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What the REIT?!

Current Tax Issues for the REIT Community.

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IN THIS ISSUE

REITs, Huh, Yeah; What Are They Good For? Absolutely (Almost) Everything! Uh Huh
Page 2

Sales of Property Outside the Prohibited Transactions Safe Harbor
Page 4

Professor Trust on REITs and Selected Income Tax Credits
Page 7

INTRODUCTION

REITs have been rather quiet in the capital markets for some time now. Rising interest rates have made debt more expensive. Trading prices have reflected steep discounts to "net asset values", or "NAVs". But REITs, our favorite investment vehicle and favorite creature of the Internal Revenue Code, are alive and well. In this episode of What the REIT?!, we remind ourselves and others of some of the great ways REITs can be used in investment structures. We also spend some time with "prohibited transactions," as we find REITs spending a fair amount of time considering the repositioning of their portfolios or the raising of capital through property dispositions and other monetization events (rather than debt or equity offerings). Lastly, we would be remiss if we did not discuss another subject near and dear to Professor Trust—the intersection of REITs with renewable energy and income tax credits, which has been brought to the fore with the Inflation Reduction Act. We hope you enjoy.

Reits, Huh, Yeah; What Are They Good For? Absolutely (Almost) Everything! Uh Huh

As most are no doubt aware, REITs are widely considered a tax-efficient vehicle for investing in real estate. This is mostly due to a REIT's general ability to avoid being subject to federal income tax to the extent it annually distributes its taxable income and gain. However, what is not nearly as well known is the multitude of additional ways in which REITs can be utilized to achieve various tax results. Below are just a few of the magical ways in which REITs may be so utilized.

UBTI Blocker

Though a tax-exempt organization generally is not subject to tax on its investment income (including interest, dividends, rents, and gains from assets producing such income), it may be subject to tax on certain income types in a number of circumstances (referred to, generically, as "unrelated business taxable income" or **UBTI**). One such example of UBTI is rental income earned by a tax-exempt entity from property where services are provided to the tenants, other than those services generally considered necessary for the basic habitation or use of the rented space. Another example is income or gain earned by a tax-exempt entity with respect to property financed with debt. In each of these situations, if the tax-exempt entity invests in the subject property through a REIT, the income and gain earned by the tax-exempt entity, in the form of dividends (including capital gain dividends) paid by the REIT, generally will not be considered UBTI, even though the underlying income and/or gain would be UBTI if earned directly or indirectly (through a partnership) by the tax-exempt entity.[1]

ECI Blocker

A non-U.S. person is subject to U.S. tax and filing requirements to the extent it earns income treated as "effectively connected with a trade or business within the United States" (**ECI**). Even income typically viewed as passive in nature, such as interest or rental income, if earned from the operation of a U.S. lending or real estate rental business, respectively, generally would constitute ECI and, as a result, a non-U.S. person earning such income directly or indirectly (through a partnership) would be subject to U.S. tax and filing obligations with respect to such income. However, if any of the above income is earned by a REIT in which a non-U.S. person is invested, the REIT would serve as a "blocker" to shield the non-U.S. investor from the ECI and resultant direct tax and filing obligations.

This structure works particularly well to block ECI in the case of a real estate loan origination business, since mortgage loans are qualifying REIT assets that generate qualifying REIT income, and dividends paid by the REIT would, under no circumstances, constitute ECI.[2] Although dividends paid by the REIT would be subject to a 30% U.S. withholding tax (except to the extent reduced or eliminated by an applicable treaty), no U.S. income tax return filing would be required for non-U.S. investors, which is often a principal motivation for a non-U.S. investor to avoid incurring ECI.[3] Moreover, depending on the status of the investor and laws of the relevant jurisdiction, any such withholding taxes may be creditable in the investor's home country against its tax liabilities there.

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[1] A REIT can generally provide virtually any type of service to its tenants if structured correctly, although in some cases such structuring may involve the incurrence of some amount of corporate tax if the services are provided by a "taxable REIT subsidiary." It should be noted that if a REIT has significant concentrated ownership (is "predominantly held") by specified tax-exempt pension plans, UBTI-type income may actually flow through to these tax-exempt investors under certain circumstances.

