

Renewable Energy REITs: A New Capital Source for Energy Funds and Developers

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This article explores the use of REITs as an investment vehicle for renewable energy projects, with a focus on how REITs can facilitate monetization transactions for energy funds and developers.

Many years ago, the government came to the realization that prevailing energy prices could not justify the capital expenditure and risk profile presented by the typical renewable energy project. In order to make renewable energy facilities economically viable and thereby encourage their development, the government enacted a number of renewable energy subsidies over the years, including tax credits, cash grants, and other tax benefits (collectively, “renewable energy tax incentives”). These incentives supplemented the revenue produced by a renewable energy facility and could convert a money-losing endeavor into a money-maker.

The renewable energy tax incentives proved quite successful, and industry sources estimate that those incentives were responsible for two-thirds of new wind energy investments and most new solar energy investments in the United States. As anticipated, the renewable energy tax incentives attracted to the renewable energy space both energy-focused private equity funds (“energy

funds”) and developers of renewable energy projects (“developers”).

Given the vintage and nature of the various renewable energy tax incentives—which offer benefits to taxpayers for only a limited number of years after a renewable energy project begins operations—we are approaching the point in the cycle at which many energy funds and developers will begin monetizing their facilities in order to return capital and profits to investors (in the case of energy funds) or lock in profits and generate capital for new investments (in the case of developers). Although some energy funds and developers will either sell their facilities to traditional buyers or execute refinancing transactions with banks and traditional financial players, other energy funds and developers are beginning to realize that the traditional players may not be available, or available at the right price, for their facilities.

Those energy funds and developers are increasingly evaluating the real estate investment trust (“REIT”) market as a source of

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new capital. The basic idea behind a renewable energy REIT is that the REIT provides investors with a publicly traded security that offers a stable yield, while providing energy funds and developers with access to public investors who are willing to provide capital at attractive prices.

This article explores the use of REITs as an investment vehicle for renewable energy projects, with a focus on how REITs can facilitate monetization transactions for energy funds and developers.

I. Summary of the REIT and Energy Tax Landscape

A. Key Benefits of REIT Status

From a commercial, legal, and investor perspective, a share of stock in a REIT does not look different than a share of stock in a regular corporation such as Apple or Ford. REITs, however, are different than regular corporations in that REITs do not pay federal corporate income tax on REIT-level income so long as they distribute that income to shareholders. Thus, for example, if a REIT earns \$100 of income and makes a \$100 distribution to its shareholders, the REIT is not subject to tax.

As illustrated in Table 1, REIT status provides several shareholder-level benefits that are generally not available in other tax-exempt vehicles, including those listed below:

- *Tax-Exempt Investors: Elimination of Tax Exposure.* If a tax-exempt investor were to invest in renewable energy assets directly (or indirectly through a fund, JV, or master limited partnership (“MLP”)), it would generally be subject to the 35% unrelated business income tax (“UBIT”) on operating income and, in certain circumstances, could be subject

to the UBIT on a portion of the gain realized on exit.¹ If, however, the tax-exempt investor holds the renewable energy assets through a REIT, then the UBIT generally will not apply to either distributions received by the investor from the REIT or gain recognized by the investor on the sale of REIT stock. When combined with the REIT-level exemption from tax, the use of a REIT to hold renewable energy assets reduces the tax exposure of a tax-exempt investor on both operating income and exit gain from 35% to 0%.

- *Foreign Portfolio Investors: Substantial Reduction of Tax on Operating Income; Potential Elimination of Tax on Exit.* If a foreign portfolio investor (e.g., a foreign pension or sovereign wealth fund) were to invest in renewable energy assets directly (or indirectly through a fund, JV, or MLP), it would generally be subject to U.S. tax at varying rates as high as 55% on both operating income and gain realized on exit.² Depending on its circumstances, a foreign investor in a REIT can enjoy two types of tax benefits, one that applies to operating income and another that applies to gain realized on exit. First, distributions made by a REIT to a foreign investor will be subject to either 30% or 15% withholding tax, depending on whether the foreign investor is eligible for tax treaty benefits. Second, a foreign investor in a REIT enjoys two exceptions to the tax that is generally imposed on foreigners that sell U.S. real property investments. Under the first exception, a foreign shareholder is not subject to tax on the sale of stock in a “domestically controlled” REIT (i.e., a REIT more than 50% of the value of which is owned by U.S. persons at all

times during a 5-year look-back period). Under the second exception, a foreign shareholder that owns less than 5% of the stock of a publicly traded REIT is not subject to tax on the sale of that stock even if the REIT is foreign controlled. Thus, from the perspective of a foreign investor, holding renewable energy assets through a REIT can reduce the tax on operating income from as much as 55% to as little as 15% and the tax on exit from as much as 55% to as little as 0%.³

- *Retail U.S. Investors: Simplified Tax Reporting.* For a retail U.S. investor, an investment in REIT stock is best compared with an investment in an MLP unit.

