Proposed Regulations Provide REITs a Framework for Solar Energy Property

*Jeffrey G. Davis**

The author of this article explains proposed regulations recently issued by the Internal Revenue Service, which clarify the definition of real property for purposes of the real estate investment trust provisions under Section 856. The proposed regulations are intended to extend REITs to renewable energy property.

The Internal Revenue Service (the "Service") recently issued proposed Treasury Regulations § 1.856-10 (the "Proposed Regulations") that clarify the definition of real property for purposes of the real estate investment trust ("REIT") provisions under Section 856. As President Obama indicated in a speech given on the same day that the Proposed Regulations were issued, the Proposed Regulations are intended to extend REITs to renewable energy property "making it easier for renewable energy companies to operate and attract investment." The Proposed Regulations are proposed to apply for calendar quarters beginning on or after the date they are published as final in the *Federal Register*.

Purpose of the Proposed Regulations

Existing Treasury regulations provide specific examples of assets that constitute real property for purposes of Section 856. Additionally, between 1969 and 1975, the Service issued numerous revenue rulings addressing whether certain assets qualify as real property for purposes of Section 856. Since these published ruling were issued, REITs have sought to invest in various types of assets that are not directly addressed by the regulations or the revenue rulings. As explained in the preamble, the Proposed Regulations are intended to provide needed additional guidance as to the definition of real property under Section 856. The Proposed Regulations cover only the asset requirements for REITs and explicitly do not provide guidance regarding the income requirements for REITs under Section 856.

The Proposed Regulations provide a framework, rather than bright-line rules, for analyzing whether assets in which REITs seek to invest are real property for purposes of Section 856. Generally, the framework consists of numerous facts and circumstances that must be analyzed to determine whether an asset is real property. Additionally, the Proposed Regulations provide a number of illustrative examples, two of which specifically address whether solar energy property is real property for purposes of qualifying as a REIT. While the proposed

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framework does not seem to represent a significant change in the method of determining the REIT classification of an asset, it underscores the fact-specific nature of the analysis. As the solar energy property examples illustrate, seemingly minor factual differences could result in disparate REIT classification of solar panels.

Overview of the Proposed Regulations

Real property is defined as land and improvements to land. Improvements to land include inherently permanent structures and their structural components. To determine whether something is real property, either as an inherently permanent structure or as a structural component, distinct assets must be analyzed separately from any other assets. The Proposed Regulations provide a number of factors that must be considered. These factors generally relate to the severability of the item of property from the larger asset and the functionality of the item of property independent of the larger asset.

Inherently permanent structures include permanently affixed distinct assets that do not serve an active function. This includes property that serves a passive function—such as to contain, support, shelter, cover or protect—and that is not used to manufacture, create, produce, convert or transport. The Proposed Regulations provide specific factors that generally must be considered to determine whether a distinct asset is an inherently permanent structure. The factors broadly relate to the ability to remove the distinct asset from the real property (e.g., time, expense, damage) and the expectation of removal of the distinct asset from the real property (e.g., design, manner of affixation, contractual arrangements).

Structural components include any distinct assets that are a constituent part of, and are integrated into, an inherently permanent structure, serve the inherently permanent structure in its passive function, and, even if capable of producing active income, do not produce or contribute to the production of such income. Examples include wiring, plumbing systems and central heating systems. Similar to the inherently permanent structures determination, the Proposed Regulations enumerate factors that generally must be considered to determine whether a distinct asset is a structural component. The factors broadly relate to the ability to remove the distinct asset from the inherently permanent structure and the function of the distinct asset in serving the inherently permanent structure.

Application to a Solar Energy Site Producing Electricity for Sale to Third Parties

Example 8 of the Proposed Regulations illustrates the application of the facts and circumstances analysis to a solar energy site. In the example, a REIT owns a solar energy site, the components of which include land, PV modules, mounts and an exit wire. Electricity is distributed for sale to third parties. Additional facts and circumstances are described. Applying the relevant facts and circumstances, the example concludes that the PV Modules, mounts and exit wire are each distinct assets because each component is severable from the solar energy site and each component serves an independent function.

Because the PV modules serve the active function of producing electricity they are not inherently permanent structures. They are also not structural components of the mounts because they do not serve the mounts in their passive function of providing support. The PV modules are therefore not real property.

In contrast, the mounts perform only a passive function. Applying the relevant facts and circumstances, the example concludes that because the mounts are not easily removed, or expected to be removed, from the land, the mounts are inherently permanent structures and, thus, are real property.

The exit wire is an inherently permanent structure and, thus, is real property because it is specifically listed as such in the Proposed Regulations.

Application to a Solar-Powered Building

In Example 9, the REIT's solar equipment is mounted on land adjacent to a building that the REIT leases to a single tenant. Although the tenant occasionally transfers excess electricity produced by the solar equipment to a utility company, the solar equipment is designed and intended to produce electricity only to serve the building. Additional facts and circumstances are described.

In contrast to Example 8, the solar equipment serves the building to which it is constituent. Accordingly, the example applies the relevant facts and circumstances, notably including the fact that the REIT owns both the solar equipment and the building, and concludes that the solar equipment is a structural component of the building and, thus, real property.