Taking a Closer Look at Qualified Opportunity Zones

By Michael Thomas

Unlike previous attempts at channeling private business activity, qualified opportunity zones employ the U.S. financial markets in their search for capital.

There have been many iterations of blueprints for linking private capital to public needs over the years. Decision makers have lured private resources into choice jurisdictions by improving business prospects through tax credits, workforce development assistance, and advantaged financing, with varying degrees of success. Most of these incentives are meant to persuade companies to conduct some of their business in specific areas, cultivating economic output that brings cascading productivity to the community.

The Tax Cuts and Jobs Act (TCJA) of 2017 creates another version of incentivized economic development by creating qualified opportunity zones (QOZs). Unlike previous attempts at channeling private business activity, QOZs employ the U.S. financial markets in their search for capital. Other incentivizing policies rely on businesses' using local resources or drawing from the area workforce, but QOZs focus on the origins of all economic activity by ushering capital in the right direction first, and letting the details sort themselves out afterward.

The concept of QOZs was developed by the Economic Innovation Group, an economic policy think tank that played a big role in authoring the Investing in Opportunity Act, which created QOZs as part of the TCJA. Multiple entities were involved in constructing the framework used to determine the location of QOZs and design the incentives used to attract capital.

WHERE ARE THE OPPORTUNITY ZONES?

American Community Survey data from 2011 to 2015 was used to locate areas that are defined by Section 45D of the Internal Revenue Code as low-income communities. The identified low-income communities are Census tracts, the smallest denomination of measurement used by the Census, with a single tract encompassing a population of 2,500 to 8,000. The data defining all the tracts statewide are used by each state's governor in selecting the final QOZs, with final approval coming from the Treasury Department. To ensure that capital is not spread too thinly statewide, governors were allowed to designate 25 percent of the identified low-income communities in their state as QOZs. All told, there are over 8,700 census tracts designated as QOZs nationwide.

Section 45 defines "low-income community" as:

- Census tracts with poverty rates of at least 20 percent, or
- In the case of a tract that isn't located within a metropolitan area,

the median family income doesn't exceed 80 percent of state median family income, or

- In the case of a tract located within a metropolitan area, the median family income doesn't exceed 80 percent of the greater of statewide median family income or the metropolitan area median family income.

In addition to meeting the qualifications listed above, on a statewide basis, 5 percent of tracts that aren't low-income communities, and are contiguous to QOZs with a median family income that doesn't exceed 125 percent of median income of that contiguous low-income community QOZ, are eligible for QOZ designation.

For low-income communities to reap the benefits of economic development, and for investors to enjoy the financial incentives available to them through QOZs, an Opportunity Zone Fund (OZF) must be established to receive capital. As of now, virtually anyone can start an OZF by simply submitting the proper form when processing regular tax returns. The general requirement is that 90 percent of all funds invested in an OZF must be applied toward a QOZ. Specific guidelines detailing what constitutes qualified business activities inside QOZs are loose and have yet to be clarified by the Treasury Department.

WHAT MAKES QOZS ATTRACTIVE TO INVESTORS?

The mechanisms powering opportunity zones seem simple: Funds are funneled into an investment vehicle that acts as a capital resource for businesses bringing economic activity to low-income communities. The overall goal is to revitalize low-income communities, but the primary goal of the mechanisms funding QOZs is to use latent unrealized capital gains as a resource for community development. Like all income, those unrealized gains are eventually subject to taxation; as regular income, if the purchase and sale of the investment occurs in less than a year, and as a capital gain, if the profit was realized after the investment was held for more than a year. Opportunity zones offer a tax deferral and tax incentive to investors that move unrealized investment gains into OZFs. Any investor that reinvests a realized gain into an OZF within 180 days of the sale date is eligible to receive preferential tax treatment. This is where the mechanism can get complicated.

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Unrealized investment gains that are reinvested into OZFs remain tax-deferred until December 2026, or until the interest in the OZF has been sold, whichever comes first. Additionally, after five years, the original reinvested gains will be eligible for a 10 percent reduction in capital gains taxes, with another 5 percent reduction possible if the funds stay put for two more years. This represents significant advantages for investors. But there's more: Funds that remain inside an OZF for 10 years or more, while still receiving the preferential tax treatment on any reinvested unrealized gains, will be subject to zero capital gains taxes on profits from an OZF.

