REIT, MLP & YIELDCO RENEWABLES BUZZ

THE US RENEWABLE ENERGY INDUSTRY IS ABUZZ WITH TALK OF REITS, MLPS AND YIELDCOS. THIS ARTICLE IS AN OVERVIEW OF WHAT THESE THREE VEHICLES ARE, HOW THEY CAN BE DEPLOYED UNDER CURRENT LAW, AND INITIATIVES TO EXPAND THEIR APPLICATION. BY **DAVID BURTON**, A PARTNER IN THE TAX AND PROJECT FINANCE PRACTICES AT **AKIN GUMP STRAUSS HAUER & FELD LLP**.

The fundamental principle necessary to understand these vehicles is that if an entity's equity is publicly traded, the entity must in most instances be taxed as a corporation (ie, a C corporation). Being taxed as a corporation generally means the imposition of two layers of tax: the entity pays tax on its income and its shareholders pay a second-level tax when income is distributed to them as dividends (as well as on any gain from the sale of the stock).

This general rule applies even if the entity takes the state law form of a non-corporate entity such as a limited partnership, a limited liability company or a trust. Thus, if a partnership that makes widgets issues equity interests widely to the public, that partnership will be taxed as a corporation (and hence its income will be subject to two layers of tax).

The REIT and MLP rules are exceptions to this fundamental principle. REITs and MLPs are able to be publicly traded while avoiding the entity layer of tax (ie, only the equity holders are subject to income tax). Thus, they are the holy grail of corporate finance: relatively low cost and highly liquid capital from retail investors with a single layer of tax. In contrast, a YieldCo is an entity that is publicly traded and taxed as a corporation but that plans to manage its tax position to limit the tax that it and its shareholders incur.

What are they?

- *REIT* – REIT is an acronym for "real estate investment trust". It is a creature of the Internal Revenue Code (the "Code") and can be publicly traded or privately held, within limits. A REIT in the first instance is taxed like a corporation; however, unlike corporations, it is eligible for a tax deduction for dividends it pays to its shareholders. Therefore, the REIT pays little to no tax, while the shareholders pay tax on the dividends distributed to them. Thus, a REIT is subject to one layer of tax, which makes it similar to a partnership from a tax perspective; however, it can be publicly traded, while many entities that are taxed as partnerships cannot.

To be a REIT, the Code requires the entity to satisfy the following requirements:

i A REIT must invest 75% of its assets in "qualifying assets", which generally means real estate or mortgages secured by real estate[1].

ii At least 75% of its gross income must be from real estate mortgages, real estate gains or "rents" from real property. To be such rental income, the lessee must be unrelated to the REIT[2].

iii At least 95% of its gross income must be from rents, interest, dividends or real estate gains[3].

iv It must distribute at least 90% of its taxable income to its shareholders. (It receives a tax deduction for that distribution.)[4]

- *MLP* – MLP is the acronym for "master limited partnership". It is a creature of the Code[5]. An MLP must be organised as a state law partnership or limited liability company. An MLP is an entity that meets the exception to the rule that widely held partnerships, limited liability companies or trusts must be taxed as corporations. An MLP is subject to the partnership rules of subchapter K of the Code. For instance, it must calculate capital account balances for its partners and provide its partners with a Form K-1 at tax time on an annual basis.

The requirement to be a MLP is that at least 90% of the entity's gross income must come from "qualifying sources". So-called "good" income is limited to:

i Interest, dividends, and capital gains.

ii Rental income and capital gains from real estate.

iii Income and capital gains from natural resources activities.

iv Income from commodity investments.

v Capital gains from sale of assets used to generate the above types of income[6].

REITs and MLPs are able to be publicly traded while avoiding the entity layer of tax

"Natural resource activities" is defined to include mining, refining and transport of petroleum, natural gas, coal and other minerals. The only renewable energy resources included as a "natural resource" are ethanol, biodiesel and other alternative fuels and industrial source carbon dioxide. Thus, solar, wind, biomass and geothermal activities do not generate "good" income for purposes of the 90% test.

- *YieldCo* – YieldCo is neither a creature of the Code nor of state or securities law. It is merely industry parlance for a publicly traded corporation that plans to try to manage its operations to limit the tax that it and its share-holders pay. Thus, there are no legal definitional requirements to be a YieldCo.

Each of the three investment vehicles can be used for renewables under current law; however, REITs and MLPs are subject to relatively constraining limitations.