[2] This structure assumes that the REIT holds no real property, acquired through foreclosure, or otherwise.

[3] Additionally, the REIT would serve to block non-U.S. investors from being treated as engaged in the U.S. trade or business of the operation of the real estate, thereby avoiding the added potential concern that other income of the non-U.S. investors could be treated as ECI as a result of being deemed connected with such trade or business. Furthermore, although a taxable U.S. "C" corporation blocker could similarly be utilized to block non-U.S. investors from incurring ECI, that would typically not be a very efficient structure where there are other, non-U.S. investors, for whom the C corporation blocker would create an unnecessary layer of corporate income tax.

As mentioned above, a REIT similarly can serve to "block" ECI earned from the operation and rental of U.S. real estate. The major distinctions between non-U.S. investment in a REIT operating this type of business versus one operating a real estate lending business are the tax consequences resulting from a sale of U.S. real estate by the REIT. Any non-U.S. investor that has invested or contemplated investing in U.S. real estate is likely familiar with the dreaded "F" word, otherwise known as FIRPTA (i.e., the "Foreign Investment in Real Property Tax Act"). Under the FIRPTA regime, gain recognized by a non-U.S. person from the disposition of U.S. real estate generally will be treated as ECI, subject to the same U.S. tax and filing requirements applicable to other types of ECI. Additionally, under FIRPTA, if a REIT sells U.S. real property, distributions by the REIT attributable to gain from such sales are themselves treated as gain from the sale of the U.S. real property – meaning that a REIT is treated as a flow-through entity for this purpose, and does not serve to block this FIRPTA ECI, unless the relevant non-U.S. investor is a "qualified foreign pension fund" (QFPF), which is not subject to FIRPTA tax on the sale of U.S. real property.[4]

Domestically Controlled REIT as FIRPTA Blocker

One way to avoid the above FIRPTA consequences resulting from the sale of U.S. real property by a REIT is using a REIT owned more than 50% by U.S. persons (i.e., a "domestically controlled" REIT)[5] and, instead of having the REIT sell the U.S. real property, selling the stock of the REIT itself. Under such circumstances, gain from the sale of the REIT stock should not be subject to FIRPTA, and so non-U.S. shareholders should not be subject to U.S. tax or filing requirements with respect to any gain recognized on such a sale.

Section 892 Blocker

Sovereign wealth funds and other foreign government investors can benefit from an exclusion from U.S. federal income tax on certain income or gain derived from "securities" under Section 892 of the Code. Income or gain from U.S. real estate does not fall within the exclusion, but income or gain with respect to the stock in a REIT that owns such real estate can. As is the case with using a REIT as an ECI Blocker, gain from the sale by a REIT of real property is problematic because FIRPTA can apply to such gain when distributed by the REIT to its shareholders. Thus, sovereign wealth funds and foreign governments typically would structure their exit transactions as sales of REIT stock, rather than REIT sales of the underlying real estate. Unlike the case with regular taxable non-U.S. investors, such government investors do not need "domestically controlled" REIT status to avoid U.S. income tax on the sale of REIT stock as long as the other requirements of Section 892 are met (including that the government investor does not own 50% or more of the REIT and otherwise does not have "effective control" over the REIT).

Automatic 20% Deduction Generator

Currently, individuals (and trusts and estates) are entitled to a 20% deduction against certain types of business income that is earned directly or indirectly (through a partnership). This deduction is limited by the amount of W-2 wages paid by such business and/or the initial tax basis of the property used in such business. Ordinary REIT dividends (i.e., those paid out of ordinary income, and not capital gains) are entitled to this 20% deduction without regard to these wage and basis limitations. If, as a result of these limitations, individual real estate investors would not otherwise be entitled to the full 20% deduction if they invested directly or indirectly in the real estate, they could, instead, hold the real estate through a REIT, resulting in the full 20% deduction on the ordinary REIT dividends paid with respect to such real estate.

