

Congress of the United States
U.S. House of Representatives
Committee on Small Business
2561 Rayburn House Office Building
Washington, DC 20515-6515

MEMORANDUM

TO: Members, Subcommittee on Economic Growth, Tax, and Capital Access
FROM: Andy Kim, Chairman
DATE: Thursday, October 17, 2019
RE: Subcommittee on Economic Growth, Tax, and Capital Access hearing entitled
“Can Opportunity Zones Address Concerns in the Small Business Economy?” on
Thursday, October 17, 2019 at 10:00 A.M. in Room 2360 of the Rayburn House
Office Building

The Subcommittee on Economic Growth, Tax, and Capital Access will hold a hearing entitled “Can Opportunity Zones Address Concerns in the Small Business Economy?” on Thursday, October 17, 2019 at 10:00 A.M. in Room 2360 of the Rayburn House Office Building.

The hearing will focus on what prospects the Opportunity Zones enacted in the Tax Cuts and Jobs Act provide for small businesses and local economic development. Members will have the chance to hear from witnesses about how the law works, the status of regulatory developments, and stakeholder input. Witnesses include:

- Mr. Brett Theodos, Senior Fellow, Urban Institute, Washington, D.C.
- Mr. Aaron Seybert, Managing Director of Social Investment Practice, The Kresge Foundation, Troy, MI
- Ms. Jennifer A. Vasiloff, Chief External Affairs Officer, Opportunity Finance Network, Washington, D.C.
- Mr. John Lettieri, President and Chief Executive Officer, Economic Innovation Group, Washington, D.C.

Background

Small business owners have long been a critical stakeholder in tax discussions. This is, in part, because small businesses make uniquely valuable and substantial contributions to the U.S. economy in the form of employment and overall economic activity. Small businesses make up over 99 percent of all employers. Therefore, it is essential that federal tax law support small businesses to ensure job creation and economic growth in the overall economy, but especially in underserved and low-to-moderate income regions of the country. Small business owners generally have agreed that their priorities for reforming the tax code are: (1) lowering the tax burden on small business income; (2) decreasing the cost of tax compliance for all small firms; (3) establishing parity between the tax rates for corporate and non-corporate net business income; and (4) creating certainty for small businesses. These objectives, following passage of the Tax Cuts

and Jobs Act (TCJA),¹ raised the question of how small businesses have fared since the new tax law was enacted and whether new tax incentives were meant for small businesses.

Qualified Opportunity Zones (OZs)

The TCJA was the largest tax overhaul in many years. The new tax law makes substantial changes to both the individual and corporate income taxes rates, cutting the corporate income tax rate to 21 percent, redesigning international tax rules, and implementing a new and complicated deduction for pass-through income, to name a few.² The Joint Committee on Taxation (JCT) estimated that these changes would reduce tax revenue by \$1.5 trillion over 10 years, though new data has higher estimates.³ Unlike many small business related provisions that are set to expire over the coming years, C corporate tax provisions were made permanent.⁴

As part of the law, a new federal tax incentive – the Qualified Opportunity Zones (OZs) – were created. These zones are designed with the intention to spur economic development and job creation in distressed communities throughout the country by providing favorable capital gains treatment for taxpayers who invest in designated low-income communities. Further, to defer a gain, a taxpayer has 180 days from the date of the sale or exchange of appreciated property to invest the realized gain into a Qualified Opportunity Zone Fund (QOFs). A QOF is an investment vehicle that files either a partnership or corporate federal income tax return and is organized for the purpose of investing in OZ property.⁵ The QOF then invests in Qualified Opportunity Zone activities. Qualified funds can invest in any OZ property, including stocks, partnership interest, and business property whose use commences with the fund or if the fund makes “significant improvements” to the qualifying property. A QOF can invest in a broad range of activities and projects, including but not limited to commercial and industrial real estate, housing, infrastructure, and existing or start-up businesses. For real estate projects to qualify for Opportunity Fund financing, the investment must result in the properties being “substantially improved.”

¹ Pub. L. No. 115-97.

