A Critical Explanation of Opportunity Zones

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Administering Agency: Internal Revenue Service (IRS) of the U.S. Department of the Treasury (Treasury)

Year Enacted: 2017

Number of Persons/Households Served: There is no information regarding the number of persons or households served because neither IRS nor Treasury require this information to be reported.

Population Targeted: The statute creating Opportunity Zones and subsequent regulations do not target specific populations, such as low-income people. There are no requirements to hire or train low-income zone residents or to pay living wages, create truly affordable housing, or create or preserve small businesses owned by or serving low-income zone residents. Nor are there protections to prevent displacement of low-income people or existing local small businesses as a result of OZ investments.

The IRS states that the purpose of Opportunity Zones (OZs) is to spur economic growth and job creation in low-income communities while providing capital gains tax breaks to investors.

History

As early as 2007, former Facebook president and Napster founder Sean Parker conceived the notion of dangling the prospect of reducing or avoiding capital gains taxes to corporations and extremely rich individuals entice them to fund investments in disinvested low-income communities. Years later he created the Economic Innovation Group (EIG) to promote his idea, which came to be known as Opportunity Zone capital gains tax breaks. OZs were endorsed by Senators Tim Scott (R-SC) and Corey Booker (D-NJ) and inserted as a very small provision in the “Tax Cuts and Jobs Act of 2017,” the massive, nearly $2 trillion tax cut legislation signed into law by President Donald Trump that overall primarily benefits corporations and extremely wealthy individuals. The OZ component of the 2017 tax act was not considered and debated through the normal congressional hearing process.

Program Summary

An Opportunity Zone is composed of “low-income” census tracts that have a poverty rate of at least 20% and median family income no greater than 80% of the area median income (AMI). A census tract that is not “low-income” may be designated as part of an OZ if it is contiguous to low-income tracts that make up an OZ and it has a median household income that does not exceed 125% of the median income of the contiguous low-income census tracts that form an OZ. Up to 5% of the census tracts may qualify under this exemption. Roughly 56% of all census tracts were eligible to be designated OZs.

Governors, the Mayor of the District of Columbia, and the chief executive officers of the five U.S. territories could nominate up to 25% of their total eligible census tracts, along with up to 5% of that 25% that were contiguous non-low-income census tracts. According to the IRS, Treasury designated 8,764 zones that retain their designation for ten years. Congress later designated each low-income community in Puerto Rico as an OZ.

Some census tracts that were low income based on census data several years ago have since experienced significant demographic changes resulting in them no longer being truly low-income and that are often gentrifying.

What Is the Tax Break?

The theory of Opportunity Zones is provide an “incentive” for an investor to reinvest an unrealized capital gain, which is a gain in the value of an investment (such as a stock) that has not been taxed because the investor has not sold it yet. The OZ “program” allows an investor to defer (delay) until 2027, the capital gains tax that would otherwise be due when the investment is sold, as long as the amount of the gain is invested in a Qualified Opportunity Fund, QOF. (Taxes on the original capital gain is due no later than December 31, 2026.) In addition, if an investor holds the QOF investment for five years, the basis of their original investment is increased by 10% (meaning they will only owe taxes on 90% of the rolled-over capital gain). If the investment was made by December 31, 2019, and an investor holds it in the QOF for seven years, the basis increases by a further 5% (for a total exclusion of 15% of the gain over the seven-year period). The investor must “realize” (sell the investment) by 2027.

Significantly, an investor can exclude from taxable income until the end of 2047, all of any capital gain accrued from the investment in an Opportunity Fund (not the original gain which was deferred until 2027) held for at least ten years. In other words, after settling their original tax bill in 2027, patient investors in QOFs will face no capital gain tax on their OZ investment until the end of 2047. The OZ capital gain tax break is on top of the usual advantages for capital gains, which have a lower tax rate than the tax rate on regular income, plus the ability to defer capital gain tax until an asset is sold.

A QOF must invest at least 90% of the capital raised from OZ investors in real estate or equipment located in an OZ, and/or in an ownership interest in a business that operates at least partially in an OZ. The remaining 10% can be invested outside of the OZ. A QOF could make qualifying investments in a business which has only a minimum of 70% of its assets ("tangible property") in the OZ; meaning 30% could be held elsewhere, which could mean more dollars could leak to more affluent communities and residents where a share of the business's assets may be located.

Aside from Investors, Who Benefits?

As previously noted, neither the statute nor the final regulations require investments to benefit low-income OZ residents by building truly affordable housing in the OZ, employing low-income OZ residents, or providing affordable capital for OZ small businesses or minority-owned or women-owned businesses. Nor are there protections to prevent the displacement of low-income OZ residents or OZ small businesses as a result of new investments in distressed communities.

