Opportunity Zones: The Program & Its Possibilities
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Opportunity Zones are the first new community development tool that we've had in almost twenty years. The program idea emerged from an analysis of the nation's post-recession economic recovery by the DC-based Economic Innovation Group. Their research found that the recovery was incredibly uneven, with low-income areas having fewer jobs in 2015 than they did in 2010. In addition, most of the country's new start up activity has taken place in just three states: California, New York, and Massachusetts.

Realizing that more than $6 Trillion in unrealized capital gains were being held by investors, EIG economists and lobbyists developed the Opportunity Zones program – a tax incentive whereby investors could "roll over" capital gains into Opportunity Funds which would then be invested in qualified projects in locally designated Opportunity Zones. Community development intermediaries signed on in support of the program, which was passed by Congress in December 2017 as part of the tax bill.

Between December and April, Governors were tasked with designating 25% of eligible low-income census tracts as Opportunity Zones. In June, the IRS certified designated zones in all 50 states. Minnesota is home to 128 zones, with five contiguous tracts designated as Opportunity Zones in Duluth. The designations will be in place for the next ten years, unless extended by Congress. A map and analysis of US Opportunity Zone designations can be found here.

Investor Benefits
For corporations or individuals that have capital gains, Opportunity Zones provide a tax incentive to place those gains into a designated Opportunity Fund (note: qualified Opportunity Funds are not yet in place as the IRS is still in the rulemaking process.) In order to receive the tax benefits, investors have 6 months after realizing capital gains, to place those into an Opportunity Zone Fund.

Investor benefits accrue over time and include:
- Taxes on capital gains are deferred if rolled into an Opportunity Fund within six months of their realization.
- After five years in the fund, the tax on the capital gain investment is reduced by 10%
- After seven years in the fund, the tax on the capital gain investment is reduced by 5%
- If an investor makes a 10-year investment in an Opportunity Fund, any gains realized on that investment are tax free.

Currently the federal capital gains tax is 24%. Some states are looking at mirroring the federal tax incentives of Opportunity Zones, this is not currently under Legislative discussion in Minnesota.

Individuals are likely to be investors. Banks are less likely to be investors as they don't have significant capital gains, but they are likely to be deal partners who provide other non-equity capital.

Opportunity Funds & Eligible Investments
Opportunity Funds are investment vehicles organized as a corporation or partnership for the purpose of investing in Opportunity Zone property. Funds will self-certify per IRS guidelines. There is a "related party" rule for funds, where new investors must take a percentage of the ownership. Yields are likely to be similar to other equity funds ~8% annualized yield.

Within 6 months of establishing an Opportunity Fund, 90% of the capital must be invested as equity (not debt) into Opportunity Zone property. Eligible investments include:

- ***Business Investments*** –investments in new stock issuance for corporations and ownership interests in partnerships and LLCs. This could include: venture capital funds, operating business private equity.
- ***New equipment and other assets***
- ***Investments in real estate*** –must include an ownership interest of new construction or assets that will be "substantially improved" within 30 months of acquisition by the Opportunity Fund. This could include: real estate investment funds, enhancement/gap funding for federal tax credit transactions. Substantial improvement means that the rehab of a property must be greater or equal to the initial basis of the property at acquisition. Currently this applies on a per property basis, not across a portfolio.

We expect that people will want to keep their investments in Opportunity Funds for the full ten years to realize the greatest tax benefit. Community development has typically been financed through banks and philanthropy, Opportunity Funds create the ability to attract high net worth individuals or corporations as investors. For project sponsors, who are used to complying with the regulations tied to Low Income Housing Tax Credits (LIHTCs) and New Markets Tax Credits (NMTCs), it is anticipated that there will not be any federal compliance regulations for Opportunity Funds, unless required locally.

For information about technical program details, see the following:
- 26 USC 1400Z-2: Special rules for capital gains invested in opportunity zones
- IRS Opportunity Zone FAQs

Program Strengths, Concerns, and a Call to Action
The Opportunity Zones incentive is unlike any previous community development program.

Program strengths include:
- Local designation process that creates ownership
- Flexibility as funds can support investment in any type of asset class
- Introducing a new class of investor to community development finance

- Scalability as there is no cap and huge investment potential given $6 Trillion of unrealized capital gains
- Straightforward application from an investment and compliance standpoint, especially compared to LIHTC and NMTC

These strengths also contribute to program concerns, including:

- Lack of oversight from government entities could lead to program abuses (there are no reporting requirements, or public certification processes)
- Lack of impact incentives – incentives focus on back-end returns rather than community impact.
- Gentrification and displacement – affordable housing could be turned into luxury housing. Puts onus on local government to ensure that guardrails are in place.
- Future elimination of other tax incentives if Congress thinks Opportunity Zones should replace long-standing community development programs.