REITs for Renewables Strafford Webinar

Presented by: David K. Burton of Akin Gump
Eli Katz of Chadbourne & Parke
Kevin Pearson of Stoel Rives

March 3, 2015

Entities Taxed Only Once

- The corporate income tax essentially taxes each dollar of earnings twice
  - When earned by the corporate entity
  - When paid as a dividend to shareholders or when stock is sold (subject to reduced rates and exceptions)
- Publicly traded entities generally strive to avoid the double-tax and increase after-tax returns to shareholders
  - Congress has sanctioned certain “special” vehicles over time
    - REITs
    - MLPs
  - Always limited to specific sectors and, in the case of REITs, strict distribution requirements
- Sectors that are not lucky enough to have a single tax vehicle may try to create a similar result by structuring operations to reduce corporate taxes
  - Interest deductions
  - Depreciation deductions
  - Tax credits

REIT Overview

- Real Estate Investment Trust (“REIT”)
- Can be publicly traded or closely held (subject to certain limitations)
- Vehicle to raise public equity with a single layer of tax
- Taxed generally as a C-corporation but gets a tax deduction for dividends paid to shareholders
- Under detailed tests described below, most of assets must be real estate or mortgages secured by real estate
- Must dividend 90% of its taxable income each year

Non-Tax REIT Benefits

- Combined market value as of EOY 2012 was $603 billion
- Sponsor benefit - access to capital markets
- Investor benefits:
  - diversification of investments
  - Investments that produce relatively consistent dividend streams
  - Provides liquidity with respect to otherwise illiquid real estate investments
  - Historically strong performance compared to other types of securities
  - Provides transparency due to application of securities laws disclosure requirements

REIT Tax Requirements

- Must invest <u>75</u> percent of its assets in qualifying assets which, generally means real estate or mortgages secured by real estate
- At least <u>75</u> percent of its gross income must be from “rents” from real property, interest on mortgages secured by real property, gains from sales of real property, or dividends or gain from other REITs
- At least <u>95</u> percent of its gross income must be from rents from real property, interest, gains or dividends
  - The definitions of eligible income are less real estate focused under the 95 percent test
- To constitute rental income under either the 75 percent or 95 percent requirement, a lease must be a true lease (i.e., not in substance a debt financing), “hell or high water” and the lessee must be unrelated to the REIT
- Must distribute <u>90</u> percent of its taxable income to its shareholders each year
- It must have at least 100 shareholders and no more than 50% of stock can be held by five or fewer individuals

Historic Expansion of REIT Asset Classes

1960	REITs are created – mostly "mortgage REITs"
1969	RR approves definition of real property to include railroad assets
1970	First "Healthcare REIT" created – must lease assets to a third party operator
1971	RR approves mobile homes
1975	RR approves microwave towers
1988	PLR approves timber REITs
1999	PLR approves cold storage
2007	RR approves electric transmission & distribution assets, and data center
2009	PLR approves natural gas distribution center
2011	PLR approves environmental intangibles, cell towers, outdoor signs
2012	PLR approves roof mounted antenna & offshore oil & gas platform
2013	PLR approves solar panels mounted on cell towers that only serves the cell tower
	2014 Proposed Regulations approves a REIT owned solar project that provides substantially all its power to a building owned by the same REIT.

Sources: Feldman et al. (2012), and NAREIT (2013)

2014 proposed regulations approve REIT-owned solar project that provides substantially all its power to a building owned by the same REIT.

2014 Proposed Regulations Generally

- Existing regulations define “real property” as “land or improvements thereon, such as buildings or other inherently permanent structures”
  - Includes building wiring, plumbing, central heating, and other structural components
  - Excludes assets accessory to the operation of a business
  - Regulations do not provide a clear framework for analysis of specific facts
- Proposed regulations would define “real property” as “land and improvements to land” and provide more detailed analytical framework
- Each “distinct asset” analyzed separately by considering all facts and circumstances, including:
  - Whether it is customarily sold as a unit rather than as part of a larger asset;
  - Whether the item can be separated from the larger asset and, if so, the related cost;
  - Whether separating the item from a larger asset impairs the larger asset; etc.

