Opportunity Zones: Whose 'Opportunity' Is It Really?

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The opportunity zone tax legislation is receiving major attention in the real estate industry. Experts predict there will be a substantial amount of capital that will be deployed in this space in the coming months. An opportunity zone, or OZ, is an economically distressed community where new investments, under certain conditions, can qualify for tax breaks. The U.S. Treasury Department designated nearly 9,000 census tracts as OZs across urban and rural areas throughout the United States. It is estimated that approximately 35 million Americans live in OZs, which have higher poverty and unemployment rates than the rest of the nation. Opportunity zones are called “opportunity zones” because they are supposed to provide opportunities to the residents as well as the investors. But the question remains how well will the OZs help improve the quality of life of those living in the disadvantaged neighborhoods once development starts to pour in. Will the new capital lead to gentrification? How could current residents participate in the improvement of their communities thanks to OZ-fueled investments?

OZs have been championed for several years by Republicans and Democrats in Congress, and they were added to the tax law by Sen. Tim Scott, R-S.C., and supported significantly by Sen. Cory Booker, D-N.J. The zones allow investors who comply with regulations — some of which are still being worked out by the Treasury Department, to reduce their tax burden with preferential treatment of capital gains.

On Nov. 14, 2018, the New York Times published an article concerning Amazon’s selection of Long Island City, New York, as one of its two new secondary headquarters. The selected location is within an opportunity zone. Investors who invest capital gains proceeds into OZ funds that invest in real estate or other businesses that qualify for opportunity zone status can essentially obtain as much as a 15 percent reduction in their taxable income and receive a deferral to pay their tax until Dec. 31, 2026. If an investment is held for at least 10 years, then upon meeting statutory and regulatory conditions, the appreciation in value over cost would be eliminated from capital gains treatment.

As more developers get familiar with this tax break program, the demand for properties in areas formerly ignored by private capital will rise. There may be a market imbalance as there could be more capital seeking OZ investments than economically feasible development OZ opportunities. Industry experts expect a wave of transactions during the next 12 months that will consume the OZ pipeline in reliance upon the proposed regulations that have just been issued. For Miami, this new designation is very important because many of its opportunity zones are in areas economically viable for development. In many cases, they are on the outskirts of an urban area that is in the process of being redeveloped such as Downtown Miami. We are currently working with developer groups planning mixed-use projects in those zones as developers look to take advantage of the potential tax breaks. One of our clients is planning a mixed-use project next to the Brightline train station — a brand new commuter train that connects Miami to Fort Lauderdale to West Palm Beach and soon to Orlando — and a mixed-use project in an OZ area in the Wynwood area.

Critics of the OZ program have expressed concerns that investments in OZ designated areas may not be considered impoverished and are currently undergoing regentrification. OZ designations are intended to draw investment in economically troubled areas that otherwise would not attract investment capital.

State governors selected the zones from a list of eligible census tracts, based on a formula used to calculate eligibility for another federal effort to aid struggling areas, the longstanding new markets tax credit. Governors were allowed to designate one-fourth of eligible areas as opportunity zones. Their designations were approved by the Treasury Department in March of 2018.

A recent report by a major investment bank analyzed the economic values of OZ fund investments taking into account the tax advantages compared to a normal private equity investment without the extra tax incentives. The report, to no surprise, indicated there is a significant increase in the after-tax profit by investing in an OZ project if the investor otherwise meets the applicable guidelines in order to defer and/or reduce capital gains tax, combined with the appreciation of the OZ asset, which would not be the case in a normal private equity investment.

Recent publications and policy memoranda related to OZs have analyzed the development with OZs can become more beneficial to the public at large. Publications, including The Economist (Nov. 17, 2018, Economist 73 — Tax Breaks: Boondocks and Boondoggles), address the issue about who will benefit from the tax incentives provided to investors and what public benefits should result in connection with the anticipated new investment in OZ designated areas. The Economist article noted that, "earlier place-based policies have been difficult to evaluate, in part, because some were tried in areas that would probably have recovered without them. They also have tended to be multi-pronged, making it difficult to know what precisely has generated any success." The Economist goes on to cite that, "a study of Hilary Gelfond and Adam Looney of the Brookings Institution found that 89% of selected opportunity zones do have poverty rates higher than the national average. But when selecting census tracts to be opportunity zones, most states picked places that were more likely to show signs of gentrification than eligible ones that were passed over."

In 1996, Congress created a number of empowerment zones that were intended to offer tax breaks and grants in high poverty areas. OZ legislation and regulation, unlike the empowerment zone program, comes with no prior approval process to qualify as long as the investment conditions of the program are satisfied.

A major concern from a policy standpoint is how to benefit those people that live in OZs and make their lives better. The current legislation and the proposed regulations do not impose any requirements on generating social benefits for those who live in OZs; rather, the standards are based upon economic formulas and governmental involvement in the process could ensure that the development of OZs provides public benefit for the underprivileged residents in OZ areas since, by definition, OZs are based upon both a lower income and/or poverty standard.

Policy Link indicated that there will be substantial investments in OZs and there is a need to connect people to growth and opportunities to ensure that all residents participate and thrive.

As a result of this concern, the following factors should be considered in improving the neighborhood quality of life:

- Good jobs. This includes job training and trying to improve the standard of living of residents in the area by having governments incentivize developers or public companies to provide job training and job availability to those residents in OZs.
- Creation of affordable housing to avoid the displacement of the residents.
- Increase the services available for the lower income population including transportation improvements, health care improvements, healthy food options and educational services.
- Engaging local residents in the process as well as local officials.
- Taking advantage of community redevelopment agency grants to provide assistance to existing residents to acquire or rent affordable residential units. Therefore, residents who could not otherwise afford to acquire or rent upgraded or new units can now afford to do so based upon the grants and incentives that could be provided.
- Assistance to try to monitor the ultimate results of development in OZ areas to see what social issues are being addressed.
- Analysis of institutional lending for multi-family, single family, commercial buildings and small business institutions in OZ areas to determine what OZ areas have already attracted financing because they are already being regentrified.

The one clear benefit of OZ developments for both private industry and the government is that the property tax base will increase based upon the enhanced value being created by the OZ development. Accordingly, not only will there be job generation for the construction of buildings and the servicing of those buildings or new businesses created, but an increase in tax dollars that could be redeployed back into local OZs to benefit those residents that are otherwise affected by the potential displacement.

Finally, a noted problem with the proposed OZ program is the lack of accountability as far as outcomes compared to the intended legislative policy, and whether the tax incentives are with the investment from a results standpoint. There is no current mechanism to track the ultimate performance of the program and isolate its impact on the residents that the program was, in part, intended to benefit.

Given the current status of the OZ program, it is incumbent upon government agencies to work with investor groups and the affected residents in the OZ designated areas to effectuate many of the recommendations suggested above. At this time, the jury is out.