OPPORTUNITY ZONES: A BOON FOR DISTRESSED RESIDENTS OR WEALTHY INVESTORS?

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Abstract

At the end of 2017, the federal Opportunity Zone program was created under the Tax Cuts and Jobs Act to address the nation's growing geographic inequality. This program expands on previously tested place-based policies and aims to stimulate economic activity by encouraging private investment. Specifically, the Empowerment Zones and New Markets Tax Credit prove to be useful analogs in understanding the potential impact of the new federal program. The Opportunity Zone program addresses earlier concerns regarding the underutilization, lack of strong incentives, and restrictive scope of these programs. The program offers stronger tax incentives—primarily, deferral and a permanent exclusion on future capital gains—and removes the need to use intermediary agencies for investors receive the tax benefits of this program. These changes are badly targeted to the intended beneficiaries and fail to tie the investor benefits strongly with the employment outcomes of the poor, long-term residents. In this note, the author argues that the expansion of investor benefits from previous programs and program flexibility are likely to miss the legislative intent of Congress and accrue to the wealthy.

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I. Introduction

On December 22, 2017, President Trump signed the Tax Cuts and Jobs Act (TCJA) into law—the first major bill overhauling the tax code in over thirty years.[2] The TCJA created Opportunity Zones (OZ) as part of an effort to encourage investors to realize approximately $2 trillion in capital gains that have accumulated since the end of the Financial Crisis of 2008, and to stimulate investment in distressed communities throughout the country.[3] Originally proposed by the Economic Innovation Group and enacted with bipartisan support, the program aims to grow businesses and revitalize qualified low-income communities that were left behind despite the general post-crisis

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[2] Act of Dec. 22, 2017, Pub. L. No. 115–97, 131 Stat. 2054 (amending Internal Revenue Code of 1986); WILLIAM G. GALE ET AL., BROOKINGS INSTITUTE, EFFECTS OF THE TAX CUTS AND JOBS ACT: A PRELIMINARY ANALYSIS 1, 1 (2018), https://www.brookings.edu/research/effects-of-the-tax-cuts-and-jobs-act-a-preliminary-analysis/ [https://perma.cc/7PYH-RXEK] (analyzing the preliminary impact of the Tax Cuts and Jobs Act).

[3] Press Release, Treasury, IRS Announce Final Round of Opportunity Zone Designations (June 14, 2018), https://home.treasury.gov/news/press-releases/sm0414 [https://perma.cc/C3Q5-JFB4] (quoting Treasury Secretary Steven Mnuchin, "Incentivizing private investment into these low-income communities can be transformational, stimulating economic growth and job creation across the country."); Jim Tankersley, *Tucked Into the Tax Bill, a Plan to Help Distressed America*, N.Y. TIMES, Jan. 29, 2018, at B1, https://www.nytimes.com/2018/01/29/business/tax-bill-economic-recovery-opportunity-zones.html [hereinafter Tankersley, *Tucked into the Tax Bill*] ("The people who invest in Opportunity Funds are able to minimize their tax burden through preferential treatment of capital gains. More than $2 trillion in unrealized capital gains are sitting on individual and corporate balance sheets across America . . . .").

recovery.[4] The Opportunity Zone Program (OZP) seeks to stimulate economic activity in distressed areas by offering tax incentives for investors—primarily, deferrals on capital gains tax liabilities and permanent exclusions of subsequent gains—in return for long-term commitments of capital in OZ properties and businesses.[5]

This note will assess the OZP in light of its own provisions and similar federal policies, and conclude that this federal program is likely to benefit investors rather than its apparent beneficiaries, the residents of the distressed areas. It further argues that the major flaw in the design of the OZP, unlike previous policies, is that the OZP fails to link the granting of its tax incentives to community benefits—primarily improvements in employment outcomes and investments in human capital.

The OZP follows a line of other federal "place-based" policies, which scholars David Neumark and Helen Simpson broadly define as "government efforts to enhance the economic performance of an area within its jurisdiction."[6] These policies seek to benefit disadvantaged people indirectly by stimulating economic activity.[7] The authors distinguish these place-based policies from "people-based" policies, which benefit disadvantaged populations directly without regard to geography or residence.[8] Familiar examples of people-based programs include housing vouchers, unemployment insurance, and tax credits for the working poor, i.e., the Earned Income Tax Credit.[9]

While people-based policies clearly target disadvantaged residents, economists rationalize place-based policies on the grounds that the newly generated economic activity creates efficient agglom-

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[4] Tankersley, *Tucked into the Tax Bill*, *supra* note 3, at 1 (identifying Republican Senator Timothy Scott and Democratic Senator Cory Booker, as well as House lawmakers from both parties, as sponsors of the Opportunity Zone program).

[5] *Id.* ("The law creates 'Opportunity Zones,' which will use tax incentives to draw long-term investment to parts of America that continue to struggle with high poverty and sluggish job and business growth.").

[6] David Neumark & Helen Simpson, *Place-Based Policies* 1, 1 (Nat'l Bureau of Econ. Research, Working Paper No. 20049, 2014).

[7] *Id.* at 1–2 (such as revitalizing a city's downtown or strengthening an industrial center).

[8] *Id.* at 1 (distinguishing place-based and people-based systems).

[9] *Id.* (identifying the earned income tax credit); Adam Millsap, *Should Government Help People or Places?*, FORBES (Sept. 7, 2018), https://www.forbes.com/sites/adammillsap/2018/09/07/should-government-help-people-or-places/#521b3a57da7e (listing other types of people-based programs).

eration externalities—third party benefits stemming from the co-location of people and businesses.[10] These externalities consist of reductions in transportation costs, gains from market-size effects, and information spillovers.[11] Market-size effects in the labor market, in particular, facilitate matching skills to jobs, provide opportunities for workers to specialize, and insure against the failure of a dominant employer.[12] Information spillovers occur when workers from different firms or sectors exchange information that increases productivity, such as industry best practices and patentable ideas.[13]

Within the range of place-based policies, Neumark and Simpson further distinguish between direct and indirect policies.[14] Direct place-based policies aim to increase economic activity in disadvantaged areas, whereas indirect place-based policies aim to increase access to more economically active areas for people living in disadvantaged areas.[15] Hiring tax credits, which reduces recipient employers' federal tax liabilities, are an example of a direct place-based policy; rental assistance vouchers and transportation-based policies, which reduce recipient residents' housing and transportation costs

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[10] David Schleicher, *City Unplanning*, 122 YALE L.J. 1670, 1687–88 (2013) (providing a theoretical background on agglomeration externalities, including information spillovers); Neumark & Simpson, *supra* note 6, at 6–8 (providing survey of literature on agglomeration externalities).

[11] David Schleicher, *supra* note 10, at 1687–88.

[12] *Id.* at 1687 (listing benefits of market-size effects in labor market).

[13] *Id.* at 1688 ("Firms and individuals like to locate near each other so they can learn from one another. . . . Patent applications cite other patents from the same region at a higher-than-expected rate . . . .").

[14] Neumark & Simpson, *supra* note 6, at 1.

[15] David Neumark, *Rebuilding Communities Job Subsidies*, *in* PLACE-BASED POLICIES FOR SHARED ECONOMIC GROWTH 71, 81 (Jay Shambaugh & Ryan Nunn eds., 2018) [hereinafter Neumark, *Rebuilding Communities*] (citing to work and characterizing direct and indirect place-based policies).

respectively, are examples of indirect place-based policies.[16] The OZP falls within the category of direct, place-based policies.[17]

The OZP also follows a trend of federal government policies which increasingly rely on the private sector to address poverty, unemployment, and economic inequality.[18] Since the 1980s, the U.S. federal government has reduced its direct investment in economically troubled areas, and increasingly delegated project selection and fund administration to the private sector, as well as state and local governments.[19] While traditionally disfavored by economists, some, such as former Secretary of the Treasury Lawrence Summers, have begun warming up to the notion of place-based over people-based policies.[20] The main driver behind this shift in thinking lies in the belief that the behavioral response, specifically employment, across geographic regions may be more elastic in certain disadvantaged areas, and thus provide higher

[16] *Id.* at 81–82 (citing the Enterprise Zone program, which provided hiring tax credits to employers, as an example of a direct place-based policy, and the Moving to Opportunity Program, which provided rental assistance, as an example of an indirect place-based policy); *Moving to Opportunity for Fair Housing*, U.S. DEP'T OF HOUS. AND URBAN DEV., https://www.hud.gov/programdescription/mto (last visited July 26, 2019) [https://perma.cc/2GWB-Z5G8] (describing a policy of providing housing counseling "to help very low-income families move from poverty-stricken urban areas to low-poverty neighborhoods").

[17] *See* Neumark, *Rebuilding Communities*, *supra* note 15, at 81–82 ("[D]irect place-based policies . . . typically create incentives for hiring and other economic activity in or near areas where disadvantaged people live.").

[18] Richard Hula & Marty Jordan, *Private Investment and Public Redevelopment: The Case of New Market Tax Credits*, 10 POVERTY & PUB. POLICY 11, 12 (2018) ("Rather than directly finance redevelopment efforts, the U.S. federal government now mainly encourages private investments in low-income communities through the lure of public subsidies.").

[19] *Id.* (emphasizing the trend towards the privatization of direct financial investment in troubled areas).

[20] Benjamin Austin, Edward Glaeser, & Lawrence Summers, *Saving the Heartland: Place-Based Policies in 21st Century America*, *in* BROOKINGS PAPERS ON ECONOMIC ACTIVITY 151, 151–52 (2018), https://www.brookings.edu/wp-content/uploads/2018/03/3_austinetal.pdf ("Traditionally, economists have been skeptical about [spatially targeted] policies because of a conviction that relief is best targeted toward poor people rather than poor places . . . . In this paper, we argue for reconsidering place-based policies . . . .").

increases in the employment rate.[21] It is worth repeating that the primary justification for place-based policies, unlike people-based policies, is that they can stimulate economic activity and ultimately improve employment rates.[22]

This note is divided into six parts. Following this introduction, Part II discusses the country's problem with growing economic inequality between geographic regions, and the resulting social costs. Part III reviews earlier federal government responses—specifically, the Empowerment Zones and the New Markets Tax Credit programs—and lists some of the problems with these earlier place-based policies. Part IV focuses on the development of OZs, with a particular emphasis on the originating white paper, and reviews the specific features, requirements, and criticisms of the OZP. Part V evaluates the OZP based on criticisms of the census tract selections and investment incentives by think tanks, such as the Brookings Institution and Economic Innovation Group. Part VI provides a brief conclusion.

II. Defining the Problem

More than a decade after the Financial Crisis, many parts of the country are still facing "long-term unemployment, slow growth, and a lack of quality economic opportunities . . . ."[23] While geographic disparities in economic outcomes are not a new phenomenon, the persistence of these differences and lack of convergence in outcomes is new.[24] From the late 19th century to the 1980s, per capita income and

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[21] *Id.* at 178 ("The best case for place-based policies exists when spending in some areas generates a much bigger behavioral response than in other areas.").

[22] Neumark & Simpson, *supra* note 6, at 1–2 (describing how place-based policies tend to be more efficient in providing benefits to the people they target, in contrast to people-based policies that often require people to move or work outside the areas in which they already live).