In that context, an investment in REIT stock enables a retail investor to enjoy simple and timely tax reporting, because a REIT reports dividend income to shareholders on Form 1099-DIV. By contrast, an investor in an MLP will receive a Form K-1 which, in addition to being significantly more complex and cumbersome than a Form 1099-DIV, often requires retail investors to obtain federal tax return filing extensions every year and to file tax returns in every state in which the MLP owns assets or conducts business. For this reason, many retail investors prefer REIT investments over MLP investments.

	JV/Fund/MLP Investment		REIT Investment	
	Operating Income	Sale Gain	Operating Income	Sale Gain
Tax-Exempt Investor	35%	0% (35% in certain circumstances)	0%	0%
Corporate Foreign Investor	55%	55%	30% (potentially 15% under treaty) ⁴	0% (assumes domestically controlled REIT or <5% interest in public REIT)
Non-Corporate Foreign Investor	35%	15%	30% (potentially 15% under treaty)	0% (assumes domestically controlled REIT or <5% interest in public REIT)

B. The REIT Rules

Although the REIT rules are extremely intricate, the key rules relevant to renewable energy REITs fall into three categories—the REIT asset tests, the REIT income tests, and the REIT distribution requirement—each of which is described below.

i. The REIT Asset Tests

In order to qualify as a REIT, an entity must satisfy a number of asset tests on a quarterly basis:

- *The 75% Asset Test.* At least 75% of the REIT’s assets must consist of cash and cash items, U.S. government securities, and “real estate assets” such as

(i) interests in land, buildings, and other permanent structures (including fee ownership, easements, and leases), and (ii) loans secured by mortgages on real estate (“**real estate securities**”).

- *The 25% Asset Test; Taxable REIT Subsidiary Securities:* Not more than 25% of the REIT’s assets may consist of non-real estate securities, including non-real estate securities of one or more taxable REIT subsidiaries (“TRSs”). A TRS is any corporate subsidiary for which a TRS election is made. A REIT can use a TRS to hold non-qualifying assets or receive non-qualifying income.⁵
- *The 5% Asset Test:* Not more than 5% of the REIT’s assets may consist of non-real estate, non-TRS securities of a single issuer.
- *The 10% Asset Test:* The REIT may not own non-real estate, non-TRS securities representing more than 10% of the voting power or value of a single issuer.

The IRS has ruled that a system for the transmission of energy from a generation source to end users can qualify as a real estate asset to the extent it consists of “physically connected” and “functionally interdependent” immovable assets. The qualifying components of such a system generally include interests in land (as described above); towers or poles that are permanently affixed to the ground; lines or wires attached to the towers or poles or buried underground (including gathering lines); substations, switching stations, and distribution transformers; electric meters that are affixed to buildings; and interconnection systems (collectively, “Gathering and Transmission Assets”).

Similarly, under the IRS’s past rulings,

certain components of a power generation facility (a “Facility”) are likely to qualify as real estate assets. In particular, wind towers and the pads on which those wind towers sit likely qualify as real estate assets. So, too, do the permanently affixed racking structures that support PV solar panels. Other components of a Facility, however, are unlikely to be treated as real estate assets (for example, the turbines, blades and nacelles of a wind Facility and the inverters of a solar Facility).

ii. The REIT Income Tests

A REIT must satisfy two gross income tests on an annual basis:

- *The 75% Income Test:* At least 75% of a REIT’s gross income must consist of real estate related items such as mortgage interest, rents from real property, and gain from the sale of real property and mortgages on real property.
- *The 95% Income Test:* At least 95% of a REIT’s gross income must consist of sources that qualify for the 75% income test and other passive income such as corporate dividends (including dividends from a TRS), interest on non-real estate debt, and gains from the sale of non-real estate securities.

