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Treasury Proposes REIT Solar Regulations but Excludes Most Common Transactions

Global Project Finance Alert

On the same day as President Obama's speech championing solar, the Department of the Treasury proposed regulations defining "real estate assets" for purposes of the definition of a real estate investment trust (REIT). The same definition would apply for purposes of the real estate component of the *qualified income* standard in the publicly traded partnership definition used to determine whether a master limited partnership (MLP) will be taxed as a partnership.

The proposed regulations describe three fact patterns involving solar and analyze whether the assets involved are real estate for purposes of the REIT rules. It is critical to a REIT that the assets in which it invests qualify as "real estate" because two of the most salient elements of the definition of a REIT are that 75 percent of its assets must be real estate assets or real estate mortgages, and 95 percent of its gross income must be derived from real estate assets or real estate mortgages. It can also be critical that an MLP owns real estate, as 90 percent of its gross income must be "qualifying income," which includes rents and gains from real estate.

Three Solar Examples from the Proposed Regulations

In the first fact pattern, the REIT owns a ground-mounted solar project. The REIT leases the project out pursuant to a triple net lease. The lease is required, as REITs are not allowed under the tax code to operate businesses. It is not stated, but presumably the lessee has entered into a power purchase agreement with a utility. The proposed regulations conclude that the photovoltaic (PV) modules are not real estate; while the mounts, exit wire and the land on which the project is sited is real estate. As much of the value of the project is attributable to the modules, this example provides little opportunity for REITs.

This first example parallels the operations of utility- and many commercial-scale solar projects, so it suggests that a significant portion the solar industry will not be REIT eligible.

The second fact pattern deals with a ground-mounted solar project that is physically identical to the project in the first example, but is adjacent to a commercial building. The electricity from the project is used to power the building, although a small amount of electricity is sold into the grid pursuant to a net metering arrangement. The owner of the solar project also owns the building, and the same tenant leases the building and the solar project. The example notes that the solar project was "constructed specifically for the office building and [is] intended to remain permanently in place but [was] not installed during construction of the office building."

This second example analyzes the project as a whole, rather than considering each separate component as the proposed regulations did in the first example. The apparent rationale for the "project as a whole" analysis is that in the second example the solar project (i) serves "a utility-like function," (ii) serves "the office building in its passive function of containing and protecting the tenants' assets," and (iii) "produce(s) income from consideration for the use or occupancy of space within the building." Under this analysis, the solar project as a whole is deemed to be real estate.

The third example is a minor variation from the second in that the solar project consists of "shingles used as the roof "of the office building. It is important to note that the solar shingles are owned by the REIT which also owns the building. Not surprisingly, the example concludes the solar shingles are real estate.

Effective Date

The proposed regulations will only be effective after final regulations are published. As the regulations were not simultaneously issued in "temporary" form, the proposed regulations cannot be currently relied upon by taxpayers.

We note that House Ways and Means Committee Chairman Dave Camp's tax reform proposal discussion draft—Tax Reform Act of 2014—would limit REIT-eligible assets to those having a class life of at least 27.5 years. If this provision were to find itself enacted into law, it could override the utility of the proposed regulations. Even if the provision were not enacted into law, it remains to been seen if any members of Congress seek a legislative restriction with respect to REIT assets.

Market Implications

The first and second examples of the proposed regulations effectively exclude utility-scale solar projects from REIT eligibility because a utility-scale project cannot serve only a constituent building. The IRS last year reportedly declined to rule that Renewable Energy Trust Inc.'s utility scale projects constituted real estate, so the conclusion of proposed regulations is not surprising.

The juxtaposition of the two examples involving a physically identical project suggests that the use of the electricity trumps the physical nature of the asset in determining whether the asset is REIT eligible. Unfortunately, in commercial-scale solar, it is relatively rare for the same person to own the solar project and the building that it serves. It remains to be seen as to whether Treasury views common ownership as critical or if serving an adjacent building owned by another party would suffice. As solar projects and buildings have different investment profiles, the regulations will be more helpful if Treasury does not require common ownership.

A clarification as to whether the same party must own the solar system and the building would also create the opportunity for REITs in residential solar. The proposed regulations' omission of any discussion of residential solar is a pronounced silence.

Investment Tax Credit and Accelerated Depreciation Implications

Many industry participants are concerned about the idea of solar projects being REIT eligible. This is because if a solar project is "real estate" it may be "real property" ineligible for accelerated depreciation[1] and may not be "equipment" as required for the investment tax credit.[2] The preamble to the proposed regulations at first appears to provide comfort on this point: "These proposed regulations define real property only for purpose of sections 856 through 859." However, rather than definitively stating that these definitions do not apply for depreciation or investment tax credit purposes, the preamble provides that comments are requested to "the extent to which the various meanings of real property that appear in the Treasury regulations should be reconciled, whether through modifications to these proposed regulations or through modifications to the regulations under other Code provisions."

The concern about the depreciation implications of the proposed regulations also arises because the IRS in January issued a private letter ruling addressing the depreciation classification of conventional drywall and portable drywall (that is drywall that could be moved easily to another location).[3] The drywall example in the proposed regulations tracks the depreciation analysis in the private letter ruling: conventional drywall is real estate while movable drywall is not. So taxpayers who seek accelerated depreciation for solar projects must conclude that the proposed regulations track the depreciation rules with respect to drywall but not with respect to solar projects.

Conclusion

The proposed regulations are a welcome development; however, there is a good possibility that they satisfy no one. Solar REIT advocates will be unhappy that REIT- eligible projects will be few and far between based on the literal parameters of the proposed regulations, while the proposed regulations stop short of allaying all of the depreciation and investment tax credit concerns of traditional solar investors.

[1] *See* I.R.C. § 168(c).
[2] *See* I.R.C. § 48(a)(3)(A)(i).
[3] P.L.R. 201404001 (Jan. 24, 2014).

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