A Primer on Opportunity Zones
Looking at the Knowns and Unknowns

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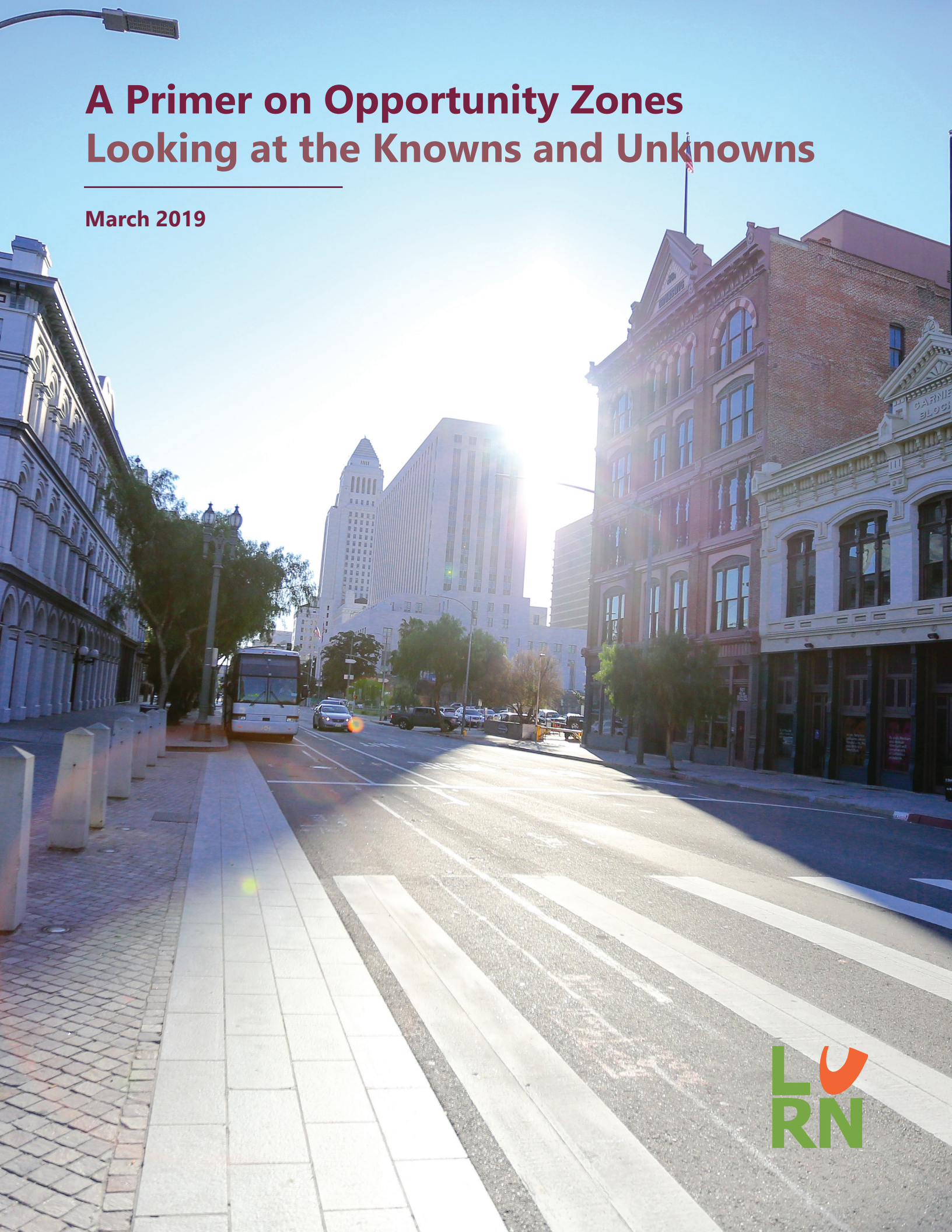


Introduction

Many of us in the community development field have come across the latest tool for investment in low-income communities: Opportunity Zones. But what are they? Where did they come from? Should we be excited? This brief provides an overview of Opportunity Zones, a new investment tool created by the Federal Government which intends to encourage investment in low-income communities of Los Angeles.

