remain unable to fully benefit from investments in solar energy facilities. Some of these issues are considered below.

Solar Facilities that Sell Electricity

As discussed above, because income from the sale of electricity is not qualifying income, and in light of the Treasury regulations with respect to qualifying assets being limited to solar systems that provide electricity to tenants of the associated real estate, REITs can only engage in limited ownership and operation of solar facilities that sell power to third parties.

Absent legislative changes to broaden the income test and asset test, entities cannot predominantly engage in the development and operation of solar facilities and qualify as REITs.

Depreciation

Renewable energy facilities benefit from very favorable accelerated depreciation — five-year depreciation under the modified accelerated cost recovery system — for most of the assets in the facility. The accelerated depreciation has been a very important component of the value of the tax attributes associated with an investment in renewable energy.

Given that REITs are generally not taxpayers themselves, the benefits associated with accelerated depreciation are more limited. Accelerated depreciation reduces a REIT's taxable

income, earnings and profits, which increases the percentage of REIT distributions that constitute a return of capital to investors.

However, the benefit of the increased return of capital distributions benefits only certain REIT investors, and many REIT investors are not subject to tax on dividend income.

In addition, many REITs have elected to make an election available to real estate businesses in connection with limitations on the deductibility of interest under Section 163(j) of the Internal Revenue Code.

Taxpayers engaged in a real property trade or business may make an election under Section 163(j)(7)(B) of the code that allows business interest expense for that tax year and all future tax years to be fully deductible.

As a result of making such election, the taxpayer must use slower depreciation on residential property, nonresidential property, and qualified improvement property assets under the alternative depreciation system rather than the modified accelerated cost recovery system depreciation.

REITs that have made such election are ineligible to potentially benefit from the accelerated depreciation available for renewable energy investments.

Leasing Solar Facilities

It also seems as though it may be difficult for a solar facility owned by a REIT that supplies power to third parties to be leased to an operator that sells the electricity, and to have a sufficient percentage of the solar facility assets to be treated as qualifying assets for purposes of the asset test.

Example 8 in the Treasury regulations seems to suggest that where the electricity is sold to third parties, the facility as a whole will not be treated as an inherently permanent structure, and that although certain components of the structure would be treated as inherently permanent, and therefore as qualifying REIT assets, the solar panels would not be viewed as qualifying REIT assets.

This example suggests that, assuming the value of the solar panels is significant in relation to other qualifying assets, it may be difficult for the lease of a solar facility that supplies power to third parties to have a sufficient percentage of qualifying REIT assets to satisfy the asset test on a stand-alone basis.

The characterization of the solar panels as not being real property also implicates the income test as income derived from the rents would not be qualifying REIT income if the fair market value of the panels and other personal property is 15% or more than the fair value of all real and personal property included in the lease.

Absent legislative or regulatory change, REITs would appear to be unable to own and lease utility-scale solar facilities, notwithstanding the fact that the income received is rental income.

Conclusion

We expect the changes in the IRA to allow the transfer of the ITC and eliminate the application of the ITC limitation in connection with such transfers to make it possible for a

REIT to not only own a solar facility, but also to benefit economically from the ITC, which will be a boon to both the real estate and renewable energy industries.

However, limitations on the ability of a REIT to benefit from solar facilities that sell electricity to third parties, and from accelerated depreciation, remain unchanged. Accordingly, while this is an important development for the REIT industry, it is not as fulsome as many in the industry and the renewable energy community might like.

Michelle Jewett, Jeffrey Bruns and Matthew McDonald are partners at Mayer Brown LLP.

Mayer Brown partner Jeffrey Davis contributed to this article.

The opinions expressed are those of the author(s) and do not necessarily reflect the views of their employer, its clients, or Portfolio Media Inc., or any of its or their respective affiliates. This article is for general information purposes and is not intended to be and should not be taken as legal advice.

[1] This discussion focuses on solar energy facilities, as they are the most obvious type of renewable energy source for REITs to invest in. However, much of this discussion should be equally applicable to other types of renewable energy facilities eligible for the ITC (including the ITC in lieu of the production tax credit).

[2] For a discussion of the climate change provisions in the IRA, see <https://www.mayerbrown.com/-/media/files/perspectives-events/publications/2022/08/the-green-energy-tax-incentives-of-the-inflation-reduction-act-of-2022.pdf>.

[3] See above for a discussion of the ITC and changes made in the IRA.

[4] The authors first discussed this change here: <https://www.mayerbrown.com/en/perspectives-events/publications/2022/08/the-us-inflation-reduction-act-solar-and-reits#:~:text=The%20Inflation%20Reduction%20Act%20of,energy%20security%20and%20climate%20change>.

[5] See Rev. Rul. 75-340, 1975-2 C.B. 270; Rev. Rul. 73-426, 1973-2 C.B. 223; Rev. Rul. 64-50, 1964-1 C.B. 231, P.L.R. 201301007 (Jan. 4, 2013).

[6] P.L.R. 202035008 (Aug. 28, 2020); P.L.R. 201901001 (Feb. 1, 2019).

[7] P.L.R. 200828025 (Jul. 11, 2008).

[8] See P.L.R. 200614024 (Apr. 7, 2006), PLR 200916014 (Apr. 17, 2009) and P.L.R. 200528004 (Jul. 15, 2005).

[9] Treas. Reg. §1.856-10.

[10] Treas. Reg. Section 1.856-10(g), Ex. 8.

[11] Treas. Reg. Section 1.856-10(g), Ex. 9.