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Developing Renewable Energy Projects in Opportunity Zones

Opportunity Zone Boot Camp

October 17, 2019

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Roadmap

- Opportunity Zones 101
  - High-level Overview
  - Drilling down: QOZ and QOZB
- Renewable Energy Project Finance 101
  - High-level Overview
  - Drilling down: Debt and Equity
- Takeaways and Discussion
  - Combining OZ and other tax incentives
  - Potential benefits, pitfalls and other issues

Opportunity Zones

An Overview

Opportunity Zone Legislation

The Opportunity Zones tax incentive was established by Congress in the 2017 Tax Cuts and Jobs Act as an innovative approach to spur long-term private sector investments in low-income urban and rural communities nationwide. This economic development initiative is based on the bipartisan **Investing in Opportunities Act**.

Opportunity Zones Defined

Opportunity Zone: A low-income census tract **(LIC)**, as determined within New Markets Tax Credits legislation, is designated as an Opportunity Zone **(OZ)** by the governor of the state or territory in which it is located. Designations will stay in place for 10 years.

Up to 25% of LICs in a U.S. state or territory may be designated as OZs.

States or territories in which there are fewer than 100 LICs may designate up to 25 LICs as OZs.

Up to 5% of census tracts contiguous to LICs may be designated as OZs, if the median family income of the census tract does not exceed 125% of the median family income of the LIC to which the tract is contiguous.

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Designated Opportunity Zones

Over 8,700
census tracts designated

1,858
rural census tracts designated

31%
average poverty rate

14.4%
average unemployment rate

60%
average family income in OZ census tracts relative to area median income (AMI)

24 million
current jobs in designated tracts

1.6 million
businesses in designated tracts

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Opportunity Funds Defined

Opportunity Fund: An investment vehicle organized as a corporation or partnership for the purpose of investing in Opportunity Zone property.

Opportunity Funds will be self-certified per IRS guidelines. They must be organized for the purpose of investing in Opportunity Zones

Opportunity Funds are required to invest 90% or more of their capital as EQUITY in Opportunity Zone property

Opportunity Zone property includes stock, partnership interest, or business property in an Opportunity Zone

Investor Incentives

U. S. investors currently **hold $6.1 trillion in unrealized capital gains**, representing a significant untapped resource for economic development. Opportunity Funds will allow these investors throughout the country to pool and deploy their resources as Opportunity Zone investments.

>

OPPORTUNITY ZONE INVESTMENTS PROVIDE AN IMMEDIATE BENEFIT

to investors of deferring payment of the capital gains tax that would be paid in 2018 until 2026. Further incentives are linked to the duration of an investor's commitment to Opportunity Fund investments.

THE OZ TAX INCENTIVE WILL ALLOW

a modest reduction in capital gains taxes in exchange for holding Opportunity Fund investments for five to seven years.

IF INVESTMENTS ARE HELD 10+ YEARS,

gains accrued on the Opportunity Fund investment during that 10-year period will not be taxed, further incentivizing patient capital.

Eligible Investments

Only equity investments are eligible for the Opportunity Zone tax incentive.

1. **Business investments**

   can include investments in new stock issuance for corporations and ownership interests in partnerships and LLCs.

2. **Investments in real estate**

   must include an ownership interest of new construction or assets that will be **"substantially improved"** within 30 months of acquisition by the Opportunity Fund.

3. **New equipment and other assets**

   are also eligible investments.