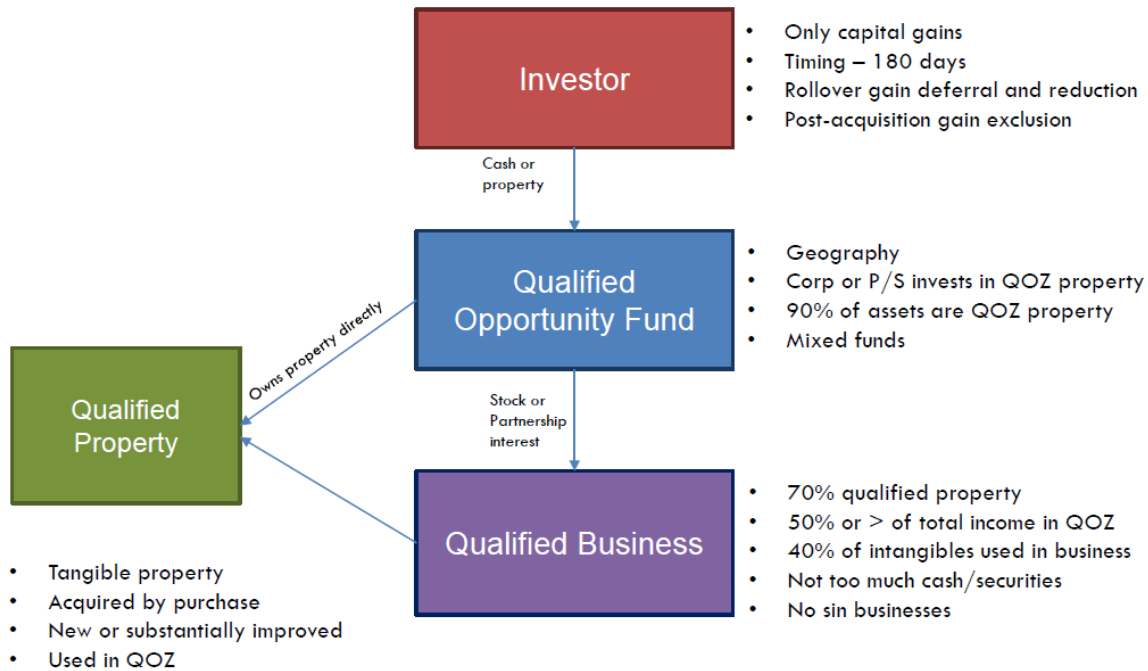
² JANE G. GRAVELLE & DONALD J. MARPLES, CONG. RESEARCH SERV., R45736, THE ECONOMIC EFFECTS OF THE 2017 TAX REVISION: PRELIMINARY OBSERVATIONS (2019).

³ *Id.*

⁴ *Id.*

⁵ To become a Qualified Opportunity Fund, an eligible corporation or partnership self-certifies by filing Form 8996, Qualified Opportunity Fund, with its federal income tax return.

Graphic 1: How Opportunity Zones Work



Source: Joint Committee on Taxation, 2019.

The intent of this subsection of the law, as outlined by advocates, was to spur economic development and job creation by providing tax benefits to investors who incentivize investment in distressed communities. The new law provides three main tax incentives to encourage investment in OZs:

Temporary deferral of capital gains⁶ that are reinvested in qualified OZ property:

1. *Taxpayers can defer capital gains tax due upon sale or disposition of a (presumably non-OZ) asset if the capital gain portion of that asset is reinvested within 180 days in a QOF.* Under current law, the deferral of gain is available on qualified investments until the earlier of the date on which the investment in the QOF is sold or exchanged or December 31, 2026.
2. *Step-up in basis for investments held in QOFs:* If the investment in the QOF is held by the taxpayer for at least five years, the basis on the original gain is increased by 10% of the original gain. If the OZ asset or investment is held by the taxpayer for at least seven years, the basis on the original gain is increased by an additional 5% of the original gain.
3. *Exclusion of capital gains tax on qualified OZ investment returns held for at least 10 years:* The basis of investments maintained for at least 10 years and until at least December 31, 2026, will be eligible to be marked up to the fair market value of such investment on the

