Coates' Canons Blog: Federal Opportunity Zones: What Local Governments Need to Know

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Opportunity Zones are the latest effort by the federal government to encourage investment in low-income census tracts. The Tax Cuts and Jobs Act, enacted at the end of 2017, grants significant tax benefits to investors who reinvest their capital gains in designated "Opportunity Zones." The market potential is enormous, with some analysts estimating that trillions of dollars could be available for investment in these zones. The U.S. Department of Treasury has certified more than 8,700 Opportunity Zones nationwide and 252 in North Carolina. Local governments are now asking what they can do in order to take full advantage of the investment potential. This post answers some common questions asked by local government officials about Opportunity Zones and offers advice for next steps.

How do Opportunity Zones (OZs) work?

When a private investor sells property (real estate, stock, etc.) and earns a capital gain, the investor must typically pay federal capital gains taxes. However, if the investor instead turns around and reinvests the capital gain into designated "opportunity zone property," then the taxes due are deferred. That is, the investor doesn't have to pay those capital gains taxes until 2026 or the year the Opportunity Zone (OZ) property is sold, whichever is sooner. The longer the investor holds on to the OZ property without selling it, the greater the benefits.

- After holding the OZ property for 5 years, the deferred taxes are reduced by 10%.
- After holding the OZ property for 7 years, the deferred taxes are reduced an additional 5%. In 2026, the deferred taxes must be paid even if the investor continues to hold the OZ property.
- If the OZ property is held for even longer—ten years or more—then there will be no capital gains tax on any gain that is realized when the OZ property is sold.

See Internal Revenue Code §1400Z–2 (b)-(c) and the DFI resource page on Opportunity Zones for a more detailed explanation of the tax benefits for investors.

Must a local government submit an application to request an Opportunity Zone designation in its jurisdiction?

There is an important role for local governments to play in Opportunity Zones, as discussed later in this post, but it is not related to zone designation. The designation process is over—Opportunity Zones have already been designated in every state. Each state government was responsible for nominating census tracts to the U.S. Department of Treasury for designation as Opportunity Zones, as occurred in North Carolina. Although the OZ designation process is complete, the work of local governments has just begun. Now local governments must identify investment-ready (or "shovel ready") projects in designated OZs and put those projects in front of OZ investors. The affirmative steps for local governments to take are discussed in greater detail toward the end of this post.

Do local governments have reporting or other responsibilities under the Opportunity Zone program?

The OZ program is a tax benefit claimed by investors, not local governments. Private investors (not local governments) will be required to comply with reporting requirements set forth by the Internal Revenue Service, which is responsible for developing and enforcing regulations for OZ tax benefits. Unless requirements are imposed on local governments by their state government, local governments have no administrative, reporting, or regulatory responsibility for the OZ program.

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Will Opportunity Zones help local governments pay for public facilities such as streets, parks, and libraries?

Opportunity Zones provide a tax benefit to investors who reinvest their capital gains into “opportunity zone property,” such as “stock … partnership interest … or business property.” Publicly-owned government facilities are not “business property,” and local governments cannot receive OZ benefits because governments don’t pay taxes. OZs encourage the construction of *private* facilities, not public ones. Of course, a local government may eventually see some property or sales tax revenue from a private facility constructed in an OZ.

Will Opportunity Zones attract private businesses with jobs?

The OZ tax benefit was structured in such a way that it will favor real estate investments, not investments in operating businesses. As one venture capitalist put it, the legislation “was written by and for real-estate investors.” Real estate development does not bring new jobs—rather, it constructs space in which operating businesses can locate, and those operating businesses may bring jobs. There are some efforts underway to figure out how to use Opportunity Zones to support and encourage operating businesses to locate in Opportunity Zones, and those efforts should be followed. However, significant job creation is not expected to result immediately from the OZ tax benefit.

Can OZ projects receive cash incentives from local governments?

In a word, no. Real estate development projects rarely qualify for cash incentives, and operating businesses don’t qualify for cash incentives unless they promise to locate substantial “jobs and tax base” that “might otherwise be lost to other states.” See blog posts here and here for further legal analysis of cash incentives. Analysts say that Opportunity Zones won’t create new jobs, but rather will “move something you are already going to do” to a nearby Opportunity Zone.

Cash grants are probably not permissible, but OZ projects may qualify for existing property tax exemptions or exclusions (as opposed to cash incentives). For example, an OZ project that involves a historic landmark in North Carolina could qualify for the historic landmark tax exclusion. A project located on a brownfield site could qualify for the brownfields exclusion. Other existing tax exemptions and deferrals available in North Carolina are described here. Outside of North Carolina, other states are considering new tax exemptions for projects that locate in Opportunity Zones. Currently there are no special OZ-related tax exemptions in North Carolina.

Some OZ proponents have discussed the possibility of using OZ investments for affordable housing. If an OZ project involves affordable housing for low- and moderate-income (LMI) persons, then a local government may provide financial support for the project to the extent such support is necessary for the benefit of LMI persons. See this blog post on the topic: Local Government Support for Privately Constructed Affordable Housing.

Are there any drawbacks or concerns with Opportunity Zones?

