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Opportunity Zones: A Place-Based Incentive for Investment in Low-Income Communities

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Abstract

The Tax Cuts and Jobs Act of 2017 (TCJA) created Opportunity Zones. The latest in a long line of place-based initiatives, Opportunity Zones provide three tax benefits for taxpayers with existing capital gains. Opportunity Zones are mostly designated from low-income communities and are the Trump Administration's main locally targeted economic development tool.

Introduction

The Tax Cuts and Jobs Act of 2017[1] included several major revisions of the U.S. tax code. Although the press thoroughly covered changes to marginal tax rates, deduction rules, and corporate rates, at least one section only received its share of attention more recently. This section, 1400Z,[2] created a new place-based tax incentive intended to spur economic development and job creation in distressed communities designated as "Opportunity Zones." Although Opportunity Zones (OZs) are the latest place-based tax incentive, they also represent a sweeping expansion of the approach—both in terms of the potential tax benefits being provided and the huge scale of the geography now covered for reduced income taxes for investors.

Designation

Starting in early 2018, the U.S. Treasury began implementing the new law through a two-part approach. First, the Treasury established a designation process through which state governors would identify specific areas for OZs. Second, the implementation of tax benefits went through a lengthier, multi-stage process that included two rounds of proposed regulations. Although potential investors and fund managers had to work with some uncertainty during this interim period, final regulations were issued in December 2019.[3]

For the designation process, the Treasury first released a list of potentially eligible Census tracts in each state based on the threshold criteria provided for in the statute.[4] State governors would then be responsible for selecting a portion of those eligible tracts to receive the final designation. Eligible census tracts fit one of two categories: (1) tracts meeting the New Markets Tax Credit (NMTC) definition for "low-income communities,"[5] or (2) tracts that are "adjacent to low-income communities" and that also meet additional conditions. In general, the NMTC definition of a low-income community (LIC) is a census tract that has a poverty rate of at least 20 percent or has a

[1] The Tax Cuts and Jobs Act is available at https://www.congress.gov/bill/115th-congress/house-bill/1/text/enr; (see section 1400Z for Opportunity Zones).

[2] Section 1400Z is quite brief and can be read in the U.S. Code at https://uscode.house.gov/view.xhtml?req=granuleid%3AUSC-prelim-title26-chapter1-subchapterZ&saved=%7CZ3JhbnVsZWlkOlVTQy1wcmVsaW0tdGl0bGUyNi1zZWN0aW9uMTQwMFotMg%3D%3D%7C%7C%7C0%7Cfalse%7Cprelim&edition=prelim.

[3] One comprehensive resource on Opportunity Zone eligibility, designation, and mapping can be found on the CDFI Fund website at https://www.cdfifund.gov/Pages/Opportunity-Zones.aspx.