Timeline for Opportunity Zone Investments

	Investment Year 2019	Year 5 2023	Year 7 2025	Year 8 2026	Year 10 2028
Tax on Capital Gain Invested	Gain realized and invested in Opportunity Fund **within 180 days***	10% reduction of capital gains tax	15% reduction of capital gains tax	All taxes due on 12/31/26. Investor pays tax on 85% of original gain	
Tax on Opportunity Fund Investment		Any gain realized on Opportunity Fund investment is fully taxable if liquidated	Any gain realized on Opportunity Fund investment is fully taxable if liquidated	Any gain realized on Opportunity Fund investment is fully taxable if liquidated	Any gain realized on Opportunity Fund investment **is tax free****

*** Tax is deferred until the earlier of investment liquidation (return of capital) or 12/31/26**

**** Any appreciation on Opportunity Fund investment is tax free if held > 10 years**

Drilling Down: QOZ

- <u>Qualified Opportunity Zone</u>
  - A Qualified Opportunity Zone (QOZ) means a Population Census Tract (PCT) that is a Low-Income Community (LIC) designated by the government as an QOZ through a qualification process.
  - The Opportunity Zone program allows taxpayers to defer capital gains by reinvesting such gains into a Qualified Opportunity Fund (QOF) and potentially exclude future capital gains on investments within the zone.
  - The governor of each state nominated no more than 25% of the total LICs within its state* to be designated as QOZ including up to 5% of PCTs that are not LICs but are:
    - ➢ contiguous with an LIC; and
    - ➢ the median family income does not exceed 125% of the median family income of the LIC with which the PCT is contiguous

*Twenty-five may have been designated if the state has fewer than 100 tracts

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Drilling Down: QOF

- Qualified Opportunity Fund
  - A QOF is an investment vehicle that is:
    - ➢ Organized as a corporation or a partnership
      - ▪ A QOF may be established as a partnership with the fund manager acting as the General Partner (GP), or Managing Member (MM) if an LLC, and the taxpayers as limited partners or members
    - ➢ The investment vehicle can become a QOF through a self-certification process by completing a form to be attached to a timely filed tax return
    - ➢ Invests and holds at least 90% of its assets in QOZ property
  - Qualified opportunity zone property includes the following:
    - ➢ Stock in a qualified opportunity zone business property (QOZB)
    - ➢ Partnership interests in a QOZB, or
    - ➢ Direct investment in qualified opportunity zone business property (QOZBP)
  - QOZBP must be tangible property that is:
    - ➢ Acquired for cash from unrelated person
    - ➢ Original use or substantial improvement
    - ➢ Substantially all QOZBP used in QOZ during holding period

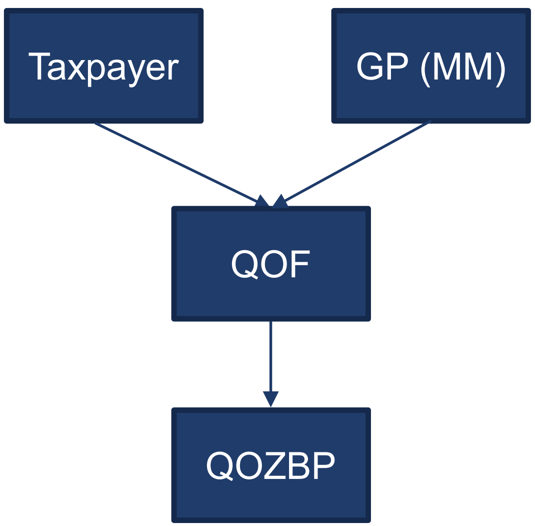
Drilling Down: QOZB

- Qualified Opportunity Zone Business
  - A QOZB is a trade or business where:
    - **At least 50% of its gross income** is derived from the active conduct of the trade or business in the QOZ
      - Safe Harbors for the 50% test (see 2019 Proposed Regulations below)
    - **At least 70% of its tangible property is located within the QOZ**
    - A substantial portion (40%) of its intangible property is used in the active conduct of the trade or business in the QOZ
    - No more than 5% of its property can be “nonqualified financial property”
    - Working capital Safe Harbor for 31 months
      - Safe Harbor for Working Capital Plans (see 2019 Proposed Regulations below)
  - A QOZB cannot be a “sin business” which includes:
    - Liquor store, massage parlor, hot tub facility, suntan facility, racetrack or other gambling facility, golf course, country club
    - **Notably absent from the list: cannabis**

