

Are Opportunity Zones Truly an “Opportunity” for Renewables?

OVERVIEW

Over the last year, as renewable energy developers, owners and investors have continued to seek avenues for enhanced project returns, the concept of Opportunity Zones has gained increasing focus. At FTI Consulting, discussions with our clients and other market participants have led us to several conclusions – first, that Opportunity Zones may, in fact, represent a form of project development alchemy, and second, that the concept is not well understood by most in the renewables industry.

Like the investment tax credit (“ITC”) and production tax credit (“PTC”), the concept of Opportunity Zones was born out of federal tax schemes designed to tilt the flow of funds toward investments deemed to be in the interest of the greater common good. However, unlike the ITC and PTC, the underlying tax incentives were not designed with renewable project development in mind – to wit, the fundamental tax incentive associated with Opportunity Zones is deferral, or forgiveness, of capital gains tax with respect to a qualifying investment. Given the depreciable nature of renewable projects, a deeper review of the underlying qualification requirements is necessary to understand the potential for value to a developer or owner of renewable projects.

In this article we provide the reader with a basic framework of Opportunity Zones, their intent, and headline qualification requirements, as well as key investor and portfolio considerations. To be sure,

not all developers and investors will be able to benefit from Opportunity Zones; however, those market participants who are able to efficiently deploy capital under the umbrella of this new tax incentive will stand to gain a key financial advantage.

BACKGROUND ON OPPORTUNITY ZONES

In December 2017, the United States government passed the 2017 Tax Cuts and Jobs Act. One provision of this act is the Opportunity Zones program, under which investors receive tax benefits to invest in low-income areas across the country. There are more than 8,700 areas designated as Opportunity Zones by the federal government; however, local governments can elect whether they would like to participate in the program.

An investor seeking to invest capital into a designated Opportunity Zone is required to invest through a new investment vehicle called a Qualified Opportunity Fund (“QOF”). A QOF can be created via a corporation or partnership through filing a Qualified Opportunity Fund form with its tax returns. The QOF must hold at least 90% of its assets in a designated Opportunity Zone. Opportunity Zone property must be purchased by the QOF after December 31, 2017, and the purchase of the asset cannot be from a related party. Note that QOF investments need to be made by December 31, 2019, to realize the full value of the Opportunity Zone incentives.

OPPORTUNITY ZONES INCENTIVES

There are three primary financial benefits to an investor in a QOF:

1. ability to defer tax on the investment in a QOF;
2. ability to eliminate up to 15% of the deferred capital gains tax; and
3. ability to remove tax on future appreciation of the QOF investment.

1. Ability to defer tax on the investment in a QOF

Capital gains (including 1231 gains and long-term and short-term capital gains) are eligible for deferral if they:

- are invested in a QOF prior to 2027;
- are invested in a timely manner after the gain was realized; and
- arise from an unrelated sale to a third party.

There are no limits on the amount of capital gains which can be invested in a QOF. Tax on the invested amount can be deferred until the earlier of:

- the date that the investment in the QOF is sold or exchanged, or
- December 31, 2026.

When the invested amount ultimately is taxed, the tax will be levied on the lower of (i) the amount of the initial investment in the QOF, and (ii) the fair market value of the investment on that date, less the taxpayer's basis in the investment.

Note that the taxpayer's original basis is subject to change based on the ability to eliminate up to 15% of the tax on the deferred gain.

2. Ability to eliminate up to 15% of the deferred capital gains tax

When an investor makes its initial investment in the QOF, the investment's basis is set at \$0. After a period of five years, the tax basis of the initial QOF investment can be increased by 10% of the deferred gain, thus permanently eliminating 10% of the tax on the deferred gain. After a period of seven years, the tax basis in the QOF investment can be increased by an incremental 5% of the deferred gain, thereby allowing the investor to eliminate as much as 15% of the tax on the deferred gain. Note that because the net gain in the QOF must vest by December 31, 2026, investments in QOFs need to be made by 2019 to qualify for the 15% basis increase and by 2021 to qualify for the 10% basis increase.

