FUNDAMENTALS OF CLEAN ENERGY

INVESTING IN OPPORTUNITY ZONES

March 2019
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Introduction

The new "Opportunity Zone" tax incentive enhances the attractiveness of renewable energy investments in certain low-income areas of the country. For projects that are properly structured, this benefit can be shared between low-income community members, project developers, installers, and investors. Clean energy projects make a natural fit for the Opportunity Zone incentive: they are long-term and location-based investments, and they offer numerous economic and societal benefits.

“Opportunity zone finance presents a watershed mechanism to permanently move clean energy assets and companies into the mainstream. This mechanism creates extraordinary value, which when shared between stakeholders enables a self-fulfilling success cycle and tunes sales strategy, while delivering long-term and stable benefits to the communities in which they are operating,” according to Jon Bonanno, CXO, New Energy Nexus / California Clean Energy Fund.

The Opportunity Zone incentive enables clean energy entrepreneurs – both project developers and corporate CEOs - to share higher project returns with their investors and access a new source of financing – and possibly on more attractive terms.

For investors, if the clean energy project or corporation is a sound investment and is located in an Opportunity Zone, utilizing a Qualified Opportunity Zone Fund structure\(^1\) as the investment vehicle can be attractive given the numerous capital gains tax benefits.

The Opportunity Zone mechanism represents a tremendous opportunity to increase investment in clean energy. However, entrepreneurs have a limited time to fully take advantage of the program as the present value of the tax incentive decays with each passing day, and the full value of the incentive will only be unlocked for investments made before December 31, 2019. Furthermore, projects must deliver the work required to meet the program requirements within 30 months.

Initial Selection of Opportunity Zones

The Tax Cuts and Jobs Act (TCJA) of 2017 created the Opportunity Zone tax incentive, a provision that is based on the bipartisan Investing in Opportunity Act. The Opportunity Zone incentive was championed by U.S. Senators Tim Scott and Cory Booker and it had nearly 100 congressional cosponsors in its original form as the Investing in Opportunity Act. Senior U.S. Treasury officials anticipate that $100 billion in private capital will be invested through this program.

\(^1\) Reference: www.MyOZFund.org
The Opportunity Zone incentive consists of Opportunity Zones and Opportunity Funds. Internal Revenue Code (IRC) section 1400Z-1 governs Opportunity Zones and 1400Z-2 governs Opportunity Funds.

Opportunity Zones are designated low-income census. The executive of each state government jurisdiction (states, territories, and D.C.) selected its own Zones by nominating up to 25% of its qualifying census tracts. To qualify, tracts must have had a poverty rate of at least 20% or a median family income that was no more than 80% of the statewide median family income. An additional 5% of each jurisdiction could also be selected if the census tract was contiguous with a low-income Opportunity Zone and the median family income was no more than 125% of the median family income of the adjacent Opportunity Zone.

The nominations were reviewed and certified by the Secretary of the U.S. Treasury via the Internal Revenue Service. The IRS designated the first set of Opportunity Zones on April 9, 2018. Qualified Opportunity Zones have been certified in all 50 states, the District of Columbia, and five U.S. territories. In total, there are 8,761 Opportunity Zones, including nearly all of Puerto Rico. The Zones represent approximately 12% of all U.S. census tracts. The full list of Qualified Opportunity Zones can be accessed via either the interactive map or the list published by the U.S. Department of the Treasury. Qualified Opportunity Zones remain in effect for ten years following designation.

Figure 1: Contiguous U.S. Qualified Opportunity Zones (8,761 areas)

Source: Environmental Systems Research Institute
**Why Create Opportunity Zones?**

Communities have not recovered evenly from the Great Recession of 2008. Most Opportunity Zones communities, in particular, continue to struggle with high poverty and low to negative job growth. An analysis by the Economic Innovation Group (EIG) found that 71% of Opportunity Zones meet the U.S. Department of the Treasury’s definition of “severely distressed.” On average, the poverty rate in the Zones is twice the national average, with incomes 40% below the national average. More than one-fifth of Opportunity Zones have poverty rates of 40% or higher, vs. only 5% nation-wide. Thirty-five million people, or 1 in 6, live in Opportunity Zones. From 2011-2015, these communities lost 6% of their net jobs.

