Memorandum

To: Secretary Steven Mnuchin, U.S. Department of Treasury
From: Scott Traum and Julia Kortrey
Date: May 6, 2019
Subject: Recommendations for Improving Efficacy of Qualified Opportunity Zones

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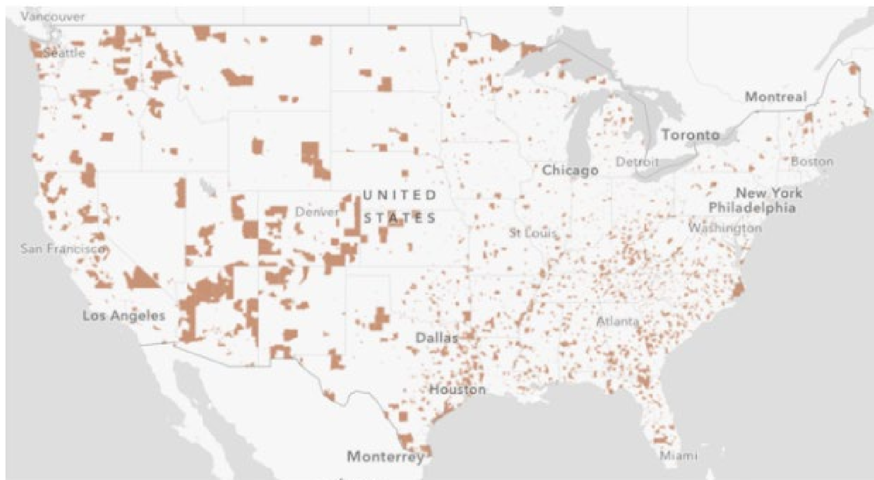
Executive Summary:
This memorandum makes three key recommendations to improving the administration of tax incentives for Opportunity Zones (OZ): improve targeting of Qualified Opportunity Funds (QOF) to neighborhoods that are in need of investment; address the disparity in investments between urban and rural areas; and increase oversight of QOF by aligning with existing investor requirements for other place-based incentives (e.g., New Market Tax Credits) in order to limit potential waste, fraud, and abuse. Previous place-based incentives have found mixed results on the net impact on affected neighborhoods and their respective regions, and these recommendations seek to mitigate some of the known challenges of these incentives. This memo uses Washington D.C. as a case example to illustrate the need for these recommendations.

Background:
OZ tax incentives are a place-based economic development tool established by the Tax Cuts and Jobs Act of 2017 and are designed to redirect unrealized capital gains into economically distressed communities with the goal of spurring revitalization and long-term investment (Investing in Opportunity Act 2017). Eligible census tracts must either meet the requirements of being a qualified low-income community (LIC) as defined by the New Market Tax Credit (NMTC) program or be a census tract that is bordering a LIC with a family median income no more than 125 percent of the LIC family median income (CRS 2018). On April 20, 2018, governors nominated up to 25 percent of these eligible tracts to be designated by the U.S. Treasury as OZs. Of the 42,176 eligible tracts, 8,762 were selected as OZs (Economic Innovation Group 2018). Figure 1 shows a map of the OZs in the continental United States.

Figure 1: Map of Designated Opportunity Zones



Source: Economic Innovation Group

Like the Empowerment Zones (EZ) of the early 2000's, OZ tax incentives offer significant federal tax breaks to investors who reinvest capital gains in designated zones. The OZ program is estimated to be the largest investment in local economic development by the U.S. federal government ever with the Joint Committee on Taxation estimating that the program will cost $1.6 billion in lost revenue over the next 10 years (Joint Committee on Taxation 2017). New regulations extend benefits to 2047 and these projected costs are unknown (Eastman & Kaeding 2019).

In the past, these types of localized tax breaks have had some success in the designated areas. Proponents of OZ tax incentives often point to economic improvement in areas that receive the benefit. For example, a 2001 U.S. Department of Housing and Urban Development (HUD) assessment of the EZ Program found a nine-percentage point jump in job growth rates in EZ areas versus comparison cities (Hebert et al. 2001). However, as discussed in the next section, there are many flaws in place-based incentives that must be rectified to help ensure a successful implementation of OZ.