Anecdotal evidence from the first three years suggests that extremely wealthy individuals and corporate investors are the beneficiaries. Anecdotes point to luxury hotels and apartments, parking lots, storage facilities, luxury student housing in census tracts next to major universities, and mostly projects long in the works or ready to go before the OZ capital gain tax break existed.

Anecdotal evidence is the only evidence available because the statute and final regulations do not call for data collection and reporting requirements that would allow OZ stakeholders to assess the outcomes of the capital gain tax breaks.

Because the entire "Tax Cuts and Jobs Act of 2017" was passed using the Senate budget reconciliation process, a provision in the OZ portion of the bill requiring some reporting was removed; consequently, there is no useful data to truly evaluate OZs. In response to lobbying by developers and potential investors, Treasury chose not to adopt modest data collection and reporting requirements in the final regulations, despite the urging of nonprofit OZ proponents in comments to proposed regulations.

Early Warnings

Red flags were waved by numerous sources in 2018.

In February, 2018, the Brookings Institution wrote:

> "There is a risk that instead of helping residents of poor neighborhoods, the tax break will end up displacing them or simply provide benefits to developers investing in already-gentrifying areas."
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> "[OZ] design and implementation has thus far precluded a rigorous comparison of its net effect on investment or its benefit to local residents."

> “The theoretical effect of the Zone tax subsidies on local residents is ambiguous. It’s a subsidy based on capital appreciation, not on employment or local services, and includes no provisions intended to retain local residents or promote inclusive housing.”

> “The value of the tax subsidy is ultimately dependent on rising property values, rising rents, and higher business profitability. That means a state’s Opportunity Zones could also serve as a subsidy for displacing local residents in favor of higher-income professionals and the businesses that cater to them—a subsidy for gentrification. Indeed, the highest returns to investors, and thus the largest tax subsidies will flow to those investing in the fastest gentrifying areas… With few guardrails that might promote so-called “smart gentrification”—policies to retain local residents and preserve or expand low- and middle-income housing—it is uncertain whether poor residents will benefit or be kicked out.”

> “The design of Opportunity Zones might encourage pressure on states to maximize tax benefits to their citizens—including their developers—to select gentrifying neighborhoods rather than the most distressed neighborhoods. Already-gentrifying areas are guaranteed to have large capital gains. Selecting those areas would maximize the tax savings to investors who would otherwise face large tax bills down the road. In contrast, the benefit for investing in moribund or deeply impoverished areas where rents and property values are stagnant is speculative.”

In August, 2018, the Tax Policy Center at the Urban Institute stated:

> “The fundamental problem with Opportunity Zones is the disconnect between the size of the potential tax costs, which are uncapped, and the social benefits from the investments, which will be hard to measure. Presumably, some taxpayers will recharacterize already-planned projects or restructure existing business arrangements through, for example, sale-leasebacks, to obtain the new tax incentives. Other taxpayers may try to invest in already-gentrifying areas that were nominated by governors, lessening the focus on economically distressed communities. And, syndicators may lure other taxpayers with the promise to delay and even eliminate taxes.”

The Dallas Federal Reserve wrote on October 18, 2018:

> “Given that O-Funds will be market-driven equity investments, investors will likely be seeking “hot” or “up and coming” areas more likely to yield high returns, as these provide greater incentives for investors. Not only will they see greater appreciation of their assets, but they will also receive a greater tax exemption: If money is held at least 10 years in an O-Fund, investors receive a permanent exclusion from taxes on the gains in the event of a sale. Given these incentives…Opportunity Funds could potentially direct capital largely to projects in areas already on the verge of gentrifying—places where high returns are most likely. In that eventuality, investors

would get a tax break while neighborhoods would simply continue on the path of gentrification, displacing some of the highest-need households from the area. Without incentives for inclusivity in place, this is a risk in these zones."

The Center on Budget and Policy Priorities (CBPP) wrote on January 1, 2019:

"The law enabled state policymakers to designate relatively affluent areas as opportunity zones, which could divert investment from truly disadvantaged communities. While the new tax break enables investors to accumulate more wealth, it includes no requirements to ensure that local residents benefit from investments receiving the tax break. Thus, this tax break could amount to a "subsidy for gentrification" in many areas instead of, as intended, for providing housing and jobs for low-income communities."