[23] JARED BERNSTEIN & KEVIN HASSETT, UNLOCKING PRIVATE CAPITAL TO FACILITATE ECONOMIC GROWTH IN DISTRESSED AREAS 1, 1 (Econ. Innovation Grp. ed., 2015); *see also* Richard Florida, *America's Worsening Geographic Inequality*, CITY LAB (Oct. 16, 2018), https://www.citylab.com/equity/2018/10/americas-worsening-geographic-inequality/573061/ [https://perma.cc/2YH7-YCBC] ("It's not just economic inequality—the gap between the rich and the poor—that is growing ever wider. Geographic inequality, the divide between rich and poor places, is too.").

[24] Ryan Nunn et al., *The Geography of Prosperity*, *in* PLACE-BASED POLICIES FOR SHARED ECONOMIC GROWTH 11, 16–17 (Jay Shambaugh & Ryan Nunn

gross state product were convergent, meaning that regions with lower economic outputs tended to grow at faster rates while regions with higher economic outputs tended to grow at slower rates.[25] Beginning in the 1980s, the opposite trend seemed to have taken hold.[26] As a result, states with lower per capita income tend to have lower growth rates.[27] This environment creates a vicious cycle, in which an economic downturn may reduce public investment and infrastructure spending, resulting in a falling tax base.[28] The falling tax base then exacerbates the lack of public investment and makes attracting private capital more difficult.[29] The consequences of poor economic performance, however, exact serious human costs as well.[30] In areas that have lower incomes and higher unemployment, individuals also face higher risks to well-being, including higher death rates, suicide rates, rates of serious illness, divorce rates, lower educational achievement outcomes for children, and lower likelihood of reemployment.[31]

Of particular concern to economists and scholars is the underemployment and disparity in human capital, which are worsened by an increasingly knowledge-based and technology-driven economy.[32] This concern is best illustrated by the effects of automation and other technological advancements in regions with strong manufacturing industries, such as Indiana and Michigan.[33] As a result of the increased

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eds., 2018) ("[I]t is newsworthy that struggling places have made unusually little headway in catching up with prospering places over the past few decades.").

[25] *Id.* at 16–17 (describing the tendency for struggling places to exhibit higher growth rates prior to the 1980s).

[26] *Id.* at 17 ("[T]his century-long trend appears to have ended.").

[27] *Id.* (explaining that regions with lower economic outputs also have lower economic growth rates).

[28] BERNSTEIN & HASSETT, *supra* note 23, at 3 (describing how a lack of investments can reduce the tax base and perpetuate economic declines).

[29] *Id.* ("This leads to a drop off of public investment and infrastructure, making it even more difficult to attract private capital.").

[30] *Id.* ("Worst of all, the longer the unemployment spell, the less likely the possibility of reemployment—and by extension the opportunity to escape these terrible costs—becomes.").

[31] *Id.* at 23 (listing social and health-related costs of persistent unemployment and poverty).

[32] *See, e.g.*, Nunn et al., *supra* note 24, at 26–27 (illustrating consequences of technology and trade policies in reducing manufacturing sector employment).

[33] *Id.* at 20, 27 ("Most economists agree that the loss in manufacturing employment is the result of some combination of [trade policy and technol-

productivity from automation, these manufacturing regions suffered from reductions in demand for labor.[34] Moreover, these regions tended to underinvest in human capital, especially college education, because "workers' time was better spent supplying labor than acquiring more education."[35] Consequently, recent solutions have focused on spurring economic activity through development of human capital in geographically disadvantaged areas.[36] Some recent proposals have included expanding programs that subsidize industry and university partnerships to encourage knowledge spillovers, and employment-focused, place-based policies that emphasize training, long-term employee retention, and high skill programs.[37] These proposals emphasize a more targeted approach to improving workers' skills, rather than simply encouraging more hiring, as did earlier programs that provided tax credits to employers for hiring employees in designated geographic areas.[38]

III. Government Response Over Time

The federal government has implemented several place-based programs over time in an effort to address poverty and spur economic development in lagging areas. This section provides an overview of

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ogy] . . . ."); NAT'L ASS'N OF MFRS., MANUFACTURING EMPLOYMENT BY STATE (2017), https://www.nam.org/wp-content/uploads/2019/05/MFG_Employment_2018103.pdf (listing the share of manufacturing jobs by state, where Indiana and Michigan have 17.0% and 13.8%, respectively); NAT'L ASS'N OF MFRS., MANUFACTURING'S SHARE OF GROSS STATE PRODUCT (2017), https://www.nam.org/wp-content/uploads/2019/05/MFG-GSP-FactSheet_201810.pdf (listing manufacturing's share of gross product by state, where Indiana and Michigan have 28.6% and 19.1%, respectively).

[34] Nunn et al., *supra* note 24, at 27 ("[M]anufacturing underwent large-scale automation in ways that have increased labor productivity and reduced the need for labor in manufacturing.").

[35] *Id.* at 12.

[36] *See, e.g.*, Neumark, *Rebuilding Communities*, *supra* note 15, at 90–91 tbl. 3 & fig. 1 (describing core features of the author's "Rebuilding Communities Job Subsidies" proposal).

[37] *Id.* (describing employment-focused place-based policy); E. Jason Baron et. al., *Extending the Reach of Research Universities*, *in* PLACE-BASED POLICIES FOR SHARED ECONOMIC GROWTH 157, 160 (Jay Shambaugh & Ryan Nunn eds., 2018) ("[T]he main channel by which universities can affect their local economies is through highly localized knowledge spillovers.").

[38] Neumark, *Rebuilding Communities*, *supra* note 15, at 93 (describing the rationale for the skill building element of the proposal).

two of the federal government programs: (1) the Empowerment Zones, and (2) the New Markets Tax Credit (NMTC) programs.[39] The Empowerment Zones program focuses on providing employment benefits—hiring credits and grants for providing training services to workers in disadvantaged areas.[40] The NMTC allows for a wider-range of projects that include providing lower-cost financing for residents in disadvantaged areas, real estate development in low-income areas, as well as projects focused on job creation and retention.[41]

A. Empowerment Zones

Between 1993 and 2016, the federal Empowerment Zones program provided tax incentives and block grants to promote investment in the neediest urban and rural areas.[42] In 1993, Congress created and authorized the Department of Housing and Urban Development (HUD) to administer the Empowerment Zones program.[43] HUD

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[39] Other examples of place-based policies include the Tennessee Valley Authority (a federal infrastructure initiative focused on developing hydroelectric dams) and Enterprise Communities (a "consolation prize" for regions not designated as Empowerment Zones that provided smaller block grants and hiring credits). Neumark & Simpson, *supra* note 6, at 3–4.

[40] *Empowerment Zones*, DEP'T OF HOUS. AND URBAN DEV., https://www.hud.gov/hudprograms/empowerment_zones [https://perma.cc/EBB8-WK3B] (last visited July 26, 2019).

[41] MARTIN ABRAVANEL ET AL., URBAN INSTITUTE, NEW MARKETS TAX CREDIT (NMTC) PROGRAM EVALUATION: FINAL REPORT (2013), https://www.cdfifund.gov/Documents/NMTC%20Program%20Evaluation%20Final%20Report.pdf [hereinafter ABRAVANEL, NMTC FINAL REPORT].

[42] Matias Busso, Jesse Gregory & Patrick Kline, *Assessing the Incidence and Efficiency of a Prominent Place Based Policy*, 103 AM. ECON. REVIEW 897, 900 (2013) ("The federal Empowerment Zone program is a series of spatially targeted tax incentives and block grants designed to encourage economic, physical, and social investment in the neediest urban and rural areas in the United States."); *See* News Release, Treasury, Empowerment Zone Designations Continue Through the End of 2016 (June 21, 2016), https://www.irs.gov/newsroom/empowerment-zone-designations-continue-through-the-end-of-2016 [https://perma.cc/7STV-5JMP] (indicating that the Empowerment Zone designations expired after December 31, 2016).

[43] *Empowerment Zones*, *supra* note 39 (providing brief history of the Empowerment Zone program, which was enacted through the Omnibus Budget Reconciliation Act).

originally selected Empowerment Zones in six cities[44] that met the zone tract requirements for population, distress, size, and poverty rate, pursuant to the designation and eligibility requirements of I.R.C. §§1391 and 1392(a).[45] HUD also required minimum unemployment rates[46] of at least the national average.[47] These requirements, particularly the minimum poverty and unemployment rates, ensured that public money would be deployed in genuinely distressed areas.[48]

The primary benefits provided under the Empowerment Zones program were Employment Tax Credits and Social Services Block Grants.[49] Beginning in 1994, the Employment Tax Credits program provided a credit of up to 20% on the first $15,000 in wages, or $3,000, per employee, for all employees in designated Empowerment Zones.[50] Between 1994 and 2000, employers claimed approximately $200 million in Empowerment Zone employment credits.[51] Additionally, Congress allocated $100 million through the Social Services Blocks Grants to each Empowerment Zone to be spent over two years on economic revitalization and social welfare services, such as adult training programs, job placement, infrastructure investments, and

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[44] The designated cities were: Atlanta, Baltimore, Chicago, Detroit, New York, and Philadelphia-Camden. Los Angeles and Cleveland were designated as "supplemental" Empowerment Zones. Mitchell Moss, *Where's the Power in the Empowerment Zone?*, CITY JOURNAL (1995), https://www.city-journal.org/html/where%E2%80%99s-power-empowerment-zone-12129.html [https://perma.cc/5WQM-7V2T].

[45] I.R.C. §§ 1391, 1392(a) (listing eligibility requirements for Empowerment Zone designation).

[46] In 1993, the minimum required unemployment rate was 6.3%. Busso, *supra* note 42, at 900 n.4.

[47] U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-06-727, EMPOWERMENT ZONE AND ENTERPRISE COMMUNITY PROGRAM: IMPROVEMENTS OCCURRED IN COMMUNITIES, BUT THE EFFECT OF THE PROGRAM IS UNCLEAR (2006) ("[C]ommunities were required to select census tracts that . . . had unemployment rates of at least the national average according to 1990 Census data.").

[48] *Id.* ("The EZ/EC program [is] one of the most recent large-scale federal programs aimed at revitalizing distressed urban and rural communities, . . . intended to improve social and economic conditions in the nation's high-poverty communities.").

[49] Busso, *supra* note 42, at 900–01.

[50] *Id.* at 900 (stating Employment Tax Credit amounts for firms operating in the first six Empowerment Zones).

[51] *Id*. at 901.

housing assistance programs.[52] By 2000, participants in the first round of Empowerment Zones spent about $400 million of the maximum allotted Social Services Block Grants, totaling about $600 million of claimed benefits.[53]

Over the roughly 25-year period since the federal Empowerment Zones program was launched, researchers have agreed that these programs were generally ineffective and failed to provide the expected benefits that they sought for those living in the targeted, disadvantaged areas.[54] Specifically, scholars have found that employers that used the Empowerment Zones hiring credits tended to hire low-skill workers with high turnover rates.[55] As a result, researchers identified several problems with the Empowerment Zones program and place-based policies. First, place-based policies can distort labor markets.[56] In other words, these policies can shift where jobs are located without creating new jobs.[57] Second, the benefits of place-based policies might not reach the intended beneficiaries.[58] Hiring credits, for instance, can be used to hire migrants from advantaged areas or non-disadvantaged residents, and, even when used to hire the intended beneficiaries, the benefits can be recaptured by landowners as higher rents or housing prices.[59]

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[52] *Id.*; Mitchell Moss, *supra* note 44 (listing representative employment programs funded by the Social Services Block Grants).