Opportunity Zones are not the first government program aimed at spurring private investment in distressed communities. Areas of disinvestment in both rural and urban communities across the US have been the target of many government policies and programs over the decades. From Roosevelt's New Deal in the 1930s, to the Community Reinvestment Act (CRA) of the 1970s, and the Low-Income Housing Tax Credit (LIHTC) of the 1980s, programs and incentives have been developed to stimulate growth and economic activity in low-income and historically disinvested areas. Opportunity Zones, created out of the Tax Cuts and Jobs Act of 2017, are the most recent. This new tax benefit incentivizes investment of capital gains into newly created Opportunity Zones as a way to spur real estate and economic development.

GLOSSARY

To help us understand Opportunity Zones and how they may impact our communities, it's helpful to define some key words:

Capital Gains
Capital gains are the profits from an asset being sold. An asset could be a stock you own, or a piece of real estate. The "capital gain" is the profit the seller acquires when that asset is sold.

Unrealized Capital Gains
Unrealized capital gains are capital gains that could be attained should sales be made, but are otherwise capital gains only on paper because there has not been a sale to receive those gains.

Equity Investment
Equity Investments are investments in a property or asset that are paid back only with the sale of that asset. This means that an equity investment is not guaranteed back, such as in the case of an asset being sold for less than it was bought.

Opportunity Zones
Opportunity Zones are ***census tracts*** that have been designated to be a place in which Qualified Opportunity Funds can invest money to gain the tax benefit from the Tax Cuts and Jobs Act of 2017.

Qualified Opportunity Funds
Qualified Opportunity Funds are the vehicle through which investment is made to buy assets in Opportunity Zones.

WHAT ARE OPPORTUNITY ZONES?

Opportunity Zones (OZ) are designated areas of census tracts where capital gains investments can be made in exchange for a tax benefit. Unlike the Low-Income Housing Tax Credit program, which is a tax credit program, Opportunity Zones and their companion Qualified Opportunity Funds (discussed below) work together to create a tax deferral, meaning investors can defer paying taxes on capital gains income invested through this new mechanism.

Opportunity Zones, and their tax benefit to investors, were developed through the Tax Cuts and Jobs Act (TCJA) of 2017, but can trace their origins to the bipartisan Investing in Opportunity Act of 2015 (IOA) and a 2015 white paper from the Economic Innovation Group (EIG). According to EIG, there is $6,000,000,000,000 (six trillion) of unrealized capital gains that can be used to boost development in underserved neighborhoods.

What Areas Were Identified as Opportunity Zones?

Designating census tracts as Opportunity Zones was a multi-step process, completed in 2018. First,, the federal government identified census tracts across the country with high federal poverty rates (over 20% of the population living in poverty), or adjacent to census tracts with high poverty rates. Second, each state was given the authority to apply additional criteria to identify the census tracts best suited for this type of investment and to submit their nominated census tracts to the federal government for approval.

What did California propose? California proposed census tracts with:

- 20% or more poverty rates; and
- at least 30 businesses (to spur further activity).

Additionally, California made sure each county had at least two census tracts to diversify the overall portfolio of investment opportunities.[1]

Following a public comment process on California's nominated census tracts, additional criteria were added[2] and a total of 879 tracts were chosen (including 183 tracts that were taken out due to negative public comments) for recommendation to the IRS. All of California's nominated census tracts were approved by the Secretary of the U.S. Treasury. Of California's certified census tracts, 193 of them are in the City of Los Angeles, and 274 in Los Angeles County.

Where Does the Money Come From?