Specific Tax Incentives of OZ's

The OZ program offers three major tax incentives to spur investment in low-income communities through QOF. Each is designed with the intent to encourage long-term capital investments in economically distressed communities across the nation. Each component of the tax expenditure relates to the treatment of capital gains and increases in value the longer an investment remains in the QOF. Below are the three specific tax breaks (Economic Innovation Group 2018):

1. **Temporary Deferral:** Capital gains that are reinvested into the QOF are untaxed until 2026;
2. **Step-up in Basis:** Exclusion of up to 15 percent of capital appreciation that increases over time; and
3. **Permanent Exclusion:** If an investment is held for at least 10 years, investors do not pay capital gains tax on profits from QOF.

Comparison to New Market Tax Credits

New Market Tax Credits (NMTC), which have existed for nearly 20 years, provide an instructive example for improving the targeting and oversight of OZs (See Table 1). The NMTC program provides non-refundable tax credits to private investments in eligible, low-income communities (Marples & Lowry 2016). The tax credits are awarded in a competitive process in which demand exceeds supply due to capped funding; this means that, in theory, the competitive process can help only the best projects receive funding, compared to the unlimited budget of OZs that will not encourage competition among investors. NMTC applicants are also required to demonstrate that their project has positive community outcomes both at the time of investment and afterward by fulfilling of number of reporting requirements, whereas OZs do not. Additionally, NMTC must be overseen by a lead agency (intermediary) whose primary mission is investing capital to low-income communities; these connections to both the community and community development agencies are critical to helping ensure the investment is good for the community and makes it easier for communities to plan and structure investment. These program guardrails have helped preserve program integrity and responsible financial stewardship of the program (Marples & Lowry 2016).

Table 1. Comparison of Opportunity Zones and New Market Tax Credits

Category	Opportunity Zones	New Market Tax Credits
Funding	Unlimited	Capped $3.5 billion per annum (thus demand exceeds supply)
Application Requirements	Broad range of potential projects, regardless of their potential "community" outcomes	"Community outcomes," including benefits to low-income persons and jobs created due to investment
Reporting	None beyond tax filing	Outcome-based reporting and compliance requirements
Lead Agency Requirements	QOFs are not required to be mission-oriented	CDE must have a primary mission of investing capital to low-income communities; governing or advisory board holds CDE accountable

Flaws of Opportunity Zones

The following are major flaws in OZ tax incentives that must be addressed when administering the policy:

1. **Place-based tax incentives do not create jobs.** Research on place-based economic development policy finds a negligible effect on job creation; rather, the observed growth in designated neighborhoods is largely the result of jobs that are redirected from surrounding areas. While this type of shifting could be good policy if correctly targeted to areas in need of investment, policymakers should be aware that OZ tax incentives do not create many new jobs. In fact, numerous reports caution states on the unintended consequences of both job creation and destruction within metropolitan regions (Peters & Fisher 2002). Conversely, if the policy is targeted to neighborhoods that are currently receiving private investment, OZ's could be counterproductive in their mission and further shift investment away from the areas that are most in need.

2. **Place-based tax incentives do not alleviate poverty.** As currently constructed, OZ tax incentives are designed as a subsidy to wealthy individuals and corporations. In theory, targeted communities will benefit from the economic growth generated by the inflow of capital. However, the value of the subsidy is dependent upon increasing property values, higher rents, and capital appreciation. Further, the policy includes no provisions intended to promote the hiring of local residents or preserve affordable housing (Looney 2018).

3. **Poorly designed place-based tax incentives waste, fraud, and abuse.** The design of OZ tax incentives leaves the potential for tax sheltering and other loopholes that encourage tax avoidance, leading some critics to call OZ's "mini tax havens for the rich" (Ajilore 2018). The U.S. Treasury does not require that a qualifying business maintain 100 percent of its

assets in the OZ. As a result, only 63 percent of total capital invested must actually flow through the targeted neighborhood for the investor to receive the full tax break (Rubin 2018). There are additional concerns surrounding the treatment of intangible property that may result in accounting gimmicks that artificially inflate the economic activity in an OZ. This type of gaming will allow businesses to claim the benefits of OZ tax incentives while adding little of value to the community.