[53] Busso*, supra* note 42, at 901.

[54] *See, e.g.*, Neumark, *Rebuilding Communities*, *supra* note 15, at 84 (summarizing studies of the federal Empowerment Zones program, as well as state Enterprise Zones programs).

[55] *Id*. at 93 ("This strategy contrasts with the bias toward the creation of low-wage, higher-turnover jobs in current and past enterprise zone programs.").

[56] *Id.* at 83 (discussing the potential distortionary effects of place-based policies on capital investments and labor mobility).

[57] *Id.*

[58] RANDALL CRANE AND MICHAEL MANVILLE, LINCOLN INSTITUTE OF LAND POLICY, PEOPLE OR PLACE? REVISITING THE WHO VERSUS THE WHERE OF URBAN DEVELOPMENT 3 (July 2008), https://community-wealth.org/sites/clone.community-wealth.org/files/downloads/article-crane-manville.pdf [https://perma.cc/8NSY-SKMK] (explaining that "the benefits of place-specific investments accrue primarily to landowners," who "are not poor," making "the placebased [sic] program . . . an inaccurate instrument for redistribution.").

[59] *Id.* at 5 (identifying that rising rents and land values diminish the benefit of wage growth for targeted populations of place-based policies).

B. New Markets Tax Credits

In 2000, Congress authorized the still-active Community Development Financial Institutions Fund (CDFI Fund) to administer the NMTC program by passing the Community Renewal Tax Relief Act of 2000.[60] Although the NMTC is slated to expire at the end of 2019, the program has already survived five rounds of renewals in 2008, 2010, 2013, 2014, and 2015.[61] As with the Empowerment Zones program, the administrators of the NMTC program aim to service specific geographic regions satisfying the low-income community requirement.[62]

The NMTC program encourages investment and economic revitalization in areas by providing tax credits and increasing the after-tax return to investors, while providing a cheap source of capital to community groups engaged in long-term projects.[63] Under this program, the federal government, through the CDFI Fund, allocates tax credits to Community Development Entities (CDEs).[64] CDEs may be either for-profit or non-profit, but to qualify for tax credits, CDEs must be certified by the CDFI Fund.[65] Meeting the CDFI Fund standard for certification requires passing two tests: the primary mission test and accountability test.[66] The primary mission test requires that CDEs serve or provide investment capital for low-income communities, and

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[60] Hula, *supra* note 18, at 15.
[61] Michael Novogradac, *NMTC Extender Legislation Faces Challenging Path to Approval*, NOVOGRADAC J. TAX CREDITS, May 2019, at 2, https://www.novoco.com/periodicals/articles/nmtc-extender-legislation-faces-challenging-path-approval [https://perma.cc/FMP3-PS7V].
[62] I.R.C. § 45D(e) (providing for rules for and definitions relevant to operation of the new markets tax credit program).
[63] Stockton Williams, *The New Markets Tax Credit: A Promising New Tool for Community Revitalization*, COMMUNITY INVESTMENTS, April 2001, at 3, https://www.frbsf.org/community-development/files/newmarket.pdf [https://perma.cc/JHY6-Z7D9] (explaining that the NMTC program aims "to encourage new investment in businesses, economic development and community facilities in low-income neighborhoods").
[64] ABRAVANEL, NMTC FINAL REPORT, *supra* note 41, at 2 ("CDEs are certified by the CDFI Fund to act as financial intermediaries that direct capital from investors to businesses or nonprofit organizations.").
[65] *Id.* at 23.
[66] I.R.C. §§ 45D(c)(1)(A), (B) (requiring primary mission and accountability tests); ABRAVANEL, NMTC FINAL REPORT, *supra* note 41, at 3, 14 (describing the primary mission and accountability tests).

the accountability test requires that CDEs maintain a governing or advisory board through which members of the low-income communities may be represented.[67]

However, the CDFI Fund has limited funding and must screen prospective beneficiaries to ensure efficient allocation of its limited resources.[68] After passing the primary mission and accountability tests, the now-certified applicants (i.e., CDEs) are subjected to another two-phase review process.[69] Once it passes these requirements, a CDE is entitled to take a tax credit worth 39% of the original investment over seven years for its investors—5% for each of the first three years, and 6% for each of the last four years.[70]

Finally, CDEs are restricted to investing in Qualified Active Low-Income Community Businesses (QALICB).[71] These businesses must generate at least 50% of their gross incomes from the low-income community, maintain a substantial portion of the tangible property within the low-income community, perform a substantial portion of the services within the low-income community, and hold less than 5% of the value of the property in nonqualified properties, including stamps, coins, futures contracts, etc.[72]

Successfully funded NMTC projects cover a broad range of activities, including real estate development, low-interest business

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[67] I.R.C. §§ 45D(c)(1)(A), (B); ABRAVANEL, NMTC FINAL REPORT, *supra* note 41, at 14 (describing that a CDE "maintains accountability to residents of LICs though their representation on any governing board of, or any advisory board to, the" CDE).

[68] The NMTC is funded to provide up to $3.5 billion per year. Hula, *supra* note 18, at 17 (stating that "Congress recently extended NMTC for another five years (2015–2019) at its current funding level of $3.5 billion a year").

[69] The first phase ranks applicants in four categories: community impact, business strategy, capitalization strategy, and management capacity. *Id.* Applicants must receive both a minimum score in each category and minimum cumulative score. *Id.* The second phase then ranks the remaining applicants by a cumulative score of the two categories: business strategy and community outcome. *Id.*

[70] I.R.C. § 45D(a)(2) (describing applicable percentages of tax credit to be realized over seven-year period); Hula, *supra* note 18, at 17 (describing realization of tax credit over seven-year period).

[71] I.R.C. § 45D(d)(2) (listing eligibility requirements for QALICBs).

[72] I.R.C. §§ 45D(d)(2)(A)(iv)–(v) (defining nonqualified properties in I.R.C. §§ 408(m)(2) and 1397C(e)).

loans, and employment training programs.[73] The following three examples of specific NMTC projects will illustrate the variance in the NMTC program. First, the Ohio-based CDE, Oak Hill Bank Community Development Corporation, provides debt financing to a start-up construction contractor supplier in the acquisition of a warehouse property.[74] Second, the California-based Clearinghouse CDFI Fund provides debt financing and technical assistance to assist Monarch Schools in its mission to educate children affected by homelessness.[75] Third, the Massachusetts-based Nonprofit Finance Fund finances Community Servings to build its "Food Campus," where its employees will serve medically-tailored meals to diabetes patients and other sufferers of chronic illness, provide job training programs for forty more candidates, and offer its services to five thousand low-income and disadvantaged persons.[76]

C. Criticisms of Past Responses

The discontinued Empowerment Zones program and still-active NMTC program are examples of federal, direct place-based policies.[77] Both policies aimed to benefit residents of disadvantaged areas by stimulating economic activity.[78] These policies further nar-

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[73] MARTIN ABRAVANEL ET AL., URBAN INSTITUTE, ANALYSIS OF SELECTED NEW MARKETS TAX CREDIT PROJECTS 5 (June 2007), https://www.taxpolicycenter.org/sites/default/files/publication/99516/412036-analysis-of-selected-new-markets-tax-credit-projects.pdf [hereinafter ABRAVANEL, NMTC ANALYSIS] (listing kinds of successfully funded NMTC projects).

[74] *Id.* (describing the Oak Hills Bank community bank's involvement in the NMTC program).

[75] *Examples of California NMTC Projects*, CAL. STATE ASSEMBLY, https://ajed.assembly.ca.gov/examplesofcalifornianmtcprojects (last visited July 26, 2019) [https://perma.cc/34HK-RM49] (providing descriptions of four NMTC projects in California).

[76] Dave Scheltz, *Community Servings Breaks Ground on 'Food Campus,'* Affirmative Investments (May 30, 2018), http://www.affirmativeinvestments.com/community-servings-breaks-ground-on-food-campus/ (last visited July 26, 2019) [https://perma.cc/9WED-6W6Q].

[77] *See* Hula, *supra* note 18, at 13 (discussing NMTC's background); *Empowerment Zones*, *supra* note 39 (describing the purpose, background, and mechanics of Empowerment Zones).

[78] Hula, *supra* note 17, at 13 ("NMTC tries to entice private investment and spur economic growth in target, underserved neighborhoods by giving tax credits to project investors."); *Empowerment Zones*, *supra* note 39 (EZs "are

rowed their geographic scopes to target disadvantaged areas by implementing selection criteria focused on unemployment and poverty rates.[79] While the Empowerment Zones program attempted to stimulate economic activity by directly awarding hiring credits to employers and granting block grants for employment-based trainings and other assistance programs, the NMTC program took an indirect approach by offering tax credits to investors acting through certified CDEs to offer business loans, develop real estate, and engage in other job creating activities.[80] In sum, the NMTC expanded both the class of eligible participants—from employers to investors in CDEs—as well as the class of eligible economic activities—wages and training programs to business loans and real estate developments.[81]

Proponents of the OZP have criticized these past policies on three grounds: (1) underutilization, (2) weak incentives, and (3) restrictive scope.[82] Underutilization represents the failure of citizens to participate in the federal program.[83] For instance, a 1998 Government Accountability Office survey of urban businesses found that 40% did not know about CDE credits, another 8% found the credits too complicated to use, and another 5% could not make use of the credits.[84] Proponents of the OZP have also criticized these past policies for their weak incentives and failure to attract large investment in capital-

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designated areas of high poverty and unemployment that benefit from tax incentives provided to businesses in the boundaries of the EZ.").

[79] I.R.C. § 45D(e) (listing eligibility requirements for NMTC low-income communities); I.R.C. §§ 1391, 1392(a) (listing eligibility requirements for Empowerment Zone nominated areas).

[80] ABRAVANEL, NMTC ANALYSIS, *supra* note 73 (explaining how NMTC took an indirect approach to improving economic activity); Busso, *supra* note 42, at 900–01.

[81] *See* ABRAVANEL, NMTC ANALYSIS, *supra* note 73 (highlighting the additions of NMTC).

[82] BERNSTEIN & HASSETT, *supra* note 23, at 11–15 (discussing weaknesses of previous programs).

[83] *Id.* at 11–12 ("One reason why the evidence may be so mixed is the underutilization of the provisions available under the various programs . . . . [B]usinesses did not pursue certain benefits due to their overly complicated nature . . . .").

[84] *Id.* at 12 (citing government reports supporting assertions about underutilization and complexity).

intensive projects and new businesses.[85] Specifically, the employment tax credits under the Empowerment Zone program and non-refundable tax credits have failed to attract new start-up businesses and stimulate the local economy in ways that have a lasting impact on communities.[86] Finally, proponents criticize the restrictive scope of the investment.[87] Specifically, the NMTC has an arduous approval process and a seven year commitment that can deter investors from committing large amounts of capital to promising projects.[88] The following section will discuss how the OZP addresses most of these concerns.

IV. Opportunity Zones

This section examines the design of the OZP, and works out the mechanics of the program selection and benefits in detail. The section will focus especially on the benefits of the program to highlight the heavily favorable investor incentives and discretion compared to the previously discussed place-based policies, and conclude by discussing some of the commonly cited criticisms of the OZP.