- *REIT* – As a general matter, a REIT can only invest in renewables to the extent the income from renewables will not result in a failure of the percentage tests above. Furthermore, a REIT has little (or no) use for the federal tax credits, because a REIT is entitled to a tax deduction for merely paying dividends and must dividend 90% of its taxable income. In addition, the investment tax credit is reduced pro rata by the percentage of the REIT's income that it distributes as a dividend[7]. The only benefit of accelerated depreciation is that the depreciation can reduces the size of the dividend the REIT must pay or can allow it to make a *distribution* that is not a "dividend" (but rather reduces the shareholder's basis in the stock of the REIT).

Under current IRS guidance, a REIT's solar activities can generate "good" income in limited circumstances.

First, a REIT could own land on which a renewable energy project is constructed and lease the land to the project.

Second, a REIT can likely own a building that it rents to tenants, and the REIT can install solar panels on the roof of the building and charge the tenants for the electricity that the panels supply; however, the solar system may only supply electricity to the building (ie, the electricity may not be sold into the grid)[8].

Third, a REIT can own mobile phone towers and install solar panels on the tower and charge the mobile phone companies that use the tower for the electricity the panels provide. The panels can only provide electricity to the mobile phone equipment on the tower, and apparently the location of the tower must be such that the grid is either unreliable or not accessible[9].

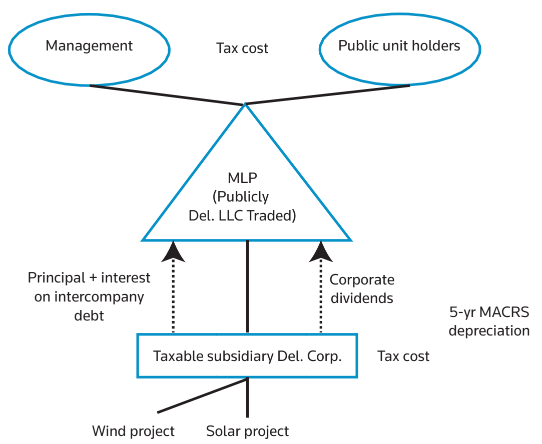
- *MLP* – An MLP can engage in the same renewable electricity generation activities as a REIT. The tax credits and depreciation from the renewable energy projects would flow through to the MLP's partners (ie, shareholders). However, unless the partner is a widely held corporation, the tax benefits would be subject to the passive activity loss and at-risk rules that limit individuals' ability to use losses and credits from such activities to offset income tax on their salaries or investment portfolio[10]. Thus, the tax benefits could potentially be suspended until the earlier of when the partner exits the MLP or the MLP generates sufficient taxable income to use them. Also, note the discussion below of the complications tax-exempt MLP partners (ie, shareholders) cause with accelerated depreciation and investment tax credits.

Alternatively, a MLP could form a taxable corporate subsidiary that owns, develops or operates renewable energy projects. It could capitalise the corporate subsidiary with a combination of intercompany debt and an equity contribution. Thus, all of the income the MLP would earn from the corporate subsidiary would be dividends and interest and thus "good" income for the MLP 90% test.

The MLP's corporate subsidiary would have interest deductions from the intercompany loan and from the project's accelerated depreciation and tax credits. Thus, at least for the five-year depreciation period, the corporate subsidiary could shelter most or all of its income from tax. Beyond five years, the corporate subsidiary would either need to acquire new projects that generate more tax benefits, rely on unused tax credits and deductions from the initial projects, or start paying tax.

If the corporate subsidiary made distributions to the MLP, the partners in the MLP would have dividend income to the extent that the corporate subsidiary had current or accumulated earnings and profits (E&P). The calculation of earnings and profits is somewhat similar to taxable income with certain adjustments; among those is that depreciation is calculated straight-line over the class life. For renewables, this means 12-year straight-line depreciation, rather than five-year double declining balance[11].

DIAGRAM 1 - MLP CORPORATE SUBSIDIARY



Further, earnings and profits are reduced by corporate taxes after giving effect to tax credits[12]. Earnings and profits are not affected by the basis adjustment applicable to the investment tax credit[13].

Similar tax results could be achieved without the MLP. However, the structure permits an existing MLP with operations that are *qualifying* under current law (eg, natural gas pipelines) to enter the renewables space without jeopardising its MLP qualification. Further, it ensures that the debt and equity of the corporate subsidiary remain in the MLP's hands.

- *YieldCo* – YieldCo is a publicly traded corporation that intends to manage its tax profile. It is not seeking to satisfy any particular definition in the Internal Revenue Code. Investment bankers have rules of thumb for a YieldCo to be attractive to the public market.