The primary concerns expressed by analysts boil down to the following:

- There is a concern that new investment won’t benefit the populations currently residing in OZs. Analysts point out that there are no guidelines for investment, so OZ “investments may be lopsided, skewing toward the lowest risk developments” that don’t benefit the community. Higher-risk investments that low-income communities actually need—such as affordable housing and job opportunities for low-income persons—are unlikely to receive investment. As a preliminary Stanford Business School paper on OZs pointed out, “because Opportunity Zone investments are not required to demonstrate specific benefits to the existing local population, investors may select projects based solely on their financial return.”
- A related concern in strong markets (such as thriving large cities) is that the lack of guidelines requiring these investments to serve the needs of existing low-income residents means that Opportunity Zone investments could lead to gentrification and displace the low-income residents who currently live in those zones.
- Finally, Opportunity Zones outside of strong markets could see little or no investment. Analysts have looked back at similar tax programs in the past, such as empowerment zones and enterprise zones, that have failed to produce the promised results—and they predict that OZs could fall into the same pattern of providing tax breaks to projects that were already going to occur anyway.

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Opportunity Zone investors must follow strict timing guidelines—why should local governments pay attention to investors' timing issues?

Opportunity Zone investors must adhere to specific time limitations. Local governments should be aware of these timing issues so they understand why development partners may be pushing projects to meet those timelines. The timing requirements also emphasize the importance of having "investment-ready" or "shovel-ready" projects in Opportunity Zones—a potential role for local governments as discussed below. The key timing requirements are as follows:

- <u>Investors have 180 days to invest in an "Opportunity Fund" after earning a capital gain</u>. After an investor realizes a capital gain on a sale of property, in order to defer the payment of taxes on that capital gain, the investor has 180 days to create an "Opportunity Fund" (a fairly simple self-certification process for a sophisticated investor) or invest in an Opportunity Fund that has already been created. I.R.C. §1400Z–2 (a)(1)(A). (Note: there are other ways for an investor to defer paying capital gains tax, such as investing in another property through a "1031 exchange.")
- <u>An Opportunity Fund must hold 90% of its assets in Opportunity Zones within 6 months</u>. Once an Opportunity Fund is created, it must meet an investment test six months later. That is, after six months, an Opportunity Fund must have at least 90% of its assets invested in opportunity zone property or pay a penalty. I.R.C. §1400Z–2 (f)(1).
- <u>For real estate investments, the investor must "substantially improve" the property within 30 months</u>. Once an Opportunity Fund acquires opportunity zone property, it must use the property for a new business purpose or "substantially improve" the property within 30 months. Substantial improvement means that the Opportunity Fund invests at least as much as the property was worth when the Fund first acquired it. It does not mean that the improvement to the property is complete. I.R.C. §1400Z–2 (d)(2)(D).
- <u>Maximum tax benefit is available for OZ investments that occur before the end of 2019</u>. OZ investments held for less than 7 years will not receive the full 15% tax reduction. All OZ deferred capital gains must be paid by 2026. I.R.C. §1400Z–2 (b)(1). Accordingly, the full 15% tax reduction is available only to those OZ investments made before the end of 2019.

What next steps should local governments take?

With the understanding that OZ projects will be most attractive to investors if they are "investment ready" before the end of 2019, local governments across the nation are acting quickly to conduct planning and predevelopment activities to prepare projects for investment. At least one state is providing financial assistance to local governments for that purpose. As noted above, however, there is no guarantee that OZ investments will benefit the local community or serve public interests. Some local governments are therefore being proactive in securing key property and preparing it for investment in a way that meets public interests (as demonstrated by projects being completed by the School's Development Finance Initiative, see the tab "For Investors"). Thus, local governments seeking to be strategic and take full advantage of the program will want to do the following:

- Survey development opportunities in the jurisdiction to identify attractive "investment-ready" projects.
- Secure control of key property (property important to the community) not already under government control through an option to purchase (do not cede control of key property to speculators who are seeking to hold out or flip property without regard to public interests).
- Conduct planning and predevelopment activities to make key property "investment ready," consistent with public goals.
- Market those projects to as many OZ developers and investors as possible (do not allow property to be tied up by the first OZ investor to come along—if one developer or investor sees potential in the project, there will be others).
- Watch out for speculators and extractive Opportunity Funds that are not focused on public interests.
    - OZ developers will seek control of key property before they have secured sufficient capital to complete the project—make sure that the developer has secured financing for the project before conveying key property, and ensure that the local government can reacquire key property in the event the developer fails to perform.
    - One Opportunity Fund markets itself to investors as a fund that will seek additional government incentives for its projects, and nowhere are public interests mentioned. Local governments will certainly welcome the attention of OZ investors in distressed Opportunity Zones, but staff should remain aware that OZ investors are not necessarily concerned with local priorities or public interests, and nothing in the Opportunity Zone legislation requires them to be.

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If your local government does not have real estate development and finance experts on staff, or if current staff do not have sufficient bandwidth to prepare properties for investment on the timeline required for Opportunity Zones, consider augmenting staff capacity by hiring additional development experts on staff or engaging public interest entities such as DFI at the School of Government, which works only for local governments and their public interest partners.

Links

- www.sog.unc.edu/resources/microsites/development-finance-initiative/opportunity-zones
- docs.house.gov/billsthisweek/20171218/CRPT-115HRPT-466.pdf
- www.brookings.edu/blog/the-avenue/2018/06/18/the-race-for-economic-opportunity-is-about-to-begin-who-is-ready/
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- opportunityzones.stanford.edu/docs/Opportunity-Zones-Analysis-of-Policy-Implications-6_29_18.pdf
- www.citylab.com/equity/2018/05/the-problem-with-opportunity-zones/560510/
- choosecolorado.com/wp-content/uploads/2018/08/OppZone-1.pdf

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