Although they appear simple at first blush, the REIT income tests present a few caveats and opportunities for renewable energy REITs.

First, if a renewable energy REIT receives rental income from a TRS, that income is treated as non-qualifying income for purposes of the REIT rules. Thus, no more than 5% of a REIT’s gross income can consist of rent received from a TRS and other sources of non-qualifying income. If, however, a REIT receives real estate mortgage interest from a

TRS, that income qualifies for both the 75% and 95% income tests. Accordingly, in order to comply with the REIT income tests, a commercial relationship between a REIT and its TRS should, if possible, be structured as a creditor/borrower relationship rather than a landlord/tenant relationship.

Second, any rental or mortgage interest income that is contingent on the *net* income of the tenant/borrower is treated as non-qualifying income for purposes of both income tests. If, however, such income were contingent on the *gross* income of the tenant/borrower, then the income would be treated as qualifying income.

In situations where a lease or lending arrangement will entitle the REIT to a share of the tenant's/borrower's income, the dichotomy between a qualifying gross income entitlement and a non-qualifying net income entitlement can create some negotiating tension. In order to ensure compliance with the REIT income tests, the REIT will often want to style its sharing entitlement as a percentage of the unadjusted gross receipts of the tenant/borrower. In order to manage its rental/interest obligations, the tenant/borrower will want to adjust its "gross" receipts by subtracting certain items that, economically speaking, ought to "come off the top"—e.g., customer rebates, state sales taxes, etc. As the tenant/borrower tries to increase the number of downward adjustments to its gross receipts, and thereby reduce the REIT's sharing entitlement, the REIT will become more concerned about whether its sharing entitlement is a non-qualifying net income entitlement. Conversely, as the REIT tries to reduce the number of downward adjustments to the tenant's/borrower's gross receipts, and thereby increase the REIT's sharing entitlement, the

tenant/borrower will become more concerned about its obligations to the REIT.

In the retail space, it is well settled that items such as customer returns and rebates can be deducted from the tenant's/borrower's gross receipts without converting the REIT's sharing entitlement into a non-qualifying net income entitlement. In other contexts, the rules are less clear, and REITs have sought IRS rulings on whether a particular sharing entitlement represented a qualifying gross income entitlement or a non-qualifying net income entitlement. For example, the IRS recently issued a private ruling to a REIT that rented space to a gaming company in exchange for a rental income stream that was in part contingent on the tenant's gross income from gaming operations. Under the lease agreement, the tenant's "gross income" from gaming operations was equal to its gross gaming receipts reduced by, among other things, the amount of gambling losses suffered by the tenant and the amount of money spent by the tenant on customer "comps" and inducements. The IRS ruled that this arrangement represented a qualifying gross income entitlement that produced qualifying rental income. Central to the IRS's conclusion was the fact that, for GAAP and regulatory purposes, the tenant's gross income from gaming operations was computed in a similar fashion. Depending on the circumstances, if a renewable energy REIT intends to earn rent or interest income that is contingent on the tenant's/borrower's income from the sale of energy, it may be advisable to seek an IRS ruling that the arrangement produces qualifying REIT income.

Third, as much as 15% of a REIT's rental income may be attributable to personal property if that personal property is leased in connection with a lease of real property. For

example, assume a REIT owns and leases a wind Facility that consists in part of real property (e.g., the land on which the Facility sits and the tower and pad) and in part of personal property (e.g., the blades, turbines and nacelles). If the value of the personal property is 15% or less of the value of the Facility as a whole, *all* of the rental income earned by the REIT under the lease of the Facility will be qualifying income for both REIT gross income tests (the “limited personal property exception”). If, however, the value of the personal property exceeds 15% of the value of the Facility as a whole, the entire amount of rent that is attributable to the personal property will be non-qualifying income for both REIT gross income tests.

iii. The REIT Distribution Requirement

Generally speaking, in order to qualify as a REIT, an entity must distribute at least 90% of its taxable income each year. In addition, a REIT will be subject to the 35% corporate income tax or, potentially, a 4% excise tax on its undistributed income.

