Master limited partnerships (MLPs). MLPs have been used to attract billions in investment to various sectors (especially oil and gas) in the last 30 years. According to some sources, MLPs had a market capitalization of over $350 billion at the end of 2012. The use of this structure (and the access to the capital it provides) for renewable energy projects, however, would require a change to the Internal Revenue Code (IRC). Under current law, in the energy arena MLPs can only be used for the extraction of crude oil, natural gas, coal, other petroleum products and related activities. In April 2013, Senator Chris Coons introduced the Master Limited Partnership Parity Act which would allow these entities to invest in renewable energy projects but this legislation has not yet been adopted (see Legal Update, Master Limited Partnership Parity Act Reintroduced and Expanded (http://us.practicallaw.com/8-526-7047)).

Real estate investment trusts (REITs). Unlike MLPs, using REITs for renewable energy projects would not necessarily require a change to the IRC. However, it would require the IRS to adopt a more expansive view of the types of assets in which REITs can invest.

This Note focuses on REITs and how they can be used to invest in renewable energy projects (namely, wind and solar projects, the two fastest growing renewable energy sectors). This Note also:

- Discusses the conditions an entity must satisfy to qualify as a REIT.
- Analyzes the coordination between REITs and renewable energy credits.
- Discusses the limitations of the REIT structure for renewable energy investment under current rules and regulations.

Despite the billions of dollars that have been invested in the renewable energy sector by private and public sources in the last 20 years, billions more are required to develop this sector to enable it to compete with oil, gas and coal as a viable source of energy in the US. However, current methods of financing these projects are not enough to meet this demand. As a result, developers have been seeking new sources of capital (or rethinking old ones) to finance their projects. These sources include:

- **Term B loans.** Several renewable energy projects were financed in 2012 using Term B loans. However, these loans are typically more expensive than commercial bank loans and are generally not available for projects that do not have long term power purchase agreements (PPAs) in place. Since many renewable energy projects are merchant plants, their access to this market is limited (see Practice Note, Project Finance: Sources of Available Financing: Term B Lenders (http://us.practicallaw.com/8-422-4846) and Article, US Project Finance: Key Developments and Trends from 2012 and the Outlook for 2013: Return of the Term B Loan Market (http://us.practicallaw.com/0-523-1991)).

- **Project bonds.** The number of solar and wind projects financed with project bonds increased in 2012. However, while project bonds have many advantages, matching the terms of the bond documents with the needs of a project (for example, a flexible and fast amendment process and a disbursement schedule that matches the project's construction schedule) is a challenge. For more information on project bonds, see Article, US Project Finance: Key Developments and Trends from 2012 and the Outlook for 2013: Re-emergence of Project Bonds (http://us.practicallaw.com/0-523-1991) and Practice Note, Project Finance: Sources of Available Financing: The Bond Markets (http://us.practicallaw.com/8-422-4846)).

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WHY ARE REITS BEING CONSIDERED TO FINANCE RENEWABLE ENERGY PROJECTS?

REITs are not new entities. They were established in 1960 under the Real Estate Investment Trust Act of 1960 to enable retail investors to own an interest in large-scale commercial real estate projects that would otherwise only be available to private corporations and wealthy individuals (Pub. L. No. 86-779). While REITs have been used for years, they have only recently become the focus of renewable energy investors and project developers. The reasons for this focus include:

- Uncertainty surrounding the continued availability of renewable energy credits (see The Uncertain Future of Renewable Energy Credits).
- The limited number of tax equity investors that are able to take advantage of these tax credits (see The Limits of the Tax Equity Investor Model).
- REITs’ tax-favored status (see The Tax Benefits of the REIT Structure).
- REITs may make renewable energy projects cheaper to finance (see The Need to Reduce the Costs of Capital of Renewable Energy Projects).
- REITs would provide developers a means to sell their interests in these projects (see The Need for Exit Capital).

The Uncertain Future of Renewable Energy Credits

Historically, renewable energy credits (namely, the production tax credit (PTC) and the investment tax credit (ITC)), have been the main drivers of investment in solar and wind projects. However, the PTC is scheduled to expire on December 31, 2013 and is not available for solar projects. While the ITC does not expire for many types of projects, on January 1, 2017, the amount of this credit will decrease from 30% of eligible project costs to 10% for solar projects, making it significantly less valuable. Moreover, on January 1, 2014, the ITC will be eliminated in its entirety for large wind projects. While market participants are likely to lobby for the extension (or increase) of these tax credits, given the current climate of fiscal austerity and political concerns about the necessity of these credits, the likelihood of this occurring is uncertain (see Practice Note, Understanding Renewable Energy: Wind: Challenges to Wind Energy Development and Growth in the US (http://us.practicallaw.com/6-504-0856)).