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[4] Even QFPF investors could benefit from the use of a REIT to hold U.S. real estate, where the operation of the U.S. real estate would result in ECI. Even QFPFs are not exempt from U.S. tax and filing requirements with respect to non-FIRPTA ECI.

[5] For purposes of determining whether a REIT is domestically controlled, generally you look through partnerships, RICs and other REITs to the ultimate beneficial owners. Additionally, the IRS has recently issued Proposed Regulations that would require a look through, for this purpose, of any U.S. corporation that is 25% or more owned by non-U.S. persons.

Conversion of 37% Interest Income to 29.6% REIT Dividend Income

Interest income is taxable to individuals at ordinary income rates, the highest marginal rate of which is currently 37% (not including the 3.8% tax on "net investment income," aka the Obamacare or Medicare tax). However, if REIT qualifying debt investments (such as loans secured by real property and CMBS) were held in a REIT, ordinary dividends paid by the REIT to individual taxpayers would be entitled to the 20% deduction described above, thereby magically converting 37% interest income into 29.6% REIT dividend income. Because this 20% deduction generally is only available to individual taxpayers, this strategy typically would not be beneficial where the relevant investors are either corporations or non-U.S. persons (or a combination of the two).

The foregoing is just a sample of the reasons why we love using REITs in our real estate tax practices. We hope you will come to love them, too!

Sales Of Property Outside The Prohibited Transactions Safe Harbor

REITs were intended to be primarily passive owners and operators of real estate assets. In furtherance of this objective, REITs are restricted from engaging in certain activities that are more closely associated with the active conduct of a trade or business. For example, a REIT generally may not directly provide services to its tenants other than those most basic to the occupancy of space for habitation. Another such example, which is the topic of this article, is the 100% penalty tax imposed on a REIT with respect to any gain recognized from "prohibited transactions."

"Prohibited transactions" refer to sales by a REIT of property held either as inventory or primarily for sale to customers in the ordinary course of the REIT's trade or business. The determination of whether a property is held primarily for sale is based on all of the relevant facts and surrounding circumstances, including, of principal importance, the intent of the REIT in acquiring and holding the property. Additionally, "primarily" for sale has been interpreted to mean "of first importance" or "principally" for that purpose. Therefore, so long as a REIT holds a property principally for investment, the fact that it also holds it for potential sale at some point should not result in the property being treated as "primarily held for sale" for this purpose. Additionally, if there is some unforeseen event or circumstance that changes the calculus surrounding the REIT's original business plan with respect to the property, the REIT's decision to sell the property earlier than originally anticipated as a result of such event or circumstance generally should not convert a property from investment property to property held for sale. Indeed, any property sold was held for sale at the time of the sale itself, and thus the mere fact of sale cannot be the critical or sole factor in itself.

Prohibited Transactions Safe Harbor

Even if a sale would, based on all of the facts and circumstances, otherwise constitute a prohibited transaction, if certain safe harbor requirements are satisfied, prohibited transaction characterization, along with its associated 100% penalty tax, will be avoided. Very generally, in order to satisfy this safe harbor with respect to the sale of real property, the following requirements must be satisfied: (i) the property must have been held for at least two years for the production of rental income;[6] (ii) in the two years preceding the sale, the REIT did not make capital expenditures includible in the basis of the property in excess of 30% of its net selling price; (iii) the REIT does not (A) make more than seven sales of property during the taxable year,[7] (B) complete sales during the taxable year that exceed 10% of the basis or value of the REIT's assets, or (C)

[6] Although there is little authority on the specific criteria for this requirement, the general view is that the two-year period would begin when the property is first capable of being occupied (legally and physically) and is held out for rental by the REIT

[7] For this purpose, multiple properties sold as part of a single sales transaction would generally be treated as only one sale. The statute only references "sales" of "property" by the "trust," raising numerous issues not squarely addressed by published guidance, such as the scope of "property" and whether sales of property other than real estate counts; and the effect of a merger or other transaction in which a REIT may or may not succeed to the safe harbor status of a predecessor.

complete sales during the taxable year that exceed 20% of the basis or value of the REIT's assets, but the three-year average percentage, in each case, does not exceed 10%; and (iv) if the seven-sale limitation of clause (iii)(A), above, is not satisfied (and, instead, either clause (B) or (C) is satisfied), substantially all of the marketing and development expenditures with respect to the property are made through either an independent contractor from whom the REIT derives no income, or through a "taxable REIT subsidiary" of the REIT.[8]

Facts and Circumstances Analysis

If these safe harbor requirements are not satisfied, a REIT must be able to satisfy the facts and circumstances analysis in order to avoid prohibited transactions treatment and its associated consequences.