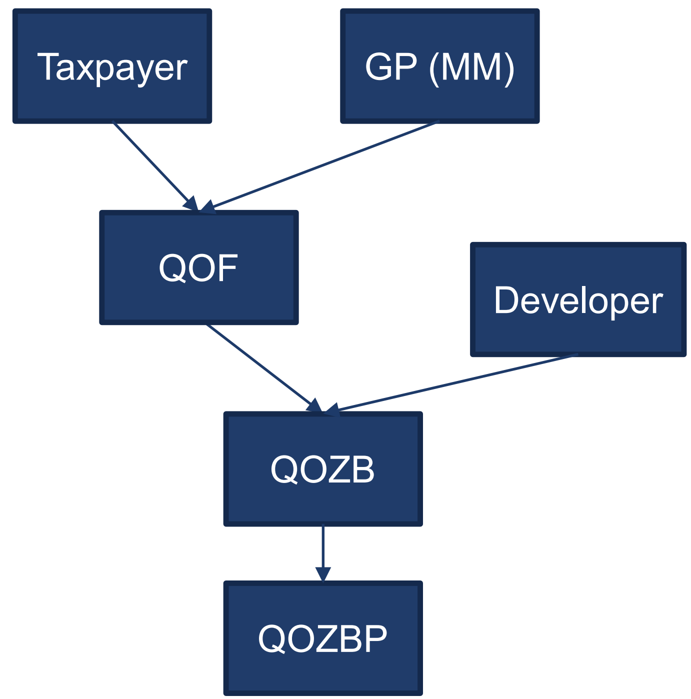
Drilling Down: QOZB

- <u>QOZB and QOZBP</u>

<u>Direct Investment by QOF in QOZBP</u>



<u>Two-Tier Structure for QOZBP</u>



Adapted from *Qualified Opportunity Zones*, KPMG (Sept. 25, 2019)

2019 Proposed Regulations

- On April 17, 2019, the Department of Treasury released a second set of proposed regulations for the Opportunity Zone legislation (the first was released in October 2018):
  1. Reinvestment of Proceeds from a sale or disposition
  2. **Real Property straddling a QOZ and a Non-QOZ**
  3. **Safe Harbors for the 50% Gross Income Test for QOZBs**
     - Three safe harbors and a facts and circumstances test for determining whether sufficient income is derived from a trade or business in a QOZ:
     - At least 50% of the **services performed (based on hours)** for such business by its employees and independent contractors are performed within the QOZ
     - At least 50% of the services performed for the business by its employees and independent contractors are performed in the QOZ **based on amounts paid for the services performed**
     - If (1) the tangible property of the business in the QOZ and (2) the management or operational functions performed for the business in the QOZ **are each necessary** to generate 50% of the gross income
     - Taxpayers not meeting any of the other safe harbor tests may satisfy a **facts and circumstances test** if, based on all the facts and circumstances, at least 50% of the gross income of a trade or business is derived from the active conduct of a trade or business in the QOZ

2019 Proposed Regulations

4. **Working Capital Plans - the 31 Month Test**
5. Measurement Periods
6. Exclusion Elections
7. Continued OZ treatment after Death
8. Vacant Property
9. **Leased Property – QOZBs; Original Use; Related Party Permissions; Anti-Abuse Rules**
10. Intangible Assets
11. **Unimproved Land**
12. Investments Held by Funds
13. Inventory
14. Debt Financed Distributions

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Recap

Investors

- Tax incentive is most valuable for 10 year investments in appreciating assets
- 180 days to invest after realizing a capital gain
- 180 days months to deploy 90% of capital in Opportunity Zones
- Capital is required to be an equity investment – loans from investors are not eligible for the tax incentive

Funds

- All capital must flow through an Opportunity Fund to be eligible for the tax incentive
- Funds are self-certified via an IRS tax form
- Fund must be established for the purpose of investing in Opportunity Zones
- 90% of fund assets must be invested in Opportunity Zones to maximize the tax incentive