The Limits of the Tax Equity Investor Model

While tax credits have been instrumental in the development of the renewable energy sector, they require investors with sufficient income tax liability to use these credits. Because the owners of generation projects are typically special purpose vehicles (or other entities with limited operational histories), project developers must rely on large banks, companies like Google and large utilities to own the equity of these entities. This necessarily limits the number of projects that can be financed using this structure. In fact, this market shrank significantly in the aftermath of the credit crisis when many banks failed or had less taxable income to offset (see Practice Note, Project Finance: Sources of Available Financing: Tax Equity Investors (http://us.practicallaw.com/8-422-4846)).

The Tax Benefits of the REIT Structure

Provided certain conditions are met, REITs can eliminate any entity level tax to which the entity would otherwise be subject (see What is a REIT?). This can attract a new pool of investors to renewable energy projects such as pension funds, retail investors and foreign portfolio investors (for example, sovereign wealth funds).

The Need to Reduce the Costs of Capital of Renewable Energy Projects

Because of the need to rely on tax equity investment, among other things, these projects are typically very expensive to finance (see Practice Note, Renewable Energy: Overview (US): High Capital Costs of Renewable Energy Plants (http://us.practicallaw.com/4-518-1338)). According to industry trade group NAREIT, there were 172 REITs registered with the SEC at the end of 2012 with a combined market value of $603 billion which owned about $850 billion in real estate. Access to this broader public market would make projects less expensive to finance.

The Need for Exit Capital

Generally, once the tax credits are exhausted, tax investors exit the project (for example, in the partnership flip structure) (see Practice Note, Project Finance: Sources of Available Financing: Tax Equity Investors (http://us.practicallaw.com/8-422-4846)). In addition, many project developers would like to monetize their interest in these projects. REITs would give developers other potential buyers for their projects.

WHAT IS A REIT?

To qualify as a REIT under applicable IRS rules, an entity must, among other things:

- Own primarily real estate assets (see The Asset Test).
- Derive the majority of its income from passive sources (see The Income Test).
- Be beneficially owned by a diversified stockholder base (see Broad-based Ownership).
- Distribute at least 90% of its income to its equity holders (see Required Distribution of Income).
- Elect to be treated as a REIT (see Election to Be Treated as a REIT).

An entity that satisfies these requirements can deduct the distributions it makes to its equity holders from its taxable income. If 100% of the gross income is distributed, the entity is essentially tax-exempt. Any amounts above the 90% requirement that are not distributed are subject to taxation at the applicable corporate rate.

For a discussion of the other conditions that a REIT must satisfy, see PLC Tax, Practice Note, REITs: Overview (http://us.practicallaw.com/8-504-7098).
The Asset Test
The REIT ownership rules require an entity to hold at the close of each quarter of the taxable year:

- At least 75% of the value of its assets in cash and cash items (including receivables), US government securities and real estate assets.
- No more than 25% of its assets in securities (other than securities included in the 75% test above).
- No more than 25% of its assets in the securities of one or more taxable REIT subsidiaries (TRS).
- Except for TRS and securities included in the 75% test:
  - no more than 5% of its assets in securities of any one issuer;
  - no more than 10% of the total voting power of the outstanding securities of any one issuer; and
  - no more than 10% of the total value of the outstanding securities of any one issuer.

(IRC § 856(c)(4).)

For a more detailed discussion of the asset test, see PLC Tax, Practice Note, REITs: Overview: REIT Asset Tests (http://us.practicallaw.com/8-504-7098).

The Income Test
In addition to the asset requirements, a REIT must also derive for any taxable year at least:

- 95% of its gross income from passive sources (including dividends, interest and rents from real property) (IRC § 856(c)(2)).
- 75% of its gross income from real property sources (including rents from real property, interest on mortgages secured by real property or interests in real property and the non-dealer sale of real property) (IRC § 856(c)(3)).

Rents from real property include:

- Rents from interests in real property.
- Charges for services customarily furnished or rendered in connection with the rental of real property, whether or not such charges are separately stated.
- 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% of the total rent for the taxable year attributable to both the real and personal property leased under, or in connection with, such lease.

(IRC § 856(d)(1).)