Opportunity Zones represent a new and innovative economic development tool for revitalizing these economically distressed communities through private investment. The concept was first introduced by the EIG in the 2015 paper “Unlocking Private Capital to Facilitate Economic Growth in Distressed Areas.”

The Opportunity Zones tax incentive is designed to spur economic development in these distressed communities by reversing the trend of capital underinvestment faced by so many low-income neighborhoods.

The Opportunity Zone tax incentive is both bigger in scale and less restrictive than other federal place-based policies, such as the New Market Tax Credit (NMTC) or Low-Income Housing Tax Credit (LIHTC), which presents a significant opportunity for the clean energy entrepreneur to tap into a source of funds. These new sources of capital are individuals or corporations with capital gains seeking efficient uses and who may have never been involved in the clean energy sector.

**Opportunity Zone Investing and How it Works**

The Tax Cuts and Jobs Act (TCJA) introduced Qualified Opportunity Zone Fund or “QOF” to the tax code. The QOF is an investment vehicle set up as either a partnership or corporation for the purpose of investing in eligible property and/or businesses located in Qualified Opportunity Zones. To receive the Opportunity Zone benefits, investors cannot invest directly in a property/business in an Opportunity Zone and must invest via a QOF.

An eligible corporation or partnership can become a QOF through self-certification by filing Form 8996, Qualified Opportunity Fund, with its federal income tax return. Twice per year, a QOF must meet the annual “qualification test” demonstrating compliance with program requirements.

The Opportunity Zone incentive encourages long-term investment through providing tax benefits to both individual and business investors (C corporations, S corporations, partnerships, regulated investment companies, and REITs). All types of capital gains (but only capital gains, not ordinary gains) are eligible for the tax benefit. In 2017, EIG found that there was over $6 trillion in unrealized capital gains via mutual funds, stocks, and corporate balance sheets, representing a vast source of potential funds for investment.

Investors must invest their capital in a QOF within 180 days of the sale or exchange that generated the capital gain in order to receive any of the tax treatment benefits available under the Opportunity Fund program. An investment in a QOF must be made in exchange for an equity interest (which includes preferred stock and
partnership interests with special allocations) in the QOF.

QOFs must hold 90 percent or more of its assets in Qualified Opportunity Zone properties/businesses, other than another QOF. QOFs can invest in Qualified Opportunity Zones through:

- Partnership interests in a partnership that is a Qualified Opportunity Zone Business (“QOZB”).
- Stock in a corporation that is a QOZB.
- Direct investments in property such as real estate located within a Qualified Opportunity Zone.

Under the proposed regulations described below, the requirements for a trade or business to qualify as a QOZB include requirements that at least 50 percent of the QOZB’s gross income must be derived from the active conduct of its business within the Opportunity Zone and 70 percent or more of its tangible property must be located within a Qualified Opportunity Zone. Both of these requirements are easy to meet for most wind and solar developments.

There are several business types that are excluded from being QOZBs, including “any private or commercial golf course, country club, massage parlor, hot tub facility, suntan facility, racetrack or other facility used for gambling, or any store the principal business of which is the sale of alcoholic beverages for consumption off premises.”

The U.S. Department of the Treasury issued proposed regulations governing Opportunity Funds on October 19, 2018. While QOFs must invest their funds in qualifying assets within six months, the proposed regulations provide a working capital safe harbor of up to 31 months if the capital is held at the QOZB level. The safe harbor applies if the QOZB has a written plan that designates the funds for the acquisition and/or substantial improvement of tangible property in an Opportunity Zone, has a written schedule for the deployment of the funds within 31 months of the QOZB’s receipt of the funds, and the QOZB “substantially complies” with written plan and schedule. Due to the 2026 maximum deferral date, there is an urgency to have capital sources deploy their capital gains into QOFs prior to December 31, 2019 in order to capture the entire 15% of basis adjustment, which is an important part of the clean energy asset return rate improvement.
Opportunity Zone Benefits: Community, Entrepreneurs, Investors

Opportunity Zone investing into clean energy can offer significant direct benefits to communities, entrepreneurs, and investors.