"The definition of "low-income community" is broad enough to include some areas that are not truly distressed, such as areas adjacent to some elite colleges — for example, the University of Virginia and the University of California at Berkeley, where a large concentration of students skews the income data. Furthermore, the law lets governors designate a subset of areas that are adjacent to a low-income community and have a median income of no more than 125 percent of the median income of the adjacent low-income community. Thus, they could designate as opportunity zones a number of areas that many would not consider "distressed…These "outlier" zones could attract a significant share of the opportunity zone investment and come to account for a disproportionate share of the lost federal revenue."

"This tax break does *not* include rules or tests requiring its direct beneficiaries to make specific investments that actually produce public benefits or requiring that opportunity zone businesses hire workers from, or provide services to, the local community. If anything, its incentives push in the opposite direction: the tax break is worth the most with respect to investments whose value rises the fastest. As a result, investors will likely select investments — such as luxury hotels rather than affordable housing — based mainly on their expected financial return, not their social impact."

Toward the end of 2019, Brett Theodos, Senior Fellow at the Urban Institute testified before the Subcommittee on Economic Growth, Tax, and Capital Access of the House Committee on Small Business. Mr. Theodos mentioned a number of concerns in his written testimony:

"Under the current legislative structure and executive implementation, the incentive is extremely open-ended. It lacks sufficient spatial targeting to the neediest communities. It lacks sufficient use targeting to projects that will truly benefit communities. It lacks any mechanism for community input or control. And it lacks any requirements around transaction-level reporting, though the certification process has the mechanism to permit it."

"It is notable how little community input is required to access federal resources under this new incentive. There are no stipulations in the incentive's structure for community voice or alignment with localized goals. No prioritization is given to projects and businesses that fill specified capital gaps and meet designated community needs. Moreover, communities have no recourse to mitigate harm. The incentive could go toward projects or businesses that directly counteract community priorities (e.g., pricing out current residents and small businesses or contaminating the environment).

"There are no requirements that new apartments be rented to low- or moderate-income residents; no requirements that federally backed investment occur only when fully private-market financing is unavailable; and no requirements that investors establish an oversight board of community development experts and representatives…The federal government has not sufficiently narrowed the eligible uses of this incentive to activities that will directly benefit low- and moderate-income residents or contribute to broader economic development in truly disinvested communities."

An OZ Picture Starts to Emerge in 2019

As 2019 rolled around, numerous media reported various high-end projects that had been planned for some time that were located in OZs, sometimes after affluent developers lobbied their governors to include their project area in an area that either had not been selected or that was not eligible for OZ designation.

The New York Times highlighted:

- A luxury hotel and opulent restaurant in New Orleans' already trendy Warehouse District.
- A 46-story luxury apartment tower complete with a yoga lawn and a pool surrounded by cabanas and daybeds in a Houston neighborhood already occupied by projects aimed at the affluent.
- A luxury office tower in Miami's Design District where commercial real estate prices had nearly tripled in the last decade, and which developers had already planned 12 residential towers and large-scale retail and commercial spaces.
- An existing office tower (with a Jaguar dealership on the ground floor) owned by a hedge fund needing to fill the remainder of the offices. The project is in the far west side of Manhattan already filled with other high-end office towers.
- A 35-story tower in downtown Portland, OR with a Ritz-Carlton hotel, condominiums, and office space.
- A self-storage center in Connecticut (and another in San Antonio reported by the *San Antonio Express-News*).

ProPublica published a series of articles.

In Florida, Wayne Huizenga Jr., billionaire son of Waste Management's owner, had long planned to build luxury apartment towers, Marina Village, adjacent to the existing Rybovich superyacht marina on the West Palm Beach, FL waterfront, a short drive north from Mar-a-Lago. Superyachts that can stretch more than 300 feet and cost more than $100 million are serviced at the marina, and their owners enjoy Rybovich's luxury resort amenities. Jorge Pérez, the "condo king" of South Florida and CEO of the Related Group, a partner in Marina Village, is quoted as saying "It [the proposed development] worked as a market-rate rental. Now it works that much better as an opportunity zone." In other words, the capital gain tax breaks were not economically necessary for the project to succeed.

The census tract of the planned Marina Village was not originally picked to be a part of an OZ, but was included after lobbying by Mr. Huizenga. Not selected to be OZs were the three top picks of city leaders, three tracts in the North End of West Palm Beach that were low-income, and racially and ethnically diverse. They were also attractive areas for growth, rebounding from significant blight and are well positioned for new investment, according to the city.

Also in Florida, the owner of the Tampa Bay Lightning, Jeff Vinik, had plans in 2014 for luxury apartments, hotels, stores, and restaurants surrounding the hockey team's arena in downtown Tampa. Vinik's firm requested the are be designated an OZ, and the governor did, even though the census tract has a median family income twice as high as the metro area.