A. Overview

The OZP is a federal program that provides tax incentives—tax deferral, step-up in basis, and permanent exclusion on capital gains—for investors from more economically successful regions to reinvest their capital gains to address the widening geographic disparity in economic outcomes throughout the country.[89] The OZP provides a flexible scheme for investors to invest their capital gains, as opposed to

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[85] *Id.* ("All three categories failed to provide a direct incentive either for investing in new companies and small businesses, or for larger investments in infrastructure . . . .").
[86] *Id.* at 12–13.
[87] BERNSTEIN & HASSETT, *supra* note 23, at 14 ([R]estrictions on the size of investment that can qualify discourages large well-capitalized investors from participating . . . .").
[88] *Id.* at 14–15.
[89] I.R.C. § 1400Z-2 (listing investor benefits of the OZP); Tankersley, *Tucked into the Tax Bill*, *supra* note 3 (stating the intent of the OZP to attract long-term investment to struggling areas of the country). *See* Florida, *supra* note 23 (summarizing reports from the Brookings Institution and Economic Innovation Group that assess the extent of the geographic disparity within the United States).

ordinary income, in a wide range of projects.[90] The statute's primary mechanism for confining these invested capital gains in the target areas is the "90 percent asset test."[91] This test requires that the investing entities—Qualified Opportunity Funds (QOFs)—hold at least 90% of their assets as Qualified Opportunity Zone Property (QOZP).[92] The statute also prohibits transactions between related parties and "sin businesses" (e.g., country clubs, gambling facilities, racetracks, and massage parlors).[93] These restrictions avoid the obvious moral hazards associated with transactions between related parties, and limit how such investments could undermine the goal of promoting economic development within the selected communities.[94]

Instead of allocating tax credits to an administrative agency, which then distributes the credits to qualified projects, the OZP allows

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[90] KENAN FIKRI & JOHN LETTIERI, ECONOM. INNOVATION GRP., THE STATE OF SOCIOECONOMIC NEED AND COMMUNITY CHANGE IN OPPORTUNITY ZONES 16 (2018) https://eig.org/wp-content/uploads/2018/12/OZ-Whitepaper-FINAL.pdf.

[91] E.g., *IRS Issues Additional Guidance on Investing in Opportunity Zones*, GIBSON DUNN (Apr. 22, 2019), https://www.gibsondunn.com/irs-issues-additional-guidance-on-investing-in-opportunity-zones/ [https://perma.cc/L4RC-D6RM] (explaining IRS guidance on opportunity zone investments, including the "90 percent asset test" for QOFs).

[92] To receive the deferral, QOFs must invest that portion of taxpayers' investments in a qualified investment within 180 days of when the capital gains would have been recognized. I.R.C. § 1400Z-2 (a)(1)(A). Additionally, the values of the assets held by the QOFs are measured at two points: on the last day of the first 6-month period of the taxable year the fund is created, and the last day of the taxable year. I.R.C. § 1400Z-2(d)(1).

[93] I.R.C. § 1400Z-2(d)(3)(A)(iii) (referencing prohibited business activities under I.R.C. § 144(c)(6)(B)); I.R.C. § 707(b)(1); I.R.C. § 267(b); I.R.C. § 144 (c)(6)(B) (enumerating specifically prohibited businesses); Steven Rosenthal, *Opportunity Zones May Create More Opportunities for Investors and Syndicators Than Distressed Communities*, TAX POLICY CENTER (Aug. 2, 2018), https://www.taxpolicycenter.org/taxvox/opportunity-zones-may-create-more-opportunities-investors-and-syndicators-distressed [https://perma.cc/3YC3-4BGM]; Mary Childs, *Why 'Qualified Opportunity Zones' May Be The Next Hot Thing in Investing*, BARRON'S (Nov. 10, 2018), https://www.barrons.com/articles/tax-benefits-attract-investors-to-qualified-opportunity-zone-funds-1541851200 [https://perma.cc/K3F4-R96A].

[94] Rosenthal, *supra* note 92 (explaining certain transactions might be "less beneficial for the community").

taxpayers to take advantage of the program's tax benefits directly.[95] This feature imposes lower barriers to entry for investors and should encourage both greater capital participation and expedited project schedules.[96] As with the NMTC program, investors in OZ must use an intermediary to be eligible for participation.[97] The investor first invests into a QOF, the intermediary, which then invests the capital in QOZP.[98] Although the Internal Revenue Service (IRS) guidelines currently exist only as proposed regulations, the IRS has indicated that both QOFs and taxpayers will be able to self-certify and take deferral elections on standard forms issued by the agency.[99]

B. Selection of Qualified Opportunity Zones

Qualified OZ include those census tracts nominated by the respective governors of each state meeting the statute's "low-income community" requirements.[100] The statute imports the definition of "low-income community" used under the NMTC in I.R.C. § 45D(e)—having a poverty rate greater than 20% or median family income less

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[95] I.R.C. § 1400Z-2(a); SEAN LOWRY & DONALD J. MARPLES, CONG. RESEARCH SERV., R45152, TAX INCENTIVES FOR OPPORTUNITY ZONES: IN BRIEF 6 (2018) (explaining the relief from capital gains taxation directly benefits owners of capital rather than populations that live in the OZ zone).

[96] BERNSTEIN & HASSETT, *supra* note 22, at 17 (explaining that allowing taxpayers to participate directly will allow "private investors to redeploy capital to regions in need of economic development," such as, depressed communities).

[97] I.R.C. § 1400Z-2(d) (describing the investment vehicle that investors must invest in to be eligible for special rules for capital gains invested in opportunity zones); LOWRY & MARPLES, *supra* note 95, at 1 (explaining the tax incentives are specifically for investments held by investment vehicles that the tax code calls "qualified opportunity funds").

[98] LOWRY & MARPLES, *supra* note 95, at 1 (explaining the tax incentives are for investments held by QOFs in qualified opportunity zones nominated by the governor).

[99] Current proposed regulations indicate that the QOFs will self-certify their status on the Form 8996 and taxpayers will take the deferral elections on Form 8949. Investing in Qualified Opportunity Funds, 83 Fed. Reg. 54,279, 54,282–83 (proposed Oct. 29, 2018) (to be codified at 26 C.F.R. pt. 1).

[100] I.R.C. § 1400Z-1(b)(1) (explaining a qualified OZ means a population census tract that is a low income community if nominated by the chief executive officer of the State).

than 80% of the statewide median family income.[101] Governors had the opportunity to nominate a minimum of twenty-five low-income census tracts, and up to a maximum of 25% of the total number of low-income communities in their respective states.[102] Additionally, governors were allowed to elect up to 5% of their total nominations for census tracts that did not qualify as low-income communities so long as they were contiguous with designated low-income communities and did not have a median family income exceeding 125% of the contiguous census tract's median family income.[103]

In addition to the statutory requirements under I.R.C. § 1400Z-1, the governors' designation of the OZ was further constrained by the Joint Committee on Taxation's (JCT) directive.[104] The JCT is a non-partisan committee of the United States Congress comprised of five members from the Senate Finance Committee and five members from the House Ways and Means Committee that advises both houses of Congress on tax legislation.[105] The Joint Committee on Taxation required the governors to consider the census tracts' demonstrated success in administering similar geographically targeted or place-based policies, including Empowerment Zones, NMTC, and renewal communities, as well as the amount of focus from other state and private economic development initiatives, and recent layoffs in the prospective census tracts.[106] There is a concern here that the designation of qualified OZ in this manner may divert funds from the most distressed regions and funnel capital into areas that are already gentrifying and have

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[101] I.R.C. § 1400Z-1(c)(1) (defining "low-income community" as the same meaning as when used in section 45D(e)); I.R.C. § 45D(e) (defining "low-income community" as a poverty rate greater than 20% or median family income less than 80% of the statewide median family income).

[102] In smaller states, where 25% of low-income communities was less than 25, governors could simply select 25 low-income tracts. I.R.C. § 1400Z-1(d) (defining the number of designations permitted).

[103] I.R.C. § 1400Z-1(e)(1)–(2) (explaining designation of tracts contiguous with low-income communities).

[104] JOINT COMM. ON TAXATION, JCX5617, DESCRIPTION OF THE CHAIRMAN'S MODIFICATION TO THE CHAIRMAN'S MARK OF THE "TAX CUTS AND JOBS ACT" 53 (2017) (requiring governors to consider OZ selection factors not required by statute).

[105] *Overview*, JOINT COMMITTEE ON TAXATION, https://www.jct.gov/about-us/overview.html [https://perma.cc/E7YB-ZYAH].

[106] JOINT COMM. ON TAXATION, *supra* note 104.

support from previous public-private partnerships.[107] Moreover, the qualified OZ designations cannot be changed once approved, and do not expire until the end of 2028.[108] As of July 9, 2018, the Secretary of the Treasury has designated over 8,700 qualified OZ across the United States.[109]

C. Benefits

To overcome the problem with weak incentives in previous place-based programs, the OZP provides for three primary benefits to taxpayers: (1) temporary deferral of capital gains invested in qualified OZ, (2) step-up in basis for investments held in qualified OZ, and (3) permanent exclusion of capital gains tax on qualified OZ investments held for at least ten years.[110] The following subsections will discuss each of the benefits in detail. The IRS has clarified that taxpayers of various legal structures are eligible to participate in the OZP and claim its benefits.[111] Though C corporations do not have preferential rates on long-term capital gains, they too are eligible to participate in the OZP.[112]

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[107] FIKRI & LETTIERI, supra note 90, at 7 ("[M]uch of the commentary on Opportunity Zones has focused on the presence of or potential for gentrification in the designated communities."). Discussion concerning whether such fears about misallocation of the Opportunity Zone capital on gentrifying regions will be taken up later. *See infra* Part V.

[108] I.R.C. § 1400Z-1(f) (explaining designations remain in effect for a "period beginning on the date of the designation and ending at the close of the 10th calendar year"); Investing in Qualified Opportunity Funds, 83 Fed. Reg. 54,279 (proposed Oct. 29, 2018) (to be codified at 26 C.F.R. pt. 1) ("[T]he designations of all qualified opportunity zones now in existence will expire on December 31, 2018.").

[109] I.R.S. Notice 2018-48, 2018-28 I.R.B. 9 (July 9, 2018).

[110] I.R.C. §§ 1400Z-2(b)–(c) (detailing the special rules for capital gains invested in opportunity zones); LOWRY & MARPLES, *supra* note 95, at 4 (summarizing the investors benefits of the OZP).

[111] Investing in Qualified Opportunity Funds, *supra* note 98, at 54,280 ("The proposed regulations clarify that taxpayers eligible to elect deferral under section 1400Z-2 are those that recognize capital gain for Federal income tax purposes. These taxpayers include individuals, C corporations (including regulated investment companies (RICs) and real estate investment trusts (REITs), partnership, and certain pass-through entities . . . .").

[112] *Id.* at 54,590.