Illustrative Example of Basis Calculation

Below is a simple basis calculation showing an indicative \$200 capital gain amount invested into a QOF:

Initial Basis
\$0

Basis Increase after 5 Years
 $\$200 \times 10\% = \mathbf{\$20}$

Basis Increase after 7 Years
 $\$200 \times 5\% = \mathbf{\$10}$

Total New Basis after 7 Years
 $\$20 + \$10 = \mathbf{\$30}$

Original Gain less New Basis
 $\$200 - \$30 =$
\$170 recognized gain

3. Ability to remove tax on future appreciation of the QOF investment

Any additional gain realized on a QOF investment held for 10 years is not subject to federal tax. For example, if \$200 were invested into a QOF, any growth in the investment over \$200 would be tax free. Note that even if investors hold the investment for 10 years, they would still recognize the original deferred gain in 2026.

OPPORTUNITY ZONE ACTIVITY TO DATE

The benefit of the creation of Qualified Opportunity Zones ("QOZs") has not gone unnoticed. To date, more than 90 opportunity funds have been formed, according to the National Council of State Housing Agencies¹. Most of these initial QOFs have focused on real estate assets as their primary investments.

Real estate investments made by QOFs have been categorized along traditional lines: commercial real estate, affordable housing, multi-family residential housing, single family housing, student housing and workforce housing. However, a smaller number of funds have identified areas of investment other than real estate, including: infrastructure development, small business development, community revitalization, economic development and **renewable energy**.

QOFs which have identified renewable energy as an investment focus include¹:

| Renewable Energy Opportunity Funds |
|---|
| 1787 Capital Opportunity Fund |
| Activated Capital Opportunity Fund |
| Cresset-Diversified QOZ Fund |
| D.R.E.A.M. Fund |
| Garnett Station Partners Opportunity Fund |
| HeroHomes.com Opportunity Fund I |
| Obsidian Opportunity Fund |
| Propel Opportunity Fund |
| Puerto Rico Opportunity Fund |
| SC Opportunity Fund |
| Urban Array Opportunity Fund |

While renewable energy investment will be a focus for these funds, most have not yet specified how they plan to deploy QOF capital.

OPPORTUNITY ZONES AND RENEWABLE ENERGY INVESTMENT

Of the tests to qualify as an Opportunity Zone Business (“OZB”), two seem to best fit renewable energy investments²:

1. The investment must “substantially improve” the property, meaning that improvements made to the property must exceed the acquisition cost of the property within 30 months of the purchase.
2. Properties must derive 50% of any gross income from active business within the Opportunity Zone.

Renewable energy projects or investments would likely meet these thresholds because they require substantial investment to develop and would likely service customers within a given Opportunity Zone.

QOFs could provide an additional source of capital for renewable energy projects, with a potentially attractive cost of capital given the tax incentives available to QOF investors. Investment could come from two sources:

1. investment into renewable energy projects by industry-agnostic QOFs, or
2. investment into renewable energy projects by QOFs, which were raised by renewable energy/storage developers.

INTERACTION WITH OTHER RENEWABLE ENERGY TAX INCENTIVES

As is widely known in the renewable energy industry, renewable energy projects typically qualify for either the PTC or the ITC. The PTC provides tax credits based on the production of the underlying renewable facility, while the ITC provides tax credits based on the eligible investment cost of the renewable facility.

Since the capital gains incentive for QOFs relates to the investment in the fund and not the renewable energy project itself, QOF tax incentives are separate and distinct from other renewable energy incentives such as the PTC and ITC. The returns for investors in renewable energy focused QOFs would therefore comprise two pieces:

1. the returns associated with the underlying assets in which the QOF is invested, including any PTC/ITC incentives, and
2. the economic benefit associated with QOF capital gains deferral and exemption on the initial investment.

For this reason, the tax benefits of QOZ investments can be used either to supplement PTC/ITC tax benefits, or (as the PTC/ITC phases out or steps down) to provide an alternative method of increasing all-in returns on renewable energy investments.

POTENTIAL STRUCTURE

Critical for QOFs is the ability to source and pool capital from investors with significant amounts of unrealized capital gains. While, according to the Economic Innovation Group, unrealized capital gains in the U.S. were estimated at \$6.1 trillion in 2017², deploying this capital into QOFs likely requires specialized fund managers and/or intermediaries.