Required Distribution of Income
The REIT must annually distribute to its equity holders at least 90% of its taxable income (IRC § 857(a)(1)). Any income not distributed is subject to the 35% corporate income tax and, potentially, an additional 4% excise tax, if certain conditions are not met. For more information on this requirement, see PLC Tax, Practice Note, REITs: Overview: REIT Distribution Requirements (http://us.practicallaw.com/8-504-7098).

Election to Be Treated as a REIT
Even if an entity meets all the requirements set out in the IRC, it will not be considered a REIT unless it also makes an election with the IRS to be treated as a REIT (IRC § 856(c)(1)).

A REIT that wishes to invest in renewable energy assets generally will not have any difficulty with the ownership, income distribution or election requirements of the IRC. Nor will it have any difficulty meeting any of the other organizational requirements set out in the IRC (see PLC Tax, Practice Note, REITs: Overview: Organizational Requirements for REITs (http://us.practicallaw.com/8-504-7098)). The asset and income tests, however, especially the question of what constitutes a real estate asset for the purposes of these tests, present more difficulty and are the focus of this Note.

DEFINITION OF A REAL ESTATE ASSET
Section 856(c)(5)(B) of the IRC defines real estate assets as real property including interests in real property and interests in mortgages on real property. It does not, however, define real property, the crux of this definition. Real property is defined in the Income Tax Regulations as land or improvements thereon, such as buildings or other inherently permanent structures thereon (including items which are structural components of such buildings or structures). Under this regulation, real property also 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 regulation also provides, however, that real property does not include assets accessory to the operation of a business, such as machinery, printing presses, transportation equipment which is not a structural component of a building, office equipment, refrigerators, individual air conditioning units, grocery counters, furnishings of a motel, hotel or office building, etc., even though such items may be termed fixtures under local law. (Treas. Reg. §1.856-3(d)).

In determining whether a component of a solar or wind project is a real estate asset, there are two main questions that investors, developers and their counsel should consider:

- Is the asset an inherently permanent structure?
- Is the asset accessory to the operation of a business?
Inherently Permanent Requirement

To determine whether an asset is inherently permanent, a Tax Court case in 1975 articulated six questions that should be considered:

- Is the property capable of being moved, and has it in fact been moved?
- Is the property designed or constructed to remain permanently in place?
- Are there circumstances that tend to show the expected or intended length of fixation or that show the property may or will have to be moved?
- How substantial a job is removal of the property, and how time consuming is it?
- How much damage will the property sustain upon its removal?
- What is the manner of affixation of the property to the land?

(See Whiteco Indus. Inc. v. Comm’r, 65 T.C. 664 (1975)).

Applying this test and other factors and considerations, the IRS has held through the years that the following are real property:

- **Mobile homes.** In a revenue ruling, the IRS concluded that because, among other things, these structures were not intended to be moved (the wheels and axles were removed from the unit, and the unit was affixed to the ground by six or more steel straps), they are real estate assets (see Rev. Rul. 71-220, 1971-1 C.B. 210).

- **Communication towers.** The IRS determined in a private letter ruling (PLR) that wireless communication towers, broadcast communication towers, fencing, shelters and permanently installed backup generators are real estate assets because they were constructed to remain permanently in place, cannot be readily moved and were unlikely to be moved (see IRS PLR 201129007).

- **Certain railroad property.** The IRS concluded in this revenue ruling, without much discussion or analysis, that trackage, roadbed, buildings, bridges, and tunnels of the railroad are inherently permanent and not accessory to the operation of a business and are real property (see Rev. Rul. 69-94, 1969-1 C.B. 189).

- **Large billboards and signs.** In this PLR, the IRS found that billboards are real estate assets because they were designed and constructed to remain permanently in place (see IRS PLR 201143011).

- **Electric power transmission systems.** This ruling, although only a PLR, is one of the most significant for renewable energy projects because it addressed energy related assets. Although the exact nature of the system that is the subject of the ruling was not disclosed, it is generally understood to refer to electric distribution and transmission assets, including transmission and distribution lines, transformers and substations. The IRS found that this system, to the extent it consisted of physically connected and functionally interdependent assets that serve as a passive conduit to allow energy created by a generation source to flow through the system to end users, was inherently permanent, and therefore, a real estate asset. In reaching this conclusion, the IRS found relevant, among others, the following facts:
  - it was not feasible to move all or any substantial part of the system;
  - each component of the system was intended to serve indefinitely and remain in place once affixed to other system parts and to the underlying land; and
  - the system did not include any machinery or equipment that creates or generates energy.