The money invested into Opportunity Zones originates from the private market, spurred by a tax incentive approved through the TCJA. When an individual or company sells property or stocks, any appreciation in value is known as "capital gains." If capital gains income is invested in an OZ within 180 days, the investor can defer payment of taxes on the capital gains income. The longer the capital gains income remains invested, the greater the tax incentive.[3] To invest in an Opportunity Zone, an investor invests their resources into a Qualified Opportunity Fund which manages the investments that go into the Opportunity Zone.

There is no cap on the amount of money that one can invest into a Qualified Opportunity Fund (discussed below), meaning investors can invest as much of their capital gains as they want into a fund.

It is important to note that this is a federal tax

benefit only; therefore, all other state and local tax requirements still apply on capital gains. Although, public comment for rulemaking was open until the end of December and jurisdictions weighed in on this issue. For example, the City of Los Angeles recommended to the IRS to require that states also have these benefits, in order to draw as much investment as possible and not deter investors because of the cost of State taxes. The official rules record has not come out as of the publishing of this piece.

Wait, What's a Qualified Opportunity Fund?

To invest in an Opportunity Zone, an investor places their money into a Qualified Opportunity Fund (QOF). The QOF is simply the investment mechanism created to receive capital gains income investments and to direct funds into OZs. While there is no federal government agency process or approval required to certify a QOF – rather, QOF's can self-certify by filling out a form and submitting with their taxes– the legislation/regulations[4] establish some general criteria, namely:

- 90% or more of its property must be held in qualifying OZs.
- Its sole purpose must be to invest in OZs, but it cannot invest in other QOFs.
- Self-certification by completing this form and following these instructions, which include definitions of the types of eligible investments, which include property, stocks, partnerships and business ventures. [5]

QOFs are able to invest in a few different types of assets: physical property and buildings or land, businesses and business ventures, or stocks. Property that QOFs can invest in must either be new development or put in as much money into rehabilitation/renovation of the property as was invested to buy the property if it is an existing building. This is key in understanding what development will look like in the future: we anticipate that new projects and major renovations/rehabilitations will be the physical manifestation of this incentive. Under the current law, investments can be made into a QOF until December 2026, and the Opportunity Zone designation is valid until December 31, 2028. Given this, it is likely that a bigger development boom will happen in California, and specifically Los Angeles, in the coming decade – dramatically altering what it means to live in the City or County of Los Angeles.

It is important to note that neither relevant federal law nor regulations require investments to advance equity, affordable housing, or small businesses, or be done in consultation or collaboration with local communities. This is why it is critical that local municipalities and state governments implement requirements around these investments to ensure that the communities identified as Opportunity Zones are positively impacted and benefit from this tax incentive.

OPPORTUNITY ZONES IN LOS ANGELES

The OZs in the Los Angeles area include neighborhoods like Hollywood, East Hollywood, Westlake, Watts, Wilmington, Van Nuys, Sun Valley, and many others. Notably missing from the list, however, is Boyle Heights, which advocates requested to not be designated. Upon review, it is obvious that Los Angeles' OZs cover many known underinvested, lower-income neighborhoods. At the same time, closer review of the certified census tracts uncovers that areas like the Arts District and Mid-Wilshire, with much more advantaged socio-economic profiles, are also certified Opportunity Zones.

Los Angeles could expect to see significant investment activity through OZs and QOFs as there is an incredible amount of development both currently underway and planned for the future across greater Los Angeles. According to one source, in the City of Los Angeles more than a quarter of new-construction residential units, and half of new-construction commercial space falls within OZ boundaries.[6] Significant future development plans in Los Angeles include Metro's Twenty-Eight by '28, the LA River Revitalization Plan, and the new Rams Stadium - just to name a few.

Looking at the 274 Ozs in Los Angeles County and 193 in the City of Los Angeles, LURN developed an informational map to explore income and economic characteristics to see how neighborhoods compare to Opportunity Zones. The numbers are from the 2017 5-Year ACS data. Below is a brief breakdown of how the OZs compare overall to the County, also derived from 2017 ACS 5-Year data.