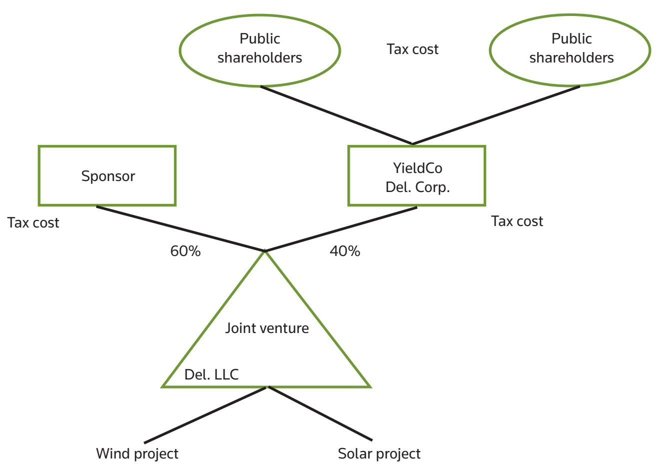
First, the transaction needs to be of a sufficient size to merit the cost of the initial public offering (IPO) and the ongoing costs of being a public entity (eg, Sarbanes-Oxley compliance). Roughly speaking, that means the YieldCo needs to be raising at least approximately US$150m or more in equity in the IPO.

Second, the market will demand consistent cashflows to pay distributions, so that means substantial Ebitda (ie, earnings before interest, taxes, depreciation and amortisation).

Finally, it is preferable for the sponsor to have skin in the game by retaining a substantial interest (ie, more than 50%) in the projects in which YieldCo will invest. This ensures the sponsor continues to maximise the operations of the assets, rather than using YieldCo as a means to cash out. Thus, the sponsor needs more than US$300m in project assets to support an IPO.

One means to execute this is for the sponsor to contribute its project assets, worth for instance US$375m, to a limited liability company taxed as a partnership. Simultaneously, the sponsor forms YieldCo, which is a corporation, and YieldCo issues shares to the public in exchange for US$150m. YieldCo contributes the US$150m to the newly formed partnership and takes back a 40% interest that leaves the sponsor with a 60% interest.

DIAGRAM 2 - YIELDCO



> To maximise its value, Yieldco will need to keep growing. New assets with tax credits and depreciation are needed to shelter taxable income generated by older assets

The partnership will not pay tax and rather will pass the tax attributes through to sponsor (60%) and YieldCo (40%). The hope is that those attributes are mostly tax credits and depreciation, so YieldCo does not have any current federal income tax liability. The partnership also distributes 40% of its cash from operations to YieldCo. YieldCo in turns distributes that cash to its public shareholders.

The cash distributions to the public will be taxable dividends to the shareholders to the extent of YieldCo's E&P. The calculation of E&P in a renewable energy context is discussed above. To the extent that the cash distributions exceed YieldCo's E&P, the distributions will reduce the shareholders' basis in their shares of YieldCo. A lower basis means a larger gain when the shareholders sell their shares, which if the shares were held for more than a year would be taxed at the 23.8% long-term capital rate.

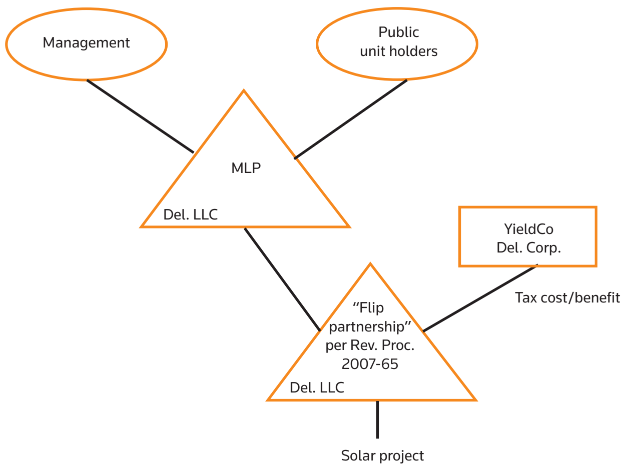
To maximise its value, YieldCo will need to keep growing. New assets with tax credits and depreciation are needed to shelter the taxable income generated by older assets that have exhausted their tax benefits. Otherwise, YieldCo will owe income tax itself, and its distributions will be characterised as dividends that its shareholders must pay current tax on.

The future

- *The future for REITs and renewable energy* – Twenty-six members of Congress requested that Treasury issue a revenue ruling concluding that renewable energy projects generate "good" income for purposes of the REIT test. Thus far, Treasury does not appear to be entertaining that request.

