



August 12, 2014

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Room 5203
Internal Revenue Service
P.O. Box 7604
Ben Franklin Station
Washington, DC 20044

TRANSMITTED VIA FEDERAL E-RULEMAKING PORTAL

Re: Definition of Real Estate Investment Trust Property

To Whom It May Concern:

The Solar Energy Industries Association (SEIA) is the national trade association for the U.S. solar energy industry. On behalf of our 1,000 member companies and the more than 143,000 American taxpayers employed by the solar industry, we appreciate the opportunity to submit comments on the Notice of Proposed Rulemaking of the Definition of Real Estate Investment Trust Property and specifically the solar-related examples. SEIA would also like to request the opportunity to have the Chair of SEIA's Tax and Accounting Committee, David Lowman from Hunton & Williams LLP¹, present and elaborate on the arguments below during the public hearing scheduled for September 18, 2014.

These comments serve to explain how the proposed rule would impact the solar industry and provide suggestions on how the rule could be improved to facilitate the solar industry's use of real estate investment trusts (REITs). However, as the IRS expands the definition of real property for the purposes of renewable energy development, the IRS should continue to explicitly make clear that these regulations only apply to Internal Revenue Code Sections 856-859 so as to avoid conflicts with the ITC or tax depreciation.

The Rule Should Allow for Third-Party Ownership and Tax Equity Partnerships

The proposed rule provides two examples relating to solar energy sites and solar-powered buildings. In both examples, the REIT owns the land or building on/aside which the solar energy asset resides as well as the solar energy asset. The Internal Revenue Service (IRS) does not explain why a REIT must own both the real estate (land or building) and the solar energy assets as ownership does not establish permanence or whether an item is a structural component. This

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equivalent ownership requirement does not square with third-party ownership and tax equity partnership models that currently dominate solar energy financing.

As the solar energy industry has matured, innovative solar financing models, such as third-party ownership and tax equity partnerships, have developed to make solar affordable and accessible to more Americans. In fact, almost all utility-scale solar projects involve a tax equity partnership, and the majority of annual installed residential systems in many states are now third-party owned (TPO). More than 90 percent of New Jersey's residential solar market has consisted of TPO systems since Q2 2013.² In Q1 2014, more than 50 percent of New York's distributed generation systems were TPO, and in California, Arizona and Colorado, 69 to 81 percent of installed distributed generation systems were TPO.³

Third-party financing usually occurs through two models—leasing and power purchase agreements (“PPAs”). In the PPA model, an installer/developer builds a solar energy system on a customer's property at no cost. The solar energy system offsets the customer's electric utility bill, and the developer sells the power generated to the customer at a fixed rate, typically lower than the local utility. At the end of the PPA contract term, property owners can extend the contract or buy the solar energy system from the developer.

In the lease model, a customer will sign a contract with an installer/developer and pay for the solar energy system over a period of years or decades, rather than paying for the power produced. Solar leases can be structured so customers pay no up-front costs, some of the system cost, or purchase the system before the end of the lease term.

A solar developer or installer does not typically own the building or land aside/on which the solar system is installed in either the lease or PPA financing model. Because the proposed rule would require the REIT to own the building or land, solar developers and installers that use the third-party financing model would be prevented from using a REIT to provide financing to customers.

Another component of solar financing is tax equity. To obtain a low cost of capital, solar installers and developers will often partner with tax equity investors, which range from large banks to well-known companies and investor-owned utilities. Tax equity investors want to reduce their tax liability and use the Solar Investment Tax Credit (ITC) to do so. The ITC is a 30 percent tax credit for solar systems on residential and commercial properties. The owner of the solar system receives the credit. REITs generally would not serve as tax equity partners because they do not derive benefit from the ITC as they are not flow-through entities like partnerships. Furthermore, REITs cannot pass through the ITC to a lessee. Thus, REITs are limited in how they can interact with solar installers and developers.⁴

² GTM Research and Solar Energy Industries Association, “Solar Market Insight Report” (Q1 2014) at p. 16, available at <http://www.seia.org/research-resources/us-solar-market-insight>.