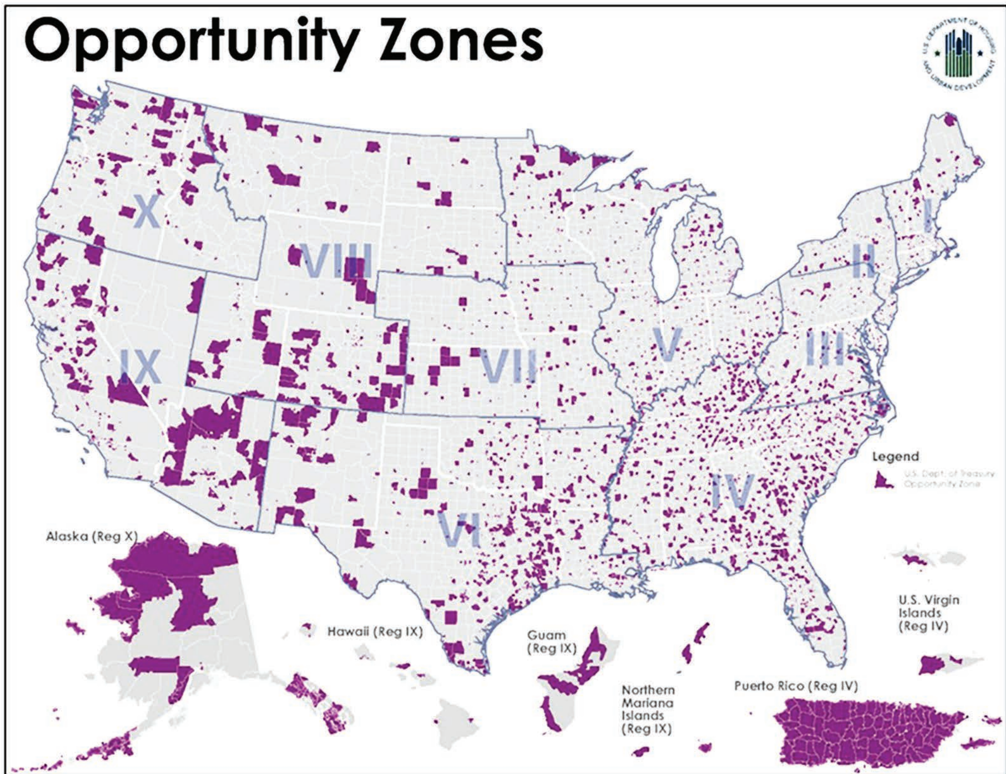
[4] IRS Notice 2018–48, "Designated Qualified Opportunity Zones under Internal Revenue Code § 1400Z–2," (July 2018). Available at https://www.irs.gov/pub/irs-drop/n-18-48.pdf.

[5] The NMTC definition, in section 45D(e) of the tax code, provides:
(e) Low-income community
For purposes of this section—
(1) In general, the term "low-income community" means any population census tract if—
(A) the poverty rate for such tract is at least 20 percent, or
(B)
(i) in the case of a tract not located within a metropolitan area, the median family income for such tract does not exceed 80 percent of statewide median family income, or
(ii) in the case of a tract located within a metropolitan area, the median family income for such tract does not exceed 80 percent of the greater of statewide median family income or the metropolitan area median family income.
Note some additional criteria are for limited exceptional cases in subsequent paragraphs (see (e)(2) - (5)).
Available at https://www.law.cornell.edu/uscode/text/26/45D.

median family income of 80 percent or less of its state or metropolitan area median income. Under the second part of the OZ definition, tracts contiguous to LICs, with family incomes less than 125 percent of the adjoining LIC, would also be eligible for designation. See exhibit 1 for the locations of all OZs.

Exhibit 1

Locations of Opportunity Zones in the United States



Source: HUD

Governors[6] were able to designate 25 percent of the eligible census tracts in their states as OZs. No more than 5 percent could be contiguous OZs, and a contiguous OZ could only be designated if the LIC that it touches is also designated (exhibit 2). An additional provision designated all LIC tracts in Puerto Rico as OZs; in effect, that provision means that nearly every tract in Puerto Rico is an OZ, due to high poverty rates. In total, more than 8,700 Census tracts were designated as OZs.[7] Nearly 32,000 LIC tracts were eligible for designation, and an additional 10,000 contiguous

[6] In this article, the word "governor" includes the governors of all states, the mayor of the District of Columbia, and the executives of every U.S. territory. In terms of the designation process, states (and territories and Washington, DC) that had fewer than 100 eligible tracts could still designate up to 25 tracts from the eligible list.