	Los Angeles County	Los Angeles County OZs	City of Los Angeles OZs
Median Household Income	$66,213	$37,346	$38,357
SNAP Benefits in the last 12 Months	9.95%	18.67%	16.79%
Families Below the Poverty Level	14.03%	27.63%	26.16%
Female Head of Household Below Poverty Level	22.23%	39.03%	36.71%
Female Head of Household with Children, Below Poverty Level	31.77%	50.31%	49.00%
Children Living Below Poverty Level	22.19%	42.30%	40.91%
All People Living Below Poverty Level	17.38%	31.20%	29.29%

This data shows us that people living in poverty will be the most affected (particularly single mothers with children) by this incentive. Within Los Angeles County, around 1 in 5 children live in poverty, but in the OZs, 2 in 5 do.

Given the disproportionate impact that Opportunity Zones will have in communities where low-income households live, we must ask ourselves a few key questions:

How can we ensure that investments that are deployed in an Opportunity Zone make a positive impact in the lives of the most marginalized families? What systems will be in place to monitor how new construction and renovations impacts low-income households? If new housing is built, and new businesses are opened, will they serve the existing community? If not, who will they serve?

Los Angeles City Council has begun answering these questions by submitting recommendations to the IRS on what provisions should be added to the incentive at the federal level. Their recommendations included the following:

- Establishment of accountability measures such as reporting on outcomes of investment and who is setting up the QOFs;
- Requiring that QOFs file a Declaration of Intent to show what it is they intend to do with their investments;
- CDFI's be added as a QOF Business eligible for investment;
- States follow federal tax code to further incentivize investment;
- Promoting healthy communities through investment into services such as transportation options, healthy foods retail, and other amenities;
- Establishment of explicit provisions in the law to allow for state and local authorities to implement further requirements on OZs and QOFs; and,
- Providing a system to report if OF investments "result in the eviction of tenants or small businesses, dramatically increase rents in the acquired properties, or result in the loss of deed restricted or rent stabilized housing".

The last recommendation implies an understanding that Opportunity Zone investments should benefit the lives of those who live in disinvested communities. But how will self-certified QOFs champion these principles?

THE UNKNOWNS

As with any new national mechanism of this nature, there remain many questions about the efficacy and especially, the potential impacts of investments in Opportunity Zones. One of LURN's biggest concerns is that mass investment in disinvested communities has historically led – intentionally and unintentionally – to gentrification and displacement of existing residents, small businesses, and neighborhood organizations. How can we work to make sure that Opportunity Zones are different?

There are also a number of outstanding technical questions related to the mechanics of the tax benefit and the drafting of the related legislation and regulations. For example, what properties will qualify for investment by QOFs? There are a number of developments around Los Angeles that have been identified as possibly qualifying, but they have already broken ground without a clear answer. Can existing construction projects qualify for an Opportunity Zone's tax incentives? If so, what does this mean for existing construction across Los Angeles and other areas across the nation seeing a building boom?

The questions move up in scale as well. For example, what impacts will deferring tax revenue have on the federal government's budget? Capital gains tax revenue will be

reduced as a result of this mechanism. What other sources of revenue will make up this loss, if any? Where will there be funding cuts in the budget?

We believe that Opportunity Zones can have impacts in not only the "zones" they target, but other programs that rely on resources that would otherwise be generated by the revenue being deferred. The effects of Opportunity Zones may be felt at every level: from neighborhoods seeing money poured into them and new construction happening, to governments experiencing their tax revenue cut due to this deferment and need for reallocating resources to cover any losses.

Implications For Los Angeles

Los Angeles has an important opportunity to ground Opportunity Zones investments within a framework of equity. The City and County stand to see even more private investment as a result of this new tax incentive, and our region can serve as a model for how the public sector can engage with the private sector to drive development in a way that meets the needs of its most vulnerable residents.

To do this, leaders should be proactive in organizing communities to define how Opportunity Zones should guide investments in their communities.