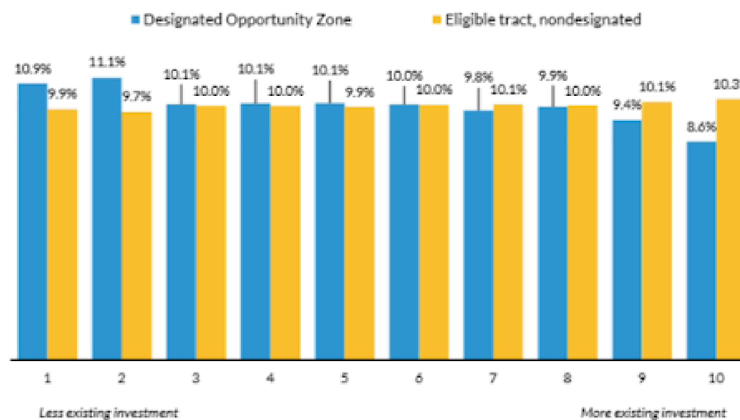
OZ regulations also lack sufficient guardrails to ensure that incentives are used appropriately. There is no cap on the amount of tax benefits a qualified investor can receive; potential for community outcomes is not considered in the approval of qualified investments; and there are no outcome-based reporting and compliance requirements for investors. In contrast, NMTC – a similar program about which many developers are familiar – has all of these guardrails to protect the integrity of the program.

Recommendations

1. Apply measure of previous investment and socioeconomic change when designating OZs to ensure policy is best targeted to communities that are most in need.

A common criticism of place-based tax incentives is that they unnecessarily incentivize investments that would have occurred without their presence; leaving the nomination process up to the governor's discretion allows for the selection of zones that may already be on their way to development because of past policies and/or naturally changing demographics. A study by the Urban Institute analyzed the governor's selection of OZs by access to investment and found almost no discernment by this measure. Only 4 percent more OZs were selected from low investment tracts than from high investment tracts. Figure 2 below shows the breakdown of designated OZ's and non-designated eligible tracts by access to investment.

Figure 2: Comparison of Designated and Non-designated Opportunity Zones by Level of Investment



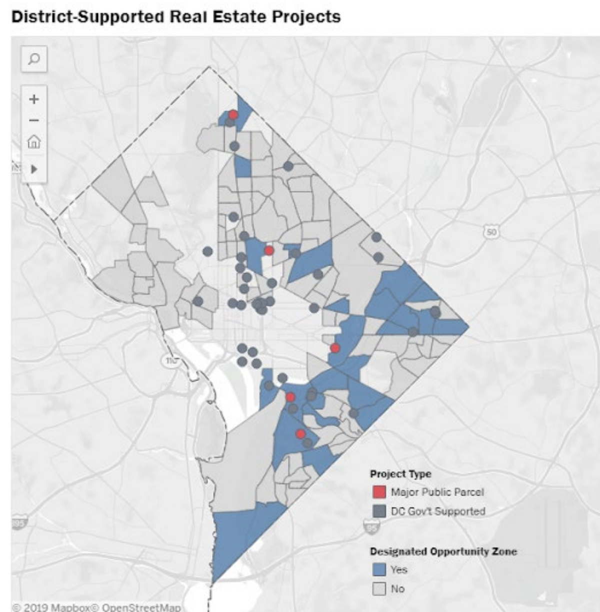
Source: Urban Institute

The study also found major state-by-state variation in selection of OZ's relative to the tract's access to outside investment. Areas that were already experiencing economic development were more likely to designate zones that had greater access to capital. Perhaps the best example of this is Washington, DC, which was recently found to have the highest intensity of gentrification in the United States (Richardson et al. 2019). While the Mayor of Washington, D.C. – who has

nomination authority in this position – engaged the community in the decision-making process, she still chose many census tracts that are already experiencing heavy investment (Office of the Deputy Mayor for Planning and Economic Development 2018). According to the Urban Institute, "more than 44 percent of Opportunity Zones designated in the greater D.C. region already receive high levels of investment" and 32 percent have recently gentrified (Theodos & Meixell 2018).