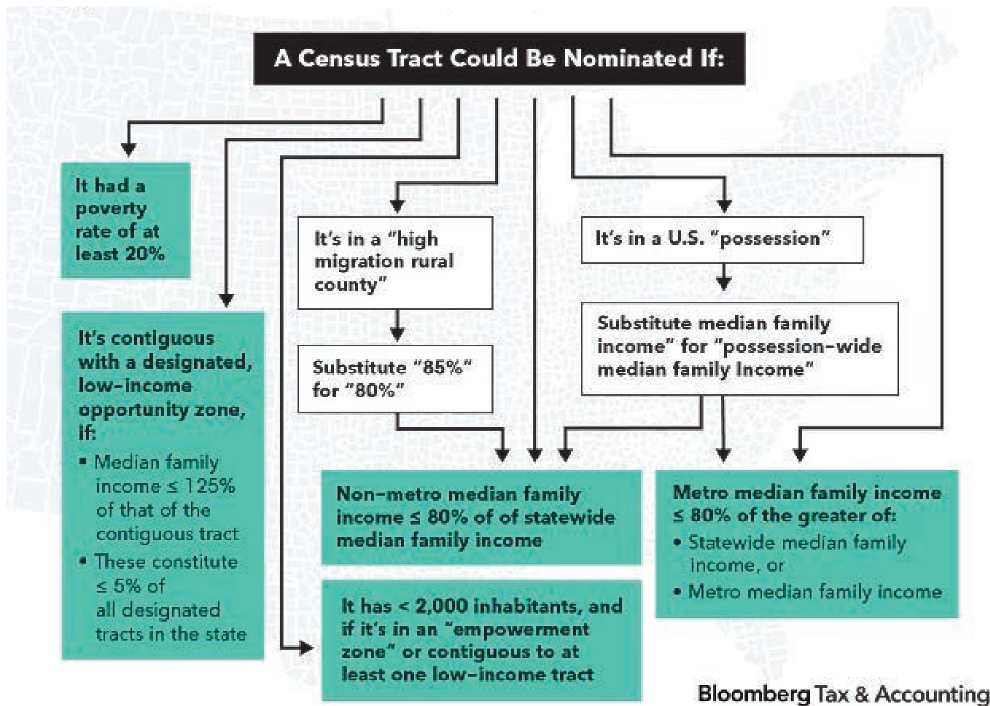
In addition to several notices identifying lists of eligible census tracts, the IRS provided guidance to governors on the process for designating census tracts as Qualified Opportunity Zones (QOZs) in Revenue Procedure 2018-16, available at https://www.irs.gov/pub/irs-drop/rp-18-16.pdf.

[7] To see a map, consult https://opportunityzones.hud.gov/resources/map.

communities met the criteria, but most—more than 95 percent—of OZs are LIC tracts. These numbers fit with the general requirements laid out in the designation procedure that around 25 percent of eligible tracts could be designated, and 5 percent could be contiguous communities.

Exhibit 2

Opportunity Zone Tract Eligibility Criteria



Source: Bloomberg Tax, https://news.bloombergtax.com/daily-tax-report/2020-census-could-expand-opportunity-zones-chosen-for-tax-breaks

Regulations

The Treasury issued final regulations implementing the investment and tax benefit provisions for OZs in December 2019 ("Opportunity Zones Resources," n.d.).[8]

The final regulations implement a number of key provisions from the Tax Cuts and Jobs Act. Under the law, an individual taxpayer cannot simply claim the various benefits and incentives. Instead, to be eligible, all investments have to be made through a business vehicle that meets various criteria provided in the law. The investment vehicle is called a "Qualified Opportunity

[8] The Opportunity Zone Final Regulation, with additional background materials, is available at https://www.irs.gov/newsroom/irs-and-treasury-finalize-opportunity-zone-guidance.
An FAQ provides additional information: FAQ from the IRS https://www.irs.gov/newsroom/opportunity-zones-frequently-asked-questions.
For the proposed rules, see:
October 2018 Proposed Rule: https://www.regulations.gov/document?D=IRS-2018-0029-0001
May 2019 Proposed Rule: https://www.regulations.gov/document?D=IRS-2019-0022-0001

Fund" (QOF)—a partnership or corporation that invests at least 90 percent of its assets in an OZ property. That property can be stock, a partnership interest, business property, or business. Some issues were rather thorny, such as the definition of an OZ business. It is easy to imagine two possible extremes: requiring at least $1 of revenue in an OZ to qualify or requiring 100 percent of revenue in an OZ to qualify. Neither one is a good definition; the first confers status on businesses with no real connection to an OZ other than a token transaction or a PO box, and the second eliminates the possibility of mail order fulfillment or growth outside OZ boundaries. After proposing a minimum standard of 90 percent of income, in the end, the IRS settled on three safe harbors around 50 percent of business occurring in an OZ, based on either an hours, payment, or tangible property test. Some simpler issues were quickly settled. For example, a business cannot fall into prohibited categories laid out elsewhere in the tax code, including golf courses, country clubs, massage parlors, tanning facilities, racetracks, casinos, or alcohol distributors. If the QOF chooses to invest in a business property, that property only qualifies as an OZ property if, in addition to its physical location in an OZ, the investors substantially improve the property to the point of doubling its basis.[9]

