OPPORTUNITY ZONES: SECOND ROUND OF PROPOSED REGULATIONS ARE GOOD NEWS FOR RENEWABLES, BUT REFINEMENTS ARE NEEDED

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The Opportunity Zones ("OZ") incentive created in the 2017 Tax Cuts and Jobs Act (the "TCJA") can be a powerful tool for renewable energy and other industries, as we discussed soon after the TCJA became law. The first set of proposed regulations interpreting the complicated statutory provisions governing the OZ incentive was released in October 2018 (the "First Round Regulations"), which is addressed in our prior alert. As we discussed in a subsequent alert focused on renewables, the OZ incentive can be beneficial for the renewables industry for a number of reasons, but we and many members of the renewables industry have been waiting for valuable clarifications to the rules. On April 17, 2019, our patience was rewarded with a 169 page release from the Department of Treasury (the "Second Round Regulations").

WHAT IS THE OZ INCENTIVE?

The OZ incentive consists of three tax benefits for investors.

1. U.S. federal income taxes on capital gains invested in a qualified opportunity fund ("OZ Funds")--which may be organized as a partnership or a corporation--may be deferred until the earlier of the day on which the taxpayer disposes of its interest in the OZ Fund or December 31, 2026. The amount ultimately recognized may also be reduced by basis step-ups (see below) and if the fair market value of the taxpayer's OZ Fund interest is lower than the capital gain that the taxpayer deferred by investing in the OZ Fund.
2. If the taxpayer holds the OZ Fund investment for at least five years, the basis of the taxpayer's OZ Fund interest may be increased by up to 10 percent of the gain the taxpayer deferred by investing in the OZ Fund. The taxpayer's basis will be increased by up to another five percent of that gain if the taxpayer holds the OZ Fund investment for at least seven years, for a total of 15 percent. These basis increases may be used to withdraw cash, utilize excess losses, or reduce the amount of capital gain recognized on December 31, 2026.
3. If the taxpayer holds the OZ Fund investment for at least 10 years, capital gains realized upon disposition of the investment are free from federal income tax due to a step up in basis of the investment to its fair market value at the time of disposition.

Any U.S. person and certain non-U.S. persons can invest in an OZ Fund and benefit from the OZ incentive. This includes individuals, corporations, partnerships, and trusts. Partners investing capital gains from a partnership can choose to have a longer window to invest in an OZ Fund than the partnership would.

An OZ Fund is a partnership or corporation that acquires tangible property or an equity interest in a second partnership or corporation that is a qualified OZ business (an "OZ Business") and uses those assets in a trade or business other than several "sin" businesses listed in the law. Both the OZ Fund and any OZ Business must meet several requirements concerning, among other things, where they use the tangible assets they own or lease and how much of their assets are intangibles, cash, cash equivalents, and short-term debt.

DOES THE OZ INCENTIVE MATTER ONLY FOR PEOPLE WHO PAY TAX OR HAVE CAPITAL GAINS TO INVEST?

No. The OZ incentive can be used only by people who pay U.S. federal income tax and have capital gains to invest. However, tax-exempts and taxpayers who do not have capital gains to invest should pay attention.

First, the value of property located in or near an OZ is already increasing and is expected to continue to increase as more OZ Funds deploy capital in OZs. Therefore, tax-exempt and nontaxable organizations should expect more competition for investments located in OZs and should also consider whether they should demand a premium for assets they own in OZs when it is time to exit.

In addition, due to the nature of the OZ incentive and certain other tax-incentive programs, we also anticipate that there will continue to be a place in OZs for tax-exempts and taxpayers that do not have capital gains to invest. For example, many OZ Funds and OZ Businesses will need to borrow to fund operations and cash distributions and many OZ Businesses may qualify for other tax incentives that cannot be efficiently used by OZ investors. In addition, some of the most attractive infrastructure projects require more capital than can be efficiently raised or deployed by many OZ Funds or require non-OZ capital for portions of a project located outside of an OZ.