In general, whether a property is held "primarily for sale to customers" is determined by looking to the REIT's intent in acquiring and holding the property. However, the REIT's actual activities relating to the property will be relevant in determining and supporting the nature of such intent. The courts and the IRS have looked to a number of factors in determining a taxpayer's intent in holding a property, including: (i) the nature and purpose of acquiring the property; (ii) the length of time the property was held; (iii) the efforts involved in marketing and selling the property; (iv) the number, substantiality, and continuity of property sales; (v) the extent of development, subdivision, and advertising to increase sales; and (vi) the time and effort devoted to property sales.

Typically, the need to apply the facts and circumstances analysis to avoid prohibited transaction characterization would arise where property was acquired with the intent to hold it for investment for an extended period, in satisfaction of the safe harbor, but some unforeseen event or circumstance results in a sale of the property outside the safe harbor requirements.[9]

The following are some of the more common factual scenarios illustrative of the above, and an analysis of the prohibited transaction considerations applicable to each such scenario. There are obviously many other scenarios that may arise, and each should be analyzed in light of its own particular facts and circumstances.

1. Unsolicited Offer to Purchase. A common scenario is the receipt by the REIT of an unsolicited offer to purchase the property for a price significantly greater than that which the REIT would have reasonably expected to be able to sell the property. It is important that the REIT was not otherwise intending to sell the property or involved in marketing the property at the time it received such an unsolicited offer (cf. scenario 2, below). The generally accepted view with respect to this scenario is that the mere fact that a REIT takes advantage of such an unexpected offer should not convert a property otherwise held for investment into a property held for sale and treated as a prohibited transaction, since the REIT is merely trying to maximize its return on the property, a motivation consistent with an investment in investment property. Additionally, once the REIT receives such an unsolicited offer, the REIT should not be precluded from engaging an agent and/or marketing the property in order to ensure that it obtains the best possible price in selling the property.
2. Unexpected Increase in Value of Property. Similar to the one-off offer to purchase a property for an unexpectedly high price, an unexpectedly rapid and significant increase in a property's market value can often provide ample justification for a REIT to sell the property outside the safe harbor without having to treat

[8] Even if the safe harbor is satisfied, it may be necessary to determine whether the sale is treated as a "dealer" sale for purposes of determining whether any resulting gain on the sale qualifies as capital gain. Satisfaction of the safe harbor merely allows the REIT to avoid the 100% prohibited transactions tax but is not determinative as to the character of the gain for any other purpose, including capital gain characterization.

[9] The most common situation would involve a sale within the two-year safe harbor period, or sales in excess of seven properties in a single taxable year.

the sale as a prohibited transaction. In such a scenario, the REIT should be able to market the property for sale in order to obtain the best possible price, as opposed to waiting to receive an unsolicited offer. As described above, it is the REIT's intention in acquiring and holding the property that is relevant for purposes of a prohibited transaction determination; the fact that an unforeseeably large increase in the value of the property made it economically prudent to sell the property earlier than originally planned should not change the REIT's initial intent.