In Maryland, years well before OZs, Sangamore Development, owned by Under Armor CEO Kevin Plank, started quietly buying waterfront properties in a mostly vacant, isolated peninsula cut off from downtown Baltimore by I-95. The intent was to move Under Armor's headquarters there and develop the area dubbed Port Covington with offices, a hotel, apartments, and shopping – all geared to millennials. Prior to gaining OZ designation, Port Covington already had $660 million in tax increment financing, a Brownfields tax credit, and $233 million from Goldman Sachs. Did it need more tax breaks to be viable?

The Port Covington tract, which includes a gentrified corner of South Baltimore north of the largely empty peninsula, was too wealthy to be an opportunity zone. It couldn't even meet the test to be included as a contiguous, non-low-income tract. Without going into the details, due to intensive lobbying with the governor and especially to a mapping error, Port Covington is now in an OZ. The Port Covington tract is 4% Black, while tracts recommended by Baltimore but excluded by the governor were 68% Black and have a poverty rate three times higher than Port Covington's.

In another part of Baltimore, East Baltimore, a PBS News Hour story focused that neighborhood's OZ. Pastor Donte Hickman of the Southern Baptist Church purchased a building to gut and renovate it into a workforce center. They also purchased three liquor stores across the street in order to build affordable housing. One block over a laundry was demolished in order to develop a health and wellness center. While the community met with many developers, Pastor Hickman, bemoaned the fact that the developers were only interested in how much money they could make; they needed a 10% or 12% return. However, the $32 million project could not generate that level of return so none of the developers were interested. This very poor East Baltimore neighborhood received no OZ investment.

In Michigan, Quicken Loans founder and Cleveland Cavaliers owner, Dan Gilbert, had spent the past decade buying 100 buildings in downtown Detroit. Three areas of downtown Detroit with Gilbert holdings were selected as OZs. Critics assert that two of the tracts are significantly wealthier by median income than the surrounding area, and one of the tracts sought by Gilbert was not initially included but was eventually added after lobbying, even though it did not meet the poverty criteria. These census tracts already included Gilbert-owned office space with high-end tenants including Microsoft, JP Morgan, and Quicken Loans. A boutique hotel sits in another Gilbert property that is now in one of the OZs. Gilbert already had several long-planned projects, including construction of a skyscraper.

The OZ Picture Comes into Focus in 2020 and 2021

The Urban Institute's "An Early Assessment of Opportunity Zones for Equitable Development Projects" set out to assess how OZs, despite being viewed primarily as an *economic development* tool were working as a *community development* tool to fulfill an equitable development mission for mission-oriented entities that have a community development purpose of helping people in poverty with quality jobs, affordable housing, and community amenities like grocery stores. The Urban Institute concluded, "The incentive as a whole is not living up to its economic and community development goals. The incentive's structure makes it harder to develop projects with community benefit in places with greatest need. In contrast, OZs are providing the biggest benefits to projects with the highest returns, which are rarely aligned with equitable development." The report lists a number of challenges faced by mission-oriented actors:

> "Many mission-oriented actors are struggling to access capital. Many project sponsors are struggling to access the class of investors—wealthy individuals and corporations with capital gains—for whom the OZ incentives are tailored. Additionally, many mission-oriented projects yield below-market returns that most OZ investors appear unwilling to accept. As OZ incentives are not structured to encourage resident or community engagement, mission-oriented projects struggle to compete for attention with higher-return projects—for which OZs provide much larger subsidies because of the design of the incentives."
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> "A further challenge for mission-oriented projects is that the sponsors are seeking to support a community asset with a lifetime well beyond the 10-year time horizon of the OZ incentives. Given that an illiquid investment over a 10-year horizon is already challenging for OZ investors, the type of investment many mission actors need and

the OZ market's investment parameters are mismatched. Because of these challenges, we mostly saw mission-oriented projects succeed in using OZs when the capital stack also layered in significant other subsidy sources, or when a well-connected project sponsor was able to locate an investor willing to accept significantly below-market returns."

"The vast majority of OZ capital appears to be flowing into real estate, not into operating businesses [which could lead to job creation], because of various program design constraints and the undesirability of selling equity from both the business owners' and the investors' perspective."

"Ultimately, most developers and investors view OZ incentives as providing a relatively small boost to overall returns. The OZ incentives have had mixed effects in terms of making projects work that would not otherwise happen. Some developers reported that the incentives did make a decisive difference in allowing a project to go forward, while others were clear that their project would have proceeded with or without OZ equity."