Eligible Investments

- Must be equity investments
- Real estate investments must include substantial rehabilitation – doubling basis within 30 months
- "Sin businesses" are not eligible
- Other requirements include property use in "active conduct of business" and limits on assets held in cash

Renewable Energy Project Finance

An Overview

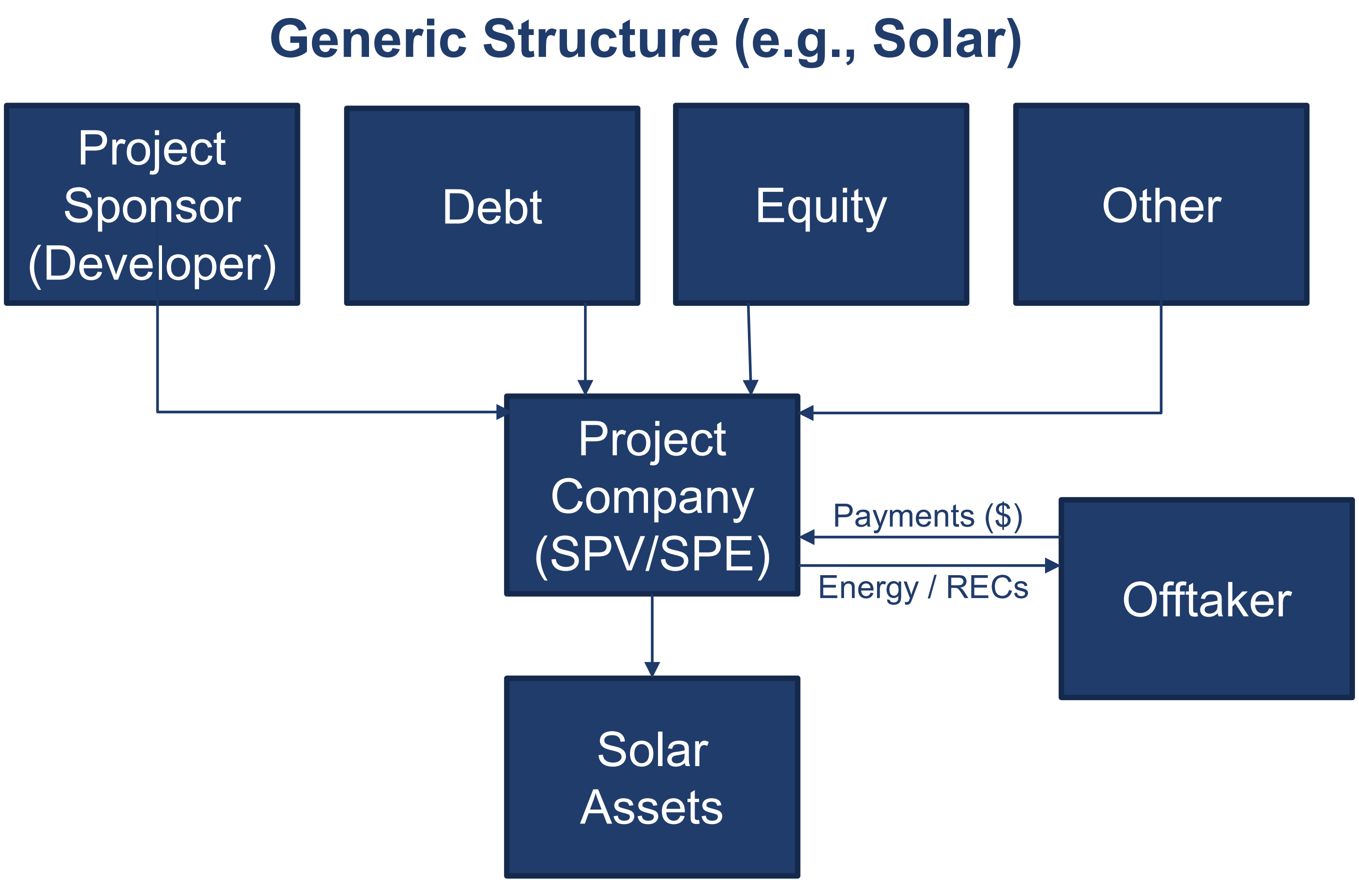
Renewable Energy Project Finance

- Project Finance
  - A means of financing a company created for the specific purpose of owning, constructing, and operating a project with limited or no recourse to the project's sponsor
  - Enables financing from multiple sources of capital and from multiple investors
- Project Sponsor
  - The Project Sponsor (Developer) and will invest some equity and will raise nonrecourse debt based on the project's future cash flows