3. Liquidation of REIT. A REIT may decide to liquidate earlier than originally anticipated for any number of reasons, including: (i) a change in the economic outlook of the assets in its portfolio; (ii) receipt of an unsolicited offer for all of its assets, substantially in excess of what it could otherwise have expected to receive from their individual sales; or (iii) an unexpected change in market conditions that allows for the achievement of the REIT's targeted returns through a current exit. If one or more of the asset sales made pursuant to such liquidation do not satisfy the safe harbor requirements, they would need to be analyzed under the facts and circumstances approach. Similar to the previous two scenarios, if the assets had been acquired for investment, with a view toward their long-term appreciation, the REIT's decision to sell all of its assets in liquidation, prompted by a change in circumstances, should not cause those assets to be treated as held for sale in the ordinary course of a trade or business. The IRS has issued a number of private letter rulings concluding that a sale of all of the REIT's assets (initially acquired for long-term investment) pursuant to a liquidation of the REIT were not treated as prohibited transactions.[10] The mere fact that a REIT is liquidating is not a "get out of jail free card" for avoiding prohibited transaction treatment but may be an additional helpful factor in the overall analysis.

4. Sale of One or More Properties of an Acquired Portfolio. Where a portfolio of properties is sold as a "package deal," a REIT acquiring such a portfolio may wish to dispose of one or more of the included properties shortly following their acquisition (for example, because they do not fit within the REIT's overall strategy, or because the REIT does not wish to acquire the number of assets for the full purchase price required to retain the entire portfolio). If the REIT's intention of acquiring and selling some of the properties was primarily due to the REIT's desire to acquire the other assets in the portfolio for investment purposes (and not, for example, due to an opportunity to make a quick profit on the properties being sold), there can be a good case for those sales avoiding prohibited transaction status, although the extent of post-acquisition sales activity will factor in as well. In a somewhat analogous scenario, the IRS ruled that where a REIT divided a property it held into two components, (i) air rights for condominium development and (ii) all other rights to the property, the disposition by the REIT of those air rights did not constitute a prohibited transaction.[11]

5. Miscellaneous Scenarios. The IRS has ruled favorably as to prohibited transaction status in a number of other scenarios, including: (i) a REIT's sale of property to pay off debt it had intended to repay through an IPO that failed due to poor market conditions;[12] (ii) a sale of properties by a REIT to obtain liquidity needed due to poor

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[10] See, e.g., PLR 8938004 (June 19, 1989) (sale by REIT of in excess of 40 properties in connection with its plan to liquidate as a result of the depressed economic condition in the Southwest not treated as prohibited transactions); PLR 201340004 (June 13, 2013) (disposition by REIT of all of its properties pursuant to plan of liquidation not classified as prohibited transaction where the REIT held each property for at least seven years, and for the production of rental income for at least two years, with all dispositions made through an independent broker).

[11] PLR 9724013 (March 17, 1997). The division of the property into those two components, one for investment and one for development and sale, can be said to be similar to the acquisition of multiple properties, some with the intention to hold for investment and some to be held for sale.

[12] PLR 9123042 (March 12, 1991).

[13] 201315004 (January 7, 2013).

economic conditions;[13] and (iii) a sale of mall properties leased by a tenant facing economic difficulties to a potential acquirer of the tenant in order to help facilitate that transaction with the intention of preventing the bankruptcy of the tenant and the closing of its stores.[14]

If a prospective sale of property will not meet the prohibited transactions safe harbor and the facts and circumstances surrounding the sale are unfavorable, a REIT can pursue other alternatives, such as structuring the sale as a non-taxable exchange pursuant to Section 1031 of the Code or a sale by a taxable REIT subsidiary (TRS) of the REIT. However, we find REITs sometimes too readily fall back on the TRS alternative in lieu of engaging in the facts and circumstances analysis referenced herein, which analysis may have resulted in a reasonable level of comfort that the sale is not a prohibited transaction and, thus, need not incur the tax drag resulting from use of a TRS. In this regard, we observe that any property has the potential to be sold outside the safe harbor and, thus, it behooves REITs to make a habit of planning appropriately, such as maintaining contemporaneous documentation regarding the original investment intent for acquiring and holding a property and any relevant changes in facts and circumstances serving as a rationale for selling the property sooner than originally anticipated.

Professor Trust On Reits And Selected Income Tax Credits

Professor Trust says: Done right, REITs do not pay U.S. federal income tax. That is because, since their creation in 1960, REITs can deduct their dividends; REITs are required to distribute most of their income as dividends; ergo and in somewhat circular fashion, REITs, by their nature, eliminate their taxable income with dividend deductions. As a result, REITs have not had much use for income tax credits, including income tax credits associated with renewable energy or other technology investments, because they are not supposed to have income tax liabilities to which such credits could apply. Has that changed?