These distribution requirements can make it difficult for a REIT to retain its operating cash flow. Although some REITs borrow money in order to satisfy the REIT distribution requirements, other REITs rely on two techniques to simultaneously retain cash and satisfy the REIT distribution requirements. First, a REIT can establish a dividend reinvestment plan (“DRIP”) under which each shareholder will receive its dividends in REIT stock unless it affirmatively elects to receive cash. Second, a REIT can pay a cash/stock dividend under which each shareholder must elect to receive its dividend either in cash or in REIT stock, but with a cap on the percentage of the total dividend that can be paid in cash (e.g., 20%). In both cases, if structured

properly, the full amount of the dividend—even the portion paid in REIT stock—will be treated as a taxable dividend that counts toward the REIT distribution requirements. Because a non-cash dividend is taxable to shareholders (other than tax-exempt shareholders), many REITs structure such dividends in ways that ensure that every shareholder can receive enough cash to pay the tax due on its dividend income.

C. Renewable Energy Tax Incentives

Several renewable energy tax incentives have been available to investors in renewable energy projects. These incentives include a production tax credit that is contingent on the amount of energy produced and sold by the project (the “PTC”), an investment tax credit for money invested in certain energy property (the “ITC”), a cash grant from the Treasury in lieu of tax credits (“cash grants”), and accelerated depreciation (including bonus depreciation) for certain types of machinery and equipment used to produce renewable energy.

The renewable energy tax incentives vary in the nature of the benefits they confer, the requirements for achieving those benefits, and their suitability for a particular project or ownership structure. Although a detailed description of the renewable energy tax incentives is beyond the scope of this Article, a few key features of those incentives may influence an energy fund’s or developer’s decision about how to structure its exit from a renewable energy project. Particularly relevant is the fact that the renewable energy tax incentives are structured so that their benefits expire after a period of time that depends on the particular incentive.

For example, the PTC is based on the energy produced and sold by a Facility for

the 10-year period beginning on the date the relevant Facility is placed in service. After that 10-year period, the Facility will no longer generate a PTC regardless of how much energy it produces and sells.

Similarly, a taxpayer that received the ITC or cash grant generally must hold its investment for five years. Specifically, the ITC and cash grant, which are received in the year a Facility is placed in service, may, depending upon the particular circumstances, be “recaptured”—that is, repaid to the IRS or the Treasury—if the Facility or an interest therein is disposed of within the first five years.

Finally, accelerated depreciation generally allows the owner of a renewable energy Facility to recover its entire investment in the Facility over a five-year period on an accelerated basis. After that five-year period, the owner will have no basis left to depreciate.

Each of the renewable energy tax incentives therefore has its own “exhaustion date”—the end of the 10-year period in the case of a PTC project, and the end of the relevant five-year period in the case of an ITC, cash grant, or accelerated depreciation project. After the exhaustion date of a particular incentive, the benefits of the incentive cease to apply.

II. REITs as a Capital Source for Renewable Energy Projects

A. Potential Renewable Energy REIT Operating Structures

Before considering the types of transactions that a REIT can facilitate for an energy fund or developer, one must understand which end-result structures are viable for the REIT. Although the optimal structure for a renewable energy REIT will turn on several factors,⁶ two basic structures are well suited for

an exit transaction: the Landlord Structure and the Owner/Operator Structure.⁷ As with many REIT structures, it is possible for the same REIT to employ a different operating structure for each Facility in which it owns an interest.

i. The Landlord Structure

Under the Landlord Structure, the REIT will typically own (i) the Gathering and Transmission Assets, (ii) the land underlying the Facility, and (iii) any other components of the Facility that may be owned by the REIT without jeopardizing its REIT status, including, for example, Facility components that are treated as real estate assets (e.g., wind towers and pads or solar racking structures) and, subject to the REIT rules, certain Facility components that are not real estate assets (the assets described in clauses (i) through (iii), collectively, “REITable assets”). Any components of the Facility not owned by the REIT (“non-REITable assets”) would be owned either by an unrelated operator of the Facility (a “Generation Entity”) or by a TRS of the REIT.⁸ Figures 1 and 2 illustrate the Landlord Structure with and without a TRS, respectively.

If a TRS is not used, the REIT would lease the REITable assets to the Generation Entity, and the Generation Entity would use those leased assets, together with the non-REITable assets that it already owns, to produce and sell energy to a buyer (commonly referred to as an “offtaker”). Alternatively, if a TRS is used to hold the non-REITable assets, the REIT and the TRS would jointly lease their respective assets to the Generation Entity, which would use the leased assets to produce and sell energy to an offtaker. In either case, the rents payable by the Generation Entity to the REIT may be

contingent on the Generation Entity's gross income from the use of the leased assets.