⁶ Capital gains are the profits from the sale of an asset, such as stock, land, or a business and considered taxable income.

date the investment is sold. Effectively, this amounts to an exclusion of capital gains tax on any gains earned from the investment in the QOF when the investment.⁷

Table 1: Investor Benefits

Illustration of Opportunity Zone (OZ) Tax Benefits

Year	Investment Value	Basis Adjustment	Mandatory Recognition of Reinvested Capital Gain	Taxable Capital Gains if Sold
2019	\$100,000	\$0	-	\$100,000
2020	\$107,000	\$0	-	\$107,000
2021	\$114,490	\$0	-	\$114,490
2022	\$122,504	\$0	-	\$122,504
2023	\$131,080	\$0	-	\$131,080
2024	\$140,255	\$10,000	-	\$130,255
2025	\$150,073	\$10,000	-	\$140,073
2026	\$160,578	\$15,000	\$85,000	\$60,578
2027	\$171,819	-	-	\$71,819
2028	\$183,846	-	-	\$83,846
2029	\$196,715	-	-	\$0

Source: CRS calculations. Illustration of Opportunity Zone (OZ) Tax Benefits for a Hypothetical Investment of \$100,000 in Reinvested Capital Gains Made in 2019 (Assuming an annual rate of return of 7%).

Note: Investments maintained (a) for at least 10 years and (b) until at least December 31, 2026, will be eligible for permanent exclusion of capital gains tax on any gains from the qualified OZ portion of their investment when sold or disposed. In this hypothetical, the \$196,715 in earnings over the 10 years that the investment is held in a QOF would be excluded from capital gains tax, and tax would be due on the initial \$100,000 in outside capital gains rolled over into the QOF after applying the OZ adjusted basis increase benefit of 15% (i.e., tax due on \$85,000 in capital gains).

Although OZ tax incentives alone might not themselves generate a positive investment return from an otherwise unprofitable economic development in a distressed community, developers may be able to combine the benefits of multiple local and federal tax incentives because there are no rules against double dipping for the same investment. For example, taxpayers can pair the New Market Tax Credit (NMTC) benefits with tax benefits offered by OZs by having an established QOF qualify as a community development entity and apply for an allocation that would then allow the organization to make an equity investment in a Qualified Opportunity Zone Business (QOZB). Collectively, the tax benefits could make a project located in one area more profitable than other alternatives, though studies have found that place-based incentives tend to shift investment from one area to another, rather than create an increase in overall economic activity.⁸

Characteristics of Opportunity Zones

Opportunity Zones are economically distressed communities that have been designated by state governors and territories based on Treasury nominated eligible census tracts, which were then

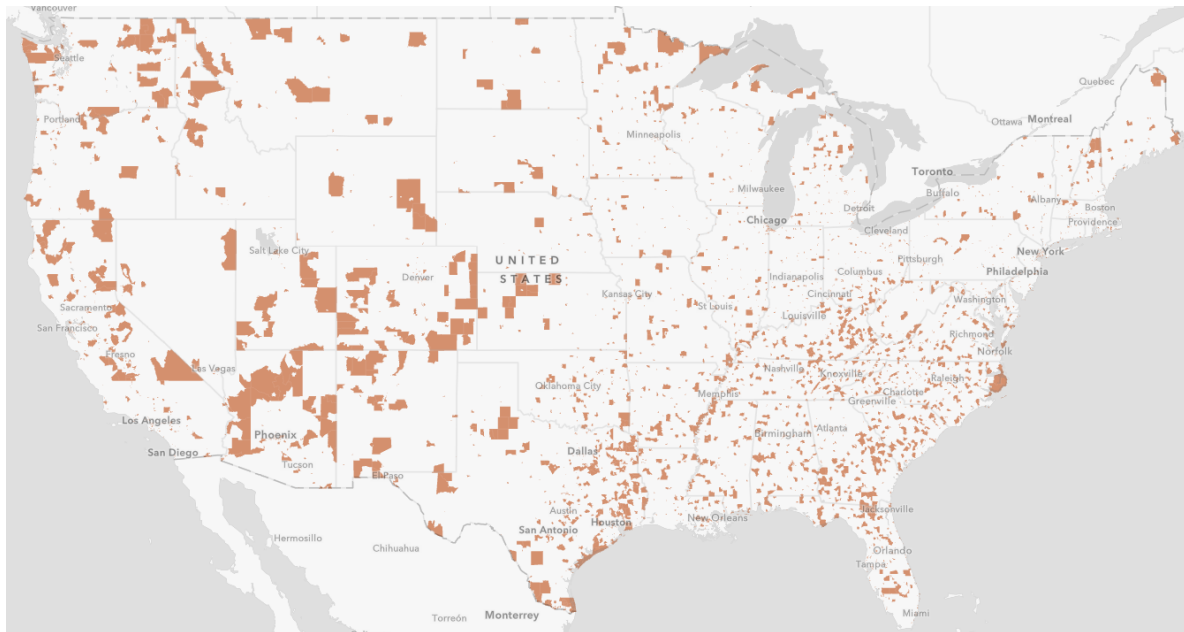
⁷ SEAN LOWRY AND DONALD J. MARPLES, CONG. RESEARCH SERV., R45152, TAX INCENTIVES FOR OPPORTUNITY ZONES: IN BRIEF AX REVISION (2018).