The IRS also found it significant that the REIT would not operate the system but rather lease it to a third party under a triple net lease (see IRS PLR 200725015). Although a REIT may perform certain self-management activities with respect to properties it owns, such as leasing and arranging repairs, income earned directly or indirectly from managing or operating real property is an impermissible tenant service under Section 856(d)(7) of the IRC. A more than de minimis amount of impermissible tenant services income will taint all income from the rental of the property in which such impermissible tenant services are provided.

- **Pipelines.** Another IRS determination that is relevant to renewable energy projects is the pipeline ruling. Similar to the transmission system ruling, the IRS held that a gas transmission system (which included pipes, compressors, monitoring equipment and equipment to convert natural gas into liquid natural gas) is a real estate asset because:
  - the system was physically and functionally interdependent;
  - it was not feasible to move all or any substantial part of the system;
  - the system was a passive conduit that does not include any machinery or equipment capable of producing product (in this case, natural gas) or any commodity; and
  - the REIT will not operate the system or deliver product to end users.

(See IRS PLR 200937006.)

- **Total energy systems.** A total energy system is a self-contained facility for the production of all the electricity, steam or hot water, and refrigeration needs of associated commercial or industrial buildings, building complexes, shopping centers, apartment complexes, and community developments which may be permanently installed within the building, attached to the building, or it may be a separate structure nearby. The IRS has ruled that certain total energy systems may be real estate assets if:
  - they are structural components that are included with an interest held in the building or inherently permanent structure to which the component is functionally related; and
  - the mortgage covering the total energy systems also cover the building.

(See Rev. Rul. 73-425, 1973-2 C.B. 222.)
While the IRS has issued many revenue rulings (which are administrative rulings that have precedential value), its views of these issues have been mostly set out in PLRs. These rulings are limited to the facts and representations set out in the letter and to the taxpayer requesting the ruling. However, they are instructive as to whether the IRS views certain renewable energy assets as real estate assets under Section 856 of the IRC.

Not Accessory to the Operation of a Business Requirement
To qualify as a real estate asset, an asset must not only be inherently permanent, it must not be accessory to the operation of a business. The IRS has not, however, been consistent in its findings as to when an asset is accessory to the operation of a business, and therefore, personal property or is instead a real estate asset for purposes of Section 856 of the IRC. However, based on rulings that have been disclosed, it can be concluded that an asset is accessory to the operation of a business if it is equipment or machinery, even if it is inherently permanent.

The IRS has found that the following are accessory to the operation of a business and not real estate assets:

- Grocery counters and hotel furnishings (Treas. Reg. §1.856-3(d)).

APPLICATION OF REAL ESTATE ASSET TEST TO RENEWABLE ENERGY PROJECTS
The income and asset tests raise several issues for REITs that want to invest in renewable energy projects without jeopardizing their status. Wind and solar energy projects consist of many assets. In the case of:

- A wind project, these assets include wind towers, turbines, land, easements, buildings and transmission facilities (including transformers, wires and substations) (see Practice Note, Understanding Renewable Energy: Wind (http://us.practicallaw.com/6-504-0865)).
- A solar project, these assets include solar panels, photovoltaic (PV) cells, inverters, mirrors, substations and real estate property interests (see Practice Note, Understanding Renewable Energy: Solar (http://us.practicallaw.com/2-519-8033)).

While some of these are clearly real estate assets (for example, buildings and the leaseholds to land that are an important part of any wind or solar project), the status of some other assets (for example, the solar panels or turbines) is more open to dispute.

Are Solar or Wind Energy Assets Inherently Permanent?
For a REIT to own a renewable energy asset, the asset must be inherently permanent and not be accessory to the operation of a business. While many parts of solar and wind projects are capable of being moved, they are not generally moved except for maintenance and repair, if at all. These assets are generally:

- Designed for the site where they are located. Because of the nature of the resource on which they rely, these projects are typically installed only after project developers have conducted a thorough analysis of the proposed site (including topographical surveys, analysis of the wind or solar resource at the site and environmental studies). For example, in the case of solar projects, the size of the panels selected, how they are oriented and other installation decisions take into account the results of this analysis. Similarly, in a wind project the height of the towers and the turbines selected depend on the site. It is, therefore, not a simple matter to remove a turbine or panels and locate them elsewhere, once installed.
- Expected to remain in place for the duration of the project’s useful life, which may range from 20 to 30 years. The value of an installation is based on its location and its ability to generate electricity at that site. In addition, these components must be kept in place to generate the electricity the project is required to deliver under any PPA or power sale agreement to which the project owner is a party.
- Attached to the area where they are located. Many solar projects are bolted to the roof or attached to poles that are driven into the ground in the case of ground-mounted PVs. In the case of wind projects, turbines are installed on foundations.