As described above, it is possible, subject to limitations, for a REIT to own those components of a Facility that are not treated as real property for purposes of the REIT rules. The REIT asset tests, for example, would allow up to 25% of the REIT's assets to consist of personal property and securities.⁹ In addition, the limited personal property exception would allow the REIT to own, and to lease to the Generation Entity, a significant amount of personal property without violating the REIT gross income tests. Specifically, if the value of the personal property components of a Facility is less than 15% of the value of the Facility as a whole, then all of the rental income received by a REIT upon a lease of the Facility—even the portion of the rent attributable to the personal property—would be treated as qualifying “rents from real property” for purposes of both REIT gross income tests. If the personal property components exceed this 15% threshold, the REIT could nevertheless qualify for the limited personal property exception by causing the excess to be held through a TRS.

ii. The Owner/Operator Structure

In the Landlord Structure, the REIT does not obtain an equity ownership interest in the Generation Entity. The Owner/Operator Structure, as illustrated in Figure 3, is designed to provide the REIT with such an interest. In order to comply with the REIT requirements, the Generation Entity would have to elect to be a TRS of the REIT. Because a renewable energy REIT cannot lease property to its own TRS, however, the parties would have to alter the commercial relationships between and among the REIT, the Generation Entity, and the offtaker as follows:

- The REIT would own the Gathering and Transmission Assets but would *not* own the land underlying the Facility or any real estate components of the Facility (e.g., tower, pads, racking, etc.).
- The Generation Entity would own the land underlying the Facility and the Facility itself, including the real estate components of the Facility.
- The REIT would make a mortgage loan to the Generation Entity in order to enable the Generation Entity to acquire, develop, or refinance the Facility. The REIT would take a security interest in the land and the real estate components of the Facility. The mortgage interest received by the REIT may be contingent on the Generation Entity's gross income from the use and sale of the mortgaged assets.
- Because a REIT cannot receive rent from its own TRS, the REIT cannot lease the Gathering and Transmission Assets to the Generation Entity. Accordingly, the relationship between the REIT and the Generation Entity, on the one hand, and the offtaker, on the other hand, must be structured so that the offtaker enters into separate commercial agreements to: (i) purchase energy from the Generation Entity; and (ii) rent the Gathering and Transmission Assets from the REIT. Thus, the offtaker would pay the Generation Entity for energy and would pay the REIT for the right to move that energy across the REIT's Gathering and Transmission Assets.

In terms of operating cash flow, the rental income received by the REIT from the offtaker and the mortgage interest and dividends (if

any) received by the REIT from the Generation Entity would not be subject to tax at the REIT level. The Generation Entity would be subject to tax on its net income—i.e., its income after payment of mortgage interest to the REIT and other expenses related to the operation of the Facility, including depreciation—but may reduce that tax liability through the use of renewable energy tax incentives, if any are available.

Although the combination of REIT-level tax benefits and Generation Entity-level tax attributes (e.g., interest deductions on amounts paid to the REIT and depreciation deductions on assets held by the Generation Entity), may make the Owner/Operator Structure efficient from an income tax perspective, the structure must be monitored carefully in order to prevent REIT-qualification issues. For example, under the 25% asset test, the stock of a TRS such as the Generation Entity cannot represent more than 25% of the REIT's gross assets. Depending on the values of the REIT's other assets, including any real estate mortgages owed by the Generation Entity to the REIT, the REIT could have trouble complying with the 25% asset test unless the REIT owns less than 100% of the equity of the Generation Entity or the Generation Entity owns less than 100% of the Facility. Because the 25% asset test would have to be re-run every time the REIT acquires another non-real estate asset, including more stock in the Generation Entity itself, the use of the Owner/Operator Structure would require constant monitoring.

B. Moving Renewable Assets from an Energy Fund or Developer to a REIT Structure

Once a REIT that is seeking to invest in a renewable energy project has determined which structure to adopt for that project, the

REIT and the selling energy fund or developer must determine how to move that project from the energy fund or developer to the desired REIT structure. For both of the REIT structures discussed above, this move may be accomplished via either a taxable transaction or a tax-free transaction.

i. Taxable Sale-Leaseback

Perhaps the simplest method for moving a renewable energy project from an energy fund or a developer to a REIT structure is a simple taxable sale of the components of the project to the REIT (or, where applicable, to a TRS of the REIT), followed by a lease of those components by the REIT (and the TRS) to the Generation Entity (which may be the energy fund or developer, or a third-party generator).