Kresge Foundation Model and Trepidations about OZs

An example of a mission-oriented developer discussed above by the Urban Institute has been the Kresge Foundation, which announced in March 2019 that it was committed to providing $22 million in investments to two goal-aligned investment managers, Arctaris and Community Capital Management, which agreed to covenants committing them to develop affordable housing, create living wage jobs, prohibit displacement, and form community advisory boards.

Unfortunately, as early as June 2019, the Kresge Foundation signed on to a letter from the U.S. Impact Investment Alliance which states:

"…this transformative tax break could leave residents and communities vulnerable to displacement. These residents understandably fear losing their voice in defining their economic futures. Meanwhile, there is no guarantee capital will flow to the most distressed neighborhoods, or to the projects that are best for those who work and live there. Indeed, many such Opportunity Zones are at risk of losing out and falling further behind, while Zones in already-gentrifying parts of urban areas like New York City or Washington, D.C., continue to draw the lion's share of development capital."

In 2021 Aaron Seybert, managing director of social investments at the Kresge Foundation remarked:

"We have always and continue to want this incentive to succeed, but we continue to have trepidations about that. Those fears have only grown as we hear directly from people in communities who say the incentive is causing more harm than good.

OZ doesn’t require measurement, accountability or tracking of any impact beyond dollars in; it rewards appreciation regardless of social impact. This is not a worthy measure. If millions go into a community, but they’re invested into liquor stores, storage units, and condominiums that price people out of housing opportunity, are the people who live there any better off? OZ is just the latest example of policymakers and investors doing something *to* low-income communities rather than *with* them.

When Kresge issued an RFP in 2017 with the Rockefeller Foundation to source ideas on how to crowd in capital to the most distressed Zones, we received more than 150 proposals. But most came from potential fund managers with little to no experience working in these communities. Very few had insight on how they would incorporate things like community voice into their processes, how they would align projects with community-identified needs, how they would invest in small businesses, or how they would include long-term job creation in their investment plans.”

Mr. Seybert concluded:

“In short, I trust our community partners who have been investing in low-income communities far longer than OZ has been around. The majority tell me it’s not working for them, and, in some cases, it’s making their work harder. The news-friendly bright spots are a tiny fraction of capital flowing through this incentive. I’m not interested in continuing to evaluate OZ by anecdote when there are likely billions in investments we will never know about. We can no longer put lipstick on the proverbial pig. The downside risk is too great for the communities Kresge serves. We need full transparency into OZ, we need some level of local accountability for the capital invested, and we need better evidence that the tool can deliver against community needs at scale. Without these, I don’t think the incentive should continue to exist at all.”

Testimony Before the Oversight Subcommittee of the House Ways and Means Committee, November 16, 2021

Brett Theodos, Senior Fellow at the Urban Institute

“In the years since Opportunity Zones’ inception, it has become increasingly clear that their structure is preferenced against operating businesses, against smaller and rural projects, and against the types of mission-aligned projects that could deliver maximum community benefit. Although the incentive can be used to finance projects that yield community benefit, the fundamental design of the incentive makes doing so challenging at best and often impossible. As such, when Opportunity Zone projects have been impactful, they have (1) succeeded after substantial concessions and wrangling; (2) relied on highly altruistic investors who have forgone larger returns; or (3) drawn on other substantial federal, state, and local subsidies to make projects work. **The Opportunity Zone program is not standing on its own two feet to produce impact or reach communities the private market is not already serving**.” (emphasis added)

“Unfortunately, based on our interviews of people involved in Opportunity Zone projects and attempted projects to date, the structure of the incentive appears to be least workable for the projects that could have the greatest impacts on equitable development.”

Opportunity Zones disadvantage high-impact projects in several ways, including:

- The tax exemption on Opportunity Zone projects is structured to provide the largest financial benefits to the projects that provide the highest returns, rather than rewarding impact investors who are willing to support projects with large social impacts. Luxury housing in appreciating neighborhoods, therefore, may receive much larger public support than, say, affordable housing projects.
- The 10-year time horizon of most Opportunity Zone investments is not long enough for many beneficial projects, such as affordable housing, health care centers, or schools. This causes equitable development project sponsors to scramble to put together refinancing plans that may not work in a future interest rate or real estate market environment. Conversely, the 10-year time horizon is too long, too illiquid, and too fixed to encourage non–real estate business investments.
- The financing that Opportunity Zones is designed to promote is poorly suited for most equitable development uses. Despite its expense to the US Treasury, the incentive is a rather shallow subsidy or boost to return on the front end (through the temporary deferral and step-up in basis), while the permanent exclusion of gains is speculative. As such, Opportunity Zones largely promote market-rate private equity investment in multifamily and commercial and industrial real estate. But disinvested rural and urban Zones have complex and long-standing challenges that often require a deeper subsidy than Opportunity Zones can provide. Communities need small businesses that will create quality jobs as well as community resources such as affordable housing, schools, childcare centers, and health care. Market-rate private equity for real estate is a poor vehicle to deliver these kinds of investments. It is unlikely that Opportunity Zone financing alone can unlock the small business growth or the development of community institutions and amenities that is needed to promote sizable job creation or equitable growth.

