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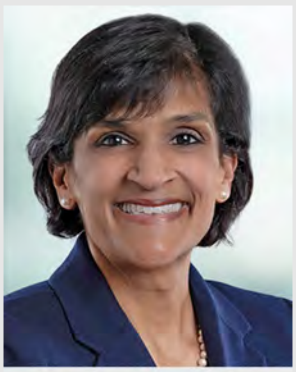

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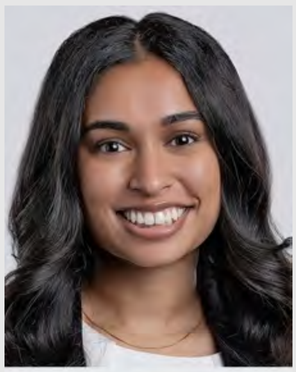

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In this installment of Real Assessment, Yalamanchili and Patel examine how New York's commercial property assessed clean energy loan program may affect property development and operations in New York.

Introduction

Commercial property owners in New York have a new tool in their arsenal to make eco-friendly upgrades to their aged buildings. The New York State Energy Research and Development Authority's (NYSERDA's) commercial property assessed clean energy (C-PACE) program allows property owners to borrow money for energy-efficient or renewable energy projects and to make long-term, low-cost payments via an assessment on their property tax bill. C-PACE loans are unique in two ways: (1) The financing agreement is tied to the property, meaning that the repayment obligations transfer with property ownership, whereas traditional mortgage financing is typically discharged upon a sale of the property; and (2) all eligible energy upgrades can be fully financed without the property owner having to put money down. C-PACE is a financing mechanism developed by various states to promote energy efficiency for long-term environmental sustainability. The list of eligible financing projects is extensive, but the road to obtaining C-PACE financing is particularly lengthy and complex. Since C-PACE loans result in tax assessments affecting real property taxes in New York, tax, accounting, and legal professionals should be mindful of how these loans may affect property development and operations.

Legislative History

C-PACE originated in Berkeley, California, in 2008 as a pilot program called the Financing Initiative for Renewable Solar Technology.[1] It was used as a financing tool for solar panel installations to address the upfront cost barriers of green energy improvements. The property tax financing was an important tool because it gave property owners access to funding tied to the property value, not personal credit; it also solved the dilemma of owners recovering the cost before the property was sold. The city realized that property owners were less likely to invest in renewable energy projects if they planned to sell their property before the investment was recouped. However, by attaching the financing to the property, the loan can be transferred with

[1] Local Government Energy Efficiency, "Berkeley FIRST — Financing Initiative for Renewable and Solar Technology," Institute for Local Government (undated).

ownership, encouraging owners to take a risk for energy-efficient projects. Following California's lead, C-PACE financing legislation is now available in over 40 states and the District of Columbia, with over $7 million in investment projects nationwide.[2]

New York enacted C-PACE financing legislation in 2009.[3] Under this legislation, any municipal corporation may establish a "sustainable energy loan program" using money from federal grants, federal credit support, or the state of New York. The statute lays out general guidelines for C-PACE financing such as qualified beneficiaries, repayment terms, and energy audits. It requires NYSERDA to issue specific guidelines for the implementation of loans. The purpose of this legislation is to promote clean energy projects. New York state legislators say C-PACE financing "fills a large void for clean energy financing for projects such as deep energy improvements in buildings and long-term renewable energy projects."[4] Before its amendment in 2020, article 5-L did not allow new construction buildings to benefit from C-PACE financing. Proponents of extending C-PACE financing to new buildings argued that it would provide a compelling incentive to design sustainable, high-performing buildings from the outset. When New York adopted this amendment in 2020, it joined 21 other states offering C-PACE financing for new construction. In August 2024 NYSERDA updated its guidelines to include a provision that allows new construction buildings to be eligible for C-PACE financing.

Initially, when New York implemented the C-PACE program in 2009, it permitted municipalities to opt in to the financing structure. At the time, over 60 municipalities opted in — the majority in upstate New York. However, New York City decided not to participate until 2019, when it established its own C-PACE financing program via Local Law 96, known as the Climate Mobilization Act. The New York City Energy Efficiency Corp. (NYCEEC) administers the program and promulgates rules to implement the city's C-PACE financing. New York City's C-PACE financing generally follows the same guidelines as NYSERDA, including adopting an amendment to make new construction buildings eligible for C-PACE financing. Owners and developers, including leasehold owners under long-term ground leases, may now access C-PACE financing to construct new buildings or renovate or retrofit existing buildings with energy-efficient improvements.