A taxpayer reported in February 2013 that it received an IRS ruling that loans secured by certain renewable energy assets qualify as real estate assets. But because this ruling has not been made public, it is not clear the assets it covers.

While there is a lack of clarity as to the solar and wind energy assets that constitute real estate assets, based on various IRS rulings, the following energy project components are, or are likely to be, real estate assets:

- Towers or poles that are permanently affixed to the ground.
- Lines or wires (distribution or transmission lines) attached to the towers or poles or buried underground.
- Substations.
- Switching stations.
- Distribution transformers.
- Interconnection systems.
- Electric meters that are affixed to buildings.
- Permanently affixed racking structures that support PV solar panels.
- Wind towers and the pads they sit on.
Are Solar or Wind Energy Assets Machinery or Equipment?
In determining whether an asset is real property, the permanency of the asset is not the only requirement project developers and their counsel must consider. The project cannot be accessory to the operation of a business. Based on various IRS rulings, an asset is accessory to the operation of a business if it is machinery or equipment that creates or generates product, whether or not it is inherently permanent. While many renewable energy assets may satisfy the permanency test, in many cases, they will not satisfy the accessory to the operation of a business test since they produce electricity.

Based on the above, it is likely that the following would not be real estate assets:
- Generators.
- Solar panels and inverters.
- Turbines.
- Nacelles and blades.
- PV cells.

While the IRS has made it clear that machinery and equipment are accessory to the conduct or operation of a business and, therefore, not real estate assets, it has also:
- Treated income earned from these assets as rents from real property under certain circumstances without addressing whether the assets themselves are real estate assets (see, for example, when these assets are used to provide a permissible tenant service). (See Customary Tenant Services.)
- Focused on the passive nature of certain assets as critical in the determination of whether they are real property and not equipment or machinery.
- Not defined what makes an asset equipment or machinery.

As a result, many practitioners have argued that some electricity generating solar and wind equipment should be considered real property for purposes of Section 856 of the IRC. They maintain, for example, that solar panels are passive conduits (not unlike the transmission assets that the IRS has ruled are real estate assets) that do not actually generate energy (as opposed to converting it) and should not be viewed as assets accessory to the operation of a business. Also, once these projects are installed, they require little oversight or active management.

While there is some room to argue that certain power generation equipment should be considered real estate assets, this is not the view that the IRS has taken. To be certain that particular renewable energy components are real estate assets for the purposes of the income and asset tests, investors and developers should obtain a private ruling from the IRS.

HOW CAN REITS BE USED FOR RENEWABLE ENERGY?
While many practitioners have questioned whether it is appropriate for the IRS to classify certain solar and wind energy assets as machinery and not real estate assets, until the IRS issues a ruling clarifying its prior positions or expanding the definition of a real estate asset, the majority of the assets of a wind and solar project is unlikely to be classified as real property and, therefore, generally cannot be owned by, or generate income for, a REIT without jeopardizing its status. However, while REITs’ participation in this sector is limited by the many regulations to which they are subject, REITs can and are participating in this sector.

Under current IRS regulations, REITs can:
- Lease land, property and other REIT qualifying assets to an unrelated entity (see Leasing Structure).
- Provide mortgage financing to an entity to acquire or build land or REIT qualifying assets (see Mortgage Financing Structure).
- Combine the lease and mortgage financing structure (see Hybrid Leasing and Mortgage Financing Structure).
- Subject to certain conditions, own non-qualifying assets: through a subsidiary (see Taxable REIT Subsidiaries); or directly (see Customary Tenant Services, Total Energy Systems and Limited Ownership of Non-Qualifying Assets).

Leasing Structure
One of the ways in which a REIT can easily integrate renewable energy in its investment portfolio is a lease of qualifying assets to a utility or an independent power producer (IPP). In particular, the REIT leases property it owns (whether rooftop space on buildings or land) to either:
- A utility to build a rooftop PV installation, ground-mounted PV or a concentrated solar project or a wind project. The utility then sells the electricity the project generates to its customers.
- An IPP to build and operate a solar or wind project. The IPP then sells the electricity the project generates to a utility or other third party.

In both cases, the REIT does not:
- Own the electricity generating assets.
- Earn income from the sale of electricity generated by those assets.
- Operate or manage these assets (IRC §856(d)(7)).