“Early evidence reveals the effects of these limitations on Opportunity Zone activity. This year, research from the Congressional Joint Committee on Taxation revealed the uneven distribution of Opportunity Zone activity in designated census tracts across the country. Overall, Opportunity Zone capital has been ‘highly spatially concentrated … directed toward the real estate and construction sectors, and gravitates toward tracts with relatively higher educational attainment, income, density, and preexisting upward income and population.’ The Zones that attracted Opportunity Zones investment dollars were far more economically robust than the substantial number of Opportunity Zones that received $0 in Opportunity Zone investment. To date, 51 percent of Opportunity Zone dollars have been invested in real estate firms, while 9 percent have been invested in construction firms, 9 percent have been in finance, and 7 percent have been in property owned or leased directly by Opportunity Funds. Perhaps most striking, just 1 percent of Opportunity Zone tracts account for 48 percent of total investment, and 5 percent of Opportunity Zone tracts account for 87 percent of total investment."

Mr. Theodos' testimony includes a footnote from an April 12, 2021 paper by Patrick Kennedy and Harrison Wheeler, *Neighborhood-Level Investment from U.S. Opportunity Zone Program: Early Evidence* that further supports the above quote. The authors write, "We find that OZ investments are highly spatially concentrated in a relatively small number of census tracts [84% of designated Opportunity Zone tracts in our sample receive zero OZ investment] and are heavily concentrated in the real estate sector. Among tracts designated as OZs, investors favored neighborhoods with higher income, educational attainment, home values, and pre-existing population and income growth. These neighborhoods have also experienced significant changes in their demographic composition over the past decade, with increasing shares of college educated adults and declining shares of non-white residents."

David Wessel, Director of the Hutchins Center on Fiscal and Monetary Policy, Senior Fellow in Economic Studies, Brookings Institution

"Nothing in law or regulation requires OZ investors to put their money into those [OZ] census tracts that really need the money or into projects that will benefit the people who live in the zones. The available evidence and my reporting suggest that the bulk of the money is going to real estate projects that would have been done otherwise or projects that will not do much to improve the lives of the low-income residents of the zones. Proponents and drafters of the Opportunity Zone legislation were so determined to make the tax break attractive to wealthy investors and so allergic to oversight from Washington -- which they argued limited the effectiveness of other place-based policies -- that they avoided the guardrails and oversight that might have directed more money to places and people most in need of private investment. They also underestimated the cleverness and aggressiveness of the huge industry of accountants, lawyers, wealth advisers and real estate fund managers who find every possible way to exploit the tax code to save their clients' money. I fear that when we finally get all the data, we will learn that Opportunity Zones did more to cut taxes for the wealthy than to improve the lives of people who live in the zones."

Mr. Wessel's testimony also cites the Patrick Kennedy and Harrison Wheeler paper, adding, "The preliminary descriptive evidence suggests that OZ capital may disproportionately benefit a narrow subset of tracts in which economic conditions were already improving prior to implementation of the tax subsidy." Mr. Wessel notes that "This is not surprising: Most (though not all) investors are looking for the highest return with the lowest risk rather than the highest social return. There is no requirement or even incentive for OZ funds to create new, good jobs for zone residents or increase the supply of affordable housing. Almost anything goes. So we get hotels, condos, self-storage facility and high-end student housing."

Prior to testifying, in an interview Mr. Wessel offered observations

This is a story about a tax break conceived as a way to help poor folks that was designed and implemented, in my view, in a way that made it easy for legions of accountants, tax lawyers, financial advisors, and money managers to exploit, to cut taxes for their wealthy clients without having to show or even assert that these investments actually lift up the communities in which they are located. [It is also] a story about what happens when there's such antipathy to government oversight and no requirement that a provision like this be used for its stated purpose, that you get condos, office towers, self-storage facilities, luxury housing, and census tracts that qualify only because the census counts college kids as poor since they don't have any income.

"By design, this program allows investors to cherry-pick the best, most profitable projects."