2014 Proposed Regulations – “Improvements”

- “Improvements” includes “buildings” and other “inherently permanent structures” and their structural components
- “Inherently permanent structure” is an item that serves a passive function, such as containments, support, shelter, etc., and not an active function such as manufacturing
- If an item is not specifically listed, whether it is an inherently permanent structure is determined by applying following factors:
  - Manner in which affixed
  - Damage that removal would cause to the item to which it is affixed
  - Time and expense required to move the asset

2014 Proposed Regulations – “Structural Components”

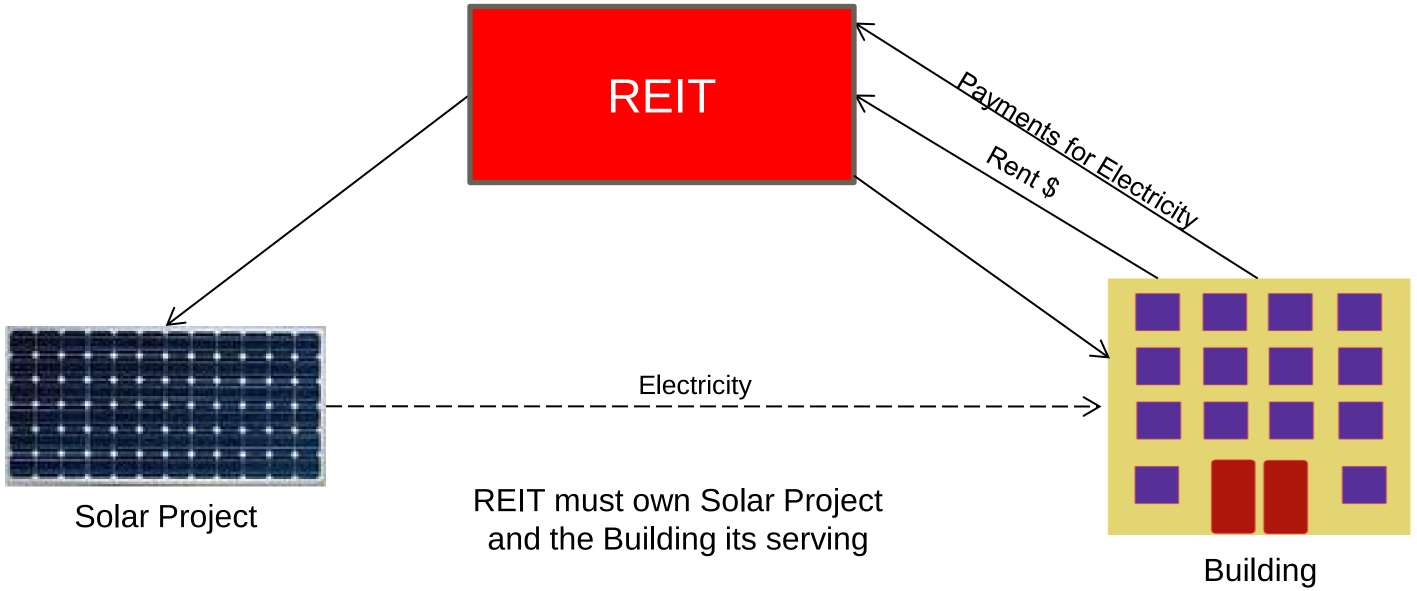
- Structural components means any distinct asset that is
  - A constituent part of, and integrated into, an inherently permanent structure and
  - Serves the inherently permanent structure in its passive function
- Examples of structural components include wiring, plumbing systems, central HVAC systems, etc.
- Whether a type of property that is not specifically listed is a structural component is determined by applying the following factors (among others):
  - The manner, time and expense of installing and removing;
  - Whether the asset is designed to be moved;
  - The damage removal would cause;
  - Whether the item produces income from consideration for the use or occupancy of space on the inherently permanent structure;
  - Whether the item will remain when the tenant vacates the premises

2014 Proposed Regulations – Examples

- Proposed regulations contain a number of examples to illustrate the application of the rules
- Ground mounted PV module example
  - Facts – Typical ground-mounted solar array leased to tenant
  - Conclusions:
    - Modules, mounts, and exit wires are distinct assets
    - Mounts are inherently permanent structures and therefore qualify
    - PV modules are not structural components of mounts and therefore do not qualify
    - Exit wire is inherently permanent and is a transmission line and therefore qualifies
- Solar-powered building example
  - Facts – Ground-mounted PV system adjacent to building owned by same REIT; designed to produce power solely to service the building; VERY NARROW FACTS
  - Conclusions:
    - Solar energy assets constitute a structural component of the building and therefore qualify
    - Result would not change if solar shingles were used as the roof of the office building

2014 Proposed Regulations – Solar

- The fact pattern based the proposed regulations is very narrow
- Regulations not effective unless and until finalized
- Unless business models change, the solar REIT regulations will apply to very few transactions