As details emerge about how Opportunity Zones work, we should begin to think about what equitable investments should look like in Los Angeles. As outlined above, given current real estate development markets, public investment in large infrastructure projects, and the concentration of Opportunity Zones in Los Angeles, the city and county both stand to see even more private investment as a result of this new tax incentive.

With major developments happening in Los Angeles in the coming years (such as Metro's 28 by '28, the LA River Revitalization, and the California High Speed Rail), LURN is concerned about how money is deployed to build out these projects in an equitable way. Without explicit parameters, the investments in these projects does not have to benefit the residents that live in the OZs. Ideally, the OZ incentive works in concert with other programs and zones to help guide development in a way that fits the City of Los Angeles' recommendations to the IRS – for example, the Good Food Zones, Transit Oriented Communities, and Metro's adopted Equity Framework. There are tangible ways in which these existing policies can be leveraged to influence OZ investments in an equitable way.

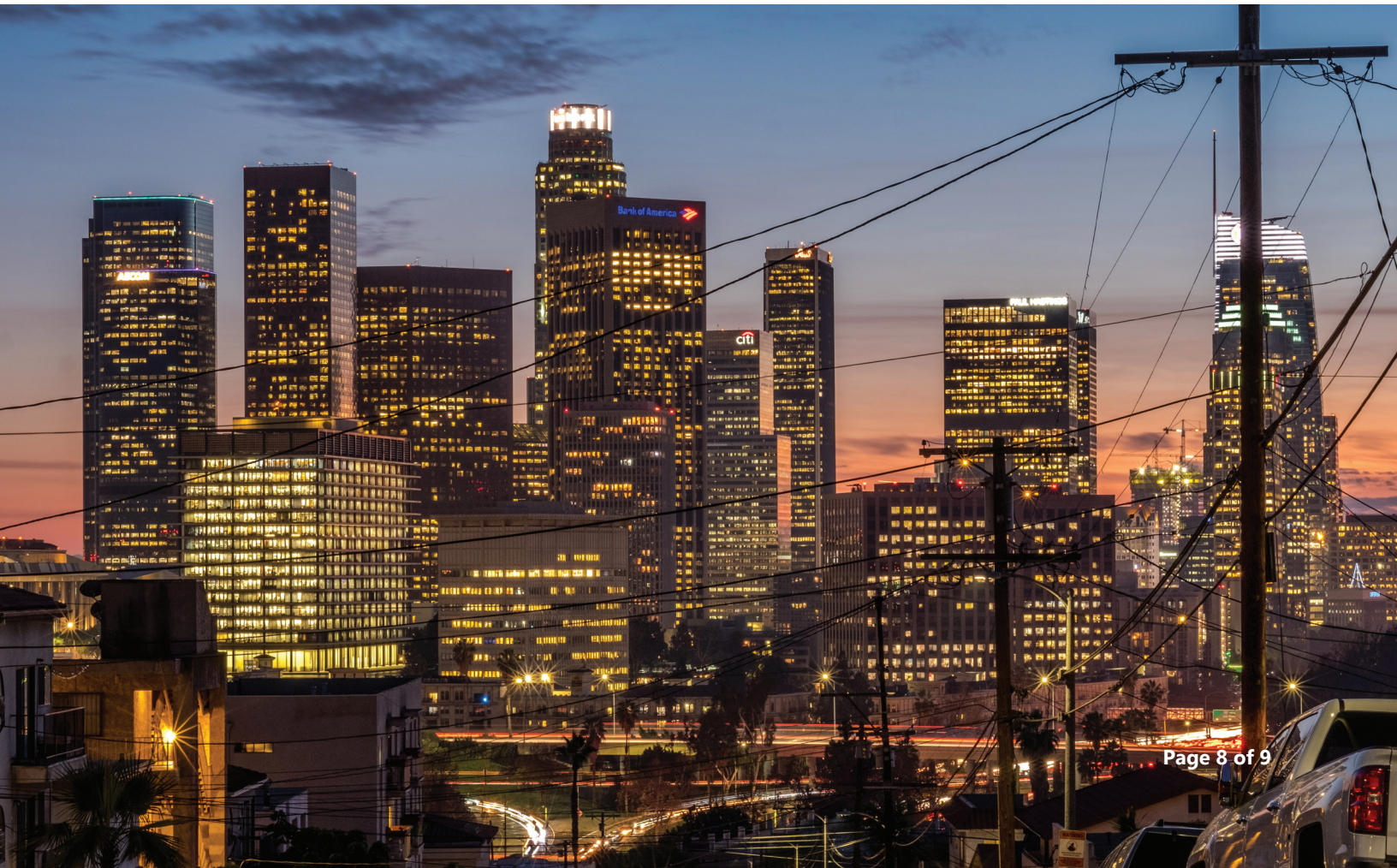
There are also programs that can be leveraged statewide and will, in fact, intersect in crucial ways with OZ and QOFs, such as the Ellis Act (where landlords are allowed to evict tenants in order to build market rate housing), and the newly introduced SB 50.

