

Tax Alert

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Proposed Rules Would Offer REIT Status to Certain Solar AssetsBY [JONATHAN TALANSKY](#)

The modified “flow-through” tax treatment afforded to REITs depends on the entity’s ability to meet certain asset and income-based tests, all of which in turn key off of the definition of “real estate.” On May 9, the IRS and Treasury issued proposed regulations (the “Proposed Regulations”) that create a new framework for defining “real property” for purposes of the REIT rules. Although the IRS has stated that the Proposed Regulations represent merely “a clarification of the existing definition of real property,” some of the new regulatory examples and illustrations will give comfort with respect to certain assets in the solar renewable energy space.

At a high level, the Proposed Regulations provide that property must be unitized into “distinct assets,” and each distinct asset is then tested to determine whether it is real or personal property. Under the standards set forth in the regulations (standards which were already contained in numerous REIT rulings that the IRS has issued over time) the touchstones of “real property” are passivity and permanency. The Proposed Regulations contain safe-harbor lists of distinct assets that qualify as real property, and enumerate certain criteria to use if a particular asset is not given safe harbor treatment.

The examples contained in the Proposed Regulations affirm that the following nontraditional assets are “real property” for REIT purposes: perennial fruit-bearing plants, a 5-ton sculpture permanently affixed to a building by supports, bus shelters, electrical and telecommunications systems of a data center, and the foundation and racks supporting a photovoltaic module that converts solar energy at a site. The “exit wires” that transmit the power to a grid are also good REIT assets, but the solar modules themselves are not since they can be separated and they serve the “active” function of producing electricity for sale to third parties. If, however, the generated electricity were used to power a building on the solar site, the modules would be qualifying REIT assets (even where the tenant occasionally transfers excess electricity to a utility). This is important because the Proposed Regulations therefore exclude solar projects situated on real property that sell the generated electricity to a third party such as a utility.

The preamble to the Proposed Regulations underscores the fact that the term “real property” is relevant in various provisions of the tax law, and is potentially subject to different meanings under different provisions as a result of “the regulatory process and decades of litigation.” For example, in the depreciation and the investment tax credit context, as well as for purposes of FIRPTA, taxpayers seek to characterize property as personal property and not as real property. On the other hand, for REIT qualification purposes, taxpayers have urged a more expansive definition of real estate.

The financing of renewable energy projects is closely tied to the availability of tax incentives. Developers of renewable energy have used various credits and other federal tax benefits to help finance their energy projects. These programs face their own measures of uncertainty and several have expired or will be expiring in the near future. For this reason, developers have lobbied for changes that would make certain tax-preferred structures (such as REITs or MLPs) available for renewable energy investment.

With respect to REITs, a long line of authority has left many questions regarding the ability of certain renewable assets (specifically, solar and wind) to qualify as “real estate” for purposes of the REIT rules. These authorities have drawn distinctions and created dichotomies that in some cases are inapposite to solar and wind technology, and at the very least are extremely difficult to apply in a sensible manner. For this reason, the publication of the Proposed Regulations represents a hopeful first step for developers and sponsors who hope to use the REIT structure for certain projects.

The “clarification” of the REIT rules to accommodate solar renewable energy technology will undoubtedly be a welcome development to many. That being said, developers of these projects will still need to conduct financial modeling to assure that REIT status can be maintained. They will also be interested in financing strategies that combine REIT structures with other federal and state tax credits.

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