Prop. Reg. § 1.856-3(g), Ex. 9

2014 Proposed Regulations – Distributed Generation Wind

- The 2014 proposed REIT regulations do not reference distributed generation wind; however, IRS lawyers have stated that the proposed regulations would be equally applicable to distributed generation wind
  - Distributed generation wind means the wind turbine is substantially dedicated to providing power to a specific building, rather than into the grid
- So the same REIT would have to own the distributed generation wind turbine(s) and the building the turbine(s) provided power to

Discussed further at: http://www.akingump.com/en/experience/practices/global-project-finance/tax-equity-telegraph/irs-creates-narrow-distributed-generation-wind-opportunity-for.html

REIT Investment in Renewables Under Existing Tax Requirements

- As a general matter, a REIT can invest in renewables to the extent the income from renewables will not result in a failure of the income percentage tests
- No real appetite for tax credits or accelerated depreciation renewables investments generate because a REIT is entitled to a tax deduction for merely paying dividends and must dividend 90% of its taxable income.
- ITC reduced pro rata by the percentage of the REIT's income that it distributed as a dividend (i.e., 90%)
- A REIT's assets related to renewable energy generate "good" income in only three limited circumstances
  1. Ground lessor for a renewable energy project
  2. The same REIT owns both (a) a distributed generation solar (or wind) project and (b) the building the project is dedicated to serving (from proposed regulation example)
  3. Own mobile phone towers and install solar panels on the tower and charge the mobile phone companies that use the tower for the electricity the panels provide
     - The panels can only provide electricity to the mobile phone equipment on the tower, and the location of the tower must be such that the grid is either not accessible or unreliable

REIT as Ground Lessor

Tax Equity Investor

Developer

REIT
(Ground Lessor)

Project
Company

Offtaker/Utility

Land Leases

Power Purchase
Agreements

Hannon Armstrong's (NYSE: HASI) uses this REIT structuring. *See, e.g.*, http://americanwindcapital.com/news-events/

Cell Phone Tower with Solar Panels

REIT
(Tower Owner)

Rent for Tower

Payments for Electricity Generated by the Panels and Used by the Tower

Mobile Phone Company

REIT owns mobile phone towers, installs solar panels on the tower and charges the mobile phone companies that rent the tower for the electricity the panels provide. The tower either should be in a region in which the grid is not available or is unreliable. *See* P.L.R. 201301007 (Jan. 4, 2013) (describing a similar arrangement but not specifying that the power generation was from solar).

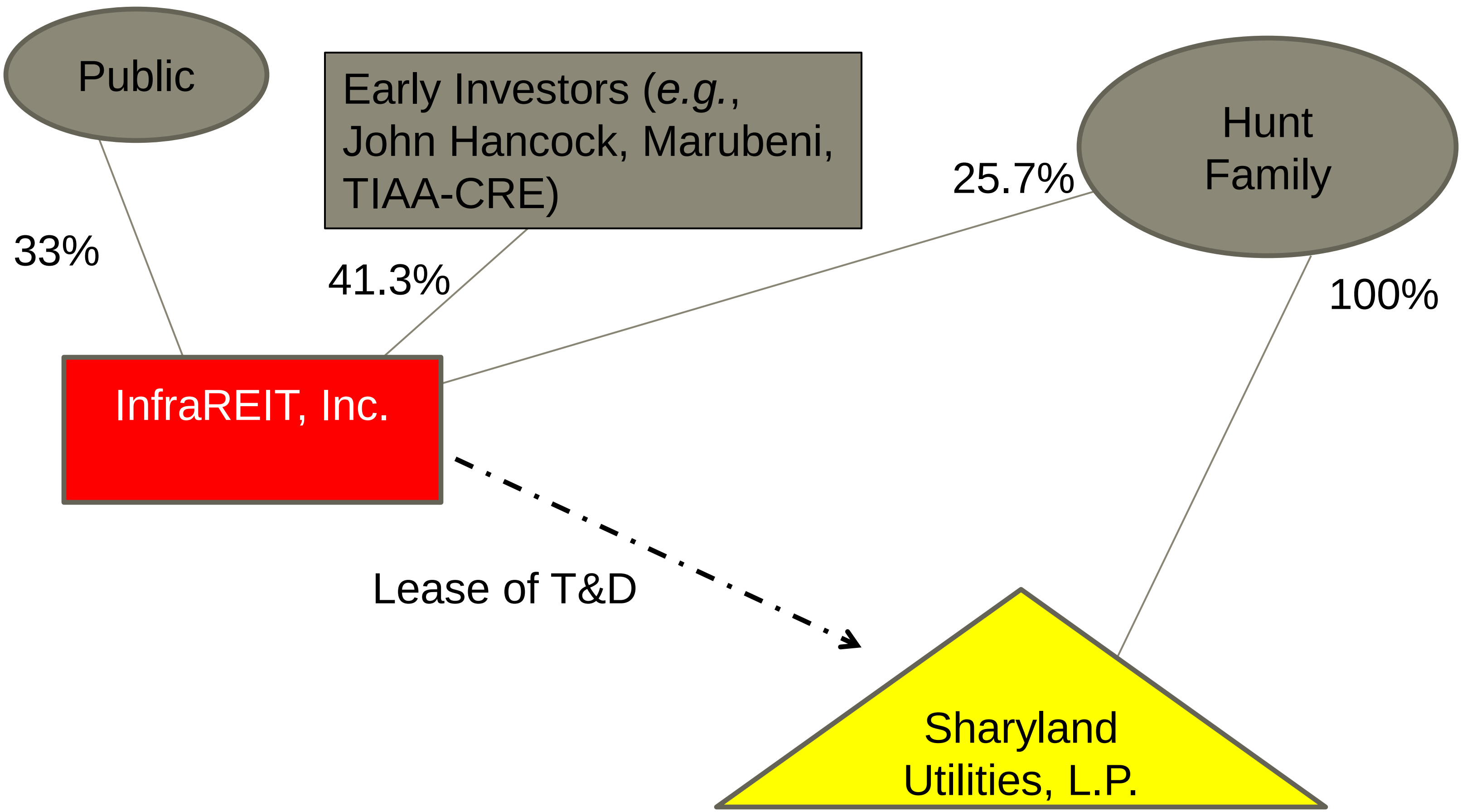
REIT Owns and Leases Out Transmission & Distribution (T&D) Assets

