

# ESG and the Commercial Real Estate Industry: Financing Options and Tax Incentives for a Greener Future

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Investors, lenders, developers, governments, non-profits, and other real estate market participants are increasingly considering environmental, social, and governance (ESG)-related factors, such as climate change, sustainable energy, and energy efficiency in making decisions about what projects to pursue and what materials and technology to utilize.

The application of ESG considerations vary from industry to industry based upon the specifics of each industry; however, the impacts of climate change particularly affect the real estate industry. The real estate industry has a considerable impact on climate change and the increased frequency and strength of natural disasters not only affects the physical safety of properties but also risks investments. Investors are beginning to recognize the impacts of climate change and incorporating these externalities into their investment strategies. Several green financing options have gained popularity to offset the significant upfront capital investment required to construct, renovate, or retrofit buildings to reach sustainability goals. Similarly, tax incentives have been recently expanded to promote energy efficient improvements. This alert will discuss some of these green financing options and tax incentives.

## C-PACE

Commercial Property Assessed Clean Energy (C-PACE) financing assists property owners in covering the upfront costs of eligible energy efficiency improvements and ground up construction projects. C-PACE financing requires state or local legislation authorizing C-PACE financing. A private lender then provides financing to a local authority that will oversee the C-PACE programs. The financing allocated to a project is recorded in the land records and runs with the land until the assessment is paid off, which is on a five-to-30-year term. The local tax authority includes the C-PACE special assessment as a line item on the property's tax bill, which is collected to reimburse the private lender. Although this is the usual C-PACE structure, C-PACE legislation is not universal across the country. State and local authorities apply different rules and regulations, so it is important to understand how the local C-PACE financing structure will affect a project.

Typically, 20-25% of development costs are eligible for C-PACE financing, and the financing is

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usually less than 3-5% of the collateral value. C-PACE financing is offered at a fixed rate, which is normally around 5-6%, and does not include a balloon payment. It is non-recourse because it is tied to the property instead of the owner and is usually automatically transferable upon the sale of the property. The consequences of defaulting under C-PACE financing are similar to failing to pay a property tax bill.

C-PACE programs are gaining in popularity with 39 states and the District of Columbia approving programs, and more than \$4 billion has been allocated to projects since 2009. C-PACE programs are popular because they provide for longer-term amortization without upfront investment. However, there are some considerations to account for in deploying C-PACE financing. For example, because this debt is tied to the property, lenders and mortgage-holders may take issue with the funding structure because their interests may be subordinated to C-PACE financing.

Even with these considerations, lenders may consent to C-PACE financing because it cannot be accelerated and does not affect lender's existing foreclosure rights and remedies since the C-PACE structure and financing does not require inter-creditor agreements. Even though inter-creditor agreements are not required, lenders often request a recognition agreement as well as control over the disbursement of funds and a waiver of prepayment penalties in case of foreclosure. Recourse or construction guaranties, which are terminated upon completion, are becoming more common with C-PACE financing. Lenders can also require the property owner escrow C-PACE assessments, like other property taxes. C-PACE is a cost-effective financing option because interest rates are typically lower than other financing or forms of debt, such as mezzanine debt, that are not secured by the property so can help improve debt service coverage. Ultimately, C-PACE programs can benefit the asset by modernizing the property, which reduces operating costs and increases net operating income (NOI) and valuation of the property. C-PACE financing is relatively new and lenders may require negotiated changes to get comfortable with the financing structure, so it is important to include counsel early in the process.

## **Energy-as-a-Service**

In another attempt to incorporate energy efficient and sustainable policies without a large upfront capital expenditure, energy providers are implementing a new business strategy known as Energy-as-a-Service (EaaS). The EaaS business model replaces the old model where a service provider charges a customer for energy consumed with a subscription model that combines hardware, software, and other monitoring services.

In the EaaS model, the subscribers are private sector commercial building owners. An energy company evaluates the building and makes energy efficient upgrades, which can include retrofitting lights and HVAC systems; implementing renewable sources like solar and wind; and incorporating on-site energy storage systems, smart thermostats, and electronic vehicle chargers. Energy providers also offer additional services like energy management to track energy consumption and adopt strategies to meet energy efficiency goals. The energy provider retains ownership and manages the equipment for the term of the subscription, which is typically five-to-20 years. The subscriber pays a recurring subscription fee for the services that is ultimately less than the original utility bill. At the end of the term, the subscriber can either extend the term, purchase the equipment, or return the equipment to the energy company. EaaS is a popular financing structure because the building owner benefits from the expertise of the energy provider managing and operating the equipment. Because the energy provider retains ownership of the equipment, the financing is off-balance-sheet financing.