1. *Tax Deferral*

First, the tax on capital gains invested in OZ may be deferred until the earlier of the date in which the investment is "sold or exchanged" or December 31, 2026.[113] This ensures that investors will pay their deferred taxes within a fixed period of time, differing from other tax deferral, or non-recognition, mechanisms in the tax code that have no fixed deadlines, such as §1031 like-kind exchanges for real property and §1033 rollover non-recognition exchanges.[114] The tax deferrals confer three distinct benefits: (1) leverage effects, (2) reduction in net present value of tax liabilities, and (3) intrinsic option value.[115] As with tax deferrals in general, the financial benefits of this provision are that it provides an additional source of equity funding for investors that can be used to leverage up their investments, and that it reduces the net present value of the tax liability on the investors' capital gains, or investment in the QOF.[116] In the case of OZ, there is an additional intrinsic option value in the deferral.[117] Section 1400Z-2 (b)(1) provides that the tax liability is includable in the earlier of the year in which the investment is sold or exchanged, or 2026.[118] Since investors have the ability to sell or exchange their investments, they will be able to manage their tax liabilities over time.[119] The leverage effects and intrinsic option value will typically have explicit and larger financial impacts on the investor's after-tax returns, whereas the reduction in net present value will confer an implicit benefit.[120]

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[113] I.R.C. §§ 1400Z-2(b)(1) (defining inclusion events).
[114] *See* I.R.C. §§ 1031, 1033 (providing examples of other tax deferral provisions).
[115] Rebecca Lester et al., *Opportunity Zones: An Analysis of the Policy's Implications*, 90 STATE TAX NOTES 221, 225 (2018).
[116] Peter Brady, *Marginal Tax Rates and the Benefits of Tax Deferral*, INVESTMENT COMPANY INSTITUTE (Sept. 17, 2013), https://www.ici.org/viewpoints/ci.view_13_marginal_tax_and_deferral.print [https://perma.cc/XRJ7-4AJG] (explaining leverage effects of tax deferrals).
[117] Rebecca Lester, *supra* note 115, at 225 (explaining that the intrinsic option value of tax deferrals permits investors to elect when to trigger taxable events and thus affect marginal and effective tax rates).
[118] I.R.C. § 1400Z-2(b)(1).
[119] Rebecca Lester, *supra* note 115, at 225 (explaining the benefit of intrinsic option value of tax deferrals).
[120] Illustrated through the following examples, spanning from Footnote 120 to Footnote 132.

To illustrate the leverage effects of the tax deferral, consider an investor who could commit $8 million after-tax dollars to a qualifying project. If she financed the project using 20% equity ($8 million of after-tax dollars) and 80% debt ($32 million borrowed), the project would have a total asset value of $40 million. After applying the tax deferral on her capital gains tax liability, and avoiding $2 million in immediate tax liability, she would have instead $10 million in equity, and could finance a project worth $50 million (see Table 1 below). Assuming fixed rates of returns, this would yield a proportionately larger total return for the investor. As some scholars have pointed out, this incentive could impact the terms of financing agreements and have price effects on property and investments in the designated OZ.[121]

Table 1 Tax Deferral: Example Comparison between Non-OZ and OZ Investments

	Non-OZ	**OZ**
Gain	$10 million	$10 million
Immediate Tax Liability	$2 million	$0
Investable Capital	$8 million	$10 million
Asset Value	$40 million	$50 million

Next, to understand the reduction in net present value, assume that an investor sells stocks that she originally purchased for $1 million for $1.2 million, realizing capital gains on that transaction worth $200,000. Let us also assume that she is taxed at the top capital gains tax rate of 20%, so if she does not make use of any other non-recognition provisions, she would have a tax liability of $40,000 payable in that year, and the net present value of the tax liability is $40,000.[122] If, however, she invests the capital gains, $200,000, in a QOF, then she could elect to defer the tax.[123] If we further assume that she holds the investment in the QOF for 5 years with a discount rate of 3%, then the net present value of her future tax liability decreases from $40,000 to

[121] Rebecca Lester, *supra* note 115, at 225.
[122] I.R.C. § 1(h). (providing the top capital gains rate).
[123] *Opportunity Zones Frequently Asked Questions*, INTERNAL REVENUE SERV. (Oct. 22, 2019), https://www.irs.gov/newsroom/opportunity-zones-frequently-asked-questions [https://perma.cc/2YUA-C9KG] (stating that investing in a QOF defers tax treatment).

$34,504.[124] The investor is thus $5,496 or 2.75% better off compared to the original investment. This translates to a compound annual growth rate of 0.54%.[125]

Last, the intrinsic option[126] gives investors the ability to spread the recognition of their gains over time and reduce average tax rates.[127] This feature confers a larger benefit to individuals and businesses more sensitive to changes in marginal capital gains tax rates—specifically, retirees.[128] To demonstrate the benefit of the intrinsic option value, take for example a restaurant owner who sells his long-run business for a profit of $500,000 and has no other income. Assuming only a federal capital gains tax, the investor would owe $72,366 or pay an effective rate of 14.47%.[129] If, however, he invested the money in a QOF, and withdrew the amount in ten equal payments of $50,000, he would owe $1,594 or pay an effective rate of 3.19% in each year.[130] Now consider an individual with larger gains of $50 million when evaluating the benefit of the intrinsic option. As in the previous example, assume only a federal capital gains tax. The higher earning individual would owe $972,366, or pay an effective rate of 19.45% by dividing the income into ten equal payments of $5 million.[131] If the partnership invests the proceeds in a QOF and withdraws the amount in ten equal payments, as in the previous example, it would owe $72,366 or pay an

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[124] Net Present Value = Future Tax Liability/(1+Discount rate)^# of years = $40,000/(1.03^5)

[125] Compound Annual Growth Rate = (1.0275)^(1/# of years)-1 = (1.0275)^(1/5)-1 = 0.54

[126] The "intrinsic option" refers to the option that individual investors have to realize and pay taxes in years where they have lower income. Rebecca Lester, *supra* note 115, at 225. When tax rates are graduated, this action amounts to income averaging and spreading income over a number of years can reduce effective tax rates. *Id*.

[127] *Id.* at 225 (discussing multiyear deferral options).

[128] *Id.* at 225 (explaining the effects of investing in a QOF on retirees' tax benefits).

[129] Tax liability = 0.15*($434,550-$39,375)+0.20*($500,000-$434,550) = $72,366. Effective Tax Rate = 100*$72,366/$500,000 = 14.47%. *See* I.R.C. § 1(h).

[130] Tax liability = 0.15*($50,000-$39,375) = $1593.75. Effective Tax Rate = 100*$1593.75/$50,000 = 3.19%. *See* I.R.C. § 1(h).

[131] Tax liability = 0.15*($434,550-$$39,375)+0.20*($50,000,000-$434,550) = $972,366.30. Effective Tax Rate = 100*$972,366.30/$5,000,000 = 19.45%. *See* I.R.C. § 1(h) (prescribing this formula).

effective rate of 14.47% each year.[132] The case for the individual making $500,000 from a sale produced a difference exceeding 11% in the effective tax liability, whereas the case for the partnership making one hundred times the individual from a sale produced a difference of approximately 5% in the effect tax liability. This effect is sensitive to the income of the taxpayer and does not apply on a per dollar basis. Accordingly, it should be a larger consideration for individual taxpayers with total gains below the top bracket and irrelevant to corporate taxpayers, which have a flat corporate rate.[133]

Table 2 Intrinsic Option Value: Restaurant Owner Example

	Non-OZ	**OZ**
Gain	$500,000	$500,000
Total Tax Liability	$72,366	$15,940
Tax Rate	14.47%	3.19%

Table 3 Intrinsic Option Value: Partnership Example

	Non-OZ	**OZ**
Gain	$50 million	$50 million
Total Tax Liability	$972,366	$723,660
Tax Rate	19.45%	14.47%

Since Congress did not define "sold or exchanged"[134] in the statute, the IRS has published proposed regulations to enumerate the events that trigger inclusion of the deferred gains.[135] Some of these events include disposition of interests in QOF partnerships and corporations, dispositions of interests in an S corporation if such disposition leads to a change of more than 25% in the aggregate interests of

[132] Incorporating the same formula provided in Footnote 129. *See* I.R.C. § 1(h).
[133] I.R.C. § 11 (establishing the different tax treatment for various tax brackets).
[134] I.R.C. § 1400Z-2(b)(1).
[135] I.R.C. § 1400Z-2(b)(1); Investing in Qualified Opportunity Funds, 83 Fed. Reg. 54,279 (proposed May 1, 2019) (to be codified at 26 C.F.R. pt. 1) (providing "a nonexclusive list of inclusion events").

the original shareholders, transfers by gift, and partnership distributions in excess of basis.[136]

2. Step-Up in Basis

Second, the statute provides for a step-up in basis for these qualified investments: 10% for investments held for at least five years, and 15% for investments held for at least seven years.[137] The statute also provides that the investor's basis in the property shall be zero.[138] While not explicitly addressed in the statute, the reason for setting the basis to zero is to limit tax avoidance on pre-tax dollar investments.[139] Unlike the tax deferral, the "step-up" provides an explicit benefit to the investor, but as we will see, the step-up provides a weaker financial incentive.[140]

If we take the same investor from the tax deferral example, with an adjusted basis of $1 million, sale price of $1.2 million, and investment of qualified investment of $200,000, then we can calculate the tax benefit of the step-up provisions. First, if she holds the investment in the QOF for five years, she gets a step-up in basis of 10%.[141] The basis in her investment after five years increases by 10% of the original investment from $0 to $20,000. Assuming she sells the investment for $200,000 and there is no further gain, the investor's capital gain is then calculated to be $180,000 and her capital gains tax liability

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[136] Investing in Qualified Opportunity Funds, 83 Fed. Reg. 54,279 (proposed May 1, 2019) (to be codified at 26 C.F.R. pt. 1) (describing various "inclusion events").

[137] I.R.C. §§ 1400Z-2(b)(2)(B)(iii), (iv) (explaining that the basis for an investment held for at least 5 years "shall be increased by an amount equal to 10 percent of the amount of gain deferred," which is also applied to investments held for at least 7 years, plus an addition 5%).

[138] The "basis" for investments made with deferred capital gains differs from typical investments, which normally would apply a basis equal to the purchase price. I.R.C. § 1400Z-2(b)(2)(B)(i) (setting "the taxpayer's basis in the investment" at zero).

[139] *See* I.R.C. §§ 1400Z-2(a)(1), (b)(2)(B) (establishing income reporting rules for opportunity zone capital gains).

[140] *See* I.R.C. §1400Z-2 (providing for various tax breaks for investors in QOFs).

[141] I.R.C. §§ 1400Z-2(b)(2)(B)(iii), (iv) (explaining that the basis for an investment held for at least 5 years "shall be increased by an amount equal to 10 percent of the amount of gain deferred," which is also applied to investments held for at least 7 years, plus an addition 5%).

decreases from $40,000 to $36,000. The investor is thus $4,000 or 2% better off compared to the original investment. This translates to a compound annual growth rate of 0.39%.[142]

The calculation for the seven-year, 15% step-up in basis follows the same process. First, the investor receives an additional 5% step-up in basis of the original investment—increasing from $20,000 to $30,000. Her capital gain is then calculated to be $170,000, and her capital gains tax liability decreases from $36,000 to $34,000. The investor is thus $6,000 or 3% better off compared to the original investment. This translates to a compound annual growth rate of 0.42%.[143]

Table 4 Step-Up: Tax Liabilities and Respective Compound Annual Growth Rate (CAGR) at 0, 5, and 7 years

	Tax Liability	CAGR
Immediate	$40,000	0%
After 5 years	$36,000	0.39%
After 7 years	$34,000	0.42%

3. *Permanent Exclusion of Capital Gains*

Finally, the statute provides a permanent exclusion of capital gains from Qualified OZ Properties on investments held for at least ten years.[144] The permanent exclusion applies only to the capital gains stemming from the QOF's direct investment in the QOZP, and not those gains invested by taxpayers into the QOF.[145] For instance, if the taxpayer in our previous examples invests her $200,000 of capital gains into a QOF, and the fund places the full amount into a QOZP, the taxpayer will first pay the capital gains tax, adjusted for the step-up in basis, $34,000, by December 31, 2026.[146] If the taxpayer disposes of

[142] Compound Annual Growth Rate = (1.02)^(1/# of years)-1 = (1.02)^(1/5)-1 = 0.39

[143] Compound Annual Growth Rate = (1.03)^(1/7)-1 = 0.42

[144] The exclusion is framed as a basis equal to fair market value on the date of disposition. I.R.C. §§ 1400Z-2(c); LOWRY & MARPLES, *supra* note 95, at 4.