- Leading example is InfraREIT, Inc. (NYSE: HIFR) which is backed by the Hunt family and went public on Jan. 30, 2015
- S-1 provides: “There is little or no guidance in the tax law regarding the qualification of T&D assets as real estate assets for purposes of qualifying as a REIT.”
- “We hold a private letter ruling from the IRS that provides that T&D systems qualify as real estate assets.”
- “If we were not able to treat the T&D assets as real estate assets and/or the rent therefrom as qualifying rental income … , we may fail to qualify as a REIT.”

- The S-1 does not provide a citation to the PLR, but it is widely understood to be PLR 200725015 (Jun. 22, 2007).

Akin Gump STRAUSS HAUER & FELD LLP

InfraREIT's Structure



Due to the rental income requirements, REITs are limited in their ability to operate assets; however, REITs often lease to an affiliate

Taxable REIT Subsidiary (TRS) Diagram

Public Unit Holders

Tax Cost

REIT (Publicly Traded Del. Corp.)

Principal + Interest on Intercompany Debt

Corporate Dividends

Taxable REIT Subsidiary (TRS) Del. Corp.

Tax Cost after Tax Credits and 5 – Yr MACRS

Taxable REIT Subsidiary (TRS) Structure

- TRS would have interest deductions from the intercompany loan and from the projects' accelerated depreciation and tax credits
- At least for the five year depreciation period, the TRS could shelter most or all of its income from tax. Beyond five years:
  - The corporate subsidiary would either need to acquire new projects that generate more tax benefits
  - Rely on unused tax credits and deductions from the initial projects, or
  - Start paying tax

Limits on use of a TRS

- A TRS is permitted to engage in activities that the REIT cannot engage in directly
- Up to 25% of the total value of a REIT’s assets can be invested in a TRS
- A REIT can have more than one TRS but collectively subject to the 25% limit
- TRS is taxable as a regular C corporation
- Rents received from a corporation in which a REIT owns 10% or more of the total voting power or total value of shares are excluded as “rent from property” under the income tests
- A TRS cannot deduct such interest expense in any year when such deduction exceeds 50% of adjusted gross income
- A 100% excise tax is imposed on deductions claimed by a TRS to the extent the deductions do not meet “arm’s length” pricing principles

REIT's Cousin: Master Limited Partnership (MLP)