³ *Id.*

⁴ Regarding a REIT's interaction with solar developers and installers, the question remains, however, whether a REIT that owns a portfolio of solar projects' debt can be considered a REIT asset. SEIA seeks clarification on this issue.

SEIA proposes that the IRS modify the proposed rule such that equivalent ownership of the land or building and solar energy assets is not required. In the ITC regulations, for example, the owner of the solar energy installation need not own the building or land on which the installation resides. The same concept could be applied here.

At a minimum, if joint ownership of the solar energy asset and the building or land aside/on which it resides is required, the rule should provide for non-equivalent ownership of the solar energy assets and the land or building. Equivalence is very difficult to determine in highly structured transactions, and common ownership would rarely be present in the context of a renewable power project.

It is also important to note that a partner for ITC tax purposes is deemed to own a proportionate share of the solar assets. Owning a partnership asset rather than having a deed to the land or equipment should be considered ownership of the asset, and a deed should be unnecessary in this context.

Structural Components Must be Able to Serve Dual Purposes

Solar energy systems sited behind the electric meter, usually located on buildings or homes or adjacent to a building, may produce excess electricity on a daily or weekly basis. For instance, on a hot summer day, when a homeowner is not at home, his solar system may be producing more electricity than the home can use. Or a solar system sited on a commercial office building may produce excess electricity on the weekend when workers are not in the office. If the structure is located in a state that allows for net energy metering (NEM), the excess electricity can be fed back into the electric grid and sold to a utility that distributes it to other customers.

The IRS recognizes that NEM is possible in REIT structures as it states in Example 9 that “the tenant occasionally transfers excess electricity produced by the Solar Energy Site Assets to a utility company.”⁵ However, it goes on to say that “the Solar Energy Site Assets are designed and intended to produce electricity only to serve the office building.”⁶ The IRS does not define “occasionally.” Buildings’ frequency to net meter will vary and the amount of energy a building may net meter is regulated by the marketplace as utilities often set limits on the percentage or amount of electricity that a building may net meter. Moreover, under the Public Utilities Regulatory Policies Act, utilities are required to purchase electricity generated (excess or otherwise) by qualifying facilities at avoided cost rates.⁷ Thus, the IRS should make it clear that a solar energy system that net meters, regardless of its frequency in doing so, can still be owned by a REIT.

⁵ 79 Fed. Reg. 27,508 at 27,514 (May 14, 2014).

⁶ *Id.*

⁷ 16 U.S.C. § 824a-3a.

Additionally, the IRS should allow for a power generation unit that is a structural component of a building to serve dual purposes—provide power to a building and net meter. Solar energy systems installed on buildings are designed to produce electricity *primarily* to serve the building, but, as is the case with net metering, they may not *only* serve the building. The IRS should change the language in the example to reflect this distinction.

Finally, solar energy system owners derive other non-rental income from an installation aside from net metering. For instance, all grid-tied solar energy systems produce two distinct products – electricity and renewable energy credits (RECs). RECs represent the property rights to the non-power aspects of a solar energy system. RECs can be sold separately from the electricity generated by the solar energy system. For example, a utility may purchase RECs associated with a solar energy project to help satisfy its renewable portfolio standard requirements. If the expense of paying an electric bill or including energy efficiency measures is allowable for a REIT then when solar energy net meters or other utility bill credits or energy offsets serve to reduce the electricity or other energy operating expenses of the REIT, such reduction, utility bill credits and RECs should also be allowable either as eligible REIT income or permitted revenue that does not count as ineligible REIT income.