Recommendations from Experts

For all of the following, Treasury should take the initiative, and Congress should act if Treasury cannot (due to legal reasons) or will not.

Get better data. Treasury should require QOFs to provide basic data about OZ transactions, such as: where are OZ funds going and how much is going to each OZ, what types of projects are developed, and who benefits (by various categories). This information should be publicly available.

Make OZ more like a "program," not merely an "incentive." An agency such as Treasury's Community Development Financial Institution (CDFI) Fund should have administrative authority over OZs to ensure proper oversight of QOFs and to properly collect, aggregate, and share data about investments with the public. The CDFI Fund is tasked with similar responsibilities for the New Markets Tax Credit and has thus already developed the necessary capacity and competencies.

Provide bigger OZ capital gain tax breaks for projects in the most economically depressed communities. That will provide more OZ money to places that really need it. The one-size-fits-all approach will direct money to places already attractive to investors.

Limit the projects for which the OZ capital gain tax break can be used. Federal tax expenditures should not be used for projects such as self-storage facilities, luxury hotels and housing, or upscale shopping districts. And, for real estate investments, which are the bulk of OZ projects, Congress should adopt a more narrowly defined set of community needs. For instance, only allow real estate transactions involving an operating business that is owner-occupied, or commercial and industrial real estate in tracts with high vacancy rates, and housing sold or rented at below-market prices.

Size the OZ capital gain tax break based on social impact. Evidence from the Joint Committee on Taxation suggests that OZs investments are concentrated in less distressed zones and high-return real estate projects. Congress can address this, for example, by deepening the step-up in basis with very strict conditions. The step-ups could be further targeted and differentiated by the level of economic distress of OZs. The best-off zones might get no step-up in basis, the next tranche of zones could receive a 5% step-up in basis, and so on.

Rather than providing the largest OZ capital gain tax breaks to the most profitable projects regardless of their social impact, the capital gain tax breaks should instead depend on project impacts. By targeting OZ capital gain tax breaks to investments with the greatest impacts, investments could be more deeply subsidized while more efficiently using total federal tax expenditures. OZ capital gain tax breaks could be based, for example, on the number of quality jobs created by an OZ investment.

Require a rigorous certification process to qualify as a Qualified Opportunity Fund (QOF). A Qualified Opportunity Fund does not have to even assert that it is helping low-income people or communities. All that a QOF has to do is file an IRS form self-certifying that it is an investment vehicle organized as a corporation or partnership for the purpose of investing in QOF property and that it holds 90% of its assets in QOF property. Treasury should require QOFs to demonstrate an intention to and plausible mechanism for investing in projects that provide genuine community benefit, and to adhere to disclosure and reporting requirements and community engagement processes.

Support mission-driven QOFs that are accountable to the community. Congress should support mission-driven actors, such as community development financial institutions (CDFIs), reforming the OZ capital gain tax break to give preferential treatment to CDFI-controlled and other mission-driven vehicles. CDFIs, for example, have a long track record of making substantial investments in low-income communities, and are accustomed to taking on higher risks than conventional investors and to working with the kind of investees who have been struggling to access OZ capital, such as small businesses and less sophisticated developers. CDFIs have successfully mitigated such risks by providing hands-on technical assistance to their investees. A major constraint to increasing the impact of CDFIs has been the lack of equity to capitalize them. A redesigned OZ capital gain tax break could encourage equity investments in CDFIs that set up Qualified Opportunity Funds.

Better support investment in small businesses. Very little OZ investment is going to small businesses, the group of investees the OZ capital gain tax break was supposed to most benefit. Policymakers could change OZ to support subordinated or hybrid debt or equity products for small businesses, rather than pure equity. Policymakers could also grant greater flexibility around certain program rules for mission-driven funds that specialize in small-business investing.

Broaden who can invest. Other actors such as foundation endowments and pension funds have substantial resources and are most likely to consider community investing, compared to many capital gain holders, if an incentive can be structured to engage them.

Revisit zone designations. Redesignate OZs based on the most current Census data to avoid designating census tracts that seemed "low-income" due to out-of-date Census data but had improved demographically and were experiencing economic gains. Remove OZs that originally gained designation based on such out-of-date data, and phase out the OZ capital tax gain break for any projects not yet initiated. OZ designation should be subject to public comment before becoming final.

Remove all contiguous tracts, those that did not meet the low-income threshold but were eligible because they bordered low-income tracts.