In all of these cases, tax-exempts and taxpayers without capital gains to invest will need to consider and understand the unique effects that the OZ incentives have on the market and their counterparties.

HOW DO THE SECOND ROUND REGULATIONS HELP RENEWABLES?

1. OZ investors can use the five- and seven-year basis increases to claim accumulated depreciation or withdraw accumulated cash tax-free.

To the extent an OZ Investor's invests qualified capital gains in an OZ Fund, the OZ investor's initial basis in that OZ Fund is zero. In the case of an OZ Fund that is a partnership, the investor's zero basis limits the investor's ability to claim U.S. federal income tax credits and depreciation deductions in respect of the OZ Fund's property. It can also limit the investor's ability to withdraw cash from the structure. An investor's basis can be increased by causing a partnership OZ Fund or OZ Business to borrow. Basis is also increased when net income (that is, income after expenses and deductions) is earned by the OZ Fund and allocated to the investor. As noted earlier, Code [1] Section 1400Z-2, which authorizes the OZ incentive, indicates that an OZ investor that holds its OZ Fund interest for at least seven years prior to recognizing deferred gain could also increase its basis in its OZ Fund interest by up to 15 percent.

The Second Round Regulations clarify that the basis increases available after a five- or seven-year holding period are available only before deferred gain is recognized, which will occur upon the earlier of a disposition of the OZ Fund interest or the 2026 tax year. (However, we anticipate additional legislation to give investors an additional year to meet these holding periods.) Importantly, the Second Round Regulations also clarify that these basis increases can be used for any purpose under the Code. Therefore, they can be used to absorb depreciation deductions and cash that have accumulated in a partnership OZ Fund as a consequence of the investor's low basis and related legal limitations. Moreover, cash withdrawals to the extent of the basis increase would not be subject to tax or accelerate recognition of deferred capital gain to the extent that the withdrawals did not exceed the investor's basis at the time of the withdrawal (see below).

2. OZ investors can participate in leasing structures.

The Second Round Regulations state that tangible assets that are leased from another person and used by an OZ Fund or OZ Business may be qualified property for purposes of the asset tests applicable to OZ Funds and OZ Businesses. There are several important points to raise in this respect:

- New and used property can be qualified OZ property, provided that the OZ Fund or OZ Business entered into the lease after 2017 and the lessee and lessor are not related (generally, 20% or more common ownership or one entity owns more than 20% of the other entity). In this scenario, lease prepayments are not limited by the OZ rules, but generally applicable tax law (e.g., capital leasing rules and Code Section 467), still apply.
- Used property that is leased by an OZ Fund or OZ Business from a person that is related (as described above) to the OZ Fund or OZ Business will still be qualified OZ property if, within 30 months after the lessee takes possession of the leased property under the lease, the lessee purchases a sufficient amount of additional property that is used in the same or a substantially overlapping OZ. Thus, it should generally be possible for an OZ Fund or OZ Business to lease an operating renewables facility and then purchase and place in service additional property (e.g., storage or a second phase), provided that the OZ Fund or OZ Business spends enough money purchasing the additional property. In this scenario, no more than 12 months of lease payments may be prepaid.
- Tangible assets that an OZ Fund or OZ Business leases to another person also may be qualified property for purposes of the asset tests. Put another way, an OZ Fund or OZ Business can be in the equipment financing business if certain requirements are met (for example, equipment must be substantially used in an OZ). In addition, because of the rules above, a lessee in an equipment financing arrangement structured as a sale leaseback could be an OZ investor.

These rules increase the monetization opportunities for owners of operating renewables and the ways in which OZ capital can be effectively and efficiently deployed to improve the economy in OZs. They are also sufficiently favorable that it may be possible to use an inverted lease (aka, lease passthrough) structure for a project that qualifies for the investment tax credit ("ITC") where the ITC investor takes the lessee position and the OZ investor takes the lessor position. On the flip side, it also appears that a lessee in a sale leaseback of equipment could be an OZ investor.