- Project Company
  - A newly established special purpose entity/vehicle (SPE/SPV), legally distinct from the Project Sponsor, often an LLC

Renewable Energy Project Finance

- Debt
  - Typically non-recourse lending
- Equity
  - Often short-term and in exchange for tax incentives
- Offtaker
  - The electricity generated by the Project is sold to one or more customers (Offtaker) under a long-term contract, typically a power purchase agreement (PPA)
- RECs
  - One renewable energy credit (REC) represents one MWh of electricity generated by a renewable energy resource; RECs may be bundled in the PPA or sold separately

Renewable Energy Project Finance

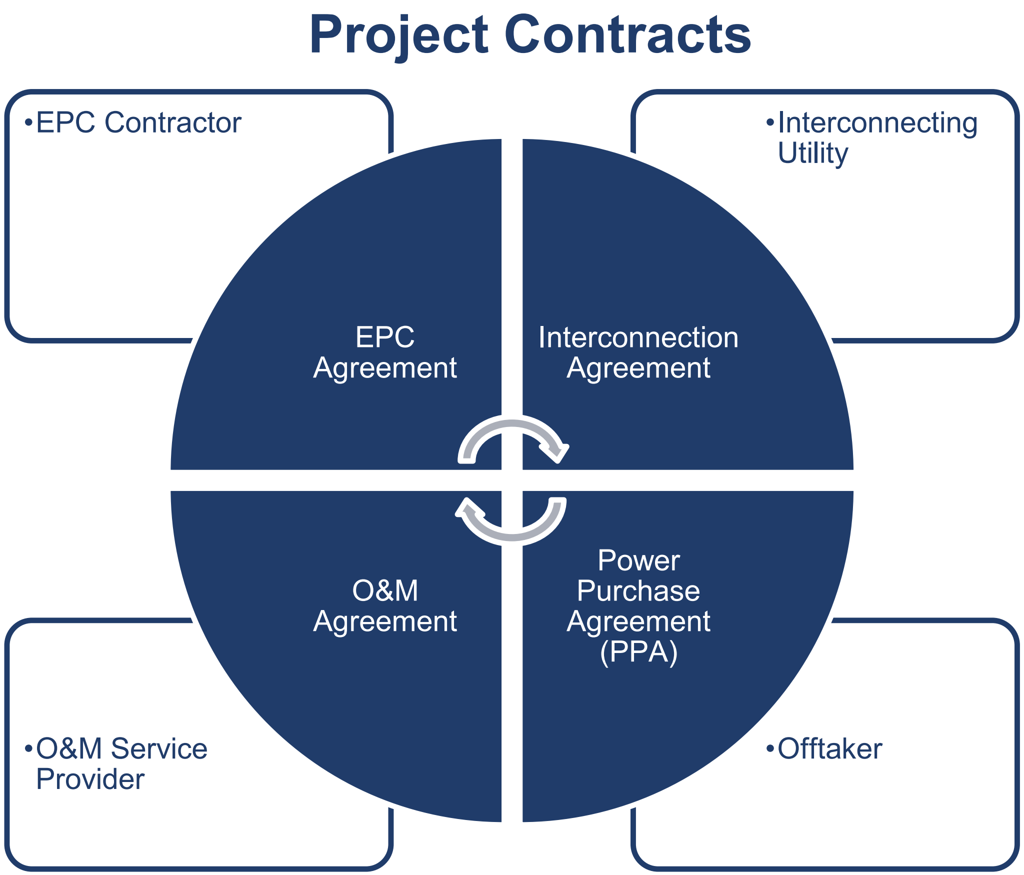


Adapted from *Financing Renewable Energy Projects*, Ansar (ABA 2019)