Limit the Active Asset Restriction to Assets Used in the Production of Goods and not to Assets that Produce Electricity

In Example 8 of the proposed rule, PV modules are considered items of machinery or equipment that “produce electricity for sale to third parties, which is income other than consideration for the use or occupancy of space.”⁸ As such, the IRS determined that PV modules are not inherently permanent structures, and thus are not considered real property. While the REIT rules are designed to help pool capital of static, non-producing, permanent assets, the fact that the assets “produce” a good isn’t necessarily relevant. The IRS should consider limiting the active asset restriction to assets that use raw or pre-processed tangible materials in the production of separately inventoried goods, versus the use of a natural resource (e.g. wind or solar) to produce energy. If a REIT is not prohibited by tax law or regulations from saving money by cooling its buildings by simply opening a window to let a breeze in, and isn’t prohibited from saving money by lifting a window shade to let sunlight in, then a REIT should not be penalized for owning and using solar power systems in building operations. This is also consistent with the current restriction against REITs selling inventory and fits the Obama administration’s goal of helping a meaningful number of renewable energy projects fit into the REIT category.

Though installed system costs continue to decline,⁹ and module prices have correspondingly decreased, modules still generally comprise the largest cost of a photovoltaic (PV) solar project.

⁸ *Id.*

⁹ From Q1 2013 to Q1 2014, residential system prices fell 7%, from \$4.91/W to \$4.56/W. Non-residential system prices fell 5.7% year-over-year, from \$3.95/W to \$3.72/W. Utility system prices once again declined quarter-over-quarter and year-over-year, down from \$2.14/W in Q1 2013 and \$1.96/W in Q4 2013, settling at \$1.85/W in Q1 2014. *Supra*, note 1 at pp. 55-63.

By determining that modules are not real property, the IRS has significantly reduced the value proposition of a solar energy installation making it less attractive for REIT ownership.

Delineate that all Components of a Solar Energy Project Are Real Property

In Example 8, the IRS helpfully delineates specific components (mounts and exit wire) of a solar energy project that are considered real property for purposes of a REIT. While creating an exhaustive list is difficult, there are a few other major components of a solar energy installation that should also be listed and defined as real property. The solar industry and regulators have used the term of art “balance of systems” to define all of the components of a solar energy installation outside of the module itself. For instance, all solar energy installations use an inverter to convert the variable direct current (DC) output of a PV solar panel into a utility frequency alternating current (AC) that can go into a commercial electric grid. Inverters serve no independent purpose; they merely help provide power and anti-islanding protection to the realty to which they relate. Islanding occurs when a distributed generator (DG), such as a solar energy system, continues to power a location when electrical grid power from the utility is no longer present. Islanding can be dangerous to utility workers if they do not realize that a circuit is still being powered. As such DG systems must have inverters, which have anti-islanding capabilities to detect islanding and immediately stop producing power. Inverters should be considered inherently permanent structures similar to exit wire because even though they convert electricity, inverters are installed during construction of the solar energy site and are designed to remain permanently in place as a safety device and transmission component. When installed on a building, inverters are structural components as they work together with the solar energy system to provide electricity to the building.

In addition to inverters, many solar energy systems also have fuse boxes, meters, charge controllers, quick disconnect switches and monitoring systems. As the technology has advanced, energy storage, in the form of batteries or other devices, is now also used to complement solar energy installations. These components should be considered structural components because they are usually affixed to the building aside which the solar energy project is installed and are distinct assets that are a constituent part of, and integrated into, an inherently permanent structure.

Furthermore, the entire solar energy installation should be considered real property because, similar to a building’s central heating or central air conditioning systems, it serves as part of a building’s electrical system. Moreover, when installed with an energy storage device like a battery, the entire solar installation can serve as the building’s only electrical system when the conventional power grid is down by providing emergency back-up power, which is increasingly valued by consumers and policymakers in the aftermath of extreme weather events like Hurricane Sandy.

As for solar energy sites, such as those referred to in Example 8, the sunlight used to power those sites could be considered an interest in real property or real property as defined by the IRS.¹⁰ As such, any gain from the sale of this property interest is eligible REIT income. Similar to air rights over real property¹¹ or fruit-bearing plants in Example 1,¹² a REIT should be allowed to sell their solar energy rights to any person wishing to acquire them and have any income from the sale of those rights treated as eligible REIT income. Moreover, like the fruit-bearing plants in Example 1, the balance of systems used to convert sunlight into solar power should be considered real property.