[145] I.R.C. §§ 1400Z-2 (defining a QOF as any investment "for the purpose of investing in qualified opportunity zone property").

[146] *Id.* (explaining that, where there is a gain from the sale of property, "gross income for the taxable year shall not include so much of such gain as does not exceed the aggregate amount invested by the taxpayer in a qualified opportunity fund").

the property after ten years, she will not pay any additional tax relating to the disposition, and her compound annual growth on her after-tax returns will equal the capital appreciation of the QOZP.[147]

D. Criticisms of Opportunity Zones

Critics have reasoned that the OZP is unlikely to attract new investment, that it will have larger than intended tax costs, and will accrue primarily to the benefit of property and land owners.[148] The concern is that the federal government will be funding a large, uncapped tax incentive program to benefit wealthy investors, without meeting the policy's purpose of revitalizing the disadvantaged communities and lifting up the longtime residents of these communities.[149]

1. No New Investment

Opponents of the OZP claim that the program will not actually encourage new investment, but merely give an undeserved benefit to investors who would have invested in projects anyway.[150] Looking at another place-based investment program, the NMTC program, an Urban Institute report "reasonably . . . concluded from the analysis that between three and four of every 10 projects would likely not have proceeded without NMTCs . . . . About two of every 10 early NMTC projects did not show evidence of needing NMTCs in order to come to fruition."[151] Moreover, critics fear that the OZ tax incentives will actually subsidize and accelerate gentrification—the displacement of longtime residents in underserved communities by rising property values resulting from new investment.[152] The following discussion of

[147] *Id.* (setting a basis for property held for 10 years as the fair market value of the QOZP).
[148] *See, e.g.*, Rosenthal *supra* note 93.
[149] *Id.* ("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.").
[150] *Id.* (explaining that "some taxpayers will characterize already-planned projects or restructure existing business arrangements . . . to obtain the new tax incentives").
[151] ABRAVANEL, NMTC FINAL REPORT, *supra* note 41, at 103.
[152] *See, e.g.*, William Fulton, *Opportunity Zones: Gentrification on Steroids?*, KINDER INSTITUTE (Feb. 20, 2019), https://kinder.rice.edu/urbanedge/2019/02/20/opportunity-zones-gentrification-steroids [https://perma.cc/JZ4W-NC4W] (reporting that, in Houston, "two-thirds of the neighborhoods susceptible

land rents will further illustrate how the benefits of place-based policies accrue to investors.

2. *Land Rents*

Researchers have historically found that place-based policies benefit landowners who capitalize on subsidies; specifically, residential housing prices and rental property businesses.[153] Since the federal government does not impose any requirements that investors offer community members equity stakes in OZ or other place-based policy properties, researchers have found that the benefits of the programs tend to capitalize, at least in part, in the land and housing prices.[154] Furthermore, real estate investments inherently satisfy the Qualified Opportunity Zone Business Property (QOZBP) criteria, and are unlikely to face significant federal limitations or transaction costs in qualifying under the current regulations.[155]

3. *Uncapped Potential Tax Costs*

Unlike previous place-based tax incentive programs, such as in the NMTC Program, the federal government has not placed a maximum level for credits for the OZP, and the scope of investments is

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to gentrification in the near future are located in opportunity zones," and defining gentrification as "a situation where longtime residents of an underserved neighborhood are squeezed out by rising property values that result from new investment"). *See also*, Andrea Riquier, *A tax break to hasten gentrification? Housing market's Opportunity Zones may miss their target*, Market Watch (Nov. 28, 2018), https://www.marketwatch.com/story/a-tax-break-to-hasten-gentrification-housing-markets-opportunity-zones-may-miss-their-target-2018-11-23 [https://perma.cc/89WP-VRUP] (illustrating various negative impacts of the program on communities, including the transition of owner-occupied homes to rentals).

[153] *See, e.g.*, Benjamin Austin et al., *Saving the Heartland: Place-Based Policies in 21st Century America*, Brookings Papers on Economic Activity (March 8–9, 2018), https://www.brookings.edu/wp-content/uploads/2018/03/3_austinetal.pdf (finding that place-based policies "seem to get capitalized into housing prices, especially in depressed areas").

[154] *Id.* ("If a place-based policy makes an area more attractive to a group, then that group will move into the area, or bid up prices, or both, depending on the elasticity of housing supply.").

[155] *See generally* I.R.C. § 1400Z-2(d)(2) (defining "qualified opportunity zone property" as including qualified opportunity zone stock, partnership interest, or business which would include real estate investments).

more wide-ranging than in previous programs.[156] Currently, the Joint Committee on Taxation estimates that the OZP will cost the federal government $1.6 billion between 2017 and 2027 in uncollected tax revenues, with a peak impact on the deficit of $12.4 billion in 2025—the last year before the statutory recognition event.[157] At the end of 2026, the IRS will collect the previously deferred and stepped-up gains, reducing the deficit.[158] Despite a tepid initial response by investors,[159] perhaps due to the novelty and regulatory uncertainty over these OZs, the uncapped exploitation of OZ benefits remains a concern.[160]

V. Analysis

This section will consider whether the OZP is likely to meet its drafters' intended goal of stimulating economic revitalization in the country's distressed geographic areas, and, ultimately, closing the gap between the wealthiest and poorest residents. This discussion will consider three questions. First, does the selection of OZs, on its face, target those areas most in need? Second, is the OZP likely to garner sufficient capital participation to impact the selected communities (i.e.,

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[156] *Id.* (outlining the requirements for as "any stock," "any capital or profits interest," or "tangible property used in a trade or business" of qualified opportunity zone properties); *cf.* Hula, *supra* note 18, at 16–18 (highlighting the limitation placed on NMTC credits in order to qualify for investments, including type of class of financial institutions, competition for limited funds and project type and location).

[157] I.R.C. § 1400Z-2(b)(1)(B) (listing the statutory recognition year as earlier than December 31, 2026); Scott Eastman & Nicole Kaeding, *Opportunity Zones: What We Know and What We Don't*, TAX FOUNDATION (Jan. 8, 2019), https://taxfoundation.org/opportunity-zones-what-we-know-and-what-we-dont/ [https://perma.cc/FZ3L-KK8G] (totaling of the annual cost estimates of opportunity zones).

[158] Eastman & Kaeding, *supra* note 156, at 6 (estimating the annual cost to be positive in 2026 and 2027 as $8.1 and $2.7 billion, respectively).

[159] *Opportunity Zone Fund Directory*, OPPORTUNITYDB (Sept. 23, 2019), https://opportunitydb.com/funds/ [https://perma.cc/U2JH-HN4H] (reporting as of September 23, 2019 that 117 funds have raised approximately $37.4 billion).

[160] *Few rush to invest in Opportunity Zones*, INVESTMENT NEWS (Apr. 10, 2019), https://www.investmentnews.com/article/20190410/FREE/190419995/few-rush-to-invest-in-opportunity-zones [https://perma.cc/N4U6-TQDW] (detailing the lack of initial investment produced by the passage of the opportunity zone tax breaks, referencing the uncertainty of some investment as reason for hesitancy in taking advantage of the tax breaks).

would these investments have occurred anyway)? Third, to what extent do the laws surrounding the OZP adequately address the shortcomings of previous place-based policies, and does it introduce its own set of problems? It appears that state governors have adequately targeted the neediest census tracts and that the features of the program will eventually draw in larger investments to the designated OZs.[161] However, the flexibility for OZP investors and the absence of laws linking benefits to either employment or community outcomes will likely frustrate the transfer of private capital to distressed residents.[162]

A. Selection of Opportunity Zones

OZs were nominated by state governors and subjected to minimum poverty rates and maximum median family incomes.[163] The selection of OZs, on its face, seems to target those areas most in need.[164] However, no formal legislative or regulatory guidance exists to address a major criticism of opponents that this program will accelerate gentrification by concentrating capital in already-improving census tracts and avoiding investment in the most severely distressed areas.[165]

Recent reports analyzing designated OZs tend to show that state governors, in general, selected census tracts that were the most in

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[161] *See generally* FIKRI & LETTIERI, *supra* note 89, at 3, 5 (arguing for reasonable local intervention to guard against gentrification or unequal distribution in low-income areas, given that "[g]overnors generally went further in targeting high-need areas with their selections than required by statute" and the likely increase in investment in the designated areas).

[162] *Id.* at 3 (emphasizing the need for regulatory implementation, alignment with community needs and investor incentives, and broad engagement across all sectors (public, private, and non-profit) in order to "ensure the incentive unlocks an effective distribution of the capital").

[163] I.R.C. § 1400Z-1 (setting limitations on the definition of qualified opportunity zones, defining "low-income community" as the same meaning as when used in section 45D(e)); *see also* I.R.C. § 45D(e) (defining a "low-income community" generally as having a poverty rate of at least 20% and the median family income as below 80% of either the statewide median family income, or the metropolitan area median family income, depending on the location).

[164] FIKRI & LETTIERI, *supra* note 90, at 7 (commenting on the "generally strong need-targeting" of certifying opportunity zones).

[165] *Id.* (expounding on "the commentary on Opportunity Zones" as focused on "the presence of or potential for gentrification in the designated communities" proliferating from the current given legislation and regulation).

need of economic revitalization.[166] Demographic information reported by the U.S. Treasury Department and analyzed in a Brookings Institution report tends to show that the governors designated zones in the most needy census tracts.[167] In fact, 71% of designated zones qualified as "severely distressed"[168] on the Community Development Financial Institution Fund's classifications.[169] In comparison, 59% of the pool of low-income communities eligible for nomination by the state governors before April 20, 2018 was considered to be severely distressed.[170] While governors were also permitted to designate up to 5% of their census tracts along contiguous tracts, reports indicate that only 230 of the 8,762 census tracts, or 2.6%, were contiguous.[171] These numbers suggest that state governors favored selecting more distressed areas.[172]

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[166] *Opportunity Zones: How Communities Were Selected for Participation*, MISSION INVESTORS EXCHANGE (Aug. 2018), https://missioninvestors.org/resources/opportunity-zones-how-communities-were-selected-participation [https://perma.cc/T3XK-QVJS] (detailing the process states enacted to identify potential qualified opportunity zones, by requesting assistance and input from "local governments and other stakeholders").

[167] FIKRI & LETTIERI, *supra* note 90, at 7, 11–12. (citing Brookings Institute study: 70% of OZs came from neediest quintile in 11 states, >50% of OZs came from neediest quintile in 37 states).

[168] Severely distressed zones have poverty rates of 30% and a median family income less than 60% of the area's standard. *Id.* at 6 ("71 percent of zones qualify as "severely distressed" on the U.S. Treasury Department's Community Development Financial Institution (CDFI) Fund's classifications, which generally means a poverty rate of 30 percent or an MFI no greater than 60 percent of the area benchmark.").