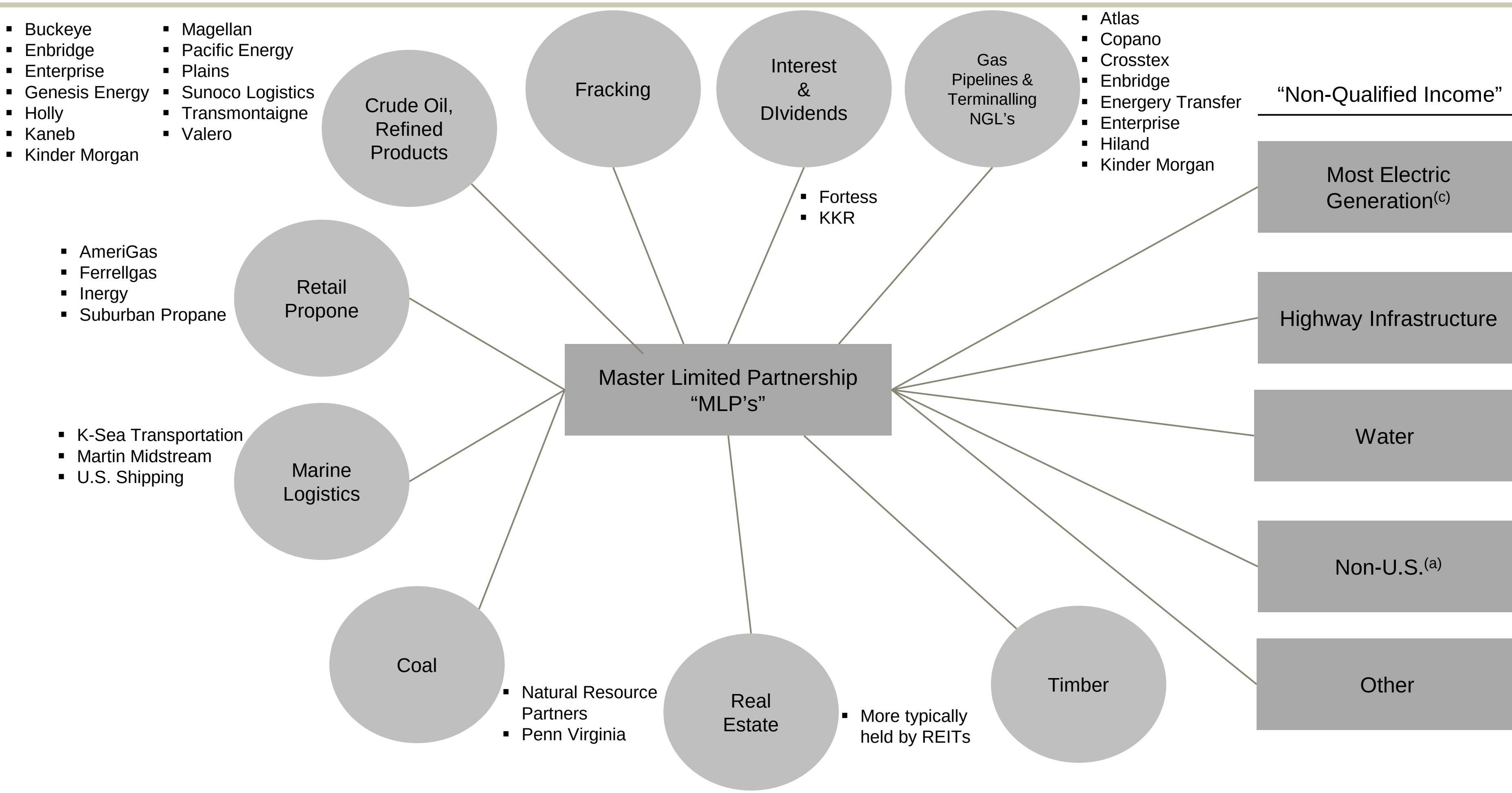
- An MLP qualifies for a specific exception to the "publicly traded partnership" rule that treats widely held partnerships, limited liability companies or trusts as C corporations
  - MLPs are subject to the partnership rules of subchapter K
  - Able to pass through losses and credits, subject to passive loss rules and other limitations
- To qualify as an MLP at least 90% of the entity's gross income must come from "qualifying sources"
  - Interest, dividends, and capital gains
  - Rental income and capital gains from **real estate**
  - Income and capital gains from natural resources activities
  - Income from commodity investments[1]
- Broader definition eligible assets than REITs
- Unlike REITs, no distribution requirements

[1] I.R.C. § 7704(d)(1).

Master Limited Partnership (MLP) – Current Law

- "Natural resource activities" include:
  - Mining
  - Refining
  - Transport of petroleum, natural gas, coal and other minerals
- The only renewable energy resources included as a "natural resource" are:
  - Ethanol
  - Biodiesel
  - Geothermal
  - Alternative fuels and industrial source carbon dioxide
- Solar, wind and biomass activities do not generate "good" income for purposes of the 90% test

Relevant MLP Investment Classes



(a) Certain minerals and natural resources must be located within the United States for MLP qualification. However, any non-qualifying assets could be housed under a foreign blocker corporation and become qualifying asset but raises foreign withholding tax issues.