Renewable Energy Project Finance

- Levelized Cost of Energy (LCOE)
  - Measures lifetime costs divided by energy production
  - Calculates present value of the total cost of building and operating a power plant over an assumed lifetime.
  - Allows the comparison of different technologies (e.g., wind, solar, natural gas) of unequal life spans, project size, different capital cost, risk, return, and capacities
  - Financing comprises ~36% of solar project costs
  - Cost of capital is largest contributor to reducing LCOE
  - In other words, reducing the cost of capital will go a long way to reducing the LCOE for the project

Renewable Energy Project Finance



Adapted from *Financing Renewable Energy Projects*, Ansar (ABA 2019)

Drilling Down: Debt

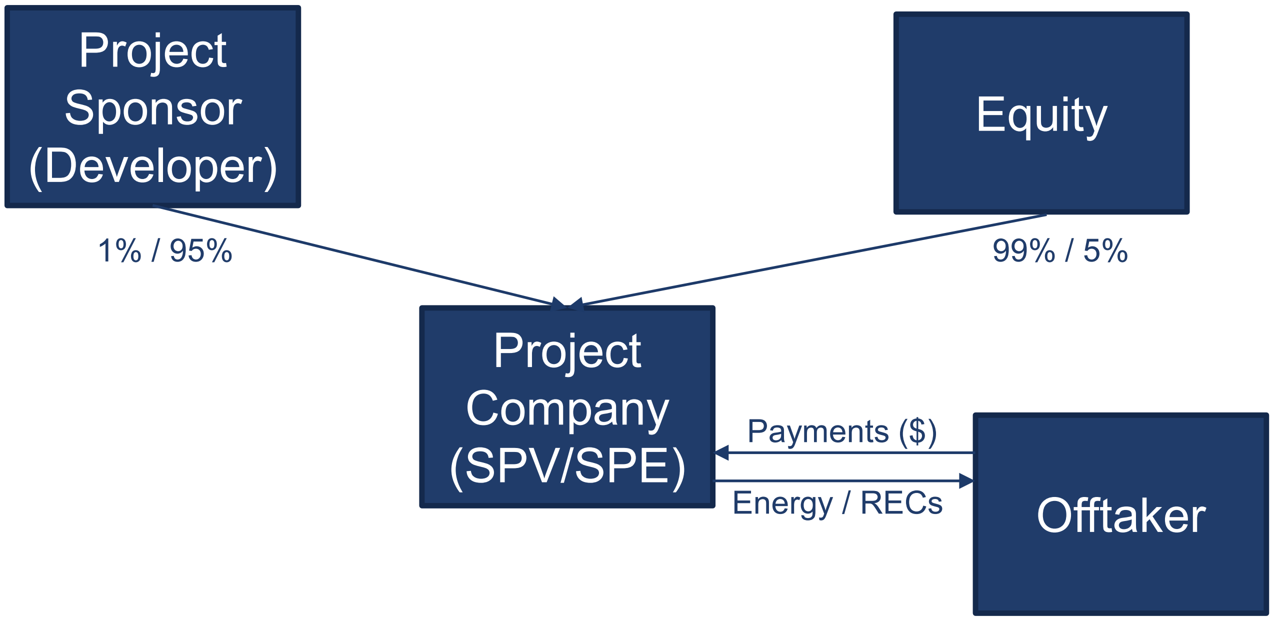
- Project Loans
  - Development Loans
    - Early stage costs like interconnection deposits and studies, permitting, site control
  - Construction Loans
    - Equipment and component procurement, construction contracting
    - Greatest need for capital during this time, tightest debt restrictions
  - Permanent Financing
    - Following construction completion and Commercial Operation Date (COD), debt converts to less onerous financing