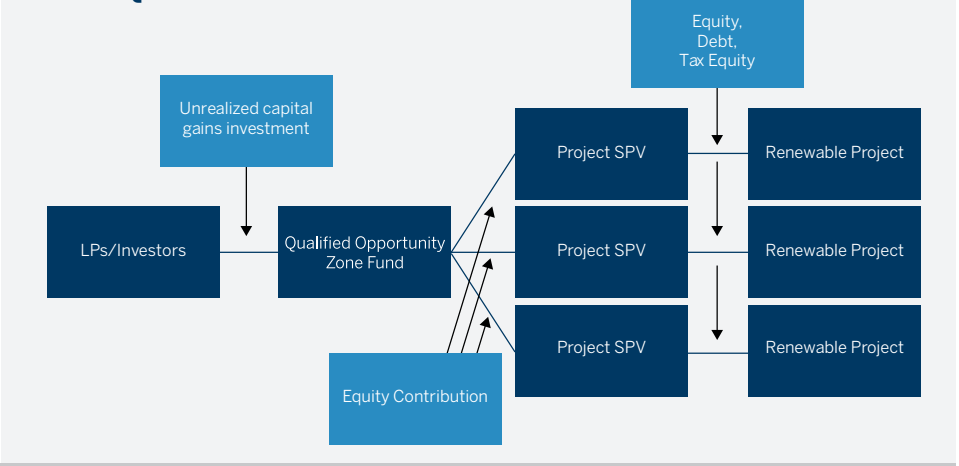
There are several structures that can be used by QOFs for investments in renewable energy projects. One possible structure is a partnership model, in which a general partner (“GP”) raises funds sourced from limited partners who have unrealized capital gains. As in a traditional fund, the GP would remain responsible for all investment and management decisions. Capital could then be deployed as equity investments into various renewable energy project special-purpose vehicles.

There are many derivations of the structure shown below which can be used by a QOF. For example, after raising the QOF funds, the GP of the QOF could also partner with a third-party developer to deploy capital into specific renewable energy projects. This can be achieved through a development services agreement, or in a variety of other ways.

CURRENT DEVELOPMENTS/APPROACH

A recent example of a renewable energy focused QOF is the Obsidian Opportunity Fund (“Obsidian OF”), which focuses on various investments across 86 opportunity zones in Oregon. While these include commercial real estate and broader infrastructure investments, a significant investment focus is also on solar energy projects.

Potential QOF Structure



A keystone project of Obsidian OF is the development of the Obsidian Solar Center, a 600 MW solar and storage project in Fort Rock, Oregon, which is expected to begin construction in 2019.

While Obsidian OF has focused primarily on utility-scale solar for its initial investments, a diverse range of technologies and applications potentially could be employed in opportunity zones, including utility-scale solar and wind, commercial and industrial solar (with or without storage), as well as waste-to-energy technologies.

CONCLUSIONS AND KEY CONSIDERATIONS

While the majority of QOFs being established are dedicated to real estate investment, QOFs may provide opportunities for the development of renewable energy projects in QOZs. The incentive for investors in QOFs should provide a competitive source of equity funding for renewable energy projects and for the developers of these projects. Moreover, developers may themselves look to raise QOFs directly to gain access to this additional and competitive source of capital.

For renewable energy focused QOFs to contend with real estate or other QOF asset classes, they will need competitive risk-adjusted returns. A hybrid approach may also be viable, in which a QOF invests in real estate which is complemented by the building of integrated or collocated renewables projects.

When evaluating the implications of QOZs for renewable energy investments, there are a few considerations which potential investors should keep in mind:

- While it is anticipated that additional guidance and clarity will be provided by the IRS over the course of 2019, there remains uncertainty surrounding implementation of initial IRS rules regarding Opportunity Zones. Specific outstanding questions include:
 - How and when will investors be able to exit QOF positions?
 - How are distributions treated for tax purposes, if made during the investment period?
- To take full advantage of the QOZ incentives, investments must be deployed in 2019. This implies a need to originate and acquire shovel-ready projects on an expedited basis; projects at the earlier stages of development are unlikely to be completed within this time frame.
- Renewable energy assets typically depreciate over time. Since a major QOZ incentive is the exemption from additional capital gains if the investment is held for ten years, it may be difficult to realize the full benefit of the QOZ incentives.

On balance, FTI Consulting views the prospect of QOF investments in renewable energy projects as an additional (and potentially attractive) pool of capital for developers with projects in QOZs, especially for developers with shovel-ready projects. In addition, Opportunity Zones can provide renewable energy investors with enhanced returns in the waning days of the PTC and ITC.

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SOURCES

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