Moreover, there appears to be significant overlap between the District's designated OZ's and pre-existing or planned real estate projects – some of which receive government support in the form of spending or tax breaks (Zippel 2018). For example, Audi Field, home of the Major League Soccer team D.C. United, currently resides in an OZ. The construction of the 20,000-person stadium was confirmed in June of 2015 with a commitment from the D.C. Council to provide over $150 million in funding for its construction (Neibauer 2015). Since that time, the area has experienced significant development, much of it prior to its designation as an OZ. The map (Figure 3) below shows the overlap between DC's designated OZ's and other major land projects.

Figure 3. Map of Designated Opportunity Zones and Other Major Public Projects



Source: DC Fiscal Policy Institute

Additional tax incentives are not only unproductive in these types of neighborhoods but can also exacerbate the negative effects of gentrification. This is particularly concerning as the District of Columbia and other urban areas are facing a housing affordability and homelessness crisis. Instead, the District and other states should have been more discerning in the targeting of their development policy to help ensure that economic growth is shared equitably throughout the region.

In order to avoid subsidizing areas no longer in need of further subsidizing like these areas in D.C., the Treasury should consider applying a measure of previous investment and

socioeconomic change when designating OZ's to better ensure policy is best targeted to communities that are most in need.

2. Address investment disparity between urban and rural areas.

In its current status, OZs do not sufficiently enable rural OZ areas – which comprise 40 percent of OZs – to compete with urban OZ areas (Farmer 2019). OZs in urban and large metropolitan areas tend to have a number of distinct advantages over more rural areas, such as a more educated workforce, access to public transit, and a growing regional population (with demographic trends shifting toward people moving back into cities). Since OZs do not account for these differences, rural OZs are pressured to offer more incentives than they can afford to companies that may not want to take a risk investing in harder to revitalize areas. Numerous media reports have catalogued the disparities between OZ investment in rural areas compared to urban areas (e.g., Farmer 2019, Charles 2019). For example, Florida's Opportunity Zone program has reported very little investment in its rural OZs while money has flowed into urban areas (Farmer 2019). The Treasury should consider creating different programs or rules for rural communities to facilitate more parity in investment. Similarly, the federal government could increase tax incentives for rural areas.

3. Increase oversight and enforcement to improve program integrity.

The current administration of OZ tax incentives must be improved in order to protect against waste, fraud, and abuse. And as the largest investment in place-based tax incentives with nearly 9,000 designated tracts, it is a prime target for unsavory investors and poor local government management to take advantage of the system.

First, the Treasury must more clearly define qualifying investments to ensure real investments into the community are being made and to prevent tax sheltering and other loopholes that encourage tax avoidance. Second, the Treasury should consider implementing the same guardrails against waste, fraud, and abuse as are in the NMTC program. This means instituting a cap on the amount of tax benefits a qualified investor can receive, ideally tying limits to changes in levels of investment within the respective census tract. Additionally, proposed investments should be evaluated based on the expected community outcomes to ensure that incentives are going to the intended investments. Finally, the complete absence of outcome-based and compliance reporting must be remedied to both ensure the integrity of the program and render the program evaluable. Because these standards already exist in the NMTC and are familiar to investors, adding these measures will not create significant burdens for investors.

Conclusion

OZs are one of the most expansive economic development policy tools in a generation and have the potential to transform neglected and low-resourced communities. However, improvements in administration, oversight, and enforcement are necessary to avoid the pitfalls that have fallen previous place-based incentive programs. Better targeting of QOF and policy alignment with other successful programs like the NMTC are critical to the success of OZs.

Works Cited and Bibliography

Ajilore, Gbenga. 2018. "How a Tax Break Meant for Low-Income Communities Became a Mini Tax Haven for the Rich." Center for American Progress. TalkPoverty.org. Center for American Progress Retrieved from: https://talkpoverty.org/2018/12/13/tax-break-low-income-opportunity-rich/

TalkPoverty.org is a project by the Center for American Progress that posts stories of living in poverty and provides data-driven analysis on policy topics related to poverty. This article examines different ways that wealthy investors have benefited from the lack of oversight associated with OZ's.