**Community**

Communities designated as Opportunity Zones are often underserved by investment capital. The Opportunity Zone incentive has the potential to provide significant investment to these communities over the next decade. These long-term patient capital investments have the potential to encourage investment in the local economy and to spur job growth.

Unlike real estate investments, clean energy projects through QOFs do not have the risk of subsidizing gentrification. They bring great potential for positive, high-impact outcomes for the local community, as QOF investments in well-structured clean energy projects and businesses can have a myriad of benefits for the local community:

- Higher energy resiliency
- Lower cost electricity
- Health benefits from clean energy assets (air and water quality)
- Low environmental and visual impact
- Job training (with associated potential for long-term upward mobility)
- Improved low-carbon mobility access

Local low-income communities may be able to get a host of indirect benefits, to the extent that jobs, job training, and clean energy are made available to those communities. There may also be a boost to local existing businesses, who benefit from more construction and ongoing operations in their area. These community-based benefits are likely to appeal and align with the interests of impact investors.

**Entrepreneurs – project developers or corporate CEOs**

Likewise, entrepreneurs can benefit from the potential investment capital available through QOFs. QOFs offer a new source of investment dollars and the ability to offer more financial value to investors through the program’s tax incentives. Entrepreneurs in this context are defined as any clean energy project developer (solar, wind, energy storage, biomass, biodigester, EV charging station bundles, demand-flexibility purchase agreement, carbon avoidance contracts, etc.) or a clean energy CEO raising a round of capital through a new share issuance, likely through a Regulation D or Regulation CF Seed/Series funding round.

By utilizing investment via QOFs, clean energy entrepreneurs can expand the addressable renewable energy project market by providing a higher return to investors, thus enabling slightly higher risk renewable energy projects to get financed. Alternatively, some of the extra value created by the tax breaks could instead be used to pay for a third-party risk mitigation mechanism, such as a credit wrap or a larger loss reserve. Projects that previously were on the margin of being economical may now be able to attract financing.

In short, the Opportunity Zone tax incentive presents developers with the opportunity to focus on the vastly
underserved sector of the C&I market, Class B and Class C real estate, which to date have generally been deemed riskier than utility scale renewables projects and residential solar loan/lease portfolios. If approached and packaged in an investor-friendly manner, Opportunity Zone financing could bring Class B and Class C space (the majority of the market) into play for clean energy project development.

Additionally, QOFs investments enable more entrepreneur-friendly terms on corporate equity for the clean energy entrepreneur. As a result of the tax benefits through QOFs, terms offered to investors via the QOF structure can be more flexible and company favorable without alienating investors.

**Investors**

For investors, QOFs minimize their tax burden through the preferential treatment of capital gains. Investors receive three key benefits: capital gains tax deferment on the upfront capital invested, capital gains tax reduction on the upfront capital, and capital gains tax elimination on the proceeds from the Opportunity Zone investment. There is no cap on the amount of capital that can be invested in qualified Opportunity Zones via QOFs nor on the amount of proceeds that can be realized tax-free. Likewise, there are no limits on the deal size or fund size. The sooner capital gains are deployed in a QOF, the better the potential financial results for investors through maximizing the net present value of the associated benefits.

- **Deferral of gains recognized on the original sale of over seven years:** Investors can defer tax on any prior capital gains invested in a Qualified Opportunity Zone Fund (QOF) until the earlier of the date on which the investment in a QOF is sold or exchanged, or December 31, 2026. If sold earlier, there is currently some clarity required from Treasury on if the capital gains can be rolled into another QOF and remain tax-free.

