

Enabling REITs to Deploy Renewable Energy: Toward a Workable Legal Standard

By: Ameet Ashok Ponda, Paul W. Decker, Sarah D. Wellings

March 4, 2024

When Treasury promulgated [Treasury Decision 9784, I.R.B 2016-39](#) nearly a decade ago, the net metering renewable energy safe harbor (Section XI “Renewable Energy”, Subsection A) was welcome guidance that was fit for the time and the technology. But given the advances in renewable energy technology and today’s commercial realities, Treasury and IRS should now issue additional guidance that fully enables REITs to deploy renewable energy infrastructure in commercially sensible ways.

Specifically, in addition to retaining the existing net metering renewable energy safe harbor, Treasury and IRS should issue guidance that (i) confirms that the income generated by a REIT’s provision of electricity to its tenants from renewable source energy that is produced onsite (*e.g.*, via an onsite solar or wind installation) does not constitute Section 856(d)(7)(A) “impermissible tenant service income” and (ii) enables a REIT to deploy and utilize renewable energy infrastructure during a “ramp up” period or a period of tenant vacancy pursuant to an “appropriate in size” for the building (or other property) legal standard. While regulatory guidance is always appreciated, the guidance here could take the form of subregulatory guidance, such as a notice or private letter ruling.

As a means to advance the discussion of developing guidance that REITs may rely on in all seasons, we at Sullivan & Worcester LLP provide the following outline to describe (i) the current state of the law, (ii) common commercial situations unaccounted for by the current net metering standard of the safe harbor, and (iii) a proposed additional legal standard that is both consistent with existing REIT principles and that would provide REITs with greater certainty in their ability to satisfy the applicable REIT gross income and asset tests during a ramp up period or periods of economic downturn.

- **Background.** REIT landlords are routinely called upon to make available reliable, clean, and economical electricity to their property common areas and their property tenants.
 - A REIT landlord providing such electricity to tenants, whether as part of a bundled or separate charge, earns Section 856(d)(1)(B) “rents from real property” because such provision of electricity to tenants is geographically customary.
- **Not ITSI – Definitive Pronouncement.** Treasury and the IRS should confirm that the income generated by a REIT landlord’s provision of electricity to its tenants from renewable source energy that is produced onsite does not constitute Section 856(d)(7)(A) “impermissible tenant service income” (ITSI) because Section 856(d)(7)(C)(ii) affords protection from that adverse result.
 - There is already authority, including legal precedent, for this favorable conclusion, including: [Treas. Reg. § 1.512\(b\)-1\(c\)\(5\)](#), [Rev. Rul. 69-178](#), PLRs [200828025](#), [201301007](#), [201450017](#), [201901001](#), [202132002](#), [202133003](#), and [202150014](#).
 - But a more modern and more definitive IRS pronouncement on this point would bring welcome clarity, because classifying as ITSI the income from the provision of such onsite produced electricity has the very real potential to disqualify all of the REIT’s revenues from the affected property for REIT income testing purposes, per Section 856(d)(7)(B) and [Rev. Rul. 98-60](#).

- Current Safe Harbor & Workable Legal Standard. In addition to retaining the existing safe harbor in the above-cited Treasury Decision, the Treasury and IRS should articulate a workable general standard, as suggested below, in order to address a “ramp up” tax year, tenant vacancies, and other natural and often unexpected or unplanned fluctuations in electricity usage.
 - Current Safe Harbor Standard – “Net Metering”. Currently, the safe harbor applies only when, over the course of the taxable year, the REIT landlord purchases more electricity from the grid than it sells to the grid.
 - When the safe harbor condition precedent is satisfied, three favorable conclusions follow, *viz.*:
 - (i) the renewable energy installation is not disqualified from structural component status (and can thus be Section 856 “real property”),
 - (ii) the sales of electricity to the grid are ignored for purposes of REIT income testing, and
 - (iii) the sales of electricity to the grid will not give rise to dealer property gains subject to Code § 857(b)(6) taxation.
 - However, there is a “cliff effect” in the safe harbor: even 1kW of excess electricity sales to the grid over the course of the taxable year can remove the subject renewable energy installation from these three favorable conclusions by placing the entire series of transactions outside of the safe harbor.
 - Cliff Effect Risk in Ramp Up and Downturn Periods. This “cliff effect” may occur in several commercially common situations, such as the “ramp up” during the initial taxable year of a building’s construction, or a taxable year where there is an unexpected tenant vacancy (and particularly if the vacancy occurs at the beginning of the taxable year).
 - REIT landlords are on the calendar taxable year, per Section 859.
 - For properties in the northern hemisphere, the days and weeks surrounding the June 21 summer solstice are longer than days and weeks surrounding the December 21 winter solstice; this means, of course, that solar panels will generate larger amounts of electricity in the summer than in the winter. Similarly, other seasonal patterns may affect wind energy production over the course of a calendar taxable year.
 - Ramp-up risk: For a REIT landlord that completes its building construction (including for example the solar installations therein) in the late spring, its initial taxable year of installation will not be representative of its net metering experience with the grid in subsequent years, because several of the shorter daylight months will be missing from this initial taxable year; this can be expected to skew an otherwise reasonable scale of solar installation at a building to produce a violation of the net metering safe harbor (*i.e.*, the sale of electricity to the grid will likely go over the “cliff”).
 - Downturn risk: Similarly, after the initial year, if a REIT experiences an unintended vacancy in the building, meaning that tenant demand for electricity

drops (temporarily) below expected levels and there is thus more electricity to offload to the grid, and especially if this drop in tenant demand occurs during the early portion of the year and persists through the longer daylight months, these events also could skew an otherwise reasonable scale of solar installation at a property to produce a violation of the net metering safe harbor (*i.e.*, the sale of electricity to the grid will likely go over the “cliff”).

- New Legal Standard – “Appropriate in Size”. The solution to the “cliff effect” is to preserve the existing safe harbor while adding a more general legal standard, *viz.*, that a REIT with a renewable energy installation “appropriate in size” for the building (or other property, *e.g.*, cellular tower compound) will be afforded the same three favorable conclusions afforded to REITs that satisfy the net metering safe harbor.
 - In particular, a general legal standard of “appropriate in size” for the property can permit a REIT landlord to benefit from the three favorable conclusions even if there are excess net metering sales from the property to the grid for a particular taxable year due to commercially common situations such as the ramp up period or an economic downturn.
 - This “appropriate in size” standard is, in effect, the workable legal standard for parking lots located within or adjacent to REIT buildings, including those parking lots that are open to the general public for parking. See [Rev. Rul. 2004-24, 2004-1 C.B. 550](#) (“Each parking facility is located in or adjacent to a building occupied by tenants of R and is appropriate in size for the number of tenants and their guests, customers, and subtenants who are expected to use the facility.”).
 - This “appropriate in size” standard is also the legal standard for whether particular facilities and amenities are part of the RIDEA property (healthcare facilities and lodging facilities) that may be leased to a related-party TRS under Sections 856(e)(6)(D)(i)(II) and 856(d)(9)(D)(iii) (“The term ‘lodging facility’ includes customary amenities and facilities operated as part of, or associated with, the lodging facility so long as such amenities and facilities are customary for other properties of a comparable size and class owned by other owners unrelated to such real estate investment trust”). Compare, *e.g.*, PLR [201033022](#) with PLRs [201429024](#) and [201930003](#).
 - Many states already impose limitations on the size and scope of a property owner’s renewable energy facility (which limitations may be based on the local utility’s determination of the expected onsite electricity needs of the property itself), and REITs are thus already limited on the amount of electricity that may be sold to the electrical grid from time to time in a steady state.