EAGER INVESTORS AND UNCERTAIN CONDITIONS

As of now, there is uncertainty over how everything will shake out once OZFs have been opened and capital has been invested. For those using funds from OZFs for business activity, accessing the funds appears easy. Since anyone can open an OZF, a real estate developer could open up a fund and directly access whatever capital comes in from investors. But what about the municipalities that manage the jurisdictions designated as QOZs? Like their private-sector counterparts, they wait with relative uncertainty for the issuance of Treasury guidelines.

Officials of local government have the advantage of knowing the ins and outs of their jurisdictions, but who determines how engaged they will be with those investing and developing within QOZs? What expectations do private and public interests have for one another? QOZs did not attract much attention initially, but the private sector has begun to take notice. Firms such as Goldman Sachs, Fundrise, and Sakari Luxe have either opened funds or are seriously investigating their prospects. Firms are racing to open funds to take advantage of the time-sensitive benefits; the sooner they invest, the longer their clients can defer the taxes owed

on their unrealized gains. But with further guidelines soon to be issued, institutional investors have been hesitant to make their moves. Additionally, the size of this program won't really be fully recognized until money starts pouring in, making it difficult to get a handle on what resources to expect and how much the policy will end up costing in tax expenditures.

The Joint Committee on Taxation estimates that the policy will result in a $1.7 billion cost in tax expenditure over 10 years. The expected tax revenue loss is not being actively offset from elsewhere in the budget, and unless the Treasury issues guidelines specify otherwise, the amount of capital gains taxes that can be avoided through OZFs is potentially limitless — there are currently no caps set for investing in QOZs or the associated funds. This is exciting, in one respect, as some estimates measure $3.8 trillion in unrealized capital gains owned by U.S. households. It is also precarious, considering the amount of tax-revenue the federal government could be relinquishing to private interests through this policy.

Certainly, many local decision makers would be receptive to capital injections from the financial markets directly into their districts. In a perfect world, new funds from outside investors meant to cultivate economic growth would go toward exactly what would be most helpful in that given community. But as the program stands now, private interests will be encouraged to indiscriminately pursue the greatest return on their investment, while local municipalities mull over how to channel the new capital that arrives. Good or bad, municipalities containing QOZs that are adjacent to one another may find themselves competing for the attention of private investors.

A DIFFERENT DYNAMIC

QOZs are far from the first version of geographically based economic development policy. We have seen empowerment zones and the Obama-era promise zones, both of which were conceived with the same overall goal as QOZs. And although there were significant differences between empowerment zones and promise zones, QOZs are more unusual.

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Empowerment zones offered tax credits for businesses that employed individuals living within them, offering credits to subsidize wages directly. Promise zones were more regulated and addressed problems specifically, focusing on job training, battling high school dropout rates and recidivism while deploying multiple federal employees from several agencies. Empowerment zones were more about the relationships between local businesses and the federal government through the tax credit, but promise zones actively engaged local governments as part of the effort to improve their communities.

CONCLUSIONS

QOZs could be creating a scenario where local governments are actively reaching out to private interests, attempting to persuade OZF managers into investing capital into their districts. Interactions between governments and private capital could change when the Treasury issues guidelines. Instead of a direct transfer of resources from the federal government to a designated area, there will be multiple entities acting in their own self-interest. Businesses and developers want to build assets that generate profit. Opportunity Zone Fund managers want to invest in projects and businesses that produce the greatest return for their clients, while local municipalities want development directed to their districts to stoke economic productivity and bring a better quality of living to their communities. Each of those objectives is reasonable and expected. But can the citizens and leaders of municipalities within QOZs depend on three forces, all working toward their own objectives, to achieve better opportunity and growth for their distressed communities? The potential of this policy seems evident. But with so many actors, and with little guidance currently available from the applicable regulatory bodies, the potential for unintended consequences could be just as powerful as the economic forces this initiative is attempting to harness. ❚

MICHAEL THOMAS provides general support to GFOA's Ferderal Liaison Center on legislative initiatives, specifically issues involving infrastructure and transportation.