Tax Incentives

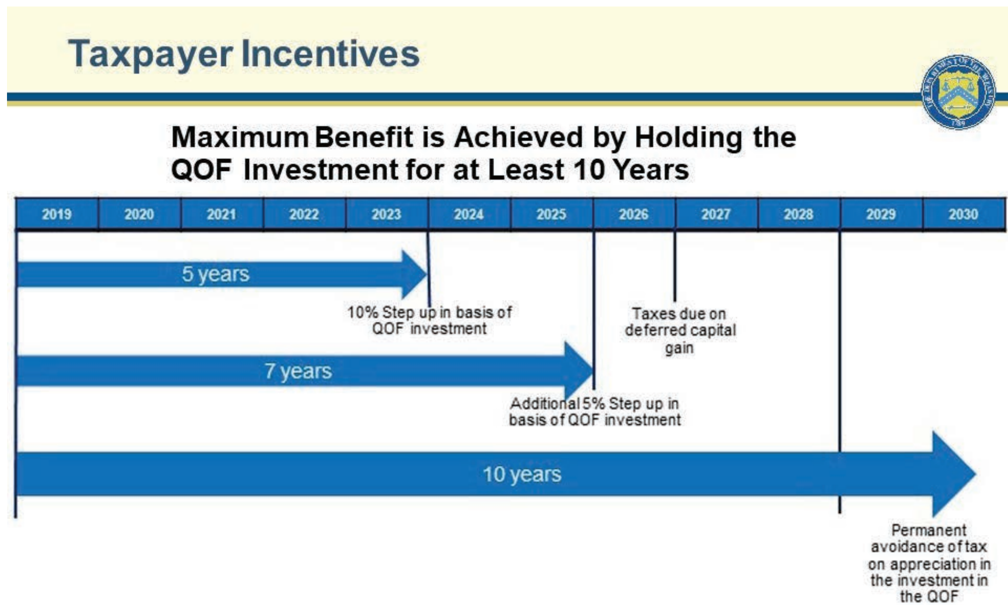
Investors who follow these rules are eligible for some very attractive tax incentives, as illustrated in exhibit 3. Three main categories of tax incentives are available: a 0-percent tax on new gains, deferred taxation, and a basis boost. First, the 0-percent tax on new gains; if an investor holds a stake in a QOF for 10 years, any capital gains that have accrued to the QOF investment are taxed at a federal rate of 0 percent. A capital gain is defined as income from the sale of property, including stock, business property, and financial instruments.[10] Capital gains are distinguished from ordinary income, like wages, rents, dividends, and interest. Worth noting is that the IRS has ruled that the QOFs may exist through 2047 to prevent a mass liquidation event at the expiration of OZ designation in 10 years. Many states also match their state capital gains tax to federal policy, so the state in those cases would also tax the gains at 0 percent.

[9] In short, the cost basis is the value of the investment made. If an investor buys a piece of property for $25, their basis is $25. If they then sink an additional $50 into improvements on the building, their basis increases to $75. This is a simple example and not intended to be representative of all of the complex ways in which real estate investment occurs in this country. For a brief explanation, see https://www.hrblock.com/tax-center/income/real-estate/how-to-calculate-cost-basis-for-real-estate/.

[10] The tax code provision defining the types of assets whose sale is eligible for reduced "capital gains" tax is provided in 26 U.S. Code § 1221. See https://www.law.cornell.edu/uscode/text/26/1221.

Exhibit 3

Taxpayer Incentives: Three Tax Changes



Note: Assumes investment on January 1, 2019.
QOF = Qualified Opportunity Fund.
Source: https://opportunityzones.hud.gov/investors

A second type of tax incentive is deferred taxation. If an investor places capital gains realized elsewhere into a QOF within 180 days of realization, the tax on those gains is deferred and potentially lowered. Investors would not have to pay federal capital gains tax on those gains until either the tax year in which they sell their stake in a QOF or the 2026 tax year, whichever comes first.