## **Energy Savings Performance Contracts**

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An Energy Savings Performance Contract (ESPC) is a financing option that encourages implementing energy efficient upgrades. Unlike EaaS financing, building owners under ESPCs are in the public sector and typically include state and local governments, K-12 schools, universities and colleges, hospitals, and federal government agencies. Under an ESPC, an energy services company (ESCO) analyzes a building's energy usage and identifies potential energy efficient improvements. The ESCO then procures a loan to make the improvements. The building owner makes recurring payments to the ESCO that are based on the expected energy savings for the term of the ESPC, which is typically 10-to-20 years.

The ESCO guarantees the energy savings and covers any payments that exceed the monthly energy savings realized from the improvements. Therefore, the ESCO's compensation is linked to the level of energy savings achieved. Unlike EaaS financing, the building owner under an ESCO owns the equipment and the financing is secured by liens on the equipment. However, because the building owner owns the equipment, after the completion of the ESPC term, the owner benefits from continuing to use the equipment and retaining all energy savings realized.

All 50 states, Puerto Rico, and the District of Columbia authorize ESPCs, but the success of the programs is largely determined by the level of state involvement. Some states prescreen ESCOs to ensure they are qualified and establish public offices to monitor ESPCs, so it is important to learn how each state's program operates.

## **Green Bonds**

Green bonds are another financing option to fund sustainable projects. Green bonds are a fixed-income instrument that are issued to generate funds that are earmarked for energy efficiency, pollution prevention, and other sustainable projects. Green bonds are typically linked to the issuer's assets and carry the same credit rating as the issuer's other debt obligations. This is important because it means that green bonds are comparable to "plain vanilla" bonds, and are not entirely dependent on the project's success.

Green bonds were first issued in 2007 and today are a \$500 billion industry. To qualify for green bond status, the bonds are often verified by a third party, such as the Climate Bond Standard Board, to ensure that the funds will be allocated to environmentally focused projects. The most common types of green bonds are either use of proceeds bonds, which are bonds dedicated to green projects and investors have recourse against the issuer's other assets, and asset-backed securities bonds, which are bonds often used by state or local governments and the collateral comes from the issuer's streams of revenue.

Green bonds allow issuers to highlight their commitment to green projects and diversify their investor base. Some green bonds also include tax incentives, such as municipal green bonds that have no tax on interest earned. Green bonds, however, typically incur increased transaction costs because issuers must monitor and track how the proceeds are being used to ensure they are allocated to the green project.

## **Tax Incentives**

The Inflation Reduction Act of 2022 (IRA) was signed into law on August 16, 2022, and provides, among other things, tax incentives for commercial real estate owners to implement energy efficiency programs. One important tax deduction in the IRA is an amendment to the 179D commercial

buildings energy efficiency tax deduction (179D). 179D enables owners to claim a tax deduction for installing qualifying systems in buildings. Previously, this tax deduction was only available to for-profit businesses, but the amendment expands the deductions to tax-exempt organizations. Benefits under 179D start at \$2.50 per square foot for a 25% energy use reduction in the building. The benefit rises 10 cents for every percentage increase until it is capped at \$5 per square foot at a 50% energy use reduction in the building.

Another tax incentive in the IRA is the expansion of the Energy Efficient Home Credit in Section 45L of the Internal Revenue Code (45L), which originally expired on December 31, 2021. Under the expanded 45L, an eligible developer or builder may claim the 45L tax credit for the construction or rehabilitation of an energy-efficient multi-family dwelling that is 50% more energy efficient than standard dwellings. The building standards used to qualify for the 45L credit are governed by the US Environmental Protection Agency through the Energy Star Program and the US Department of Energy Zero Energy Ready Home Program (ZERH). The IRA also increased the maximum credit per unit from \$2,000 to \$2,500 if the multi-family building meets the Energy Star standard and \$5,000 if the multi-family building meets the ZERH standard.

## Conclusion

The real estate industry can play a major role in combating climate change. Green technologies are currently available that can make buildings more energy efficient. However, constructing, retrofitting, or renovating buildings is an expensive endeavor and usually requires a large upfront capital expenditure. The green financing options discussed in this alert attempt to alleviate the prohibitively high upfront capital expenditure by providing financing that can spread the cost over a longer period. Similarly, expanding tax incentives for energy efficient improvements further encourages utilizing green technologies. Reducing emissions and energy costs not only helps the planet but also makes assets more profitable. Comprehensive retrofits to existing buildings can achieve 15-40% energy savings, which can lead to increased NOI as some projections indicate that a 10% decrease in energy use could lead to a 1.5% increase in NOI. The further development and implementation of these green financing structures can close the gap in funding, and, along with expanded tax incentives, provide further incentives to create a greener and more energy efficient future.

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