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Opportunity Zones May Help Investors And Syndicators More Than Distressed Communities.

The Tax Cuts and Jobs Act (TCJA) created a new tax-advantaged Opportunity Zone program to encourage investments in economically-distressed communities that are nominated by governors and certified by the Treasury Department. Congress had previously tried similar approaches with Empowerment Zones and Renewal Communities. But its latest effort is remarkable for its lack of a governmental oversight role and for its generosity to investors.

The law allows taxpayers to postpone until 2026 taxes on profits from the sale of any property, if the profits from the sale are reinvested in an Opportunity Zone fund that, in turn, invests in businesses in a targeted community. It also allows taxpayers to exclude from tax any gains that arise from investing in the fund if the fund is held for 10 years. This opens the door to big profits for both investors and syndicators, even as the social benefits of the initiative are unclear at best.

The process works like this: Assume a taxpayer recognizes a $200,000 profit on the sale of stock in a public company. By investing the amount of the gain in an Opportunity Zone fund, she can postpone capital gains taxes until 2026. If the taxpayer holds her Opportunity Zone fund shares for five years, her $200,000 deferred gain is reduced by 10 percent, to $180,000. After seven years, it is reduced by another 5 percent, to $170.000. And, if she sells after 10 years, she may exclude any appreciation in the value of the Opportunity Zone Fund shares. Thus, if she sold her fund shares for $300,000, she could exclude from tax her entire $100,000 gain (her basis would be $200,000, even though she had recognized only $170,000 of deferred gain). Investment banks, syndicators, or anyone else may establish opportunity zone funds. For a fee, of course.

The Joint Committee on Taxation scored the new tax incentive program as a small revenue loser over the budget window, primarily because the deferred gain must be recognized by 2026, which was within TCJA's 10-year budget window. But because the incentives for Opportunity Zone investments are so much more generous than prior programs, the revenue loss might turn out to be substantial, and far out of proportion to the local economic development they are intended to encourage.

The new Opportunity Zones have three novel features:

First, a taxpayer need only reinvest gains, not the entire proceeds from a sale of assets. The capital gains provisions of the earlier programs noted above required a taxpayer to reinvest all sales proceeds, not just profits. Other provisions in the tax code that defer gains also require reinvestment of all proceeds (e.g., like-kind exchanges, involuntary conversions, etc.).

Second, the other programs permitted a taxpayer to defer gains from the sale of assets within a qualified zone, but not defer gains from the sale of assets outside the zone. Another change: Empowerment Zone and Renewal Communities programs permitted only capital gains to be deferred, but the new program appears to permit other income to be deferred, like gains from the sale of inventory, though this may have been a drafting error.

Finally, syndicators may organize and market the opportunity funds, which can invest more expansively than earlier programs could. The Treasury has certified 8,700 Opportunity Zones, twelve percent of U.S. census tracts, many of which already attract businesses and investments. By comparison, Congress authorized only 40 empowerment zones and 40 renewal communities.

In addition, eligible Opportunity Zone businesses are more wide-ranging, including investments such as residential rental property businesses, which were excluded by the earlier programs. The additional businesses may be lower risk for investors and, perhaps, less beneficial for the community.

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. Presumably, some taxpayers will recharacterize already-planned projects or restructure existing business arrangements through, for example, sale-leasebacks, to obtain the new tax incentives. Other taxpayers may try to invest in already-gentrifying areas that were nominated by governors, lessening the focus on economically distressed communities. And, syndicators may lure other taxpayers with the promise to delay and even eliminate taxes.

We will not know for some time whether the program is worthwhile since Congress asked the IRS to begin reporting on the operations of the program in 2022. But as with many tax incentive programs, Congress might have created a more effective program by investing directly in distressed communities rather than creating new tax subsidies for investors and additional cash flows for syndicators that develop and market the deals.

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