Solar Industry® As seen on www.solarindustrymag.com on Feb. 21, 2013

REITs And Solar: The Future Is Already Here

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The solar sector is abuzz with the rumor that the Internal Revenue Service (IRS) is about to classify solar farms as the type of property that can be owned by real estate investment trusts (REITs). Although a ruling of such breadth would certainly be welcome, the more likely scenario is that any ruling by the IRS on the status of solar assets will be limited to a specific type of asset used in a subsegment of the solar energy industry.

Such a ruling is unlikely to result in the revolutionary change that so many are hoping for. Evolutionary change, however, is already occurring.

Many REITs are already contributing to the growth of the solar market, even in the absence of an IRS ruling. The challenge is identifying those structures that allow a REIT to contribute to this growth, while maintaining the required ratios of "good" vs. "bad" REIT assets and "good" vs. "bad" REIT income.

The concept of a REIT was created in 1960 when Congress passed legislation intended to give investors in real estate the same tax-preferred investment approach that investors in stocks and securities were able to enjoy under the rules for mutual funds. This legislation provided that if a company meets certain requirements related to its formation, assets and income, the company is taxed only on its undistributed taxable income.

Since most REITs annually distribute all of their taxable income, most REITs owe no corporate-level income tax.

One of the threshold questions that a REIT must address is whether the bulk of its assets consist of real property. The IRS defines real property generally as land, buildings and other inherently permanent structures. This definition does not include, however, "assets accessory to the operation of a business." It is believed that the IRS views such excluded assets as including equipment that generates electricity.

If an asset that generates electricity, such as a PV panel, is treated as a "bad" REIT asset, then a REIT can limit its investment in such assets so that it maintains the appropriate balance between "good" and "bad" REIT assets. Alternatively, the REIT can avoid investing in "bad" REIT assets altogether and instead focus solely on owning "good" REIT assets. Currently, REITs are employing both approaches.

Distributed solar generation hosting

One example of the latter approach is the participation by some REITs in the distributed solar market. A REIT leases space on the roofs of its buildings to a local utility, which pays rental fees to the REIT. The utility uses the space to host a large solar installation. The electricity generated by the installation feeds directly into the utility's electrical system for sale to its customers.

Alternatively, a REIT can lease rooftop space to a third-party operator that constructs, owns and operates the solar installation. The generator then sells the generated power to a utility under a power purchase agreement between it and the utility.

In both cases, the REIT does not own the electricity-generating assets located on its rooftops, nor does it earn any income directly or indirectly from the sale of electricity generated by those assets.

The REIT's only income from its participation in the distributed solar arrangement is from market-based rents paid for the use of those rooftops by the solar PV system owner-operator. Because the rooftop space qualifies as real property, the rental income paid for the use of that space qualifies as rental income.

Customary tenant services

Another way that REITs are currently participating in the solar market is through the ownership of a solar rooftop system that generates electricity and other forms of solar energy consumed entirely in the building on which it is located.

Such a system may qualify as real property on account of being closely associated with the building on which it is located. Even if it does not qualify as real property, however, the value of the system is likely small enough relative to the REIT's other assets that the REIT is able to meet the requirement that the bulk of its assets qualify as real property.

The other aspect of this arrangement is that it allows the REIT to take advantage of special rules relating to the services a REIT may provide to its tenants. Specifically, in addition to owning primarily real property, a REIT must derive the bulk of its income from the passive ownership of those assets.

A REIT does so by ensuring that most of its income is in the form of rental fees for the use of its assets by its tenants. This also means that a REIT may not provide services to its tenants, such as security guards at building entrances and cleaning services for tenant-occupied space. If so, the REIT is considered to be engaged in an active business, and income from its tenants will no longer qualify as “good” REIT income.

However, there are instances in which a REIT may provide services to its tenants without tainting the income received from those tenants. One example is if the services provided by the REIT are considered to be customary and usual in the geographical area in which the REIT is located.

A recent ruling from the IRS illustrates this rule: The taxpayer that requested the ruling was a REIT that owned freestanding and rooftop wireless and broadcast antenna towers. The REIT’s primary business was leasing antenna space on its towers.

However, because many of these towers were located in areas where local electric power was not available on a predictable basis, in many cases, the REIT had on-site generators that it used to provide electric power to its tenants. According to the REIT, the use of on-site generators to provide power to tenants was usual and customary in connection with the rental of tower space to tenants in the areas where the generators were located.

The IRS agreed with the REIT that providing electric power generation to its tenants did not taint the rental income it received from those tenants. The IRS noted that the REIT’s obligation as a responsible landlord was to ensure that its tenants had predictable electric service if such services were usual and customary in the relevant locations. Significantly, the IRS also observed that the REIT did not sell any of the power that it generated back to the local electricity grid.

This ruling indicates that a REIT that installs and operates a solar rooftop system to provide electricity or heat to the building on which it is located may continue to receive “good” REIT income from those tenants. The critical factor is whether providing those services is usual and customary in the geographical market in which the building with the rooftop installation is located.

Although any ruling released by the IRS in the near future on the status of solar property as “good” REIT property is unlikely to be the industry-wide game changer that some are predicting, REITs are still an important tool in the solar market’s financing toolbox. REITs have already begun to contribute incrementally to the expansion of the solar market. The challenge is to find ways to continue building on this approach under the existing framework of rules.

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