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Hot Investment Areas For REITs

Law360, New York (February 01, 2013, 11:02 AM ET) -- In recent years, there has been a steady evolution of real estate investment trusts (REITs) and an increase in entities that have announced their intent to convert to REIT status, as well as an expansion of asset categories that they hold and the corresponding income sources (e.g., cell phone towers, billboards, prisons, etc.). This progression likely will continue in the future, and new areas to watch include renewable energy assets (e.g., wind and solar projects) and, in the mortgage REIT sector, excess mortgage servicing rights.

Renewable Energy Projects

The recent proliferation of renewable energy projects has been spurred in large part by federal income tax incentives. These incentives include: (1) a production tax credit (based upon sales of energy by a project within the first 10 years after it is placed in service); (2) an investment tax credit (a one-time, up-front tax credit equal to 30 percent of the cost of tangible personal property employed in the project); (3) cash grants from the U.S. Treasury (in amounts equal to, and in lieu of, the investment tax credit); and (4) accelerated depreciation (including first-year bonus depreciation equal to 50 percent of the cost of certain machinery and equipment used in such projects). The tax credits and cash grants are mutually exclusive alternatives for any given project. All or a portion of the investment tax credit or cash grant with respect to a particular project is recaptured upon a disposition of the project within a prescribed five-year period.

The existing tax incentives are designed to benefit tax-paying persons (i.e., U.S. individuals and taxable corporations, or partnerships owned by such persons), which means that REITs, which generally incur little or no income tax, historically have not played a role in owning or financing assets associated with renewable energy projects. This may change, however, for one or both of two reasons.

First, tax laws that provide the incentives currently are scheduled to sunset at the end of 2013. Although such incentives have been slated to expire on numerous occasions in the past, only to be extended each time (including at the end of 2012 as part of the recent "fiscal cliff" legislation), in light of the escalating government budget deficits and the acknowledged need for greater revenues, the prospects for further extension are less certain in the current environment. The second factor that may bring change is that as the current owners of renewable energy projects exhaust the tax benefits available under existing law, they may, depending upon their circumstances and objectives, have a compelling incentive to divest.

REITs, with their own special and different tax benefits, could provide an abundant source of capital for acquiring or financing renewable energy projects or portions thereof. Unlike regular taxable corporations, REITs are entitled to deduct dividends that they pay to their stockholders and are required to distribute substantially all of their earnings each year. As a consequence of these two rules, REITs are viewed as yield vehicles that pay little or no income tax, and therefore have ready access to the capital markets, including important segments of investors that have, up until now, largely been excluded from renewable energy projects — namely, U.S. pensions and other tax-exempt entities, foreign portfolio investors (including governments and sovereign wealth funds) and retail investors.

To enjoy their special tax status, REITs must comply with myriad qualification requirements, including rules regarding the composition of their assets and income, which are designed to ensure that they invest principally (though not necessarily exclusively) in real estate, as well as distribution, stockholder diversification and other requirements. Subject to certain limits, REITs may house some activities in taxable subsidiary corporations (i.e., taxable REIT subsidiaries, or TRSs) which, unlike the parent REIT, are subject to tax on their income but can facilitate indirect involvement in activities that otherwise would be precluded by the tax qualification requirements applicable to the parent.

The overarching principle in designing a REIT's role in a renewable energy project is to employ a structure that splits the economics associated with the project between a taxable entity (or a partnership owned by taxable entities), which can maximize the utilization of any available tax incentives linked to tangible personal property used in the project, and a REIT, which can hold or finance the real estate elements of the project in a tax-efficient manner. Such structures could take a variety of forms, and a given REIT might employ different structures in connection with different projects.

One such structure could involve a REIT holding the real estate components of a project (such as the land, towers, pads and supporting structures, and/or the gathering and transmission assets), and leasing them to a third-party lessee that could own the power generation assets. If desired, rent could be based, at least in part, on the lessee's gross (but not net) income from the project. In the case of an existing project, as distinct from a newly developed project, the structure might be effectuated via a sale/leaseback transaction (e.g., the REIT buys the real estate elements from the current owner of the project, and leases them back).