Rather, the REIT leases a real property asset (land or building rooftop space) and receives rental income from the utility or generator, both of which are permitted under Sections 856(c)(2) and (3) of the IRC. However, the rent payable to the REIT cannot be a function in whole or in part of the net profits or income the lessee derives from the leased property (IRC §856(d)(2)(A)).

The REIT can also own and lease certain energy-related assets (which may include certain transformers, substations, towers and transmission lines, all of which constitute real estate assets under various IRS private rulings).
Mortgage Financing Structure
The other way a REIT can integrate a renewable energy project into its investment portfolio is by extending a mortgage loan to an IPP or utility. In this structure, the borrower uses the proceeds of the loan to finance the construction of, or to acquire, assets for the project. To comply with applicable IRS regulations, the collateral securing the mortgage loan should generally be real estate assets, including land, buildings and other REIT qualifying assets. REITs must derive at least 75% of their gross income from real property sources, including mortgage interests secured by mortgages on real property or interests in real property (see The Income Test). A mortgage secured only by non-real estate assets does not qualify.

Hybrid Leasing and Mortgage Financing
Depending on the needs of the parties, the lease and mortgage structures may be combined. In the combined structure, the REIT:
- Leases certain real estate or other REIT qualifying assets it owns in exchange for rent payments.
- Extends financing to acquire or build certain real estate assets or other qualifying assets that are secured by these assets.

In this case, the REIT has two income streams: rental and mortgage interest payments.

Taxable REIT Subsidiaries
Under applicable IRS rules, up to 25% of the total value of a REIT’s assets can be invested in one or more TRS (IRC §856(c) (4)(B)(ii)). Unlike the parent REIT, the TRS is:
- Allowed, with limited restrictions, to own non-real estate assets and operate and manage a business.
- Taxable as a regular corporation.

A TRS can be used, therefore, to own energy assets and enter into a PPA with an offtaker to buy the electricity the project generates.

The TRS Owns All the Assets
If a TRS is used to hold generation and other non-REIT qualifying assets, the REIT and its counsel should make sure that the value of the TRS does not exceed the 25% threshold at the end of any taxable year. This may require either or both of the following:
- The REIT to own less than 100% of the TRS’s outstanding stock.
- The TRS to own less than 100% of the generation facility.

Depending on its investment activity and asset mix, this may require frequent monitoring and valuation of the REIT’s other assets (including the TRS stock). While possible, this approach is time consuming and expensive. In addition, the consequences of not managing this properly are significant, including loss of REIT status. While some breaches of the REIT requirements may be fixed, this may be too large a risk for a REIT’s investors to accept (see PLC Tax, REITs: Common Pitfalls and Fixes Checklist (http://us.practicallaw.com/2-504-7119) and Standard Clauses, Loan Agreement: REIT Provisions (Borrower’s REIT Status (http://us.practicallaw.com/7-515-7228))).

Split Ownership of Assets
In a modification of the TRS structure, the REIT owns the REIT qualifying assets and the TRS owns the generation assets. Depending on the needs of the parties, the TRS can also own certain REIT qualifying assets. In this structure:
- The REIT extends a loan to the TRS to build or acquire the generation assets. To comply with IRS regulations, the loan must be secured by REIT qualifying assets.
- The REIT leases the project components that constitute real estate assets it owns to the TRS in exchange for rent. However, the rental income earned under the lease cannot exceed 5% of the REIT’s gross income except in very limited circumstances. This is because rents from a REIT’s TRS are excluded from the definition of “rents from real property” unless stringent conditions are met (IRC § 856(d)(2)(B) and IRC § 856(d)(8)).
- The TRS makes dividend payments to the REIT which is permissible 95% income under applicable REIT rules.

This structure must also comply with the 25% test discussed above.