- **Exclusion of up to 15% of the original taxable gain:**
  - Step-up in basis from zero to ten percent for investments held for five years, resulting in a 10% exclusion of the deferred capital gains. *Must invest by December 31, 2021 and hold for 5 years or until December 31, 2026.*
  - Additional step-up in basis of five percent for investments held for seven years, resulting in a 15% exclusion of the deferred capital gains. *Must invest in 2019 and hold through 2026.*
  - The step-up in basis reduces the taxable amount of a reinvested capital gain even if the gain loses value between investment and realization, providing a tax benefit to investors who experience capital losses.

- **Exclusion of all of the gain recognized upon the disposition of the QOF investment if the QOF investment is held for at least ten years.**

The potential financial benefit for investors can be significant, as seen in Figure 2, which shows a $1 million capital gains investment into a clean energy QOF. With $1 million invested in 2019, the investor has a $150,000 basis adjustment of its initial capital gains plus pay no tax on any gains from the disposition of the QOF investment if the investment is held for the full period.
QOF Investments and Potential Clean Energy Investments

There is tremendous potential for clean energy investments in Opportunity Zones, as many are in desirable locations for energy projects such as solar, wind, biomass, and geothermal energy facilities, along with standalone storage. Many of the most vulnerable locations (as ranked by LOCUS) are in states with significant renewable energy development potential, such as California, Massachusetts, New Jersey, and New York.

QOFs can invest in clean energy in Opportunity Zones by investing in:

- New clean energy businesses with entrepreneurs
- Expansion of existing clean energy businesses into OZs
- Expansion of clean energy businesses already within the OZs
- Commercial real estate development & renovation, changing energy from being a liability/cost center to an asset

There are many types of clean energy projects and businesses that have the potential for QOF investments in Opportunity Zones.

- Solar arrays (commercial & industrial, community, utility, residential bundles)
- Solar + energy storage (all capacities)
- Energy storage (all capacities)
- EV charging station (individual, depot, bundles)
- Micro-grids (all capacities)
- Energy retrofits (windows, HVAC, lighting, sensors, controls) for energy services
- Demand flexibility purchase agreements
- Carbon avoidance contracts
- Geothermal heat pumps
- Biomass
- Biodigesters
- Geothermal power stations
- Lithium extraction facilities
- Manufacturing facilities: batteries, EVs, solar components, wind turbines, etc.

Any projects in an Opportunity Zone must consider using QOF capital to meaningfully improve investor and developer return. As shown in Figure 3 below, integrating QOF capital boosts the short and long term IRR of a project.

**Figure 3: Incremental Benefit of Opportunity Zone Investments**

<table>
<thead>
<tr>
<th>Opportunity Zone Incremental Benefit</th>
<th>5 Year</th>
<th>7 Year</th>
<th>12/31/2026</th>
<th>10 Year</th>
</tr>
</thead>
<tbody>
<tr>
<td>Standard After Tax IRR</td>
<td>6.00%</td>
<td>6.00%</td>
<td>6.00%</td>
<td>6.00%</td>
</tr>
<tr>
<td>Incremental OZ Benefit</td>
<td>2.08%</td>
<td>1.95%</td>
<td>1.71%</td>
<td>3.08%</td>
</tr>
<tr>
<td>OZ Investment IRR</td>
<td>8.08%</td>
<td>7.95%</td>
<td>7.71%</td>
<td>9.08%</td>
</tr>
<tr>
<td>Percentage Increase</td>
<td>35%</td>
<td>32%</td>
<td>29%</td>
<td>51%</td>
</tr>
</tbody>
</table>

Likewise, the QOF benefits can materially lift the IRR for equity investments in solar projects. For example, a sponsor equity investor in a flip partnership that holds its equity stake for ten years could boost its IRR by almost 300 basis points though utilizing a QOF, as shown in the illustrative example in Figure 4. For energy asset projects, given that the market price of the assets fall from commercial operation date onwards, it is even more urgent to capitalize on the QOF opportunity in 2019 and capture the full 15% of basis adjustments for capital gains.