Nonetheless, care should be taken to ensure that the leases or leasing activity satisfy the restrictions applicable to OZ investments as well as tax rules that are generally applicable to leasing activities. In addition, the Second Round Regulations also include a generally applicable anti-abuse rule that permits the government to recharacterize a transaction if it is determined, based on all applicable facts and circumstances, that a significant purpose of the transaction is to achieve a result that is inconsistent with the purpose of the OZ incentive.

3. It is now easier to use OZ Fund structures to invest in operating businesses.

The statute establishes several criteria that made it difficult to determine how an OZ Fund or OZ Business, both of which must operate a "trade or business," had to operate in order to satisfy the OZ rules. The Second Round Regulations provide significant clarification in this regard by stating that the standard for trade or business activities is Code Section 162, a well established and extensively explored provision of existing law that generally indicates that a trade or business is any activity that is continuously and regularly carried on primarily for the purpose of earning income (as opposed to benefiting from a mere increase in value of property). The Second Round Regulations also provide a special rule for operating (and leasing) real property. In addition, several safe harbors were provided for establishing whether at least 50 percent of an OZ Business's income is properly sourced to an OZ (the "Operating Safe Harbors"). These safe harbors refer to different factors, including hours worked by employees and independent contractors, amounts paid to employees and independent contractors, and a combination of location of management and tangible assets and their contribution to the business. There is also a facts and circumstances based category.

Another concern under the statute and First Round Regulations was that it appeared that an OZ Fund investment had to be "frozen" for at least 10 years in order to reap the full benefits of the OZ incentive. This made many investors cautious of investing in certain types of activities, including venture stage and operating businesses that may be hampered by remaining in an OZ or avoiding ordinary course business combinations. The Second Round Regulations ease these concerns somewhat by providing that many□though not all□types of reorganizations that are tax-free under generally applicable tax law can be completed by an OZ Fund investor, OZ Fund, or OZ Business without triggering tax and while retaining OZ benefits. In addition, if these reorganizations are completed properly, the OZ Fund investor's holding period will be preserved so that the investor can still avoid taxation on capital gain recognized on an exit that occurs 10 years or later after the investor's initial OZ Fund investment, assuming, of course, that all otherwise applicable requirements are met.

4. It also is easier now to manage investor privacy (including certain regulatory disclosures) and exits from an OZ Fund structure.

One of the concerns with the statute and the First Round Regulations was that they made it seem that an OZ Fund structure had to be very flat, specifically that taxpayers seeking to defer capital gain had to directly invest in an OZ Fund. This would have created many problems ranging from privacy to massive logistical headaches for accomplishing an exit, which under previously released rules had to be done by disposing of OZ Fund interests. Thankfully, the Second Round Regulations make it possible to create a multi-asset investment fund that can look and feel a lot more like a traditional investment fund through a few clarifications about the consequences of an OZ Fund's disposition of qualified OZ property and transfers of a partnership OZ Fund interest.

For example, the Second Round Regulations specify that an OZ investor may exchange its interest in an OZ Fund for an interest in a partnership without accelerating recognition of deferred capital gain if the OZ investor's beneficial interest in the OZ Fund is not reduced and certain other criteria are met. In addition, an OZ investor will be permitted to elect to increase its indirect basis in an OZ Fund's assets after holding an OZ Fund interest for at least 10 years. Therefore, an OZ investor also would not recognize capital gain as a result of an OZ Fund's disposition of its assets after the OZ investor has held an interest in the OZ Fund for at least 10 years. In addition, although the relevant proposed regulation is not as clear as could be hoped, there are arguments that a direct or indirect disposition of depreciable property held by an OZ Fund (and possibly, an OZ Business) would not result in recapture of depreciation deductions.