Sale Leaseback
A REIT can also buy an existing solar or wind project from a utility or IPP and lease these assets (either directly or through a subsidiary) back to it in exchange for rental payments. To ensure that the REIT does not jeopardize its status, when structuring this transaction, the parties should make sure that:
- The REIT acquires and holds only those components of the projects that qualify as real estate assets (land, buildings and other REIT qualifying assets). The generation assets (which are personal property) should be owned by a TRS or excluded from the sale entirely. If that is not possible, and these assets must be owned by the REIT and leased back to the IPP or utility, the structure must comply with the asset and income tests set out in Section 856 of the IRC. For example, the assets cannot:
  - together with any other non-qualifying assets, total more than 25% of the total value of the REIT’s assets; or
  - generate rental income equal to more than 15% of the total rent attributable to both real and personal property under the lease. If the rental income derived from personal property complies with this threshold, the entire amount of the rental income constitutes rents from real property for purposes of this test (including rent attributable to the lease of personal property). If, however, the threshold is exceeded, the amount of rent attributable to personal property rental is non-qualifying income.
- If a TRS is used to hold any generation assets, the value of the TRS stock is not more than 25% of the value of the REIT’s total assets. In addition, if the TRS leases any assets from the REIT the rental income, together with other non-passive income, must not exceed the 5% limit (see Taxable REIT Subsidiaries).
- The project is not acquired by the REIT until all applicable renewable energy credits have been exhausted (see Coordination of REIT Structure with Renewable Energy Credits). Note that a TRS could take advantage of the PTC and the ITC.
**REITS: A Viable Alternative for Renewable Energy Project Financing?**

**Customary Tenant Services**
Under Section 856 of the Code, to qualify as a REIT, an entity must, among other things, derive at least:

- 95% of its income from passive sources such as rent, interest, and dividends.
- 75% of its income from real property sources, including mortgage interest.

*(See Income Test.)*

Assets that generate or manufacture a product generally do not qualify. However, a REIT can provide electricity to tenants in buildings it owns without violating its REIT status, if certain conditions are met. Under Section 856(d)(1) of the IRC, rents from real property includes charges for services customarily furnished or rendered in connection with the rental of real property, whether or not such charges are separately stated.

The IRS has ruled that a charge (including electricity service) is customary and, therefore, permissible rental income, if:

- It is a service that is furnished to similarly situated tenants in the geographical area where the property is located.
- The electricity generated is only being used in the building the REIT owns and the REIT is not selling the electricity back to the electric grid.

In reaching its conclusion, the IRS found that one of a REIT’s obligations as a responsible landlord is to ensure that its tenants had predictable electrical service if such services were usual and customary in the relevant locations. For more information on this issue, see IRS PLR 200828025.

It is important to note that the ruling was focused on whether income earned from these systems constituted rental income for purposes of Section 856(d) of the IRC. The IRS did not address the electricity generating system itself and whether it was a real estate asset. However, depending on the value of this asset and the other assets owned by the REIT, the fact that these assets do not qualify as real property may not matter. REITs can own non-real estate assets provided the value of these assets and the income they generate meet the income and asset tests *(see Limited Ownership of Non-qualifying Assets).*

**Total Energy Systems**
A REIT can install a total energy system that generates electricity on or near its buildings. These systems will qualify as real estate assets even though they include machinery or equipment that produces electricity, if they are:

- A structural component of the building.
- Included with land, buildings or other inherently permanent structure.


**Limited Ownership of Non-qualifying Assets**
A REIT may elect to own renewable energy assets that do not meet the requirements of Section 856 of the IRC, as interpreted by the IRS. However, to ensure that its status as a REIT is not jeopardized, this ownership must be limited so that the REIT still meets its income and asset tests. This approach, however, is fraught with risk as it would require the REIT to frequently monitor its assets to ensure that these assets, together with any other:

- Non-qualifying assets, are valued at not more than 25% of its assets.
- Non-passive sources, generate not more than 5% of its gross income.
- Non-real property sources, generate not more than 25% of the REIT’s gross income.

This monitoring may be more than some REITs are willing to do or accept. As a result, a REIT may elect to focus on activities and assets that have been expressly approved by the IRS.

**COORDINATION OF REIT STRUCTURE WITH RENEWABLE ENERGY CREDITS**

If a REIT is used in the capital structure of a wind or solar project, its use must take into account any tax credits for which the project may qualify. The two main credits that owners of qualifying commercial renewable energy generating assets are eligible to receive are:

- The PTC. This is an inflation adjusted credit for each kilowatt hour of electricity produced for 10 years after the project is placed in service.
- The ITC. This is a one-time credit equal to 10% or 30% of eligible business expenditures related to the development of qualified renewable energy facilities. The owner must continue to own these projects for five years after the project is placed in service. If the owner sells, transfers or otherwise disposes of its interest in the project within five years of the project being placed in service, all or part of the credit will be recaptured.

The owner of an eligible solar or wind project can (and may choose to) claim the PTC or ITC, depending on the renewable energy technology and the specific characteristics of the project *(see Practice Note, Renewable Energy: Overview (US): Investment Tax Credit (http://us.practicallaw.com/4-518-1338)).*

These credits are significant and have been instrumental in the development and growth of the renewable energy sector. Project developers do not want to implement a structure that does not take full advantage of these credits.

