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Investments in Renewable and Conventional Power Projects in Qualified Opportunity Zones

By Jonathan M.A. Melmed, Jonathan Talansky, Edouard S. Markson, and Nikolai Karetnyi*

Infrastructure project developers, in particular, may wish to consider using the Qualified Opportunity Zone rules to make projects more attractive to a wider universe of investors and, in the case of renewable energy projects, potentially reduce their dependence on traditional tax equity players for financing. The authors of this article discuss.

The Qualified Opportunity Zone rules under Section 1400Z of the Internal Revenue Code permit certain investors to realize substantial tax benefits if they invest capital into federally-designated low-income communities known as "qualified opportunity zones," or "QOZs," through entities called "qualified opportunity funds," or "QOFs." The QOZ regime provides taxpayers with the ability to defer recognition of capital gains by timely investing such gains in QOFs, which in turn are required to invest in qualifying businesses or projects in QOZs. A significant majority of QOFs formed to date have focused on real estate development, but QOFs targeting investments in infrastructure projects including electric generating and storage facilities may present compelling opportunities for developers and investors.

Benefits under the QOZ rules are subject to a variety of timing requirements, including investment deadlines, minimum holding periods, and a fixed end date for deferral. Because of the way these timing requirements interact with each other and with the timing requirements under the renewable energy tax credit regime, which also include deadlines, phase-outs, and sunset provisions, investments must made by December 31, 2019 to receive maximum benefits under these incentives.

Infrastructure project developers, in particular, may wish to consider using the QOZ rules to make projects more attractive to a wider universe of investors

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and, in the case of renewable energy projects, potentially reduce their dependence on traditional tax equity players for financing.

BACKGROUND

The QOZ regime is poised to be one of the most important tax incentives in a generation. It was created under the Tax Cuts and Jobs Act of 2017 to encourage investment in low-income communities. Thus far, the Department of the Treasury and Internal Revenue Service have issued two highly anticipated sets of proposed regulations under these rules.

Generally, persons with eligible capital gains may access these tax benefits by making qualifying investments (within 180 days of the realization of such capital gains) into a QOF. If an investor meets certain holding period requirements with respect to its interest in the QOF, then the investor may also (1) exclude a portion of the deferred gain, and (2) in the case of a minimum 10 year holding period, eliminate capital gains tax on all post-acquisition appreciation in the QOF interest. For an entity to qualify as a QOF, at least 90 percent of its assets must be qualified opportunity zone property, which may include, along with equity interests in certain qualifying entities, qualified opportunity zone business property ("QOZBP"). QOZBP must be tangible property used in a trade or business of the QOF, where (1) the QOZBP was acquired by the QOF for cash from an unrelated person in a sale or exchange, (2) the QOF is the "original user" of or "substantially improves" (which generally means a doubling of initial tax basis in) such property, and (3) substantially all of the use of such property was in a QOZ during substantially all of the QOF's holding period for such property.

For a business in a QOZ to qualify under these rules, it must derive at least 50 percent of its income from the active conduct of a trade or business within the QOZ. The most recent set of proposed regulations set forth three safe harbors for purposes of making this determination. These safe harbors, to varying degrees, permit businesses to reach beyond the QOZs themselves so long as the business is primarily conducted from inside the QOZ. Notably, a qualifying business is limited in the "nonqualified financial property" it can hold. Nonqualified financial property generally includes stock, debt, partnership interests, options, futures, forward contracts, notional principal contracts, and other similar property but does not include reasonable amounts of working capital.