Renewable Energy Trust Capital, Inc was not content to wait for Treasury. It has submitted a private letter ruling request to the IRS for a ruling that ground-mounted solar is real property that if leased will generate "good" income for the REIT test[14]. As of the date of publication, it appears Renewable Energy Trust is still waiting for its ruling. If the ruling is issued, only Renewable Energy Trust could rely on it in a dispute with the IRS. Other taxpayers could either request their

DIAGRAM 3 - MLP WITH TAX EQUITY INVESTOR



own ruling or hope that the IRS in an audit chooses to abide by its prior private letter ruling, though PLRs have no official precedential "weight".

Renewable Energy Trust's calculation appears to be that the lower cost of equity from retail investors will equal or exceed the benefit of investment tax credits and depreciation that it cannot use as a REIT. Further, Renewable Energy Trust could then partner with tax equity investors to execute transactions that raise cash for Renewable Energy Trust and provide the tax equity investor with a stream of tax benefits and cashflow.

The IRS is reportedly struggling with the ruling request. It could be that the IRS is concerned that ruling that ground-mounted solar projects are real property could raise questions as to whether such a conclusion is consistent with their being eligible for the investment tax credits and accelerated depreciation.

• *The future for MLPs and renewable energy* – Senators Chris Coons (D-Del.) and Jerry Moran (R-Kan.) in 2012 introduced a bill to amend the MLP rules to make income from renewable energy projects "qualifying income". The bill would not enable MLPs to act as tax equity investors, because it does not amend the passive activity loss rules or the at-risk rules. Thus, MLPs under this legislation would only be efficient with respect to providing cash equity or debt to renewable energy projects (ie, MLPs will not be tax equity investors).

The Yieldco is not a creature of the tax law. Therefore, it is not in need of a legislative change or a ruling

The prospect for MLPs and REITs for renewables received a boost when the President's adviser for energy and climate made favourable remarks about them[15].

If the bill were enacted, it would permit MLPs efficiently to raise capital to act as sponsors or developers. The MLP could then partner with tax equity investors to execute transactions that raise cash for the MLP and provide the tax equity investor with a stream of tax benefits and cash flow.

If the MLP had "tax-exempt" partners (ie, shareholders), and the typical structure of incentive profits sharing with management (ie, not a "straight-up" partnership), it would raise certain complexities for the tax equity investor's eligibility to utilise fully accelerated depreciation and investment tax credits[16]. The structure below assumes any tax-exempt partners of the MLP hold their interests through a domestic corporation that makes an election to treat any dividend or gain income from the domestic corporation as unrelated business taxable income, because then the participation of the tax-exempt investors does not taint the accelerated depreciation or investment tax credits.

Further, MLPs could purchase existing projects that had already generated their tax credits for their original owner. For investment tax credit projects, this would be after the five-year recapture period. For production tax credit projects, it would be after the 10-year credit period.

• *The future of YieldCo and renewable energy* – The YieldCo is not a creature of the tax law. Therefore, it is not in need of a legislative change or a ruling. If the MLP bill is enacted, the renewable energy industry will likely lose interest in YieldCos and MLPs will be prevalent. If the solar REIT private letter ruling is issued, the solar industry will shift to REIT; however, YieldCo will still be needed as an investment vehicle for wind and other types of renewable energy projects.■

Footnotes

1 - I.R.C. §§ 50(b)(4)(A), 168(h)(6).
2 - I.R.C. § 168(h)(6)(F).
3 - I.R.C. § 856(c)(2).
4 - I.R.C. § 857(a).
5 - The Code refers to it as a "publicly traded partnership", while MLP is the parlance of the industry.
6 - I.R.C. § 7704(d)(1).
7 - I.R.C. § 50(d)(1) (referencing old I.R.C. § 46(e)).
8 - See P.L.R. 201301007 (Oct. 2, 2012) (describing a similar scenario with solar panels on towers that support antennae and power only the antennae and related equipment).
9 - P.L.R. 201301007 (Oct. 2, 2012).
10 - I.R.C. §§ 465, 469.
11 - I.R.C. § 312(k).
12 - Rev. Rul. 63-63, 1963-1 C.B. 10.
13 - Id.
14 - Tom Konrad, IRS to Rule on Status of Solar PV Owned by REITs, Forbes (Oct. 12, 2012).
15 - Ari Natter, Official Says White House Seeking Changes to Tax Policy to Benefit Renewable Energy, DAILY TAX REP. G-9 (Apr. 9, 2013).
16 - §§ 50(b)(4)(A), 168(h)(6).