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THE CURRENT

Ten Things to Know about Opportunity Zones and Renewable Energy Investment Tax Credits

FORREST MILDER, NIXON PEABODY

The opportunity zones (OZ) incentive became part of the tax code at the end of 2017 and has since led to billions of dollars of investment in low-income communities. The new rules provide a delay in the reporting of certain capital gains till 2026 (and possible reduction in tax liability in the case of investments made prior to 2022), as well as relief from taxation that would otherwise apply to a sale of a properly structured OZ investment ten or more years later. For stakeholders in the renewable energy space, the OZ incentive provides an opportunity to enhance the benefits associated with renewable energy tax credits. In this column, we examine 10 things to know about pairing the OZ incentive with the renewable energy investment tax credit (ITC). Note: we're only addressing ITCs in this article.

1. No direct ownership. Remember that OZ investing always begins with an investment in a qualified opportunity fund (QOF); a person with a capital gain cannot just buy an asset in their own name or in the name of a "disregarded" single-member LLC. Instead, a person or entity with a capital gain generally has 180 days after that gain to invest in a QOF, subject to many possible extensions. Most notably, the start date can be as late as the due date for a pass-through entity's tax return, where a partner or member of the entity is making the investment instead of the entity (presuming the entity was the one with the capital gain). The Internal Revenue Service (IRS) has provided several extensions on account of the COVID-19 pandemic. But don't read these extensions too quickly; they all have starting and ending dates that are just a bit convoluted, with the possibility of discontinuities–the window for investing a particular gain may close and another one that applies to the same gain may reopen only after a "gap." So, make sure that you are confident of the window you are relying on and also be sure to have a record of the check or wiring of funds to establish your timely investment.

2. What about the developer? Developers are often eager to get the benefit of OZ investing, and there is nothing that prevents a person who (i) uses cash not derived from capital gains from making the investment, or (ii) acquiring some or all of its QOF interest in exchange for services. Unfortunately, the ability to invest in a QOF does not necessarily mean that such an investor gets the OZ-associated tax benefits. Remember two things–first, the OZ benefits only apply to an investment derived from a capital gain. In particular, the portion of an investment in a QOF that is derived from noncapital gain funds will not benefit from the no-tax after 10 years rule that applies to capital gain investments. Second, amounts derived from performing services can "taint" a proper capital gain investment, such that if a developer is getting both an interest for performing services, and it is also investing capital gain funds, then it should acquire two different and distinct interests in the QOF to facilitate tracking the favorable tax treatment associated with the capital gain portion of the investment.

3. The role of qualified OZ businesses. While a QOF can hold OZ assets directly, it is far more common for a QOF to make *its* investments through a second entity, called a qualified OZ business. A qualified OZ business is typically a regarded pass-through entity, most often a partnership or LLC with two or more members, although corporations can also qualify. Setting up a qualified OZ business makes it possible to use the 70% of tangible property test that applies to qualified OZ businesses, as opposed to the generally tougher 90% of all assets test that applies to QOFs. Qualified OZ businesses can use a 31-month (and possibly longer) development period to hold cash and similar items that are then spent pursuant to the qualified OZ business's "written plan" to develop qualifying assets. On the other hand, qualified OZ businesses bring other hurdles to be met–in particular, beyond the 31-month period, no more than 5% of a qualified OZ business's assets can be non-qualified financial property (NQFP), which is defined so as to exclude not only obvious financial investments, but also investments by the qualified OZ business in stock and other regarded partnerships or LLCs. So, multilevel partnership structures are generally not allowed.

In any case, qualified OZ businesses can be structured to nicely match the "flip" model often used in ITC transactions. In particular, note that outside of "sale-leasebacks," it is pretty unusual for an investor to own an ITC project outright. So, if there is going to be a QOF investor and a project company LLC, then you are likely looking at a qualified OZ business structure, whether you were thinking that way or not. Of course, using a qualified OZ business means that the transaction structure will have a second agreement and a second bank account, so be prepared to take the necessary steps.

4. Active trade or business. Another requirement that applies to qualified OZ businesses is that they be engaged in an "active trade or business," a term left conspicuously undefined by the IRS. Indeed, all the regulations tell us is that while leasing can be an active trade or business, triple-net leasing does not qualify. In addition to this, the IRS has indicated that the activity of constructing an OZ facility does not then qualify the later years of the business as "active." With this in mind, you should anticipate reserving some periodic, active function for the qualified OZ business that owns the facility, which can be performed by the sponsor on behalf of the qualified OZ business, presumably by taking responsibility for maintenance, monitoring and billing.

5. Lease pass-throughs are unlikely to work. In the lease pass-through (or "inverted lease") model, the investor becomes a partner of the master tenant, which then transmits funds to the landlord to enable the landlord to build the facility. Whether this investment is structured as a capital contribution to the landlord in exchange for a partnership/membership interest in the landlord, or a prepayment of rent which is generally characterized as a substantial loan by the master tenant to the landlord pursuant to Internal Revenue Code Section 467, such a transaction is quite likely to fail the 5% cap on NQFP, discussed above. So, expect to do most OZ investing using the "flip" structure, where the investor takes a 99% interest in the owner of the facility (the qualified OZ business) that flips down to a smaller share after the five-year recapture period has ended.

