# The Changing Environment of R&R (REITs and Renewables)

A discussion of selected tax developments and considerations

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If there is a color to the spirit of our times, it is likely to be green. Phrases like "renewable energy", "zero emission", "carbon footprint", "cap and trade" and "corporate sustainability" have become familiar and commonplace. Federal, state and local government entities continue to enact tougher laws and mandates affecting energy efficiency. Greening initiatives and economic incentives abound across governing bodies and public utilities. More than ever, commercial real estate owners will need to take into account the emerging framework of environmental regulations when buying, building, retrofitting, operating and ultimately selling their properties.

There already exists a broad menu of federal, state, local and public utility financial incentives to encourage renewable energy and accelerate capital investment. Among these are fast track permitting, rebates, green power purchasing programs, tax deductions, credits and grants. However, REITs with a sustainability initiative will confront unique tax issues and a regulatory regime that may limit their ability to avail themselves of the benefits extended to non-REIT commercial property owners.

We will use the installation of solar panels as a starting point for this discussion, given abundant REIT ownership of roof space across the USA. So far, attention has focused mainly on relatively low-cost greening action steps such as lighting retrofits or rooftop lease projects. In these deals large solar energy service providers place solar panels on rooftop space leased from a REIT. The REIT can purchase power from the energy provider, using it internally and reselling it to tenants, or possibly the tenants can opt to purchase solar power.

But what if the REIT wants to purchase solar panels for installation on its roof and avail itself of financial (tax and otherwise) incentives available? How might it be affected by the emerging environmental regulatory framework? A discussion of several relevant elements follows.

## Investment Tax Credit and Cash Grants (Federal)

A taxpayer that purchases qualifying energy property which includes renewable energy investments, such as solar and small wind property and which is placed in service before 2017[1], may receive a credit depending on the qualifying investment (varies between 10% and 30%). For

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[1] 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% 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.

a REIT these credits are limited in their utility as the benefit can only be claimed to the extent it does not distribute all of its taxable income.

For a given qualifying property, and in lieu of the credit, under the American Recovery and Reinvestment Act, a taxpayer can receive a cash grant from the Treasury Department equal to 30% of its investment in certain renewable energy properties. Generally for cash grants for solar property, construction has to begin before 2011 and be placed in service before 2017[2]. Similar to the limitations REITs are subjected to with the investment tax credit described above, a REIT can only obtain a grant to the extent it does not distribute all its taxable income.

**Emerging Revenue Generating Programs and associated REIT implications**

Jurisdictions and public utilities across the country have launched programs, such as direct incentive payments or portfolio standards, to encourage investment in or 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 (referred to here as "PBIs") generally come into being when renewable energy enters the grid, but can be sold and purchased separately from the power.

To date, there has not been any express IRS guidance on the REIT tax treatment of income from PBIs. One approach may be to treat such income as bad income as there is no current authority stating otherwise. But given the emergence of these programs and the potential role of real estate owners in leveraging billions of square feet of roof space to generate energy, is there relevant guidance one can draw on for an indication of where IRS sentiment may lie in determining the treatment of PBIs for REIT income test purposes?

Citing the legislative history underlying the tax treatment of REITs, the IRS has indicated that the central concern behind the gross income restrictions is that a REIT's gross income should largely be composed of passive income (including rental income) and not from the active conduct of other trades or businesses. In some cases, the IRS has analyzed transactions and determined that because the transactions were not inconsistent with the purposes of the REIT rules, income from the transactions could be disregarded in determining the REIT income tests. For example, in separate private letter rulings, it was held 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 (PLR 200614024 and PLR 200528004). While PBIs are incentives separate from those delivered through current tax regimes, one might argue that the analysis from a REIT income test perspective should be the same, at least to the extent that the energy system is related primarily to the real estate and its tenants.

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[2] See footnote 1. The cash grant program has placed in service date requirements that conform to the incentive tax credit placed in service date requirements.

### Treasury Authority to treat income as qualifying or excludable

With The Housing Assistance Act of 2008, Congress empowered the Treasury to treat income which would not otherwise qualify for the gross income tests by either not taking it into account or by treating it as qualifying. Even with the various credits, incentives and potential for growth in the area of renewable energy credit exchanges (and with the broad ownership of real estate by REITs), it remains to be seen whether the Treasury will use its discretion to permit REITs to benefit from these incentives without being penalized under the REIT rules. One thing is certain--REITs have the potential to be substantial contributors to the success of these initiatives.

Although the discussion above has merit and there is promise in the legislative proposals that have been set forth, until there is specific guidance from the Federal level, any REIT pondering a large solar panel purchase today may not fully enjoy the capital recovery incentives without some remedies to the current credit regime (as discussed above) and further guidance, in the area of income from PBIs.

### IRC Section 179D (Federal)

IRC Section 179D provides a good example of the nuances of the tax issues related to installing energy efficient systems. For property placed in service after January 1, 2006 and before January 1, 2014, federal tax law generally allows a commercial building owner to receive a deduction equal to $1.80 times the square footage of a building for energy efficient property installed in a building located in the US. Energy efficient property includes interior lighting systems, heating, cooling, ventilation, hot water systems or the building envelope. There is also a certification requirement that must be met in order to receive the deduction, but solar panels do not qualify within the definition of energy efficient property, thereby causing a certain amount of confusion.

Section 179D also illustrates tax issues that would specifically affect REITs embarking on sustainable energy programs. Since many REITs distribute all of their earnings, some have wondered whether the deduction is robust enough to justify the economic investment required. Another important nuance is that the deduction does not currently conform for earnings and profits purposes. This means that the REIT can lower its distributions to take into account reduced taxable income, but if the REIT maintains the level of its distributions, the entire amount is still taxed as a dividend, and so the REIT shareholder doesn't get passed through the benefit of the deduction.