The situation changed somewhat in 1999, when taxable REIT subsidiaries (**TRS**s) were created. TRSs are taxable corporate subsidiaries of REITs that can conduct activities, like active businesses, that REITs previously could not conduct. Because they are taxable, TRSs have had some use for income tax credits. Because TRSs could conduct active businesses, TRSs also might engage in activities that generate said credits. Thus, for example, ESG-minded REITs interested in solar energy might have their TRSs own solar panels and related assets; install them on the rooftops of their buildings or on land adjacent to their buildings or on parking lots; generate and sell electricity for use by tenants or even the public at large; and receive an "investment tax credit" of as much as 30% of their cost under Section 48 of the Internal Revenue Code of 1986, as amended many times (the "**Code**", the only code of importance).

We are in the midst of somewhat changes now. We say "somewhat changes" because of an occasional disregard for grammar and the fact that the Inflation Reduction Act ("**IRA**") and CHIPS Act ("**CHIPS**"), signed into law in 2022 by President Biden (a man in his 20s when REITs were created, mind you), created and expanded and extended various income tax credits, mostly related to technology and renewable energy, and introduced, or reintroduced, the concept of "refundability" and "transferability," which theoretically could help REITs make better use of such credits, but to what degree, really, remains unclear.

Here we focus on three credits extended, expanded or created under the IRA and CHIPS Acts: the "investment tax credit" ("**ITC**") for solar projects under Section 48 of the Code (courtesy of the IRA); the "production tax credit" ("**PTC**") under Section 45 of the Code (IRA again); the "alternative fuel vehicle refueling property credit" (we'll call this the "**EVCC**" for "electric vehicle charging credit") under Section 30C of the Code (yes, IRA); and the "advanced manufacturing investment credit" (we'll call this the "**Semiconductor ITC**") for investments in semiconductor manufacturing facilities under Section 48D of the Code (this time, CHIPS).

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[14] PLR 9041047(July 16, 1990).

ITCs under Section 48

Prior to the IRA, a taxpayer that installed an eligible solar (or other qualifying) project could be entitled to an ITC of as much as 30% of the eligible cost of the project. Such projects range from utility-scale solar "farms" to rooftop solar panels on an apartment building. The IRA extended the period for which taxpayers may claim the credit and, for projects larger than 1MW, imposed certain prevailing wage and apprenticeship requirements to obtain the full 30% credit. Most interestingly, the IRA made the credit potentially "refundable" under Section 6417 of the Code and potentially "transferable" under Section 6418 of the Code. More on that in a bit.

PTCs under Section 45

In lieu of the ITC, a taxpayer could claim the PTC for that solar or other project in an amount as high as 2.75 cents per kilowatt hour of electricity produced and sold to unrelated persons for ten years. As with the ITC, projects claiming the PTC ranged in scale, although taxpayers typically have elected the ITC for solar projects and the PTC for wind projects due to the economics involved. As with the ITC, the IRA extended the period for which taxpayers may claim the PTC and, for projects larger than 1MW, imposed certain prevailing wage and apprenticeship requirements to obtain the full 2.75 cent credit rate. And as with the ITC, the IRA made the PTC potentially "refundable" and potentially "transferable" under Sections 6417 and 6418 of the Code.

EVCCs under Section 30C

The IRA reinstated the tax credit for electric vehicle charging stations. Similar to the ITC, Section 30C of the Code provides a credit of up to 30% of the cost of a "qualified alternative fuel vehicle refueling" station, subject to a $100,000 per station limit. As with the ITC and the PTC, prevailing wage and apprenticeship requirements also must be met. In addition and unlike the ITC and PTC, the EV charging station must be located in an "eligible census tract," which generally means certain "low-income communities", or census tracts that are "not an urban area." As with the ITC and PTC, the EVCC can be refundable and transferable under Sections 6417 and 6418 of the Code.