As a possible alternative, a REIT could act as a mortgage lender to finance the real estate components of the project. As with the above leasing structure, the arrangement could provide for contingent interest based on the borrower's gross (but not net) income from the project. A mortgage also could provide the REIT with a share of the potential upside in the value of the mortgaged real estate via a shared appreciation provision. Unlike a leasing structure, the mortgage borrower/owner of the generation assets even could be a TRS. (This is not permitted in the case of a leasing structure because of restrictions under the REIT tax rules on the receipt of rents from related parties.)

More sophisticated and creative structures also would be possible, in which a REIT owns and leases certain real estate assets (e.g., gathering assets and transmission lines) while financing other assets (e.g., the land, tower and pads on which wind turbines are placed) via a mortgage loan, or where a TRS owns generation assets and sells energy to a buyer (e.g., a public utility), and the parent REIT owns the gathering and transmission assets that it leases to the same public utility so that it can transport the energy.

Although REITs previously have not been involved in renewable energy projects, they may provide a ready and robust source of capital in connection with the real estate elements of such projects in the future, to the extent that existing tax law incentives sunset or are exhausted with respect to a particular project — thereby facilitating complete or at least partial exits by the current owners of such projects. Depending on the specific circumstances, tax-deferred exit strategies may also be viable (e.g., through the operating partnership structures commonly used by many public REITs). Although structuring challenges will be very real, the political and economic conditions could lead to a groundswell of participation by REITs in such projects in the not-too-distant future.

Mortgage Servicing Rights

While REITs may own mortgage loans and service them (e.g., collect interest and principal payments, enforce remedies upon a default, etc.) for their own account, income derived from providing services to third parties generally is treated as nonqualifying, or "bad," income under the REIT rules. This would include fees for servicing mortgage loans owned by other investors. However, the IRS has ruled privately that the acquisition of "excess mortgage servicing rights" by a REIT may, if structured properly, give rise to qualifying real estate assets and the receipt of qualifying mortgage interest for purposes of the REIT gross asset and income requirements, respectively. This would allow REITs to acquire mortgage servicing rights from banks that are looking to exit the mortgage servicing business or from independent mortgage servicers who want to operate on a capital-light basis.

Here is how it works. Owners of large portfolios (or pools) of mortgage loans (e.g., Fannie Mae, Freddie Mac and private securitization vehicles such as real estate mortgage investment conduits (REMICs)) often engage a third party to service the loans and may compensate the servicer by granting it a share of the interest income generated by the pool (e.g., 35 basis points per year) — a so-called "interest strip" or "servicing strip." The strip also may be accompanied by a share of certain items of ancillary income derived from the pool, such as late fees. Often the servicer is a bank or other entity that originated the mortgage loans comprising the pool, bundles them and sells the resultant pool, or interests in the pool (e.g., to Fannie Mae, etc.), while retaining the servicing strip.

Moreover, the amount of the servicing strip often exceeds the arm's-length reasonable compensation amount for the pure servicing activity — and really represents a retained economic interest in the underlying mortgage pool. By way of illustration, in the example in which the total amount of the servicing strip is 35 basis points per year, the value of the actual services for which compensation is provided might only be, say, 10 basis points. In that case, the remaining 25 basis points to which the servicer is entitled represents a retained interest in the underlying pool. These are so-called "excess" servicing rights (i.e., the excess over 10 basis points in this example).

To the extent that a REIT purchases such excess servicing rights and does not undertake to service the mortgages, its investment may be treated as a "good" REIT asset (i.e., an undivided interest in a pool of qualified mortgage loans), and the income derived over the life of the arrangement in this example could be treated as "good" mortgage interest for purposes of the REIT income tests. A REIT may even purchase the entire interest strip (e.g., 35 basis points in the example), place the actual servicing component (e.g., 10 basis points) in a TRS or other affiliate, along with the associated servicing obligations, and retain the excess rights (i.e., 25 basis points) as a REIT-compliant investment asset. Because a private ruling issued by the IRS only may be relied upon by the taxpayer to whom it is issued, it may be advisable for a REIT that is interested in investing in excess mortgage servicing rights to seek a private ruling before undertaking such a transaction.

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Investments by REITs in both renewable energy and mortgage servicing assets may be widely available and attractively priced in the months and years ahead. Current owners may seek to monetize assets and strengthen balance sheets under pressure from regulators, as an outgrowth of new laws and as existing tax incentives are exhausted.

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