How to Obtain C-PACE Financing

Obtaining C-PACE financing in New York involves several steps. The applicant must be the borrower, and the property site must be eligible as consistent with the promulgated rules. Owner-occupied one- and two-family homes, or townhomes as defined in the 2015 International Building Code, are not eligible for C-PACE programs. Ineligible properties include individually owned properties and government-owned properties (including public universities and school districts). Eligible properties include both for-profit and not-for-profit organizations or any property owner other than a natural person that owns commercial real estate. The loan must be used to fund eligible improvements such as solar thermal systems, solar photovoltaic technology, and small wind projects. The energy improvements must be recommended by an energy audit, and the loan terms must be less than or equal to the weighted average useful life of the improvement. Generally, the application process follows three phases: intake, data gathering, and documentation. NYSERDA and NYCEEC established an approved list of certifying energy audit entities.

C-PACE allows for long-term, fixed-rate financing that covers 100 percent of energy upgrade costs with no cash upfront from the owner. The loans are transferable upon the sale of the building, and the repayment remains on the property tax bill. Also, projects can be retroactively financed up to three years after improvements are completed. The loans can be

[2] PACENation, "PACE Market Data" (last updated Mar. 31, 2023).

[3] *See* N.Y. Gen. Mun. Law section 119-gg (McKinney 2024).

[4] *See* NYSERDA, "Commercial Property Assessed Clean Energy (PACE) Financing Resources."

used for hard and soft project costs that are necessary to install the energy upgrades. This unique financing mechanism offers significant advantages over traditional mortgage financing.

Tax Implications

While the C-PACE program has generated excitement for its potential to assist property owners in financing energy-efficient and renewable energy projects without the burdens that accompany traditional financing, the tax implications of the C-PACE program in New York are worth considering as well:

1. IRS regulations stipulate that payments for special assessments are not deductible as property taxes.[5] If the special assessment contains interest, the payment of that component may be deductible.[6]
2. Energy-efficient improvements financed through C-PACE may still qualify for a variety of federal, state, and local tax incentives or rebates. For example, property owners may be eligible for tax credits for installing solar panels or other renewable energy systems. This is another attractive feature of C-PACE financing because it allows property owners to stack energy-efficient improvements with C-PACE financing.
3. Unlike traditional mortgage loans, C-PACE loans are not subject to the New York mortgage tax, which can be 1 percent or more of the mortgage loan amount, depending on the county where the property is located. C-PACE loans offer these additional savings.

Lease Implications

The opportunities presented to property owners by C-PACE loans may present challenges to others, including commercial tenants at properties that participate in the C-PACE program. On the face of it, these loans appear to benefit tenants since they may help the property owner make improvements to the property that are beneficial and attractive to tenants. However, tenants should be mindful of whether the expenses associated with C-PACE loans may be passed along to them. Many triple net commercial leases require tenants to pay their share of a property's operating expenses. For example, property operating expenses may include costs associated with maintenance of common areas, property insurance, and real property taxes. Principal and interest payments related to the landlord's mortgage loans are typically excluded from the operating expenses paid by tenants. However, since C-PACE loans are structured as an assessment on the real property taxes, it is likely those C-PACE payments would be included in the property's operating expenses that are payable by the tenant. If the landlord had financed those same improvements using a traditional loan structure, the interest and principal payments would likely not be passed along to the tenants as property operating expenses.

So, tenants are encouraged to consider whether C-PACE tax assessments should be excluded from the property operating expenses for which they are responsible. Landlords may argue that C-PACE tax assessments should be paid by the tenants since, presumably, the C-PACE improvements lower energy costs, improve the property, or both. If the tenant successfully negotiated that the lease excludes C-PACE tax assessments from the property operating expenses, tenants should also ensure that the lease permits the tenant audit rights to verify and confirm that the C-PACE assessments are in fact excluded from the property tax expenses. If the tenant is not successful in excluding C-PACE tax assessments from the lease property operating expenses, the tenant should ask the landlord for a history of utility and other expenses at the property to determine if the C-PACE improvements, in fact, benefited the property and reduced utility or other property operating expenses.

Conclusion

C-PACE financing offers a promising avenue for commercial property owners in New York to undertake energy-efficient and renewable energy projects. By leveraging this innovative financing

[5] Treas. reg. sections 1.164-2(g) and 1.164-4.

[6] "IRS Says PACE Interest Falls Under Mortgage Deductibility Guidelines," PACENation, July 11, 2016.

mechanism, property owners can achieve significant energy savings, enhance property values, and contribute to long-term environmental sustainability. However, navigating the application process and meeting the eligibility criteria can be complex, necessitating careful planning and adherence to guidelines set forth by NYSERDA and NYCEEC. ■