Under applicable IRS regulations, the only entity that can claim the credit is the entity that owns the assets or project that qualifies for the credit. However, because of the restrictions to which REITs are subject, they generally cannot own these assets. Moreover, as entities generally not subject to entity level taxation, they do not have sufficient tax liability to use these credits.

To ensure the project takes maximum advantage of these credits and the REIT’s status is not jeopardized:
To the extent possible, these assets should be owned by a separate taxable subsidiary or a separate unrelated entity that can claim these credits. Once the credits are exhausted, these assets may be held by the REIT, subject to the asset or income tests.

- If the project claimed the ITC, the project should only be transferred to the REIT after the expiration of the five year recapture period.
- If the project claimed the PTC, the project should only be transferred to the REIT after the expiration of the 10 year period for which this credit is available.

**LIMITS OF CURRENT RULES**

While the structures discussed in this note give REITs a means to participate in renewable energy projects, they:

- Do not allow a REIT to own a renewable energy project outright. While in some cases, the REIT can own a renewable energy project indirectly through a TRS, the conditions and requirements the REIT must satisfy, and the monitoring this may involve, may make many investors wary of pursuing these structures.
- Do not allow investors to benefit from income earned from selling electricity, which may be more lucrative over the term of a project than lease payments or mortgage interest. Although in limited cases, a REIT can install a total energy system or sell electricity as permissible tenant services, the income generated from these structures is not generally significant.
- Generally should not be used for projects that qualify for the ITC or PTC, until these credits have been exhausted and all applicable recapture periods have expired.

Because of these limitations, developers and investors want the IRS to expand the definition of real property to allow them to use REITs to hold equity in renewable energy projects and would like a means to utilize the ITC and the PTC. Legislation permitting the use of these credits may be necessary. In February 2013, a company that invests in sustainable infrastructure projects disclosed that it had received a private letter ruling from the IRS allowing it to invest in energy projects. But because it has not been made public, the scope of this ruling is unknown. Another company announced in September 2012 that it had requested a private letter ruling that solar farms constitute real property, but the company has not disclosed whether this ruling was received. While this ruling would be welcome, most market observers are not expecting the IRS to issue such a broad ruling.

**Contributor Profile**

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Professional qualifications. New York, US;

Areas of practice. Micah Bloomfield is a tax lawyer whose practice emphasizes the taxation of financial products, including asset-backed securities transactions, life settlement transactions and structured notes. Mr. Bloomfield has extensive experience with tax issues relating to hedge fund and private equity funds, XXX transactions (a type of capital market transaction used by life insurance companies), bankruptcy reorganizations and tax incentives for renewable energy projects. He has also advised dealers and other participants in numerous swap and other derivatives transactions. He has drafted model tax modules in connection with cross-border swap transactions for use in negotiating ISDA tax representations and related tax forms. Mr. Bloomfield is an active member of ISDA’s tax committee and frequently comments on proposed Treasury regulations.
For more information, search for the following resources on our website.

**Topics**
- Project Finance and Development  
  (http://us.practicallaw.com/topic8-382-8574)
- Real Estate Finance and Investment  
  (http://us.practicallaw.com/topic9-103-2086)
- Tax  
  (http://us.practicallaw.com/topic1-500-3050)

**Practice Note: Overview**
- REITs: Overview  
  (http://us.practicallaw.com/8-504-7098)
- Renewable Energy: Overview (US)  
  (http://us.practicallaw.com/4-518-1338)

**Practice Notes**
- Solar Energy Project Development Issues: Preliminary Considerations  
  (http://us.practicallaw.com/7-522-8476)
- Understanding Renewable Energy: Solar  
  (http://us.practicallaw.com/2-519-8033)
- Understanding Renewable Energy: Wind  
  (http://us.practicallaw.com/6-504-0856)
- Wind Energy Project Development Issues: Preliminary Considerations  
  (http://us.practicallaw.com/9-521-9174)

**Standard Clause**
- Loan Agreement: REIT Provisions (Borrower’s REIT Status)  
  (http://us.practicallaw.com/7-515-7228)

**Checklist**
- REITs: Common Pitfalls and Fixes Checklist  
  (http://us.practicallaw.com/2-504-7119)

For the links to the documents referenced in this note, please visit our online version at http://us.practicallaw.com/2-501-8230

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