Allow only investments that pass a "but for" test. Most project sponsors the Urban Institute interviewed in 2019 and 2020 reported that OZs were not critical for filling a financing gap or increasing the social impact goals of their venture. This means the federal government may be subsidizing investments that do not need the help. Some other federal community and economic development programs have "but for" or "substitution" tests. By restricting the OZ capital gain tax break to projects that could only proceed with the additional help of the OZ capital gain tax break, the total cost of the OZ capital gains tax break would be reduced, and federal tax dollars would be reserved to incentivize new development that could not have been generated by the private market alone.

Past Congressional Efforts

As early as June 2018, Senator Corey Booker (D-NJ), an original champion of OZs, wrote to Treasury urging stronger regulations to ensure low-income communities benefit from OZs. Some of Senator Booker's recommendations include:

- Annual reporting including an assessment of the impacts and outcomes of the investments, such as job creation, poverty reduction, and new business starts.
- Requiring each state to have a publicly accessible resource that provides information about the program's implementation.
- Requiring each prospective Opportunity Fund to provide a straightforward statement of intent as a condition of receiving QOF certification.
- Developing a rigorous list of positive and measurable community development outcomes to evaluate a QOF's performance. At the certification stage, each QOF should be able to make a commitment to a number of these outcomes.
- Developing a clear and concrete definition of abuse to discourage projects that do not benefit low-income people and communities.

Senator Booker followed that up on April 7, 2019, sponsoring S.1344, which would strengthen OZ reporting requirements and specifically require Treasury to collect data on QOFs and their impact on low-income communities.

Senator Ron Wyden (D-OR) introduced S. 2787 on November 6, 2019, which would establish annual reporting requirements and penalties for failing to file or filing reports with incorrect information. It would prohibit investments in certain luxury assets, including private planes, sports stadiums, self-storage facilities, and luxury rental properties. It would also terminate designations of contiguous communities that are not low-income as opportunity zones.

Representative James Clyburn (D-SC) introduced H.R. 5042 on November 12, 2019, which would disqualify a census tract that had a median family income greater than 120% of the national median income. It would also eliminate non-low-income contiguous tracts. In addition, rental property would not qualify unless 50% or more of the residential units are both rent-restricted (following the Low Income Housing Tax Credit rules) and occupied by individuals whose income is 50% or less of area median income. Stadiums, parking facilities, and self-storage facilities would not qualify.

Representative Henry Johnson (D-GA) introduced H.R. 4999 on November 8, 2019, which would not qualify rental housing unless 20% of the units were occupied by households with income no greater than 30% of AMI or 200% of the poverty line. The bill would also require QOFs to have an investment advisory board and meet certain investment diversity requirements.

Representative Rashida Tlaib (D-MI) introduced H.R. 5252 on November 22, 2019, which would eliminate OZs.

Other bills introduced would have expanded how the tax incentive could be used. For example, H.R. 6529 would designate small businesses affected by Covid-19 as qualified Opportunity Zones businesses, and H.R. 7262 would encourage Opportunity Funds to invest in Community Development Financial Institutions.

In 2021, Republicans introduced 2 bills. Representative Michelle Steele (R-CA) introduced H.R.4608, which would create subsequent rounds of OZ designation, starting January 1, 2027, with additional designations every ten years, effectively extending the date by which investors in QOFs can exclude 10% of capital gains after holding an investment for five years from December 31, 2026. Representative Jim Hagedorn (R-MN) introduced H.R. 4147 to increase the percentage of OZs that states could designate from 25% to 30%, which would create an estimated 950 additional OZs. The bill would also extend the OZ capital gain tax deferral date to 2029.

Ultimately, no bills modifying the OZs have passed.

Funding

The Opportunity Zones capital gain tax break is not funded through federal appropriations; it is a “tax expenditure,” resulting in the federal government losing tax revenue. The Joint Committee on Taxation estimates that OZ tax expenditures will total $8.2 billion between 2020 and 2024.

Forecast for 2022

On December 20, 2021, nine Democrats on the U.S. House of Representatives’ Ways and Means Subcommittee on Oversight sent a letter asking Treasury to consider three changes to OZ requirements: implement a rigorous certification process for QPOs, allocate a dedicated agency staff to oversee OZs, and require transaction reporting separate from tax forms.

Senator Ron Wyden (D-OR) and Chair of the Senate Finance Committee sent letters to several billionaires on January 13, 2022 demanding information to determine whether they are abusing OZs.

For More Information

The IRS Opportunity Zones webpage, https://bit.ly/3GXNEle

The Center on Budget and Policy Priorities, https://bit.ly/3rQKny1

The Urban Institute, https://urbn.is/3rPAY9B

The Brookings Institution, https://brook.gs/3H2sUsO

ProPublica, https://bit.ly/344Ewg6