⁸ For additional economic literature on geographically targeted development/ place-based policies, see SEAN LOWRY, CONG. RESEARCH SERV., R42770, COMMUNITY DEVELOPMENT FINANCIAL INSTITUTIONS (CDFI) FUND: PROGRAMS AND POLICY ISSUES (2019).

certified by the U.S. Treasury Department.⁹ These zones are generally made up of: (1) low-income community census tracts, generally defined as tracts with poverty rates of at least at 20 percent; (2) tracts in which the median family income does not exceed 80 percent of the statewide median family income if located outside of a metropolitan area; or (3) tracts in which the median family income does not exceed 80 percent of the statewide median family income or the metropolitan area median family income, whichever is higher.¹⁰ As of June 14, 2018, Treasury certified OZs of all states, territories, and the District of Columbia, totaling approximately 8,762.¹¹ Each state nominated the maximum number of eligible tracts, per statute, and these designations are final and remain in effect for 10 years.

Of the designated OZs, most have higher poverty and unemployment rates than the national average. According to Census data and an Urban Institute analysis, in designated OZs, the median household income is \$33,345, the poverty rate is 31.75 percent, and the unemployment rate is 13.41 percent.¹² Qualified OZs were also twice as likely as other U.S. communities to be located within a persistent poverty county, meaning the county had experienced a poverty rate of at least 20 percent for 30 years. Further, it is estimated that a total of 31.3 million people live in areas that have been designated as OZs, with about 56% of residents being minorities.¹³

Map 1: Designated Opportunity Zones



Source: Economic Innovation Group¹⁴

⁹ The statute defined local areas (census tracts) as eligible for selection as Opportunity Zones if they are “low-income communities” under the high-poverty or low-median-income definitions established for the New Markets Tax Credit program.

¹⁰ U.S. Code § 45D.

¹¹ Brett Theodos, Brady Meixell, and Carl Hedman, DID STATES MAXIMIZE THEIR OPPORTUNITY ZONE SELECTIONS? ANALYSIS OF THE OPPORTUNITY ZONE DESIGNATION (2018).

¹² *Id.*

¹³ *Id.*

¹⁴ Economic Innovation Group, Opportunity Zone Map, <https://esrimedia.maps.arcgis.com/apps/View/index.html?>

Preliminary Economic Effects and Concerns with Opportunity Zones

While the program was intended to target distressed communities and spur investment in undercapitalized communities, results are mixed regarding their overall impact. Skeptics of the proposal have pointed to a number of issues that need to be addressed to fully understand how effective OZs have been.