Additionally, the proposed rule only covers PV systems, but many commercial building owners are having solar heating and cooling (SHC) systems installed on their properties as well. SEIA requests that the IRS confirm that any solar heating and cooling system components (SHC collector or panels; racking and mounting components; plumbing components such as piping; insulation materials; hot water storage tanks; absorption chillers if part of a solar cooling system; desiccant wheels if part of a solar cooling system; and controls and meters) would also be considered real property.

Finally, parking structures that are covered with solar panels are being used with more frequency. The IRS should clarify that these structures are also real property. Unlike the bus shelters in Example 4, the parking structures that support solar panels are inherently permanent structures. The parking structures are permanently affixed to the land. They are not designed to be removed and would likely damage the pavement to which they are attached if they were to be moved. They would also likely require significant time and expense to move. Thus, the IRS should determine that these parking structures are inherently permanent structures and real property.

Allow Aggregated Systems under One REIT

Often, solar developers will aggregate many systems in different locations together for investment and financing purposes. REITs should be allowed to own an aggregated group of solar installations.

Clarify how Inherit Permanency Co-Exists with Local Jurisdiction

In Example 8, the IRS identifies mounts as inherently permanent structures because they are permanently affixed to the land; are not designed to be removed and are designed to remain in place indefinitely; and will remain affixed to the land after the tenant vacates the land. While these qualifications are true in many circumstances, some local jurisdictions require the restoration of project sites to either a certain depth (24 inches in some cases) or a certain function (farming, for example). In these instances, would the mounts still be considered inherently permanent structures?

¹⁰ See 26 C.F.R. Section 1.856-3(c).

¹¹ See Rev. Rul. 71-286 (1971-2 CB 263).

¹² See 79 Fed. Reg. 27,508 at 27,512 (May 14, 2014).

Limit the REIT Definition of Real Property to Internal Revenue Code Sections 856 through 859

The IRS noted that, in drafting these regulations, it was very careful to “balance the general principle that common terms used in different provisions should have common meanings,” but recognized that real property is defined differently for purposes of the ITC and depreciation. As the IRS expands the list of solar energy system components that qualify as real property, the IRS should continue to explicitly make clear that these regulations only apply to Internal Revenue Code Sections 856-859 so as to avoid conflicts with the ITC or tax depreciation. While the IRS emphasizes that the regulations and definitions herein apply only to REIT structures, those investing in or otherwise working with solar financial deals may not have that understanding and therefore further clarification will provide additional certainty. These regulations should not override or compete with other non-REIT definitions of real property or personal property as the ITC is only available for assets that are not defined as a building or a structural component of a building or land. Without this clarification, solar energy systems that are owned or affiliated in some way with a REIT would not qualify for the ITC or accelerated depreciation, significantly reducing the value proposition of a solar energy installation.

In addition, any changes to definitions herein or the inclusion of solar energy installations in the definition of real property in IRC Section 856 through 859 should not extend to master limited partnerships.

Conclusion

Earlier this year, President Obama announced that “[t]he Treasury Department and the IRS are making it easier for renewable energy companies to operate and attract investment.” We appreciate the IRS’s meaningful efforts to better incorporate solar energy installations into the definition of real property and REITs. While the IRS has taken a step in the right direction, the IRS should utilize its authority to make our suggested changes to further the Administration’s clean energy objectives.

Thank you for the opportunity to provide comments on the proposed rule regarding the definition of real property as it relates to real estate investment trusts. SEIA looks forward to the opportunity to have the Chair of SEIA’s Tax and Accounting Committee, David Lowman from Hunton & Williams LLP, present and elaborate on these comments during the public hearing scheduled for September 18, 2014.

Sincerely,



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