One Minute Memo®

Are REITs the Future for Financing Renewable Energy Projects?

Renewable energy projects, such as wind and solar power, suffer from an inability to get affordable and sustainable financing. Currently, these projects rely on tax subsidies in the form of production and investment credits, which are far from ideal due to numerous factors that allow only limited types of investors to benefit from such subsidies. The subsidies are also subject to sunset provisions in the Internal Revenue Code, leaving much uncertainty as to whether future projects will be entitled to them.

In recent months, there has been increased discussion about using other tax-efficient financing vehicles for renewable energy projects. In particular, many experts in the industry have been advocating using a real estate investment trust (a "REIT") to invest in renewable energy infrastructure. REITs are entities that are treated as corporations for tax purposes, but are generally exempt from the corporate-level income tax, provided at least 90% of its REIT taxable income distributed annually to its shareholders (and certain other technical requirements are met). Among the benefits to using a REIT is the ability for a wider range of investors - including smaller individual investors - to invest in clean energy projects. Using a REIT to finance these projects would also lower the costs, as investors in public REITs typically demand a smaller return than currently available forms of financing.

However, there are several hurdles that a REIT would face in investing in clean energy projects. In order to qualify as a REIT, a company must pass several qualifying tests, including a quarterly asset test and annual income tests, designed to determine that a significant portion of the company's assets and income are related to real estate. While there are good arguments to be made for the position that assets and income generated from clean energy projects should qualify as "good" REIT assets and income,[1] in the absence of specific guidance from Congress, the Treasury Department or the Internal Revenue Service, taking such a position would be risky.

Recently, Renewable Energy Trust Capital ("RETC"), a start-up solar power firm, has requested a private letter ruling from the IRS to classify solar projects as "real property" for the REIT tests. Given the trend in the past few years of the IRS permitting other atypical assets to be treated as "real property," including energy-generating systems, there is a high degree of optimism that a favorable ruling will be granted in the coming weeks. This optimism has been confirmed by a recent SEC filing by Hannon Armstrong Sustainable Infrastructure Capital, Inc., in which Hannon Armstrong disclosed that it has received a private letter ruling treating loans secured by certain renewable energy assets as qualifying REIT assets.

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[1] Generally, based on guidance from the IRS with respect to billboards and other non-traditional real property, if the REIT develops the infrastructure of the solar system and leases the system to an independent third party to use and operate, the rent paid under the lease should be treated as good REIT income, assuming the infrastructure otherwise meets the requirements of being real property (i.e., property that is permanently affixed to the ground such that its renewal would cause substantial damage).

While a favorable private letter ruling to RETC may not be relied upon by other taxpayers, it would be an indication of the IRS's general position on the matter. Such a favorable ruling would likely lead to numerous requests from other companies, both for solar and other forms of renewable energy (such as wind projects). Renewable energy companies will be able either to create new REITs or team up with traditional public REITs, hopefully resulting in a newly-energized industry.

Both renewable energy companies and current REITs are urged to contact our offices if they are interested in pursuing this course of REIT-owned renewable energy projects. Seyfarth Shaw could assist in the process of obtaining a private letter ruling and producing a viable structure for such an enterprise.

The use of REITs for funding renewable energy projects is just one potential vehicle that is optimistically being pursued within the industry. Other vehicles for financing and securitizing these projects are also continuing to be explored. Seyfarth Shaw is well positioned to assist companies in pursuing these opportunities as well.

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