The third type of tax incentive is the basis boost: if the gains are held in the QOF for 5 years, the basis is increased[11] by 10 percent and an additional 5 percent if held in the QOF for 7 years.

For a brief numerical example of all three forms of the OZ incentive, imagine a taxpayer has an unrealized gain of $1 million in the form of an original investment of $4 million that has turned into $5 million on paper over time. Imagine further that the investor sells that holding in late 2019 and places $1 million[12] into a QOF the next month; then the investor keeps it in a QOF until 2036, where it turns into $3 million. The investor will owe capital gains tax on $850,000 from the original $1 million gain in tax year 2026, because 15 percent is written off for holding for 7 years.[13] The basis boost reduces the taxable amount from $1 million to $850,000, and the deferral means that this tax is due in 2026.

[11] This is equivalent to reducing the tax paid by the same percentage, in the case of a flat capital gains tax rate.

[12] It is important to note that only the gain is eligible for the OZ tax benefits; the original basis may be invested in a QOF but will not receive the 0-percent tax rate or the basis boost. The deferral is irrelevant in the case of the original basis. See sec. 1400Z-2(e)(1)(B) of the Internal Revenue Code.

[13] At this point, because fewer than 7 years remain between now and 2026, if the investor were to act today, they would only be eligible for a 10-percent basis step-up for holding for at least 5 years by 2026.

On the gain of $2 million, realized in 2036, the taxpayer will owe 0-percent capital gains tax, or $0. This is the 0-percent tax on new gains.

As a further incentive—but also a further complicating matter for program analysts—many states and localities have supplemented OZ federal tax incentives with incentives or spending of their own. Federal agencies, including HUD, under the guidance of the White House Opportunity and Revitalization Council, are also revising regulations and agency spending to support the mission of seeking positive economic outcomes in OZs.

Considerations for Evaluating Opportunity Zones

The stated purpose of OZ supporters in think tanks and in Congress is to improve economic outcomes for LICs.[14] At this stage—not even 2 years into the existence of the incentive and before nearly any investment has taken place—it is impossible to say what the outcomes will be. This country and others have a history of place-based incentives, with mostly inconclusive results. For example, Empowerment Zones from the mid-1990s to the mid-2000s combined federal grant spending with tax incentives, mostly on wages and hiring. One major shortcoming of evaluations of Empowerment Zones is data availability. Some studies rely on the 1990, 2000, and 2010 Censuses, although the incentive dates do not align nicely with these points. Additionally, data may not exist for the exact geographic area that the Empowerment Zones covered. Finally, Empowerment Zones were not chosen at random; both the cities and the locations within cities were chosen for a reason, which may not be apparent to an outside researcher.[15]

Researchers may have some advantages evaluating OZs rather than past place-based incentives; however, they also face many of the same challenges. In some respects, researchers may have a more difficult time in attempting to assess the effectiveness and cost-efficiency of OZs.

Because OZs are based on census tracts, the American Community Survey (ACS) will be a source of rich economic data, collected down to the census tract level, for future research. It should be noted, however, that, although ACS data are updated each year, the census tract level data are based on aggregations of rolling 5-year samples. Thus, ACS census tract data will not be available for exact point-in-time snapshots that would allow for straightforward "before and after" comparisons to estimate the impact of the tax incentives.

Challenges will certainly remain for analysts. OZs were also not chosen at random; governors were generally able to select 25 percent of their state's eligible tracts for designation. That means that usually 75 percent of tracts were not selected. Each governor likely emphasized different criteria in nominating OZs; some may have chosen already improving areas, whereas others may have chosen the most impoverished of the eligible tracts. The use of different criteria will mean that zone designation may be highly correlated with other factors, which will confound simplistic attempts at evaluation.