Overall Economic Benefit

One of the main concerns is that while the program provides explicit benefits to the parties getting the tax benefit (investors, fund managers, real estate developers), there may be little benefit to the broader community. One study determined that while the OZ program results in an increase in the price of depreciated property and vacant land within the zones, there was not a similar resulting impact on the price of all property within the OZs.¹⁵ As a result, the study concluded that the OZ program primarily passed through the tax benefits to existing land owners, with limited evidence of additional value creation.¹⁶

Determination of Opportunity Zone

Another issue centers around determining what areas of the country qualified as opportunity zones. Initial eligibility was broad—57 percent of all neighborhoods in America qualified—and not all were truly distressed.¹⁷ State governors, which had broad discretion to select from qualifying areas outlined by the U.S. Department of Treasury,¹⁸ faced a conflict between selecting deeply distressed areas versus already improving or gentrifying areas that were more likely to provide tax benefits to investors. Finally, the statute does not contain any provision to change which communities are classified as OZ after the fact.

Oversight to gauge effectiveness of Opportunity Zones

Another issue is the lack of reporting requirements that QOFs are required to submit. Currently, because the underlying nature of the OZ program is tax policy, it is administered by the Internal Revenue Service (IRS). The IRS is having trouble identifying how many individuals are investing in QOFs, how much is being invested, which zones and what sorts of business activities are being invested in, the cost to taxpayers, and whether the program creates the opportunity for sheltering of capital gains.

appid=77f3cad12b6c4bffb816332544f04542.

¹⁵ Alan Sage, and Mike Langen, and Alex Van de Minne, WHERE IS THE OPPORTUNITY IN OPPORTUNITY ZONES? EARLY INDICATORS OF THE OPPORTUNITY ZONE PROGRAM'S IMPACT ON COMMERCIAL PROPERTY PRICES (May 2019).

¹⁶ *Id.*

¹⁷ Hilary Gelfond and Adam Looney, BROOKINGS, LEARNING FROM OPPORTUNITY ZONES: HOW TO IMPROVE PLACE-BASED POLICIES (2018). <https://www.brookings.edu/research/learning-from-opportunity-zones-how-to-improve-place-based-policies/> (last visited Sep. 27, 2019).

¹⁸ Governors may nominate up to 25 percent of a state's Low-Income Community census tracts for Opportunity Zone designation. If the number of low-income tracts in a state is less than 100, then a total of 25 qualifying tracts may be designated. The 2011-2015 American Community Survey serves as the basis for determining eligibility. Governors were also permitted to substitute a small percentage of non-low-income census tracts in their nominations, as long as the tracts are contiguous with other nominated low-income tracts and the median family income does not exceed 125 percent of the adjacent qualifying tract. Not more than 5 percent of the total number of designated tracts in a state can qualify under this criterion.

Unlike other tax incentives, such as the New Market Tax Credit (NMTC) that requires Community Development Financial Institutions (CDFI) certification, QOFs are not required to report their activities. For example, while NMTC applicants are evaluated on an established set of factors, including the overall impact the investments will have on “community outcomes,” investments made by QOFs are eligible to receive tax benefits regardless of the potential “community outcome” of a particular project.¹⁹ This has led many to requesting additional guardrails, including more reporting requirements, monitoring of compliance, and transparency within the program.²⁰

Further, proposed regulations provide the IRS with limited and vague authority to combat abuse within the program. The rule gives the IRS the authority to challenge any investment that it finds does not intend to increase business activity or investment in an OZ. However, the rule’s effectiveness is highly dependent on a well-funded and properly staffed IRS to perform enforcement and audit activities, which the agency currently lacks.

Conclusion

Created as part of the 2017 tax law, the OZ program provides investors with the ability to defer taxes that they would otherwise owe on capital gains by converting the amount of the gains into QOF that invest in OZs. If investors hold onto their interests in these OZ funds for a certain number of years, they can qualify for additional tax breaks — including a permanent capital gains tax exemption on all gains they realize on their OZ investments through 2047. The hearing will address if this new place-based policy has met its goals and potential other ways to spur economic development and job creation in low- and moderate-income regions across the country.

¹⁹ Lowry, *supra* note 7.

²⁰ Gelfond, *supra* note 19.