WHAT NEXT?

To monitor what is happening in California, a website has been set up to ensure that investment is implemented equitably. The state has also set up an inter-agency working group looking at how money should be spent, and that "truly benefits the residents of California." (Since the needs of Californians are so diverse, we think the State should consider approaching their work by prioritizing the most disenfranchised, especially as the wealth gap continues to grow). The Economic and Workforce Development Department for the City of Los Angeles has developed a website to take a closer look at OZs in Los Angeles. On the website it includes a map that allows the user to overlay information like the Transit Oriented Community tiers, Promise Zones, and other policy that could affect what money comes in. Future iterations of it will include public developments, and then later anticipates to include private developments that show possible opportunities for investment.

We look forward to continuing to monitor the development of Opportunity Zones. Los Angeles has a prime opportunity to be a model of how to channel private investment in a way that supports communities, not displaces them. To accomplish this, community members need to be at the decision-making table and policymakers must craft a clear system to guide investments that prioritizes the needs of residents, many whom have advocated for years for resources to come to their communities in the first place.

If you have any comments, questions, concerns, or additions, please reach out to Lyric Kelkar at lyric@lurnetwork.org.



End Notes

1 California initially recommended 798 census tracts.

2 Adjusting for tracts that actually have high median incomes: only tracts with median incomes below $100,000 could qualify. Allowing for local public comment to determine many of the tracts: tracts that had been recommended by local cities and counties in exchange for other tracts were done as much as possible. The intent was to let localities determine the tracts to the furthest extent possible because they know their neighborhoods best. This also allowed for adding tracts when requested by groups, as long as they fell within the other parameters. Removing tracks that residents requested be taken out: 183 tracts were taken out of the initial lot because public comments requested this. This is important to note because it meant that some neighborhoods that qualified, actively chose not to be a part of the program. Focusing on tracts that are designated in existing programs: Tracts that were selected are heavily consistent with the designation of the Legislature and Governor for disadvantaged communities for Cap and Trade purposes. Of the chosen tracts, 96 percent overlap with AB 1550 designations and 64 percent have SB 535 designations.

3 There are three timelines for investment - 5, 7, and 10 years. For 5 -7 years of investment, people will not have to pay for 10% of taxes on their capital gain. For example, if a person invests $100 in a QOF, after 5 years, they will only need to pay taxes on $90. For 7-10 year investments, people will not have to pay for an additional 5% of the taxes on their original capital gain. For example, if a person were to invest $100 of capital gain in a QOF, they will only need to pay taxes on $85. For 10+ years of investments, people will not have to pay any taxes on the capital gains invested. When millions of dollars are invested in these QOFs - it can mean the difference in paying many hundreds of thousands of dollars (or more) to the federal government.

4 § 1400Z (d) (1)

5 As the tax code stands now, there remains ambiguity around what counts as a qualified investment for the QOF to make, meaning that many of the deals that are ultimately made will have to be deemed appropriate by the IRS.

6 From October 2017 to September 2018