(b) "Removal treatment, recycling and disposal of waste products from hydraulic fracturing" P.L.R. 2012270002.

(c) Income from selling electricty generated by geothermal energy is "qualified"." Regulations proposed in 2014 would treat as qualified income from the sale of solar electricity to tenants of an adjacent building if the solar project and building have the same owner

What's Better a REIT or a MLP?

- Federal Tax reporting for a REIT is much easier
  - REIT is taxed as a corporation that receives a deduction for dividends
  - MLP is taxed as a partnership
  - MLPs must send each unit holder an IRS Form K-1, which is complex and expensive to prepare
  - REIT just sends IRS Form 1099-DIV, which is easy to prepare
- REITs do not trigger state tax reporting obligations for holders
  - Many states will require unit holders to file state tax returns where the MLP operates, if the MLP is not operating in the state through a blocker corporation
    - States have de minimis exceptions to tax return filing obligations but holders of larger amounts of MLP units will have to make state tax filings
    - If a MLP operates through a blocker corporation, avoiding state tax filing obligations will come at the cost of a corporate layer of federal income tax (35%)
- But MLPs are not required by the Tax Code to distribute 90% of their income
  - However, the market typically demands that a MLP make distributions at that level

The Future for MLPs and Renewable Energy

- The Union of Concerned Scientists estimated that MLPs would reduce cost of wind energy production by "1.2 cents per kwh, or about 40% of the value of the PTC"
  - In 2012, First Wind estimated that MLPs would offer developers 25-30% of the benefits provided by PTCs [3]
- Senators Chris Coons (D-DE), Jerry Moran (R-KS), Sen. Portman (R-OH) and Lisa Murkowski (R-AK) are sponsoring a bill, the MLP Parity Act of 2013, to amend the MLP rules to make income from renewable energy projects "qualifying income"
  - Bill would not enable MLPs to act as tax equity investors because it does not amend the "passive activity loss" rules or the "at-risk" rules
  - MLPs under this legislation would only be efficient with respect to providing cash equity or debt to renewable energy projects (i.e., MLPs would not be tax equity investors)
  - Jt. Committee on Taxation estimated that the bill would cost $307 million over 5 years and $1.3 billion over 10 years, a fraction of the $10.1 billion estimated cost for wind and solar tax credits over 5 years the J. Ct. estimated in 2012
- If the bill were enacted, it would permit MLPs efficiently to raise capital to act as sponsors or developers
- MLP could then partner with tax equity investors to execute transactions that raise cash for the MLP and provide the tax equity investor with a stream of tax benefits and cash flow

[3] http://blog.ucsusa.org/master-limited-partnerships-mlps-lower-the-cost-of-renewable-energy-projects-512; http://www.mw-cleantechcapital.com/files/2013/11/BNA-Tax-Report.pdf; Copley, Michael, *Questions linger over value of renewable energy MLP*, SNL ENERGY(August 30, 2013).

MLP Legislative Change – Technical Issues

- Equipment Leasing is not Covered
  - The MLP bill does not include income from leasing renewable energy equipment to count as "qualifying income"
    - Big issue for residential solar where the typical transaction is a lease
  - SEIA may lobby to have this fixed
- If the MLP had "tax-exempt" partners (*i.e.*, shareholders), and the typical structure of incentive profits sharing with management (*i.e.*, not a "straight-up" partnership), it would raise certain complexities for the tax equity investor's eligibility to utilize fully accelerated depreciation and investment tax credits[4]
  - The structure above assumes any tax-exempt and any foreign partners of the MLP hold their interests through a domestic corporation
  - With respect to the tax-exempt partners, the domestic corporation must elect to treat any dividends, interest or gain earned by the tax-exempt partners as "unrelated business taxable income."[5]

---

[4] §§ 50(b)(4)(A), 168(h)(6).