Thus, in the Landlord Structure, the energy fund or developer would (i) sell to the REIT the REITable assets and (ii) sell to the Generation Entity (if other than the energy fund or developer), or to a TRS of the REIT, the non-REITable assets. The REIT would then lease (jointly with the TRS, if applicable) each of its assets to the Generation Entity.

Similarly, in the Owner/Operator Structure, the energy fund or developer would (i) sell to the REIT the Gathering and Transmission Assets, and (ii) sell to the Generation Entity, which is a TRS of the REIT, the entire Facility and the land underlying the Facility. The REIT would then lease the Gathering and Transmission Assets to the offtaker, who would purchase energy from the Generation Entity.

ii. OP Contribution

A contribution of renewable energy assets by an energy fund or developer to a REIT will generally be a taxable transaction due to rules that generally prohibit the tax-free con-

tribution of appreciated assets directly to a REIT.

In contrast, the tax rules governing contributions to partnerships are much more flexible, such that the contribution of appreciated property to a partnership in exchange for interests in the partnership generally does not result in immediate gain recognition. It is therefore common for a REIT to use an “operating partnership” (“OP”) to acquire assets.

Although a contribution to a privately held OP in exchange for OP units is not, as a legal matter, equivalent to a contribution in exchange for publicly traded REIT stock, the typical OP unit is structured so that it is economically fungible with a share of publicly traded REIT stock. In particular, a REIT will ordinarily hold all of its assets through the OP, and a holder of an OP unit will generally have distribution and liquidity¹⁰ rights that are substantially identical to the rights of a holder of stock in the REIT. As an added benefit, an OP will often be able to make leveraged distributions to holders of OP units on a tax-free basis, an option generally not available to a REIT that wishes to make distributions to its shareholders. For these reasons, a contribution of property to an OP will generally yield substantially identical economic results, but superior tax results, as compared to a contribution of property to the REIT.

The common technique of using an OP to effect a REIT’s acquisition of property can be adapted to a renewable energy REIT structure in order to enable an energy fund or developer to contribute assets to a public vehicle without full and immediate gain recognition. Specifically, for both the Landlord Structure and the Owner/Operator Structure, the REIT would form and acquire interests in an OP, which could be a limited partnership,

an LLC, or any other state-law entity that is treated as a partnership for tax purposes.

In the case of the Landlord Structure, the energy fund or developer would then contribute to the OP, in exchange for OP units, the REITable assets and, if a TRS will be used to hold non-REITable assets, those non-REITable assets as well. The non-REITable assets, if any, would then be contributed by the OP to a TRS owned by the OP, and each of the REITable assets would remain in the OP. The OP would then lease (jointly with the TRS, if applicable) its assets to the Generation Entity just as the REIT would in the taxable version of the Landlord Structure.

In the case of the Owner/Operator Structure, the energy fund or developer would likewise contribute all of its renewable energy assets to the OP. The OP would then form a TRS and contribute to that TRS all of the assets to be owned by the TRS under the Owner/Operator Structure (e.g., the entire Facility and the land underlying the Facility) but would retain those assets that would otherwise be owned by the REIT (i.e., the Gathering and Transmission Assets). The OP would then lease the Gathering and Transmission Assets to the offtaker, who would purchase energy from the TRS.

Conclusion

As energy funds and developers begin to question whether the traditional sources of capital—e.g., banks—will be available for their projects, they are increasingly looking to the REIT capital markets for new opportunities. The REIT markets are capable of providing significant amounts of capital from investors who, due to the structure of our renewable energy tax incentives, generally do not participate in renewable energy projects—foreign portfolio investors, U.S.

tax-exempt investors, and U.S. retail investors. Those investors find the REIT market attractive for a number of reasons—including the steady yields offered by REIT stocks—and are thus willing to provide capital at attractive prices.

