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Internal Revenue Service Provides Favorable Guidance on REIT Tax Treatment of Transferable Renewable Energy Credits for Rooftop Solar Panels and Electric Vehicle Charging Stations

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In this article, the authors provide a general overview of recent tax guidance issued by the U.S. Treasury Department and the Internal Revenue Service and offer some related practical observations.

The U.S. Treasury Department and the Internal Revenue Service (IRS) have issued long-awaited proposed regulations[1] addressing transfers of green energy tax credits under the Inflation Reduction Act (IRA).

Prior to the IRA, a real estate investment trust (REIT) typically held solar projects through a taxable REIT subsidiary and could not benefit from these credits without paying corporate tax. The transferability feature under the IRA allows a REIT to monetize these credits simply by selling the credits to an unrelated buyer for cash without the need to use a taxable REIT subsidiary or other structuring solutions.

In the preamble to the proposed regulations, the Treasury Department and the IRS addressed several questions that had been posed by REIT stakeholders. In particular, the Treasury Department and the IRS confirmed that they do not believe that a prohibited transaction tax arises from the transfer of the tax credits. In addition, the Treasury Department and the IRS confirmed that the receipt of or the right to receive a tax credit does not result in gross income to a REIT.

These helpful clarifications will provide REITs with greater certainty in their green energy investments.

This article provides a general overview of the REIT tax guidance as well as some related practical observations.

BACKGROUND

Although REITs are generally treated as corporations, REITs generally do not have income tax liabilities because REITs are al-

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lowed a dividends-paid deduction against their taxable income. Without taxable income, prior to the IRA, it was difficult for REITs to benefit from tax credits. Prior to the IRA, a REIT would often hold solar projects through a taxable REIT subsidiary or alternatively, a REIT might have leased its rooftop to a third party so that the third party could install the solar panel and claim the tax credit.

Section 6418 of the Internal Revenue Code of 1986, as amended (the Code), enacted under the IRA provides taxpayers with an option to transfer certain green energy tax credits generated from rooftop solar panels (e.g., investment tax credit) and electric vehicle charging stations (Section 30C tax credit) to an unrelated taxpayer in exchange for cash. The transferable feature of these tax credits allows a REIT to monetize these credits directly simply by selling the credits to an unrelated buyer for cash without the need to use a taxable REIT subsidiary or lease to a third party.

It is clear that Congress intended REITs to benefit from the new green energy tax credits, but REITs have been shy to fully embrace these incentives partly due to some unanswered technical REIT tax questions. In particular, REIT stakeholders had requested the Treasury Department and the IRS to provide guidance on the following issues:

(a) Clarify that eligible credits that have not yet been transferred are treated as a real estate asset, cash, or cash item and thus, will not potentially cause a REIT to fail the asset test for REITs under Section 856(c)(4) of the Code;

(b) Clarify that the transfer of an eligible credit pursuant to Section 6418 of the Code is not considered a dealer sale under the REIT prohibited transactions rules of Section 857(b)(6) of the Code;

(c) Confirm that receipt of (or the right to receive) an eligible credit does not result in income to an eligible taxpayer that is a REIT; and

(d) Confirm that the sale of energy under Sections 45 and 45Y of the Code is not a dealer sale under the REIT prohibited transactions rules of Section 857(b)(6) of the Code.

OVERVIEW OF PREAMBLE TO THE PROPOSED REGULATIONS

Interestingly, the Treasury Department and the IRS were willing to provide guidance on only two out of the four questions posed by REIT stakeholders and they chose to do so in the preambles to the proposed regulations rather than in the proposed regulations themselves.

The Treasury Department and the IRS stated their position that a prohibited transaction tax issue does not arise from the transfer of the tax credits. This is based on the reasoning that:

(a) Section 6418 of the Code provides that the cash amount received as consideration of the REIT for the transfer of the tax credit is not includible in a REIT's gross income;

(b) Section 857(b)(6) of the Code imposes a tax equal to 100 percent of the net income derived from a REIT's prohibited transactions; and

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(c) Since cash received by a REIT as consideration for the transfer of the tax credit would not be includible in any calculation of the REIT's gross income, the transaction cannot result in any net income and, consequently, there is no prohibited transaction tax issue regarding the transfer of an eligible credit.

In addition, the Treasury Department and the IRS stated that generally, federal income tax rules do not treat as gross income a person's becoming entitled under the Code to a credit against federal income tax and that this general principle equally applies to a REIT becoming entitled to the tax credit that it may transfer under Section 6418 of the Code.

However, the Treasury Department and the IRS did not confirm that the credits that have not yet been transferred are treated as a real estate asset, cash, or cash item but stated that the proposed regulations, particularly with respect to the paid in cash and timing of sale requirements, will assist REITs in managing issues with the REIT asset test.

Lastly, the Treasury Department and the IRS declined to provide additional guidance that the sale of energy under Sections 45 and 45Y is not a dealer sale but encouraged taxpayers to review the guidance given under the preamble to TD 9784,[2] where the Treasury Department and the IRS provided guidance that in any taxable year in which the quantity of excess electricity transferred to the utility company during the taxable year from energy producing distinct assets that serve an inherently permanent structure does not exceed the quantity of electricity purchased from the utility company during the taxable year to serve the inherently permanent structure, the IRS will not treat any net income resulting from the transfer of such excess electricity as constituting net income derived from a prohibited transaction under Section 857(b)(6) of the Code. The Treasury Department and the IRS further cautioned that any transaction falling outside of this safe harbor should be analyzed on a facts and circumstances basis to determine whether the sale is subject to the prohibited transaction rules of Section 857(d)(6).

PRACTICAL OBSERVATIONS

The favorable guidance that the Treasury Department and the IRS have provided in the preamble to the proposed regulations is a step in the right direction. Even though some REIT tax technical questions remain unresolved, REIT taxpayers may take comfort that such questions are likely to be resolved favorably in light of the Congressional intent for REITs to benefit from these tax credits.

REITs that desire to install solar panels on their buildings to generate electricity for their tenants (i.e., within the net metering safe harbor) may now feel comfortable owning such solar panels directly and selling the tax credits generated to an unrelated third party for cash without the use of a taxable REIT subsidiary or other structuring solutions.

CONCLUSION

REITs are increasingly adopting ESG goals that include the use of solar. The new Treasury Department and IRS guidance should further encourage REITs to invest in these projects and encourage the development of a robust tax credit market and related insurance market.

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NOTES:

[1] https://public-inspection.federalregister.gov/2023-12799.pdf.

[2] 81 FR 59849, 59856 (August 31, 2016).

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