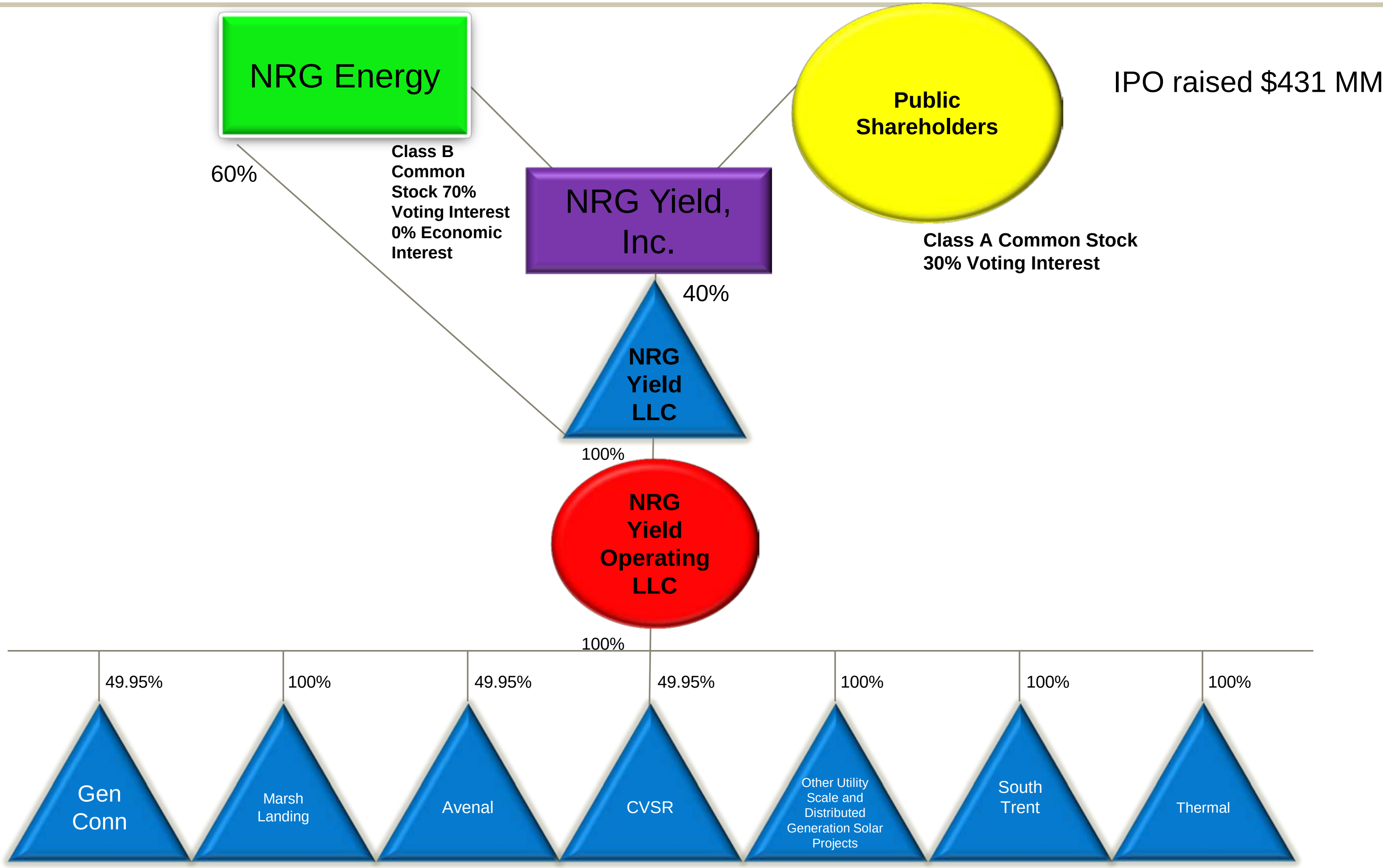
[5] § 168(h)(6)(F)(ii) (See possible exception in §168 (h)(6)(F)(iii)(I))

What is a YieldCo?

Yieldcos are "wind- and solar-generation companies, which provide power under long term contracts and pay out much of their cash flow to shareholders, similar to an MLP. Without much regard to subtlety, bankers have been calling these new stocks 'yieldcos.'"

Matt Jarzemsky, *Dividend-Paying Stocks Fit the Bill*, WALL ST. J., July 8, 2014, at C2.

YieldCo Example – NRG Yield, Inc.



NRG's "YieldCo" Structure – Tax Treatment

- NRG Yield Operating, LLC will not pay tax and rather will pass the tax attributes through to NRG Energy (60%) and NRG Yield LLC (40%)
  - NRG Yield, LLC is a flow through to NRG Yield, Inc.
- Cash distributions from NRG Yield, Inc. to the shareholders will be taxable dividends to the shareholders to the extent of NRG Yield, Inc.'s E&P
- E&P is calculated like taxable income but (i) without tax credits, (ii) using straight-line depreciation over the class life of the asset (12 years for renewables) and (iii) with a deduction for income taxes paid
- To the extent the cash distributions exceed NRG Yield, Inc.'s E&P, the distributions will reduce the shareholders' basis in their shares of NRG Yield, Inc.
- A lower basis means a larger gain when the shareholders sell their shares, which if the shares were held for more than a year, would be taxed at the 23.8% long term capital rate for individuals
- To maximize its value, NRG Yield, Inc. will need to *keep growing*
  - New assets with tax credits and depreciation are needed to shelter the taxable income generated by older assets that have exhausted their tax benefits