5. There is additional hope for projects that straddle OZ boundaries.

A new rule provided in the context of the Operating Safe Harbors discussed above provides that activities that occur on real property that lies partly within and partly outside an OZ may be treated as sufficient for an OZ Business to meet the Operating Safe Harbors. However, this rule does not address the location of tangible property (for example, solar panels, substations, and batteries) for purposes of determining whether at least 70 percent of an OZ Business's tangible property are qualified OZ property.

Interestingly, Treasury requested comments regarding whether a similar "straddle" rule should be applied to other portions of Code Section 1400Z-2. Adding this type of straddle rule to the 70 percent standard for location of tangible property of an OZ Business would reconcile the business goal of finding the optimal location of an operating business without creating false incentives to site 70 percent of a facility on one side of an imaginary line that divides a discrete parcel or contiguous parcels of property. This would be particularly beneficial to the renewables industry and many other industries that can bring jobs and wealth to rural areas, including agribusiness, resort hospitality, and large manufacturing. Moreover, there already are established concepts in the tax law that can function as anti-abuse mechanisms by specific inclusion in the final regulations.

WHAT'S THE CATCH?

Aside from the limitations discussed above and some other restrictions, there are a few points in the Second Round Regulations that must be carefully navigated.

1. Managers will have hard choices to make about distributing cash or property from an OZ Fund.

A partnership OZ Fund can make a distribution in excess of an investor's basis in its OZ Fund interest. While it has always been the case that a cash distribution in excess of basis would be subject to taxation as a capital gain, the Second Round Regulations go a step further and require that distributions from a partnership OZ Fund constitute an acceleration of recognition of deferred capital gain to the extent the fair market value of the distribution exceeds the investor's basis in its OZ Fund interest. It is important to note that the investor will not be taxed twice (that is, under the Second Round Regulations and the general rule regarding distributions in excess of basis).

This result is troubling for a number of reasons. First, a similar rule applies to corporate distributions, but it is more favorable to investors than the partnership rule discussed above. Partnerships, however, are more widely used in project finance and real estate. More worrisome is that partnerships with depreciation deductions that exceed income will find it difficult to distribute operating cash. This concern is particularly acute for project finance, e.g., investments in renewables and storage assets (as well as power infrastructure and many other assets), and also for operating businesses using 100 percent expensing of capital investments, which was also enacted in the TCJA. While an investor's basis can be increased if the OZ Fund borrows, borrowing solely to support cash withdrawals may not be aligned with sensible business goals or, in some cases, with applicable tax law. In addition, there are restrictions on the amount of cash that may be retained in the OZ Fund structure.

Thus, if a business does not, in the ordinary course, need to spend or invest excess cash, the business manager will have to make a very difficult choice that essentially boils down to how she will choose to harm her investors. For example, does she choose to trigger a taxable distribution or pay penalties for causing the OZ Fund to hold too much cash? Given the seriousness of the consequences to taxpayers and reasonable options to favorably address them, this rule may be a good topic for Treasury to reconsider when preparing final regulations.

2. Certain direct and indirect transfers of OZ Fund interests or qualified OZ property can trigger early recognition of deferred capital gain.

As in the case of the ITC, certain direct and indirect transfers of an interest in an OZ Fund or qualified OZ property will trigger taxation. In the case of the ITC, there is recapture of a credit. In the case of the OZ incentive, there is an acceleration of taxation of the capital gain that was deferred by investing in an OZ Fund. While this type of restriction was generally expected, there are a few surprising exceptions. For example, certain liquidations of a corporate OZ Fund are not inclusion events, and an investor's death is not treated as a disposition event, nor is a transfer of an OZ Fund interest by an investor's estate to an heir. However, most gifts of an OZ Fund interest (including charitable gifts) and certain kinds of reorganizations that would otherwise be tax-free will trigger taxation under the OZ rules.

Please contact the K&L Gates OZ team for assistance in implementing any aspect of the OZ incentive or if you wish to provide comments, input and ideas to the White House, Treasury and Congress. (Comments regarding the Second Round Regulations are due on July 1, 2019.)

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[1] All references to the "Code" are to the Internal Revenue Code of 1986, as amended.