Charles, J. Brian. "In the Zone." (February 19, 2019). *Governing.com.* Retrieved from: https://www.governing.com/topics/urban/gov-federal-empowerment-zones.html

This long-read article provides a narrative of a post-industrial city, York, PA, struggling to attract new investment and capitalize on the benefits of Opportunity Zones.

Congressional Research Service. 2018. "Tax Incentives for Opportunity Zones: In Brief." CRS Report. Retrieved from: https://fas.org/sgp/crs/misc/R45152.pdf

The Congressional Research Service is the public policy research arm of the U.S. Government. This is their brief on OZ's, and we use it to provide background information on the policy.

Eastman, Scott & Nicole Kaeding. 2019. "Opportunity Zones: What We Know and What We Don't." Tax Foundation. *Fiscal Fact.* No. 630 (January 2019). Retrieved from: https://files.taxfoundation.org/20190107155914/Opportunity-Zones-What-We-Know-and-What-We-Don%E2%80%99t-FF-630.pdf

The Tax Foundation is a leading independent think tank with a mission to inform smarter tax policy at the federal, state, and local level. This paper analyzes the OZ policy and outlines the effects of the policy that are stated in the regulations. However, it also delves into the parts of the policy that are intentionally vague and highlights areas of future uncertainty.

Economic Innovation Group. 2018. "Opportunity Zones: A New Economic Development Tool for Low-Income Communities." *Guidance for Governors* (February 2018). Retrieved from: https://eig.org/wp-content/uploads/2018/02/Guidance-for-Governors-FINAL.pdf

The Economic Innovation Group is a think tank that is credited with the idea for the Opportunity Zone in its current form. This is a letter that provides guidance to state governors' offices that describes the selection process to designate OZ's and the specific tax breaks that are offered to businesses that invest in QOF.

Farmer, Liz. (April 19, 2019). "Investors Are Hesitant': Rural America Might Miss Out on 'Opportunity Zones." Governing.com. Retrieved from: https://www.governing.com/week-in-finance/gov-opportunity-zones-rural-communities.html

This article provides commentary on the challenges rural areas are having in attracting investors to their opportunity zones. It provides sound bites from a number of OZ groups and other community-focused stakeholders.

Hebert, Scott, Avis Vidal, Greg Mills, Franklin James & Debbie Gruenstein. 2001. "Interim Assessment of the Empowerment Zones and Enterprise Communities (EZ/EC) Program: A Progress Report." US Department of Housing and Urban Development. Office of Policy Development and Research. Publications (November 2001).
As part of the Omnibus Budget Reconciliation Act of 1993, Congress established the Empowerment Zone and Enterprise Community programs to spur economic development. This is a place based economic development policy that is very similar to the current OZ policy and is an important point of comparison. This is a progress report by HUD that attempts to evaluate the effectiveness of the program, and finds that the program has resulted in job growth in designated areas.

Investing in Opportunity Act. 2017. S.293. (U.S.A). Retrieved from: https://www.congress.gov/bill/115th-congress/senate-bill/293?q=%7B%22search%22%3A%5B%22Investing+in+Opportunity+Act%22%5D%7D&s=4&r=2
This is the exact text of the provision in the Tax Cuts and Jobs Act of 2017 that outlines Opportunity Zones, how they are set up, and the specific tax incentives.

Joint Committee on Taxation. 2017. "Estimated Revenue Effects of the 'Tax Cuts and Jobs Act," as Passed by the Senate on December 2, 2017." JCX-63-17 (December 6, 2017). Retrieved from: https://www.jct.gov/publications.html?func=startdown&%20id=5047
The Joint Committee on Taxation is nonpartisan committee of Congress that consists of a professional staff of economists that is responsible for preparing official revenue estimates of all tax legislation. This is the revenue estimate for TCJA, including the projected cost of the OZ part of the legislation.

Looney, Adam. 2018. "Will Opportunity Zones help distressed residents or be a tax cut for gentrification." Brookings Institution. Retrieved from: https://www.brookings.edu/blog/up-front/2018/02/26/will-opportunity-zones-help-distressed-residents-or-be-a-tax-cut-for-gentrification/
The Brookings Institution is a leading independent think tank in the United States that provides education in economics, tax policy, and metropolitan governments. This article examines OZ policy and finds that the main result of the policy in cities will be to accelerate gentrification. Specifically, it notes that there are no provisions in the policy to preserve housing prices or ensure that new businesses hire people from within the distressed tract.