From an operational standpoint, REITs pose some challenges that need to be considered. Chief among them are that a significant portion of a REIT's assets must consist of real estate and mortgages on real estate, and a significant portion of a REIT's income must consist of rents from real property and mortgage interest. To address these limitations, a REIT and its subsidiaries will often need to operate as a traditional provider of sale/leaseback financing. While this may

not pose a problem for a developer that is willing to continue operating a renewable energy Facility in exchange for a cut of the energy sale income, sale/leaseback financing might not be palatable for an energy fund that wishes to make a clean break from a project.

Many major public REIT transactions represent an exercise in compromise, and a public renewable energy REIT transaction is likely to follow suit. That said, renewable energy REITs may provide a viable answer to a question that is more and more frequently on the lips of energy funds and developers: How will we monetize our facilities once our renewable energy tax incentives have been exhausted?

FIGURES

Figure 1: Landlord Model (No TRS)

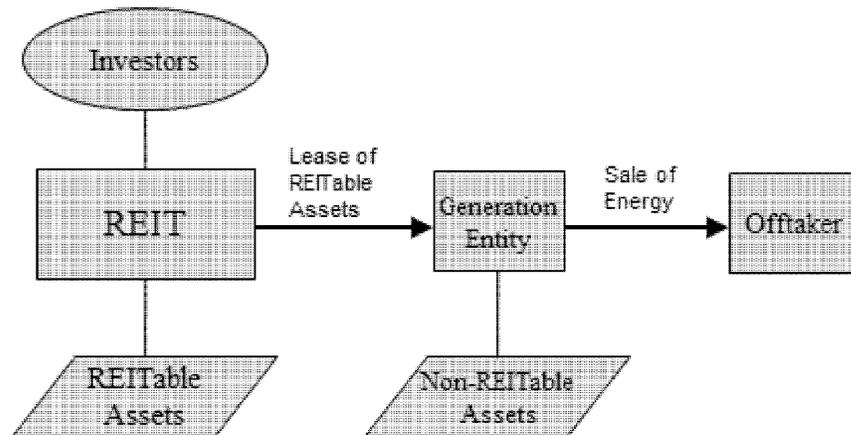


Figure 2: Landlord Model (with TRS)

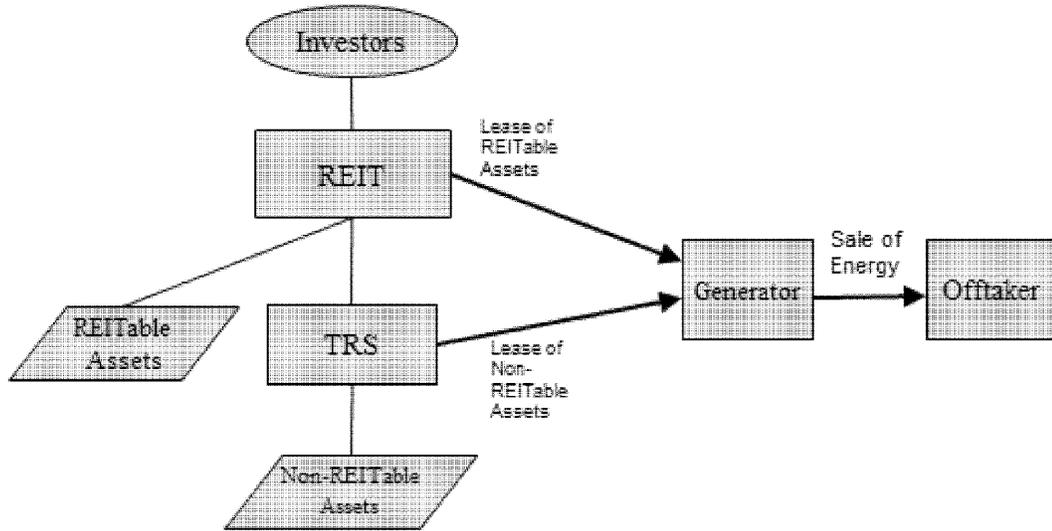
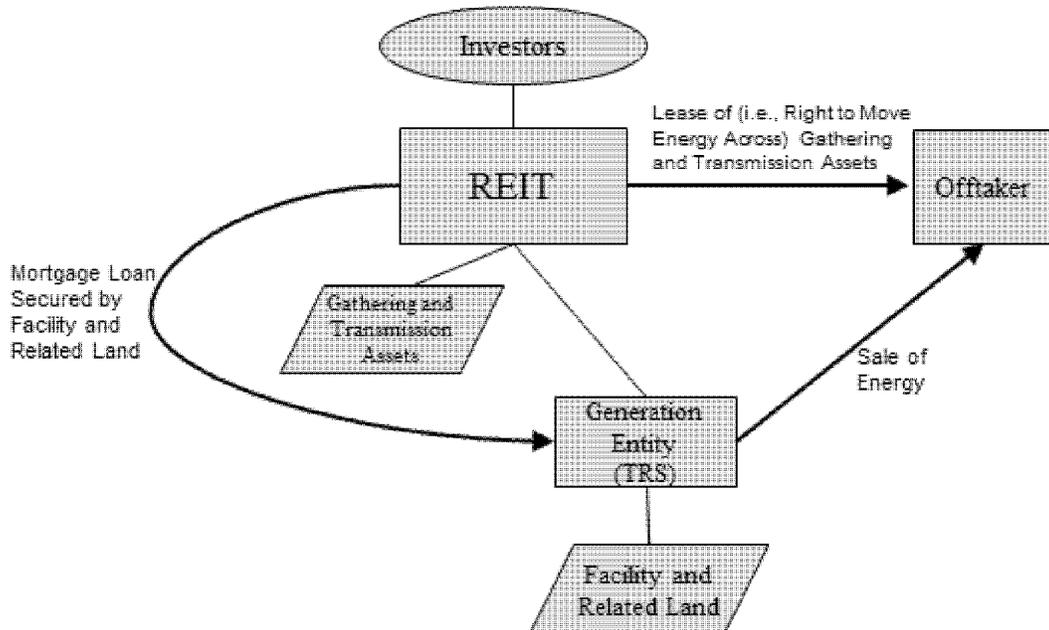