#### Selected Legislative Proposals

There are some legislative proposals and requests for clarification, as summarized briefly below, that are seeking to make strides to even the playing field for REITs. They include:

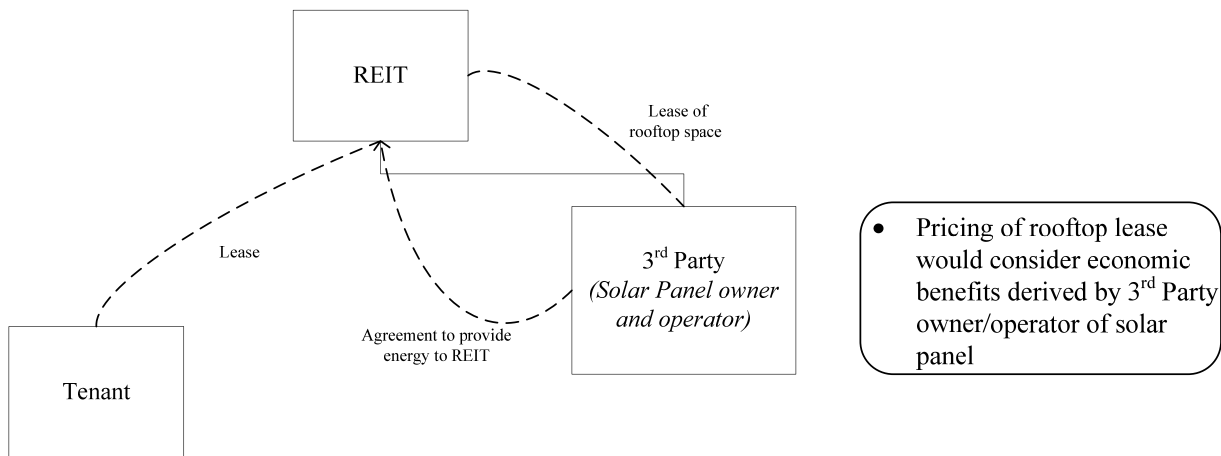
- H.R. 4256, introduced by Representative Linda Sanchez (D-CA), would remove the current limitation placed on REITs to receive grants only to the extent of retained taxable income

- H.R. 4599, introduced by Representative Earl Blumenauer (D-OR) proposes a two year extension, conversion of the grant to a renewable credit, and allow REITs to benefit

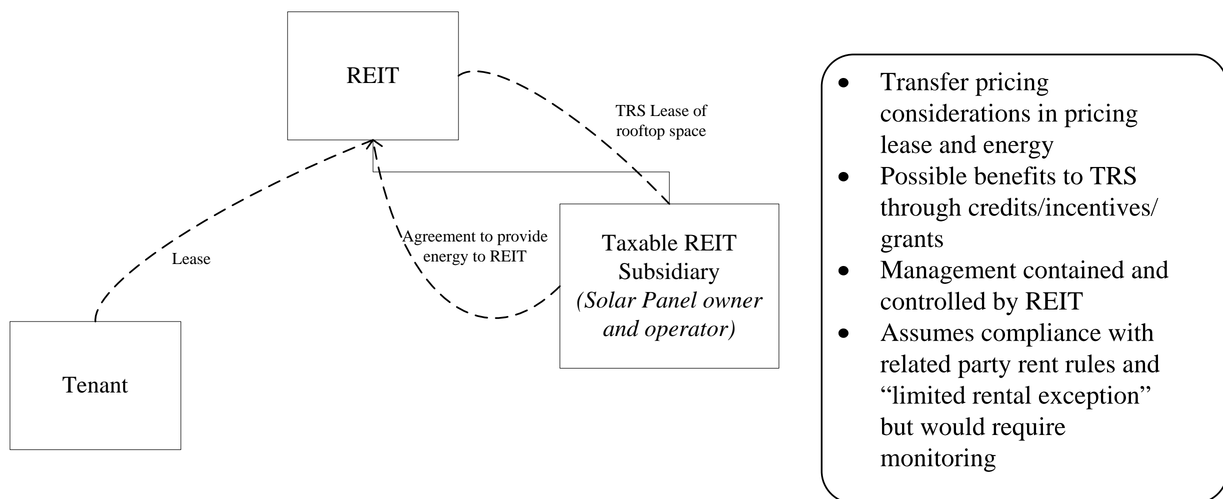
- NAREIT has suggested that Congress clarify that grants are good assets and qualifying income/or excludable from REIT tests

In the meantime, while the REIT community bides its time in an environment of legislative flux, there are common structures today that may be implemented, each with their own set of considerations and variations. Akin to equipment leases, these are depicted below:

***Scenario 1 - Third party owner of solar panels***




***Scenario 2 - The Taxable REIT subsidiary ("TRS") owner***



As depicted above, a TRS would own the solar panel. It's possible that if the TRS has other business lines that are experiencing a tax profit, it might enjoy the benefit of a credit and/or accelerated deduction. Also a REIT may consider ultimately transferring ownership of equipment from the TRS to the REIT at some later point if economically desirable and REIT-compliant.

By examing the possible installation of solar panels on a REIT controlled rooftop, it is clear that there is an emerging regulatory framework on environmental issues. Financial incentives will continue to be a key factor in stimulating advances in developing and distributing renewable energy. As popular vehicles for attracting capital and owning and operating real estate, it is inevitable that REITS will play an important role in furthering the greening trend. This analysis summarizes some selected structures for REIT participation in the renewable energy sector. But additional guidance and regulatory refinements are needed in order for REITs to more fully enjoy available incentives and impact the growth of renewable energy. Now is a good time for a lively discussion regarding tax issues that will affect REITs in the context of a strong greening trend.

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