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FACT SHEET

USING OPPORTUNITY ZONE TAX BENEFITS TO CATALYZE GREEN PROJECTS IN DISTRESSED COMMUNITIES

As part of the 2017 Tax Cuts and Jobs Act, Congress created a new tax regime for investments in "qualified opportunity zones" (QOZs). The idea behind QOZs is to encourage private investments in economically distressed communities by giving tax benefits to investors who make qualifying investments.

The QOZ tax benefits offer the potential for public agencies (e.g., local economic development agencies and green banks) and nonprofit organizations (e.g., foundations) to:

- sponsor clean energy, energy efficiency, and resilient infrastructure projects,
- locate these projects in economically distressed communities to create jobs and bring other economic benefits to these communities, and
- leverage their scarce funding with lower-cost private capital.

HOW DO OPPORTUNITY ZONE INVESTMENTS WORK?

The QOZ tax benefits generally apply to investors with pre-existing investments that have appreciated in value (e.g., appreciated stock). By investing in funds that invest in opportunity zones—known as "qualified opportunity funds" (QOFs)—investors can

- defer the capital gain tax on these existing investments through 2026,
- avoid taxation on up to 15 percent of this capital gain, and
- avoid tax on any appreciation in the QOF investment if they hold that investment for at least 10 years.

To be eligible, the QOF must hold most of its assets in one or more QOZs, which are census tracts that are considered to be "low income communities" (or in certain cases, are adjacent to low income communities). The qualifying census tracts were nominated by each state and then designated by the U.S. Treasury.

The more than 8,700 QOZs, which are located in all 50 states, the District of Columbia, and five U.S. territories, constitute approximately 12 percent of all census tracts. The QOZs range in population from 1,200 to 8,000 and have a total population of approximately 35 million. Approximately three quarters are located in metropolitan areas.[1]

The investments made by the QOFs must generally be made in a "qualified opportunity zone business," which derives most of its income from the active conduct of a trade or business in a QOZ and meets several other requirements. Those requirements include that substantially all of the business' tangible property (i) is used in the zone and (ii) was acquired by purchase from an unrelated party (or a qualifying lease) after December 31, 2017.

There are many complicated rules involved in structuring a QOF. The U.S. Treasury has issued two sets of extensive proposed regulations on opportunity zones, and guidance and practice are still developing.

WHAT'S THE OPPORTUNITY FOR CLEAN ENERGY DEVELOPERS?

Clean energy developers, such as solar and wind project developers, must raise capital for their projects because they generally cannot self-finance. Like other entrepreneurs in the capital markets, they are sensitive to the cost of capital.

The QOZ tax benefits, although not limited to "green" activities, can be used to raise lower-cost private capital to facilitate clean energy projects in distressed communities. The reason the capital is lower-cost is that the capital provider should be willing to accept a lower cash return because it is receiving a significant part of its return in the form of tax benefits. Although it is too early to predict how the market will develop (and the terms will be investment-specific), as a general matter, the QOF investors may not be willing to forgo all or most of the cash return on their investment, but they should be willing to forgo or significantly reduce the risk premium they would otherwise demand for investing in an economically-distressed area.

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Essentially, QOF investors could play a role similar to "tax equity" investors who are already an important component of solar and wind project development. Typically, solar and wind project developers are not in a position to make current use of the available (and very valuable) tax incentives, generally the investment tax credit (ITC), production tax credit (PTC) and accelerated depreciation.[2] Therefore, the developers bring in tax equity investors, typically banks and other large corporations that have sufficient taxable income to be able to use these tax benefits currently. These tax equity investors receive most of their investment return in the form of tax benefits rather than cash. This enables the project developer to attract investment capital without having to pay a large cash return.

QOFs could be similar—and complementary—to tax equity. Because of the tax benefits available to investors in a QOF, they should be willing to accept a lower cash return (or, as noted above, to forgo or significantly reduce the risk premium for investing in an economically distressed area). Moreover, there appears to be no reason why a project couldn't make use of *both* the opportunity zone tax benefits and the other tax incentives such as the ITC, PTC and accelerated depreciation. The QOF investors could invest side by side with investors receiving these other tax benefits or they could receive these other tax benefits themselves, subject to the resolution of some issues.

It should also be noted that the QOZ tax benefits are not limited to particular technologies (unlike the ITC and PTC), so long as the investments are made in opportunity zones. This means that they could be used for energy efficiency, battery storage, or electric vehicle projects, for example.

WHAT'S THE OPPORTUNITY FOR PUBLIC ENTITIES AND NONPROFIT ORGANIZATIONS?

Broadly speaking, public entities can encourage economic development in two ways. First, they can act as a source of information for private economic actors. In the case of QOZs, local economic development agencies can create websites or otherwise inform clean energy developers of the potential benefits of developing clean energy projects within a QOZ.

Second, public entities such as green banks may have capital to deploy to catalyze local economic development, particularly clean energy projects. Nonprofit organizations may also be able to provide some amount of capital for clean energy projects.

Public and nonprofit capital are scarce resources. There is not nearly enough capital to fund the necessary clean energy projects. Therefore, public agencies and nonprofit organizations must leverage their capital by attracting private sector capital.

Green banks[3] are a good example of how this process can work. Green banks bring in private capital through strategies such as (i) mitigating risk through credit enhancement, subordinated debt, and equity and (ii) funding demonstration projects that show the private sector that a type of deal can be done profitably. In the nonprofit sector, community development corporations are examples of organizations that combine their capital with private capital to execute projects.

Green banks and other public or nonprofit entities can use the QOZ tax benefits to leverage their scarce public or nonprofit capital with lower-cost private capital, as described in the previous section. As one example, a green bank could take advantage of the fact that most early QOFs are real estate-oriented, by partnering with a QOF to form an energy service company (ESCO) to provide energy efficiency audits and installations for real estate projects in QOZs.

But they can do more. The QOZ provisions, as currently written, lack "guardrails" to ensure that the projects do in fact benefit the distressed communities in which they are located.[4] By taking an active role in the projects, the public or nonprofit entities can ensure that the projects provide local jobs, clean energy, or other benefits to community residents.

Qualified opportunity funds could be a powerful tool to achieve the dual goals of spurring clean energy projects and providing jobs and other benefits for residents of distressed communities. They can also leverage scarce public or nonprofit capital with lower-cost private sector capital.

Clean energy, energy efficiency and other "green" project developers should be aware of the potential for using QOZ tax benefits to attract investment. Public economic development agencies can help spread this message.

To obtain the fullest capital gains tax benefit on the appreciated assets whose proceeds are invested in the QOF, the investors must invest in the fund by the end of 2019. Thus, the message must be spread quickly.

The foregoing general discussion is not legal or tax advice. Readers are urged to consult with their own legal and tax advisors about the tax, legal and regulatory matters in connection with the matters discussed above.

ENDNOTES

1 Some resources on opportunity zones, including a map and a list of opportunity zones, can be found at: https://www.cdfifund.gov/Pages/Opportunity-Zones.aspx.

2 Under current law, the PTC is phasing out and the energy ITC will begin to phase down next year.

3 For a definition of "green bank", see https://greenbanknetwork.org/what-is-a-green-bank-2.

4 We have expressed more general concerns about the QOZ provisions and how they can lead to inequitable outcomes in low income communities, such as gentrification that displaces long-time residents, unless protective steps are taken. https://www.nrdc.org/experts/stephanie-gidigbi/opportunity-zones-who-benefits.