[169] *Id.* (utilizing the U.S. Census Bureau's American Community Survey's 2012-2016 to determine the number of severely distressed communities under consideration for Opportunity Zone designation).

[170] *Id.* (summarizing the U.S. Census Bureau's American Community Survey's 2012–2016 as supporting the assertion that across all low-income community census tracts "only 59 percent are considered severely distressed"); I.R.C. § 1400Z-1 (detailing the requirements for opportunity zone qualifications as to be nominated by the state's chief executive officer).

[171] I.R.C. § 1400Z-1(e)(2) (limiting designation to only "5 percent of the population census tracts designated in a State as a qualified opportunity zone"); *Opportunity Zones: How Communities Were Selected for Participation*, s*upra* note 165 (asserting that of the total 42,176 census tracts eligible for Opportunity Zone designation, 8,762 were designated and 230 were in contiguous communities).

[172] *Opportunity Zones: How Communities Were Selected for Participation*, s*upra* note 165 (inferring that the Opportunity Zone program's effectiveness

In analyzing the designated OZs for signs of gentrification, the Economic Innovation Group relied on the American Community Survey 5-Year Estimates for the 2007–2011 and 2012–2016 periods, and limited their search to areas that had above-average growth rates in: (1) urban phenomenon, (2) above-average population growth, (3) influx of above-average earners, (4) affects neighborhoods with high poverty rates, and (5) rise of non-Hispanic white residents.[173] They found that these gentrifying areas accounted for a miniscule share of the designated OZs—3.7% or 291 of the 8,762 designated tracts.[174] New York, California, and Texas had the largest portion of these gentrifying tracts: 7.2%, 3.9%, and 4.3%, respectively.[175] Although these zones had a proportional share of the total population, they had 5.1% of zone business establishments and 6.2% of zone jobs.[176] These numbers reflect the fact that the zones selected in these states tended to be commercial centers rather than residential neighborhoods, making it more likely that investments would promote the kind of job-creating economic activity that the legislators intended.[177] Proponents of the OZP have also reasoned that evidence of potential abuse have focused

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depends "on attracting capital to areas of greater need", which is in part supported by the fact states did not "select the maximum allowable amount of contiguous tracts, as more likely opportunities for investment").

[173] FIKRI & LETTIERI, *supra* note 90, at 7 (looking at urban areas with population growth and income growth of at least double the national averages, neighborhoods with at least 1.5 times the national average poverty rate, and areas with growing non-White populations).

[174] *Id.* at 8 (utilizing the aforementioned criteria "filter[ed] out over 96 percent of Opportunity Zones, leaving only 291 Opportunity Zone census tracts out of a total of 7,826 that show the characteristics commonly associated with gentrification . . . 3.7 percent of all designated zones . . ." with "governors pass[ing] over far more (523) of these tracts than they nominated.").

[175] *Id.* ("New York is home to the largest number of Opportunity Zone tracts that exhibit the common signs of gentrification (37 of its 514 zones [37/514 = 7.20%]), followed by California (34 of its 879 zones [34/879 = 3.87%]) and Texas (27 of its 628 zones [27/628 = 4.30%])).

[176] *Id.*

[177] *Id.*

on outlier tracts, such as Amazon's now-abandoned[178] HQ2 in Long Island City, New York.[179]

While these numbers on census tract designations support the notion that the program has included a sufficient number of low-income investment areas, no provisions in the statutes or regulations direct the flow of investor capital or mitigate against displacement.[180] That is, there are no positive laws or additional incentives, at least on the federal level, to encourage an equitable distribution—however the term is defined—within designated qualified opportunity zones.[181] These designations are also fixed and may allow investors to exploit already-gentrified zones through 2026.[182] Since the federal laws do not provide any protections against potential displacement and accelerated gentrification, it will be left to local governments to implement zoning regulations consistent with their community values to provide such protections.[183]

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[178] Laura Stevens, Jimmy Vielkind, & Katie Honan, *Amazon Cancels HQ2 Plans in New York City*, WALL ST. J., Feb. 14, 2019, https://www.wsj.com/articles/amazon-cancels-hq2-plans-in-new-york-city-11550163050.

[179] *Id.* at 7; Jim Tankersley, *Amazon's New York Home Qualifies as 'Distressed' under Federal Tax Law*, N.Y. TIMES, Nov. 14, 2018, https://www.nytimes.com/2018/11/14/us/politics/amazon-hq2-long-island-city.html.

[180] *See* I.R.C. §§ 1400Z-1, 1400Z-2. S*ee also*, Investing in Qualified Opportunity Funds, 83 Fed. Reg. 54,279 (proposed Oct. 29, 2018) (to be codified at 26 C.F.R. pt. 1) (proposing changes to rules on deferment of investor gains from QOFs); Scott Eastman, *Measuring Opportunity Zone Success*, TAX FOUNDATION (May 29, 2019), https://taxfoundation.org/measuring-opportunity-zone-success/ [https://perma.cc/MD2Y-9L4W] (examining investor tax rules on QOFs).

[181] *See* I.R.C. § 1400Z-1.

[182] *See generally* BRETT THEODOS ET AL., URBAN INSTITUTE, DID STATES MAXIMIZE THEIR OPPORTUNITY ZONE SELECTIONS? (2018), https://www.urban.org/sites/default/files/publication/98445/did_states_maximize_their_opportunity_zone_selections_1.pdf [https://perma.cc/G7CE-SN34] (examining the success of the opportunity zone program in the context of need and efficacy).

[183] *See, e.g.*, *Opportunity Zone Program*, CITY OF BOULDER (2019), https://bouldercolorado.gov/business/opportunity-zone-program [https://perma.cc/VDQ9-58AY] (last visited Nov. 8, 2019) (describing local ordinance passed for any projects benefitting from the federal OZP).

B. Capital Participation

Despite investors' current wariness over OZs, the OZP is likely to garner sufficient capital participation to impact the selected communities.[184] The OZP addresses the shortcomings of previous policies in three primary ways: (1) allowing investors to organize under a fund structure, (2) strong incentives, and (3) flexibility.[185]

The fund structure of this program, unlike previous policies, allows for specialization and pooling of resources.[186] Specialization would allow fund managers to leverage expertise and focus on specific economic development investments in targeted geographic regions, while pooling would allow QOFs to raise larger amounts of capital.[187] The combination of specialization and pooling will both lower the coordination costs, increase the ability of investors to diversify, and allow for investment into more capital intensive projects.[188] By reducing barriers to entry on capital intensive projects, the structure will allow individual investors with lower eligible investments to participate, not just large institutional investors.[189]

The strong incentives offered by the program—tax deferral and permanent exclusion—will also offset the risks of investing in economically distressed regions and allow the QOFs to raise more capital than was possible in previous programs.[190] While the step-up in basis has been cited as a benefit of the program, it produces a quantitatively lower financial impact on the investment—only an increase of 0.39% and 0.42% compound annual growth rates after five years and seven years, respectively.[191] Moreover, the step-up in basis produces a flat benefit because it does not materialize until the taxable event, and thus, does not enjoy any additional leverage effects.[192] The tax deferral and permanent exclusion on the other hand do have the potential to

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[184] *See Few rush to invest in Opportunity Zones*, *supra* note 159 (discussing low investor turnout for OZP).
[185] *Id*.
[186] BERNSTEIN & HASSETT, *supra* note 23, at 17 (identifying benefits of specialization in fund structure).
[187] *Id.* at 17 (highlighting how changes within these programs can positively impact investors).
[188] *Id.* at 17.
[189] *Id.* at 17.
[190] *Id.* at 18.
[191] *Id.* at 17.
[192] *See* I.R.C. § 1400Z-2(b).

confer considerable benefits to investors.[193] The tax deferral benefits include a reduction in net present value of the future tax liability, offer leverage effects to allow investors to purchase more valuable assets, and create an intrinsic option value.[194] Similar to the step-up in basis, the reduction in net present value creates a relatively certain benefit, depending on the discount rate, or investors' alternative investments.[195] As of November 2018, the National Council of State Housing Agencies estimated at least 43 funds were seeking to raise $8.9 billion and Treasury Secretary Steven Mnuchin predicted figures exceeding $100 billion in private capital.[196]

Finally, the OZP offers flexibility that sets it apart from programs like the NMTC.[197] It has a self-certification process that reduces the compliance costs of participation and allows investors to invest only a portion of their capital gains, as opposed to the full amount of the proceeds from a transaction, into the QOF.[198] The IRS has also proposed regulations to keep both the class of investors and qualified investments as broad as possible.[199] Additionally, the fund structure of the program allows investors to diversify their holdings, and thus, reduce the risk of providing capital.[200]

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[193] Lester et al., *supra* note 115, at 225.
[194] *Id*. at 225.
[195] Brady, *supra* note 116.
[196] Richard Rubin & Ruth Simon, *Rich Investors Eye Tax-Favored Development Funds*, WALL ST. J., Nov. 14, 2018, https://www.wsj.com/articles/rich-investors-eye-tax-favored-development-funds-1542193201; Peter Grant, *Government Shutdown Stymies Opportunity Zone Investors*, WALL ST. J., Jan. 15, 2019, https://www.wsj.com/articles/government-shutdown-stymies-opportunity-zone-investors-11547560800.
[197] *See supra* Part III(B).
[198] I.R.C. § 1400Z-2.
[199] Investing in Qualified Opportunity Funds, 83 Fed. Reg. 54,279 (proposed Oct. 29, 2018) (to be codified at 26 C.F.R. pt. 1) (providing guidance under new section 1400Z-2 relating to potential gain deferrals resulting from investment in QOFs).
[200] BERNSTEIN & HASSETT, *supra* note 23, at 10 (finding although the NMTC "supports many different types of investments, more than half of investments through the NMTC are for the development or leasing of real estate as opposed to operating businesses that can . . . have greater potential for expansion and job growth").

C. Outstanding Issues

To a large extent, the OZP does not address the inherent shortcoming of place-based policies, and does in fact introduce a sizable set of problems. Researchers are concerned that the OZP will provide a windfall to investors for projects that would have occurred without the incentive, and fail to improve employment conditions for residents because there is no nexus between the policy benefits and employment.[201] Additionally, the IRS has not yet promulgated any regulations regarding government oversight and reporting requirements.[202] In fact, this program seems to exacerbate the government's inability to monitor investor activity and compliance.[203] The new problems are due in part to the relatively fast enactment of the TCJA and unaddressed regulations.[204] As with other place-based policies, it is difficult to distinguish between projects that were bound to happen without the incentives and those that would not have materialized but for the incentives.[205]

One of the major aims of this program was to create a flexible incentive program to attract large amounts of capital.[206] This creates a two-fold problem. First, the program creates a problem with administration. Unlike the NMTC which had a thorough, two-phase, vetting process for prospective investors, the OZP allows QOFs to self-certify.[207] This self-certification produces immediate tax expenditures

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[201] Samantha Jacoby, *Potential Flaws of Opportunity Zones Loom, as Do Risks of Large-Scale Tax Avoidance*, CENTER ON BUDGET AND POLICY PRIORITIES (Jan. 11, 2019), https://www.cbpp.org/research/federal-tax/potential-flaws-of-opportunity-zones-loom-as-do-risks-of-large-scale-tax [https://perma.cc/WQN8-MWEC] ("[T]he 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.").

[202] Rosenthal, *supra* note 93.