An average solar developer is not positioned to launch a yieldco, it may want to consider selling projects to a large company planning an IPO

David K. Burton, Partner
New York
T +1 212.872.1068   F +1 212.872.1002
dburton@akingump.com

David K. Burton advises clients on a wide range of U.S. tax matters, with a particular emphasis on project finance and energy transactions. In addition, he also advises clients on tax matters regarding the formation and structuring of domestic and offshore investment funds.

Practice & Background

Mr. Burton has extensive experience structuring tax-driven vehicles, such as sale-leasebacks, flip partnerships, inverted leases and other structures, for the acquisition and financing of renewable energy assets.

Prior to joining Akin Gump, Mr. Burton was the managing director and senior tax counsel at GE Energy Financial Services (GE EFS), one of the world's leading investors in energy projects. At GE EFS, Mr. Burton oversaw all of the tax aspects for over $21 billion in global energy projects from structuring transactions to accounting for taxes to formulating tax policy initiatives. During his tenure at GE EFS, the division's investments in wind, solar, hydro, biomass and geothermal power grew to $6 billion, making GE EFS the largest tax-advantaged energy investor in the U.S. Before joining GE EFS, Mr. Burton was a tax lawyer at GE Capital and primarily focused on aircraft and equipment leasing and financing and asset acquisitions. From 1996-2000, Mr. Burton was a tax lawyer at a large, international law firm in Philadelphia.

Mr. Burton received his B.A. *magna cum laude* from Ithaca College in 1993 and his J.D. *cum laude* from the Georgetown University Law Center in 1996, where he was on the staff of *The Tax Lawyer*.

Areas of Experience

- Global Project Finance
- Tax
- Renewable Energy
- Real Estate and Infrastructure Funds
- Investment Management and Transactional Tax
- Private Equity Transactions
- Solar
- Wind
- International Tax

Education

J.D., Georgetown University Law Center, *cum laude*, 1996

B.A., Ithaca College, *magna cum laude*, 1993

Bar Admissions

New Jersey

New York

Pennsylvania

Court Admissions

U.S. Tax Court

U.S.D.C., District of New Jersey

David K. Burton, Partner
New York
T +1 212.872.1068   F +1 212.872.1002
dburton@akingump.com

Representative Matters

Mr. Burton's recent representations include:

- advising Hunt Investment Management LLC on the formation of a fund to invest in U.S. renewable energy projects
- representation of a publicly traded company in the acquisition of an entity holding a $107 million portfolio of land and payments from land leases underlying wind and solar projects, including more than 7,500 acres of land leased to three solar projects with a value of approximately $60 million and the payments from 11 additional land leases for a portfolio of wind projects with a value of approximately $27 million
- advising a private solar developer in connection with $50 million acquisition and construction equity financing from a European based private equity firm for the pipeline of development and acquisition solar projects in the Western U.S. The capital stack for these projects will include special state-level incentives. (ongoing)
- acting as special tax counsel to NRG Energy and its California Valley Solar Ranch (CVSR) project in connection with inclusion of CVSR in NRG's public offering of securities in Yieldco
- acting as project counsel for Treasury Grant and tax matters in the financing of California Valley Solar Ranch, a $1.5B solar PV project supported by a Department of Energy loan guaranty

David K. Burton, Partner
New York
T +1 212.872.1068   F +1 212.872.1002
dburton@akingump.com

Representative Matters

Mr. Burton's recent representations include:

- representation of OneRoof Energy Group, Inc. in an IPO/reverse merger transaction pursuant to which OneRoof Energy, Inc., a national residential solar company, became a wholly owned subsidiary of a publicly traded company
- advising OneRoof Energy in a $50 million subscription receipts financing
- advising a high net worth individual on acquisition and financing of solar projects subject to virtual net metering in which the individual will *materially participate* in the operations to treat the tax benefits as *active*
- representation of State Street Bank & Trust in connection with the $260 million in tax equity financing for the Buffalo Dunes, a 250 MW wind project in Kansas backed by subsidiaries of Enel Green Power and GE Capital
- representing SunPower in connection with a sale and leaseback of photovoltaic solar energy equipment to be installed in California

Akin Gump

STRAUSS HAUER & FELD LLP