Semiconductor ITC under Section 48D

CHIPS added Section 48D to the Code, which provides a new "advanced manufacturing" ITC for investments in semiconductor manufacturing facilities. Generally, the new ITC provides eligible taxpayers with a tax credit of 25% of their qualified investments in semiconductor manufacturing facilities. Unlike the ITC, PTC or EVCC, this credit is not burdened by prevailing wage or apprenticeship requirements. In addition, this credit is refundable, but pursuant to its own provision rather than Section 6417, and the credit is not transferable. At first blush, we thought this credit was promising for REITs—semiconductor manufacturing facilities are capital-intensive real estate development projects that could make for good REIT investments, and the credit is supposed to be fully refundable to all types of taxpayers. As discussed below, whether by design or mistake, Congress appears to have not had REITs in mind at all for these types of facilities.

Refundability (i.e., "Direct Pay")

When we say a credit is "refundable," we mean a taxpayer can claim a refund of the credit amount even if the taxpayer has insufficient income tax liability to claim the credit against. Thus, with such credits, the U.S. federal government is "directly" "paying" you for the credit. Or you are treated as "directly" "paying" a tax that you did not actually pay but for which you will receive a refund.[15] Unfortunately, here REITs cannot make use of the refundable feature under Section 6417 of the Code because they are not the right type of taxpayer. For most credits under Section 6417, a REIT would have to be a tax-exempt organization, state, or certain other type of special entity to be eligible to claim a refund, and a REIT is a REIT. Thus, the ITC under Section 48, the PTC under Section 45, and the EVCC under Section 30C are not refundable to REITs.

[15] Frankly, we are not quite sure which gave rise to the phrase "direct pay".

Congress appears to have felt encouraging semiconductor manufacturing was particularly important to the national security interests of the United States. Thus, from Professor Trust's solipsistic perspective, the semiconductor ITC under Section 48D was made refundable on its own and not pursuant to Section 6417 and, unlike Section 6417, *many types* of taxpayer can claim the refund. Except, that is, REITs.[16]

Whether intentionally or not, the drafters of Section 48D ignored the fact that, as a general matter, REITs are limited, statutorily, in their ability to claim ITCs. In an audacious display of poor drafting, Section 50(d)(1) of the Code provides that rules similar to the rules of repealed Section 46(e) apply for purposes of determining limitations on the ability of certain taxpayers to claim the ITC. Under these zombie rules, a REIT that eliminates its taxable income through dividends cannot claim the ITC at all, while a REIT that eliminates the bare minimum of 90% of its taxable income only can claim a small percentage of the ITC. Thus, the refundability feature of the semiconductor ITC appears to us largely useless to REITs, even though the structure of Section 48D suggests Congress felt such feature should be widely available to taxpayers with insufficient taxable income—unlike Section 6417, Section 48D itself places no limits on the types of taxpayers eligible for refundability.[17]

Transferability

Unlike refundability, REITs might be able to make use of the transferability feature of Section 6418 with respect to the ITC under Section 48, the PTC under Section 45, and the EVCC under Section 30C (alas, REITs and the Semiconductor ITC may never meet given said credit was not made transferable, presumably because it was supposed to be fully refundable to anyone, except, alas, REITs).

Although REITs are unlikely to become "tax equity" investors in utility-scale renewable energy projects anytime soon,[18] REITs will install solar panels, and perhaps some other forms of renewable energy equipment, on their real estate to generate electricity for their tenants, and those projects might generate ITCs or PTCs for such a REIT that the REIT could, in turn, sell to third parties for real moola. In addition, REITs will install EV charging stations on their properties. Under Section 6418, very generally and subject to limitations, qualifications, and uncertainties we would be happy to discuss, a REIT could sell the credits generated by its eligible projects to "unrelated" persons and get real cash.