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2 Source: Novogradac
A key element of success for clean energy developers and entrepreneurs will be the knowledge and ability to combine different incentives with the Opportunity Zone incentive. The Opportunity Zone can be combined with other incentives, such as the Investment Tax Credit (ITC) and Production Tax Credit (PTC), to maximize the capital investment and return. Depending upon the clean energy project, QOFs can be combined with ITC, PTC, NMTC (New Market Tax Credit), HTC (Historic Rehabilitation Tax Credit), LIHTC (Low Income Housing Tax Credit), RETC (Residential Energy Tax Credit), 1031, and 1202 to maximize potential equity return. QOF capital can also be aligned with Commercial Property Assessed Clean Energy (C-PACE), a finance mechanism that offers long-term, fixed-rate financing for clean energy and efficiency projects.

Latest Regulations and News

On February 14, 2019, the IRS held a public hearing on the Opportunity Zone incentive for feedback on the first round of proposed rulemaking for the program. Witnesses included a broad range of organizations, including representatives from state economic development groups, investment funds, economic think tanks, and community reinvestment coalitions. The hearing covered a number of topics of interest to clean energy investors, including:

- Extending the period that QOFs have to invest their investors’ capital gains;
- Allowing QOZBs to satisfy the applicable standards if more than 50% of their gross income is derived from the active conduct of a trade or business (whether within or outside of an Opportunity Zone); and
- Allowing QOFs to dispose of individual assets instead of requiring investors to dispose their entire interest in a QOF in order to obtain the ten-year tax benefit.

The key themes that the witnesses testified include:

- **Data Reporting Requirements**: Establish clear and regular data reporting requirements which will ensure transparency, measure the effectiveness of the Opportunity Zone incentive, help decision-making for investors and QOFs, and prevent fraud and abuse.
- **Definition of “Substantial Improvement”**: Further clarification is sought on this definition, along with more flexibility in the timing (beyond the currently proposed 30 months).
• **Interactions with Other Tax Incentives:** Provide clarification on how the Opportunity Zone incentive will work with other tax incentives (such as ITC, NMTC, and LIHTC) as these are seen as critical to spurring investment.

• **Requirements for QOZBs:** Additional guidance is sought regarding investments in existing operating businesses (for example, clarifying that a QOF can purchase preferred stock in an existing business with growth of the net assets of the business as the desired outcome), along with clarification of the “activity” requirement (timeframe for generation of gross revenues). For the 70 and 90 percent property tests, witnesses proposed providing the option to use the unadjusted cost basis method for determining compliance.

• **Protections and Incentives for Affordable Housing:** Provide protection for current residents and existing businesses in QOZs, potentially with incentives to develop more affordable housing.

• **Investment Timing and Flexibility for Reinvestment:** Provide relief to the 180-day investment period for individuals during the first year of implementation due to the delays in regulatory guidance. Allow a longer period for QOFs to invest funds (such as 12 months). Enable QOFs to reinvest interim gains in Qualified Opportunity Zone properties without incurring a penalty or triggering a taxable act.

The IRS is reviewing the comments from the first round of proposed rules and a second round of rules is expected in March or April 2019.

**Conclusion**

Opportunity Zone tax benefits will increase the number of renewable energy projects developed because they increase investor returns, but it is hard to assess the magnitude of the increase at this time given that the regulations have not been finalized and therefore investors are unable to adequately assess the risks-adjusted return profile due from the incentive.

If structured correctly, some of the added investor benefit from the Opportunity Zone incentive can be used to help communities directly through job training, job creation and reduced electricity bills and indirectly through increased local investment. The Opportunity Zone incentive will also enable a portion of renewable energy projects that were previously unfinanceable due to low returns to become economically viable.

**About New Energy Nexus**

New Energy Nexus (NEX) is a global organization that supports the next wave of entrepreneurs with funds, programs and connections that reflect emerging trends in the clean energy economy. Our network includes more than 100 incubators and accelerators, funders and development organizations from 29 countries around the world. We have offices in Shanghai, Singapore, California, Indonesia and Vietnam.
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