[203] *Id.* ("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.").

[204] *Id.* ("We will not know for some time whether the program is worthwhile since Congress asked the IRS to begin reporting on the operation of the program in 2022.").

[205] *See id.*

[206] BERNSTEIN & HASSETT, *supra* note 23, at 16.

[207] Hula, *supra* note 18, at 17 (observing applications for NMTC applications are reviewed in two phases).

for the federal government and puts the onus on the IRS to ensure compliance. Second, the flexibility and significant incentives are anticipated to attract far more capital in the program's ten year period than the NMTC did over the eighteen year period from 2000 to 2018—$100 billion based on Treasury Secretary Mnuchin's estimate for OZs compared to the New Markets Tax Credit Coalition's estimate of $75 billion for NMTC projects.[208] Additionally, economists who are in favor of place-based policies have separately proposed aligning investor incentives with employment outcomes, particularly in training for high-skill jobs.[209] Again, the regulations and statute do not mention any ties between employment training or outcomes and the program tax incentives.[210] Finally, the IRS has not promulgated any regulations regarding reporting and monitoring; however, they have explicitly requested comments on such proposals for their next round of regulations.[211]

D. Real Estate Bias

One of the chief concerns regarding place-based policies is that the program benefits may be capitalized into land or housing prices.[212] This means that while residents may experience greater employment outcomes and higher wages, the benefits of those changes accrue to land and other real property owners because mobile workers from other regions may move into the OZ to enjoy the improving

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[208] Paul Anderson, *Coalition Releases 2018 New Markets Tax Credit (NMTC) Progress Report*, NEW MARKETS TAX CREDIT COALITION (June 6, 2018), https://nmtccoalition.org/2018/06/06/coalition-releases-2018-new-markets-tax-credit-nmtc-progress-report/ [https://perma.cc/UV39-SL6U] ("Today due to NMTC, more than $75 billion is hard at work in underserved communities."); Grant, *supra* note 196 ("Treasury Secretary Steven Mnuchin predicted the zones will attract over $100 billion in private capital.").

[209] *See, e.g.*, Bruce Katz & Jeremy Nowak, G*uiding Principles for Opportunity Zones*, New Localism (Mar. 9, 2018), https://www.thenewlocalism.com/research/guiding-principles-for-opportunity-zones/ [https://perma.cc/A8CU-K5Z4] ("If the new capital is going to assist low-income residents then it must be deployed into job creation opportunities that are aligned with skills upgrading programs."). S*ee also* Neumark, *Rebuilding Communities*, *supra* note 15, at 81.

[210] *See* I.R.C. § 1400Z-2.

[211] Investing in Qualified Opportunity Funds, 83 Fed. Reg. 54,279 (proposed May 1, 2019) (to be codified at 26 C.F.R. pt. 1).

[212] *See, e.g.,* Benjamin Austin et al., *supra* note 19.

conditions.[213] While the OZP addresses some of the issues faced by previous programs, it still requires less stringent requirements for real estate investments as opposed to other asset classes.[214] Specifically, the new program has lower capital requirements for real property investments, and continues to allow investors to invest in residential rental properties.[215]

As an exception to the 90% rule, which requires QOFs to hold at least 90% of their assets in QOZP, the IRS regulations allow for a reduced capital investment for certain Qualified Opportunity Zone Businesses (QOZB).[216] The "substantially all" requirement means that 70% of tangible property owned by a QOZB must be QOZBP.[217] This requirement stands in tension with the 90% asset rule.[218] Instead of investing in a property directly, the "substantially all" standard for businesses incentivizes investors to invest in a business or single purpose entity that owns the property, freeing up capital for property or activity outside of the designated OZ.[219] This discrepancy could

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[213] Neumark, *Rebuilding Communities*, *supra* note 15, at 81 ("One study finds strong effects on job growth, whereas another suggests that if we fully account for differences between zones and other places there is no evidence or beneficial effects. Moreover, if there are benefits, they appear to accrue to higher-income households.").

[214] BERNSTEIN & HASSETT, *supra* note 23, at 10 (observing NMTC tilts towards real estate because "it raises fewer concerns about compliance with the program's regulations and location requirements.").

[215] Investing in Qualified Opportunity Funds, 83 Fed. Reg. 54,279 (proposed May 1, 2019) (to be codified at 26 C.F.R. pt. 1); Lisa M. Starczewski, *The Eagerly Awaited Opportunity Zone Regulations: What Do They Tell Us and What Do We Still Need to Figure Out*, BUCHANAN INGERSOLL & ROONEY PC (Oct. 22, 2018), https://www.bipc.com/the-eagerly-awaited-opportunity-zone-regulations-what-do-they-tell-us-and-what-do-we-still-need-to-figure-out [https://perma.cc/HMY3-H52H]].

[216] Investing in Qualified Opportunity Funds, 83 Fed. Reg. 54,279 (proposed Oct. 29, 2018) (to be codified at 26 C.F.R. pt. 1) ("[T]he proposed regulations provide a working capital safe harbor for QOF investments in qualified opportunity zone businesses.").

[217] *Id.* ("If at least 70 percent of the tangible property owned or leased by a trade or business is qualified opportunity zone business property (as defined section 1400Z-2(d)(3)(A)(i)), the trade or business is treated as satisfying the substantially all requirement in section 1400Z-2(d)(3)(A)(i).").

[218] I.R.C. § 1400Z-2(d)(1).

[219] Investing in Qualified Opportunity Funds, 83 Fed. Reg. 54,279 (proposed Oct. 29, 2018) (to be codified at 26 C.F.R. pt. 1) (explaining purpose of "substantially all" clause).

potentially confer a special advantage to real estate investors who may easily acquire QOZBs and use those business entities to hold properties indirectly.[220]

Stated differently, the two types of ownership structures would present as follows: (1) Investor—QOF—QOZP, and (2) Investor—QOF—QOZB—QOZBP. Under the first ownership structure, an investor would have to keep 90% of his investment in the QOZB.[221] Under the second ownership structure, an investor would have to keep only 70% of his investment in the QOZB.[222]

Another aspect in which the OZP seems to favor property owners more than in previous place-based policies—specifically, the Enterprise Zone program—is in its allowance for investments in residential rental properties.[223] Although the IRS has not directly addressed this issue in its proposed regulations, some commentators believe that the clear meaning of the statute and legislative desire to include affordable housing support this position.[224] Lisa Starczewski looks to the statute defining "qualified opportunity zone business property" to determine whether housing is specifically included or excluded.[225] She reasons that QOZBP is defined by reference to a statutory provision in the Enterprise Zone program, which includes two standards, one of which specifically prohibits residential rental properties.[226] Since the drafters of the OZ statute were most likely aware of both provisions, and the OZ statute does not refer to the standard,

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[220] Observation by author.

[221] I.R.C. § 1400Z-2(d)(1).

[222] I.R.C. § 1400Z-2(d)(2)(D).

[223] Lisa M. Starczewski, *supra* note 214 (explaining that it would be counter not to include residential rental property in the definition of QOZB).

[224] In § 1400Z-2(d)(3) defining "qualified opportunity zone business property," the legislature references § 1397C(b)(2), (4), and (8), a subsection of the IRC detailing the "active conduct" requirements for "qualified business entities" under the Enterprise Zone program. *Id.* Another subsection within the statute defines "qualified businesses," which specifically disqualifies residential rental properties. I.R.C. § 1397C(d)(2). However, the commentators point out that no part of § 1400Z-2 references this specific subsection; thus, this residential rental qualification does not limit business conduct in OZs. *E.g.*, Lisa M. Starczewski, *supra* note 214.

[225] *See* I.R.C. § 1400Z-2(d)(2)(A) (QOZP statute); Lisa M. Starczewski, *supra* note 214 (examining QOZBP statute).

[226] Lisa M. Starczewski, *supra* note 214 (citing that reference to § 1397C (d)(2) in § 1400Z-2 "is there to create an active conduct standard . . . not to provide a qualified business.".).

which specifically prohibits conducting business relating to residential rental properties, Starczewski reasons that investments in residential rental properties do qualify as QOZP.[227]

Commentators frequently raise the issue that the OZP is likely to displace the residents of the distressed areas.[228] When housing prices and rents increase, low-income residents are priced out of their communities and forced to relocate.[229] In his study of the NMTC data, Freedman found that 70% of the $26 billion NMTC program tax credits were used to fund real estate developments, with the remainder going into business loans.[230] Freedman also found negligible effects of the program on median housing prices in areas with NMTC projects, and a 0.75% increase in household turnover.[231] While these results seem to suggest that the OZP may experience similarly insignificant effects on housing costs, the NMTC program restricted investments in residential real estate, requiring "substantial improvements."[232] Given the flexible investment scheme of the OZP, it is likely that investors will be able to fund more residential real estate projects than in previous programs and displace the target residents.

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[227] *Id.* (citing that reference to § 1397C(d)(2) in § 1400Z-2 "is there to create an active conduct standard . . . not to provide a qualified business.").

[228] *See e.g.*, Adam Looney, *Will Opportunity Zones Help Distressed Residents or Be a Tax Cut for Gentrification?*, BROOKINGS INST., Feb. 26, 2018, https://www.brookings.edu/blog/up-front/2018/02/26/will-opportunity-zones-help-distressed-residents-or-be-a-tax-cut-for-gentrification/ [https://perma.cc/ZE6Z-DUXR] (expressing concern that residents may be displaced for higher-income individuals).

[229] FIKRI & LETTIERI, *supra* note 90, at 10 ("[G]entrification is most concerning as a precursor to the potential displacement of existing residents as prices and land values rise . . . .").

[230] Matthew Freedman, *Teaching New Markets Old Tricks: The Effects of Subsidized Investment on Low-Income Neighborhoods*, 96 J. PUB. ECON. 1000, 1002 (2012).

[231] Neumark, *Rebuilding Communities*, *supra* note 15, at 90 (interpreting study conducted by Freedman, *supra* note 230) (citing 0.75% household turnover rate).

[232] I.R.C. § 45D(d)(3) ("[R]ental to others of real property located in any low-income community shall be treated as a qualified business if there are substantial improvements located on such property").

VI. Conclusion

More than a decade after the Great Recession, the country continues to face growing inequalities in economic opportunity, growth, and unemployment.[233] In a congressional effort to reconcile the geographic disparities in economic outcomes, federal lawmakers have enacted another place-based policy—the Opportunity Zone Program—promising to stimulate economic activity in the most distressed communities.[234] Despite the OZP's strong investor incentives and likelihood of attracting enough capital to make a significant impact within the policy's jurisdiction, it is unclear whether the potential for abuse by states and investors to accelerate gentrification and merely shift investments will entirely frustrate the legislative intent of Congress.[235] Further work should be done to examine the role of state actions in either facilitating or restricting the influx of private capital through the OZP. Specifically, to what extent will adoptions of the OZP provisions in state tax codes encourage a race to the bottom, and in what ways can existing state and local government tools—zoning regulations and community-benefits agreements—address existing doubts?

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[233] BERNSTEIN & HASSETT, *supra* note 23, at 1–2 (highlighting disparities and inequalities among individuals and geographic locals).
[234] Tankersley, *Tucked into the Tax Bill, supra* note 2, at 1.
[235] FIKRI & LETTIERI, *supra* note 90, at 9 ("Some worry that the Opportunity Zones incentive will cause rapid changes in currently non-gentrifying neighborhoods in the years ahead.").