Figure 3: Owner/Operator Model



NOTES:

¹State governments and the entities they control (e.g., state pension funds) generally take the position that they are exempt from the UBIT.

²A foreign investor would generally be subject to regular federal income tax on income and gains associated with the renewable energy assets. Thus, a non-corporate investor would currently pay tax at a maximum rate of 35% on operating income and 15% on capital (sale) gains. A corporate investor would pay tax at a maximum rate of 35% on both operating income and capital (sale) gains and, in addition, would pay a 30% branch profits tax on the amount remaining after the imposition of the 35% tax. Thus, the effective tax rate for a foreign corporate investor that is subject both to the regular federal income tax and to the branch profits tax is approximately 54%. The U.S. tax rates imposed on foreign investors may be reduced by tax treaties.

³Foreign governments and sovereign wealth funds investing through a REIT structure may be eligible for additional tax exemptions that reduce their tax on both operating income and exit gain to 0%. A discussion of those exemptions is beyond the scope of this Article.

⁴See *supra* note 3 (describing additional exemptions potentially available to foreign governments and sovereign wealth funds).

⁵The TRS, as a corporation, is generally subject to tax on all of its taxable income. There are limits on a TRS's ability to use payments on intercompany leases

and loans to reduce the TRS-level tax liability.

⁶For a more detailed discussion of the potentially relevant factors, see David F. Levy, Sean Shimamoto, & Nickolas P. Gianou, *Wind REITs: The New Tax Equity?*, Pub. Util. Fortnightly, May 2012, at 36.

⁷A REIT may lend against the components of a renewable energy project rather than acquiring an ownership interest in those components. See *id.* at 41 (discussing the "Lender Structure" and the "Landlord/Lender Structure"). An energy fund that is seeking an exit, however, will ordinarily prefer to sell its renewable energy assets to a REIT or another buyer rather than retain those assets and merely borrow against them.

⁸The REIT may own all, or any portion, of the TRS's stock. Placing the non-REITable components of a Facility in a TRS allows the REIT to gain indirect economic exposure to those components, which it would not have if those components were owned by an unrelated Generation Entity. Such a structure would, however, require careful monitoring to ensure compliance with the REIT rules for the same reasons discussed below in the context of the Owner/Operator Structure.

⁹It should be remembered that stock of a TRS is not a real estate asset and thus must be added to all other non-real estate assets when testing a REIT's compliance with the REIT asset tests.

¹⁰Liquidity is achieved by allowing OP unit holders to convert their OP units into shares of the REIT, which may then be sold on the public markets.