Drilling Down: Equity

- Tax Equity Investors
  - Renewable energy projects typically generate tax benefits in the form of tax credits, e.g. the Investment Tax Credit (ITC) for solar, and accelerated depreciation, e.g. the Modified Accelerated Cost Recovery System (MACRS)
  - Many Project Sponsors do not have sufficient taxable income to efficiently utilize these tax benefits, so Project Sponsors enter into financing structures with “tax equity investors” to take advantage of these tax benefits:
    - ➢ Partnership Flip; Sale Leaseback; Inverted Lease
    - ➢ To obtain the ITC benefits, the tax equity investor must put its dollars at risk; therefore, it enters into financing structures prior to the time the project is placed in service (i.e., pre-COD)

Drilling Down: Equity

- Tax Equity Investors – Partnership Flip



Drilling Down: Equity

- Tax Equity Investors
  - The ITC is available the year the Project is placed in service (i.e., COD) but it **vests over a 5-year period**
  - If the Project is sold before the end of 5 years, the ITC is subject to recapture proportionate to the remaining vesting period
  - The credit value of **the ITC is stepping down**:

Date Construction Begins	Placed in Service Date	ITC %
On or before 12/31/2019	On or before 12/31/2023	30%
1/1/2020-12/31/2020	On or before 12/31/2023	26%
1/1/2021-12/31/2021	On or before 12/31/2023	22%
Thereafter	Thereafter	10%

Source: Novogradac & Company LLP NOVOGRADAC

Drilling Down: Debt vs. Equity

- Back Leverage
  - If there is debt at Project Company level, a secured lender could foreclose on Project Assets in the event of default and sever the ownership chain between equity owners and the Project; and
  - Loan agreements may impose distribution restrictions, cutting off cash flow streams
  - Tax equity investors may bear such risks during brief overlap with construction loans (i.e., pre-COD), but not in permanent financing
  - To avoid this, Project Sponsor may use a back leverage debt structure where the permanent financing debt is moved up to a holding company level (above the tax equity investor level) so that the collateral securing the debt is Project Sponsor-side equity and the value of the Project Sponsor-side cash flow stream

Renewable Energy Projects in Opportunity Zones

Benefits, Pitfalls, Issues

Renewable Projects in Opportunity Zones

- Generally, a Project located in a QOZ utilizing QOF funding versus outside of a QOZ will see an increase in returns
  - Range of estimates from 200-300 to 300-500 basis points
- Reduce the LCOE of the Project
  - Equity from a QOF can reduce the cost of capital and, therefore, the LCOE of the Project (see ITC discussion below)
- However, a Project that doesn’t pencil outside of a QOZ likely won’t pencil by locating it inside a QOZ
  - The OZ program can’t make a bad project good, but it can make a good project even better
- A Project may bring tax revenues and jobs to distressed communities that need lots of both!

Renewable Projects in Opportunity Zones

- Some flexibility in structuring the investment in the Project
  - Direct investment by the QOF vs. Two-tier investment in a QOZB
  - If two-tier investment in a QOZB, can pair with other sources of capital including tax equity
- Some considerations for "twinning" QOF with ITC funding:
  - Tax equity investments are complex and can be expensive
  - Corporate Tax Rate 35% → 21%
    - ➢ Less appetite for credits and depreciation
  - To maximize both QOF and ITC, **December 31, 2019** is a critical date
    - ➢ QOF = 15% capital gains tax reduction & ITC = 30% tax credit
  - QOF exit after 10-year mark
    - ➢ Depreciation recapture

Contact

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