6. Sale leasebacks. In a sale leaseback, the developer builds a project and sells it to the investor, who then leases it back to the developer, which operates the facility. Because the facility is already built, there is no need to use a qualified OZ business, with its 31-month permission to hold funds while the project is being built. So, the finished project can be acquired at the QOF level and compliance with the active business and NQFP tests is not required. On the other hand, this transaction transfers the entire ownership of the facility to the investor, without the "magic" of the developer being able to flip into owning 95% of the facility without payment. This transaction structure is most popular with developers who don't have sufficient resources and track record to benefit from the smaller and shorter investment provided by tax-equity investors in flip transactions.

7. Normal tax rules apply. Remember that the tax benefits associated with OZ investing are very specific: essentially a delay in paying tax on the "original" capital gain until the 2026 tax year and no tax at all on the "ultimate" gain if the investor holds the QOF investment for at least 10 years. A third benefit, the 10% or 15% reduction in tax in 2026, will only benefit investments made in QOFs prior to 2022; it has otherwise expired. There aren't other federal tax benefits–in particular, OZ partnerships or qualified OZ businesses are *not* somehow exempt from annual taxation. QOFs and qualified OZ businesses set up as partnerships (or LLCs taxed as partnerships) still must file information returns, issue K-1s to their partners (or members) and those partners or members must report their share of profits and losses on their tax returns.

8. Need for debt. An OZ investor doesn't get basis from its untaxed capital gains until 2026. As noted above, the rules *had* provided a 15% basis step-up if the QOF investment was held for at least seven years, ending in 2026 or 10% for an investment held at least five years. For investments made after 2021, those adjustments are no longer available. So, if an investor completely finances the project with untaxed capital gain funds, the investor will have a zero basis in the facility and therefore be unable to absorb (i) the 50% basis reduction that applies to the ITC, and (ii) the losses associated with depreciating the facility.

To address this problem, an investor will likely want the facility to be subject to at least half the credit rate in debt that can be allocated to the investor (e.g., a $10 million facility might generate a $3 million tax credit and a $1.5 million basis reduction; so, we'd want at least $1.5 million of debt allocated to the investor). Similarly, debt will be needed to absorb losses. Typically these debts are nonrecourse to the company's members or partners, and then allocated 99% to the investor.

Those familiar with more complex tax structuring will remember that a deficit restoration obligation (DRO) is often used as a way to assure that the investor is *allocated* these losses. However, that's not the only problem here. The investor will get capital account credit for the cash put into the QOF, and from there, into the qualified OZ business, but the OZ rules don't provide the required *basis* needed to actually absorb basis reduction and enable the investor to *use* the losses. That's one of the oddities of DROs; an investor can only take losses against cash invested and their or its share of debt. An obligation to put in cash later (which is what a DRO is) will not enable an investor to use losses today. Nonetheless, a transaction *may* need *both* nonrecourse debt *and* a DRO. Projections are invaluable here.

9. Passive activity and at-risk rules. While there are widely held corporate taxpayers with capital gains taking advantage of OZ investing, the tax benefit is more likely to be used by individuals. And individuals are also more likely to be subject to the passive activity and at-risk limitations. This means it may be best if the investors otherwise have passive income (e.g., rental income from older real estate investments, or income allocated from other limited partnership interests) in order to satisfy the passive activity rules. The at-risk rules can be satisfied as to tax credits with equity and certain kinds of debt, particularly nonrecourse borrowings from banks, governments and certain similar lenders that do not exceed 80% of the credit base, or "level-payment loans" that do not exceed 75% of the credit base. Losses, on the other hand, can only be taken to the extent of an individual's actual cash investment and other property pledged as security. The bottom line is that if the QOF investors are individuals, then careful attention is called for to assure that the credits and losses can be used by the investor.

10. Dispositions of ITC investments. ITC-eligible facilities are comprised primarily of five-year property. Even if the company elects a longer depreciation life (e.g., 12 years), there is likely to be *the potential* for depreciation recapture, presuming that the facility (or the QOF or qualified OZ business interest) is sold for something higher than its somewhat depreciated or fully depreciated basis. Of course, the OZ rules step basis up to fair market value, thereby eliminating this potential difference between the two, *provided the QOF investment is held for at least 10 years*. There was a point at which it was thought the depreciation recapture (which applies to personal property, like renewable energy facilities) might not escape taxation under the OZ rules, but by now it's plain that that is the result. So, even if it is not expected that a renewable energy facility will sell for some large premium and avoid tax (the so-called "home run" associated with venture capital OZ investing), there's still a significant potential savings from the simple basis step-up to fair market value at the time of sale.

Still, as just noted, the no-tax rule only applies once the QOF investment is held at least 10 years, while most ITC investments contemplate only a six- or seven-year investment. So, the investor will either be in the deal for somewhat longer than is usual for ITC transactions or the QOF should anticipate stringing together two ITC investments, with a possible tax bill in the middle (since the sale of the first investment will not benefit from the 10-year hold exclusion from tax).

Conclusion. Despite the billions invested in OZs and the confidence expressed by OZ advisers, many of the technical rules of OZ investing remain to be discerned and developed. The IRS and Treasury have acknowledged that most of their initial rules had to do with setting up and the initial working of funds, while they were leaving later rules to be developed as the incentive got older. Don't be surprised if your tax adviser can put together an excellent and sensible approach to an OZ tax issue, but then finishes the advice with, "Of course, that's my best judgment; the IRS hasn't explicitly addressed this question." Nonetheless, OZ investors and the people who run QOFs and qualified OZ businesses who both (i) follow the advice of serious, knowledgeable advisors and (ii) apply common sense to their questions and decisions, are most likely to have their positions respected by the IRS. On the other hand, investors and managers who try to be "too clever for their own good" are less likely to fare as well.

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