[14] For an example of a think tank advocating expansion of the geographic-targeted tax cuts and incentives, see "Unlocking Private Capital to Facilitate Economic Growth in Distressed Areas." 2015. Washington, DC: Economic Innovation Group. https://eig.org/wp-content/uploads/2015/04/Unlocking-Private-Capital-to-Facilitate-Growth.pdf.

[15] For more on place-based incentives, refer to HUD's Office of Policy Development and Research periodical Evidence Matters, Spring/Summer 2019 article on Place-Based Incentives, available at https://www.huduser.gov/portal/periodicals/em/SpringSummer19/index.html.

A common program evaluation technique is the use of a "counterfactual." For example, one may attempt to answer what would have happened without the various tax incentives by comparing actual outcomes for the OZs with the counterfactual, such as similarly situated census tracts that did not receive the OZ designation. That answer is also impossible to determine with certainty because we cannot use more sophisticated evaluation methods—such as random assignment—to see the effect of OZs. Knowing whether any investment in an OZ was merely shifted from outside or represents new investment will be difficult. In recent interviews, OZ boosters and critics alike agree that the initial round of OZ investment activity would have happened anyway. In the coming years, however, outcomes for OZ residents are also difficult to determine. For example, researchers may look at increased median incomes in an area, but that may represent new residents moving in and old residents moving out. Median incomes falling in tracts adjacent to OZs and median incomes rising in OZs might mean that OZs boost incomes, or it might mean that we have spent our tax incentive dollars shifting people between tracts, with no changes in aggregate income.

Finally, one remaining challenge for OZ researchers is the availability of administrative data. The IRS has released Form-8996 to collect the amount of investment by tract from every Opportunity Fund. It is not clear how easy it will be for researchers to access this data. Without this information, researchers will only be able to look at the OZ designation itself as a potential cause of change. The amount of investment within an OZ would be more interesting to explore, given that researchers could compare a range of outcomes against a range of investment dollar amounts; perhaps some OZs will receive a lot of investment, and others none or very little. It would be odd to expect outcomes to be similar in two such OZs. As stated, however, it is unclear to what extent data on actual investment amounts will be made available for research and evaluation efforts.

It is also notable what data are not being collected. The U.S. Impact Investing Alliance released an "Opportunity Zones Reporting Framework" (Bernstein and Hassett, 2015), a guideline that recommended Opportunity Funds to collect information on investment outcomes—like jobs, North American Industry Classification System industry codes, square footage of developments, and information on the investing fund. Some impact-investing advocates, fiscal conservatives, and advocates for low-income communities are interested in data collection in more categories so that the impact per dollar invested, or per dollar of tax reduced, can be computed.

Other challenges for researchers, as mentioned previously, are the overlapping incentives and tax benefits states and localities provide. At this time, no known complete database of state and local complementary incentives within OZs for community use exists. HUD's recently launched Opportunity Zones website contains a link to every state's OZ website ("Local Leaders," n.d.). It is not always clear whether a state has made additional incentives available, but did not list them on their website, or if they have not created any such additional incentives.

Potential Areas for Research and Evaluation

It will be important to track outcomes for original and new OZ residents. One excellent way to do this would be to use the IRS internal data file of tax returns. Researchers looking at anonymized cross-sections from year to year will never know whether the people in the cross-section remained

the same. With IRS tax return data, the IRS can identify where low-income people who live in OZs in 2019 might live in 2026 and how their incomes would change. Other panel studies will be useful so long as an address can be definitively mapped to a particular tract.

It is likely that one common way to invest in OZs will be with real estate. A previously distressed community may have many possible outcomes for increased real estate economic activity. One outcome is rapid gentrification and the displacement of long-time residents. Another outcome is a greatly improved housing stock with mixed-income tenants, and previous area residents financially comfortably kept in place with a mix of policy actions. HUD is greatly interested in knowing how this will turn out, but of course, will also be actively intervening in these housing markets; that intervention may distort results.

Previous place-based tax incentives offered direct wage or hiring tax credits, but OZs have no wage or labor component. The supporters of the TCJA legislation hoped that it would boost incomes in OZs. There are a variety of research questions around the idea of using a capital tax cut to improve outcomes for labor.

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