Marples, Donald J. & Sean Lowry. (August 31, 2008). *New Markets Tax Credit: An Introduction*. CRS Report. Retrieved from: https://fas.org/sgp/crs/misc/RL34402.pdf
This CRS report provides an overview of New Market Tax Credits, outlining the program's components, investment activities, legislative developments, and policy considerations since the program expires at the end of 2019.

Neibauer, Michael. 2015. "D.C. United stadium takes key step forward." *Washington Business Journal* (June 30, 2015). Retrieved from:

https://www.bizjournals.com/washington/breaking_ground/2015/06/d-c-united-stadium-takes-a-key-step-forward.html
This article reports that the DC Council unanimously approved the construction of the DC United stadium project and agreed to put forward $150 million.

Office of the Deputy Mayor for Planning and Economic Development. 2018. "How DC Designated Our Opportunity Zones." DC.gov. Retrieved from: https://dmped.dc.gov/page/how-dc-designated-our-opportunity-zones
This is a press release from the DC Mayor's Office that provides the public with the rationale for how the District selected its OZ's. Though they claimed to have removed outliers that already receive investment and to have gathered public input, empirical evidence suggests that many designated zones had access to investment.

Peters, Alan H. & Peter S. Fischer. 2002. "State Enterprise Zone Programs: Have They Worked?" W.E. Upjohn Institute for Employment Research. Upjohn Press Collection (41). Retrieved from: https://research.upjohn.org/up_press/41/.
Peter and Fisher attempted to evaluate the effectiveness of place based economic development programs by examining 75 different EZ's in 13 states. The author's attempt to employ a model that measures whether EZ's actually create jobs or simply redirect them from other areas. They find that much of the perceived success of these programs is job growth that would have occurred in other areas and is redirected to the EZ.

Richardson, Jason, Bruce Mitchell & Juan Franco. 2019. "Shifting Neighborhoods: Gentrification and Cultural Displacement in American Cities." National Community Reinvestment Coalition. *Gentrification Report*. Retrieved from: https://ncrc.org/gentrification/
The National Community Reinvestment Coalition released a report that examined gentrification trends in major metropolitan areas from 2000 to 2013. It found that at least 135,000 people were impacted by this trend. Washington D.C. was found to have the highest intensity of gentrification with over 40 percent of tracts listed as gentrified during the examined period.

Rubin, Richard. 2018. "New 'Opportunity Zone' Tax-Break Rules Offer Flexibility to Developers." *The Wall Street Journal*. Retrieved from: https://www.wsj.com/articles/new-opportunity-zone-tax-break-rules-offer-flexibility-to-developers-1539948600
This article reports on some of the intricacies of the OZ policy and details exactly how much investors must put into a QOF to qualify for the tax incentives. One of the more important revelations in the article is that only 65 percent of invested capital must actually flow through an OZ under the current regulations.

Theodos, Brett & Brady Meixell. 2018. "Are Opportunity Zones in the Greater DC area targeted to communities in need of investment?" The Urban Institute. Retrieved from: https://greaterdc.urban.org/blog/are-opportunity-zones-greater-dc-area-targeted-communities-need-investment
The Urban Institute is an independent think tank that performs economic and social policy research. This article evaluates the selection of OZ's in the Washington DC area and found that

many of the designated zones have already received some kind of previous investment or were in the process of gentrifying.

Zippel, Claire. 2018. "'Opportunity Zones' Will Sweeten District-Supported Real Estate Deals." DC Fiscal Policy Institute. *The District Dime: Going Beyond the Budget Book* (June 8 2018). Retrieved from: https://www.dcfpi.org/wp-content/uploads/2018/06/05.24.18-Opportunity-Zones.pdf
The DC Fiscal Policy Institute is a think tank that focuses on District specific policy issues. This article examines the Mayor's designation of OZ's and notes a substantial overlap between the chosen tracts and the city's pipeline of real estate projects.