We have heard of various concerns with REITs using Section 6418 to sell ITCs from their solar or other renewable energy assets, and address a few here:

- Mere entitlement to these transferable tax credits could give rise to gross income that does not qualify for the REIT gross income tests or, even if it did, could give rise to taxable income that must be distributed. We find this concern unfounded for several reasons. First, Section 6418 itself states that proceeds from the sale of transferable credits do not give rise to gross income—it would be rather perverse if that provision ended up meaning nothing because entitlement to the credits themselves gave rise to gross income. Second, caselaw and guidance regarding transferable credits do not suggest these credits give rise to income absent express statutory statements to the contrary. Third, entitlement to the credits does not, in fact, arise until an election is made, particularly for REITs. Absent an election, which per the statute might not come until the filing of an income tax return for the year at issue,[19] a REIT generally cannot claim the credits at all due to Section 50(d)(1) and its hideous reference to repealed law.

[16] Certain other types of taxpayers may not be eligible for the credit, including states and tax-exempt entities not subject to UBIT on their investment. Why Congress did this and yet allowed such entities to benefit from Section 6417 of the Code is puzzling.

[17] See, however, the footnote immediately above.

[18] "Tax equity" investors are investors that have an "appetite" (i.e., positive taxable income and income tax liabilities) for the ITCs generated by projects and their taxable losses generated by, for example, depreciation. REITs simply cannot generate a comparable after-tax return from investing alongside tax equity investors in such projects.

[19] Consider, for example, credits that are generated by a project placed in service in 2023; the election to transfer those credits may not come until fall 2024.

- Mere entitlement to these transferable tax credits creates an asset, which must be tested under the REIT asset tests as, for example, a real estate asset (or not). We find this concern unconcerning for similar reasons. Prior to an election to transfer the credit, in a certain sense the credit does not exist for a REIT and, if one could say it did exist, the credit certainly would be an intangible feature of the underlying energy property—thus, if the property was a real estate asset (say, solar panels attached to a REIT's building that provide electricity used by tenants), then the ethereal credit would be part and parcel of such real estate, whereas if the property was not a real estate asset (say, solar panels in a utility-scale solar farm), the credit may not be a real estate asset. Would it not also be strange for a feature—transferability—clearly meant by Congress to benefit REITs (by virtue of Congress expressly turning off Section 50(d)(1)) to create a problem for REIT compliance?
- Transfers of credits could be transfers of "property" for purposes of the "prohibited transaction" rules applicable to REITs that are "dealers" in property. This poses an interesting and oft-overlooked issue for REITs—a REIT that makes more than seven sales of "property" during a taxable year may fail to qualify for the "prohibited transaction" safe harbor under Section 857 of the Code. The Code merely references "property" in the statute and not, for example, *real* property; and a REIT might sell all kinds of property throughout its taxable year, including stocks and bonds in which it has parked excess cash, obsolete business assets, and even electricity itself (after all, the sale of electricity might be inventory, or might be a service, or might be both). Surprisingly little guidance exists on this topic, yet we rarely encounter a REIT or REIT adviser that worries about such sales counting toward the safe harbor; REITs and their advisors typically focus on sales of real property (or maybe indirect interests in real property, such as interests in other REITs). While we would love some additional guidance on this issue, we never hold our breath waiting for the IRS and in the meantime life goes on.

Finally, as a practical matter, we have heard, and have ourselves expressed, the practical concern that we have no idea what sort of market will develop for transferable tax credits (including, importantly, what sort of pricing will arise) and, absent IRS guidance, uncertainties hamper the ability to transfer such credits, including uncertainties regarding how the election can be made and its application to partnerships and multi-tiered structures, including structures involving other special types of partners like tax-exempt entities. "While we have begun to see term sheets for tax credit sales, these sorts of concerns likely will persist and impair the value of transferability to REITs. We would be surprised if transferability tipped the scales for a REIT deciding whether or not to invest in renewable energy for its properties. But the credits are there, so a REIT making such investments should do so, if possible, in ways that generate the credits and the possibility of a cash reward. We would be happy to help your REIT assess such possibilities.

Professor Trust believes this will make for an interesting, if not impactful, history in retrospect.

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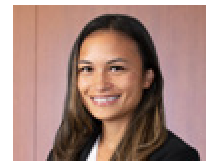

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