ELECTRICITY PROJECTS & OPPORTUNITY ZONES

These provisions present an attractive opportunity to developers of power and infrastructure projects, and potentially to tax equity investors in such projects. In a typical renewable project deal, a developer (or sponsor) partners

with a tax equity investor in a joint venture holding a project eligible for renewable electricity production tax credits ("PTCs") or energy investment tax credits ("ITCs"). Both the developer and the tax equity investor contribute capital to the joint venture, with the developer often taking an active role in the day-to-day management of the project. In the early stages of the development of the renewable project, the joint venture's profits and losses (including the PTCs and ITCs) are allocated predominantly to the tax equity investor, allowing the tax equity investor to use the PTCs and ITCs to offset its other tax liabilities. Once the renewable project becomes operational, the economics of the joint venture are "flipped" and the joint venture's profits and losses are allocated to the developer. This common structure is mutually beneficial, as the tax equity investor receives the PTCs and ITCs during the limited period in which the credits are available and the developer acquires equity financing necessary to construct and operate the renewable project. Other forms of tax efficient renewable energy investment structures are common as well.

In addition to PTCs and ITCs, the tax code offers significant incentives for investment in renewable energy projects in the form of accelerated depreciation. (These are also available, though to a lesser extent, for conventional infrastructure projects.) Non-corporate investors are generally unable to take full advantage of these incentives because of the "passive activity" rules, which generally prevent investors from using investment losses to shelter other income from tax. As discussed below, however, the QOZ rules may make it possible for individual investors with capital gains to capture some of these benefits that would not otherwise be available to them.

Many enticing industrial or vacant sites for the potential development of renewable projects are located in QOZs. In contrast to the limited number of tax equity investors who deploy capital in renewable projects, there are countless taxpayers sitting on substantial capital gains who can benefit from a QOZ investment and should present developers with an entirely new sources of capital. What's more, these investors may be willing to accept a lower pre-tax economic return, since the potential for a tax-free exit will enhance the after-tax return considerably.

A deal sponsor can structure a project as a purchase of land in a QOZ, funded by a mix of investor equity, both QOZ investors and traditional tax equity. Alternatively, a sponsor may find that QOZ investor demand is high enough that traditional tax equity capital is not needed. Avoiding the complexity of tax equity is a significant potential benefit to renewable energy sponsors. The developer can construct a solar facility, for example, and satisfy the "original use" requirement under the QOZ rules. The solar installation will

constitute an active business producing and selling electricity to identified off-takers or into the power grid.

The recent QOZ regulations clarified that, when structured properly, an exit from an opportunity zone investment held for at least ten years will eliminate all gain on the project, *including depreciation recapture*. This is a significant benefit for investors in projects that produce a lot of deprecation during the hold period, as is the case with many energy projects. QOF investors, even if they are subject to the passive activity loss limitations, should be able to use this depreciation to eliminate income tax on some or all of their operating income from the business. The deductions would ordinarily be subject to recapture at ordinary income rates, but can be tax-free after 10 years under the QOZ rules.

QOZ investors can also be utilized in more nuanced ways in energy projects, including replacing the "back leverage" in a partnership flip structure or acting as a "co-GP" with the sponsor. Although the QOZ rules themselves make it challenging for a QOF to be formed to serve as the tax equity investor (or for the tax equity investor to enjoy both benefits concurrently), there are circumstances in which this may be possible for investors who can utilize the tax incentives for renewable energy and, unlike traditional tax equity investors, are willing to remain as long-term equity investors in the projects after those benefits have been exhausted. In any case, the QOZ rules may well give rise to a new financing source for renewable energy projects in situations where investing in a QOF is more advantageous on an after-tax basis than the traditional structure.

CONCLUSION

It is fair to say that the proverbial clock is ticking for renewables developers to take *full* advantage of the opportunity zone benefits, since December 31, 2019 is the latest date on which an investor can reinvest in a qualified fund and enjoy the maximum tax deferral and tax elimination benefits of the regime. Investments through 2026 will still be entitled to a portion of these benefits and QOFs may be particularly attractive for investors who are otherwise looking to invest in these kinds of assets. While it is true that renewable energy projects tend to depreciate rather than appreciate, thereby rendering less relevant the main tax benefit of these investments (namely, a tax-free exit after a sufficient hold period), investors can still achieve highly valuable deferral, as well as elimination of depreciation recapture as described above.