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Tax Incentives for Opportunity Zones: In Brief

Updated November 20, 2018

Congressional Research Service
https://crsreports.congress.gov
R45152

CRS REPORT
Prepared for Members and
Committees of Congress

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The 2017 tax revision (P.L. 115-97) temporarily authorized Opportunity Zone (OZ) tax incentives for investments held by Qualified Opportunity Funds (QOFs) in qualified OZs.[1] The Community Development Financial Institutions (CDFI) Fund (hereinafter, the "Fund"), organized under the Department of the Treasury, designated qualified census tracts that are eligible for OZ tax incentives after receiving recommendations from the head executives at the state level. Qualified OZ designations are in effect through 2026. The tax benefits for these investments include: (1) a temporary tax deferral for capital gains reinvested in a QOF, (2) a step-up in basis for any investment in a QOF held for at least five years (10% basis increase) or seven years (15% basis increase), and (3) a permanent exclusion of capital gains from the sale or exchange of an investment in a QOF held for at least 10 years.

This report briefly describes what census tracts have been designated as an OZ, what types of entities can are eligible as QOFs, the tax benefits of investments in QOFs, and what economic effects can be expected from OZ tax incentives.

For further reading on the Fund's other programs and analysis of related policy issues, see CRS Report R42770, *Community Development Financial Institutions (CDFI) Fund: Programs and Policy Issues*, by Sean Lowry. For updated guidance regarding OZ tax incentives, including any IRS notices and proposed regulations, see websites created by the Fund and IRS.[2]

Opportunity Zone Designations

To become a qualified OZ, the CEO (e.g., governor) of the state must have nominated, in writing, a limited number of census tracts to the Secretary of the Treasury.[3] A nominated tract must have been either (1) a qualified low-income community (LIC), using the same criteria as eligibility under the New Markets Tax Credit (NMTC),[4] or (2) a census tract that was contiguous with a nominated LIC if the median family income of the tract does not exceed 125% of that contiguous, nominated LIC.[5] Nominations were due to the Fund by March 21, 2018.[6]

Figure 1 provides a screenshot of the Fund's online mapping tool, which displays census tracts that have been designated as a qualified OZ by the state or territory's CEO and approved by the Fund. A complete list of qualified OZs has been published as an IRS Internal Revenue Bulletin and is available on the Fund's "Opportunity Zone" website.[7]

[1] These provisions amend the Internal Revenue Code (IRC) as Sections 1400Z-1 and 1400Z-2.

[2] CDFI Fund, "Opportunity Zone Resources," at https://www.cdfifund.gov/Pages/Opportunity-Zones.aspx; and IRS, "Opportunity Zones Frequently Asked Questions," at https://www.irs.gov/newsroom/opportunity-zones-frequently-asked-questions.

[3] For the purposes of OZ tax incentives, a "state" includes the District of Columbia and any U.S. possession.

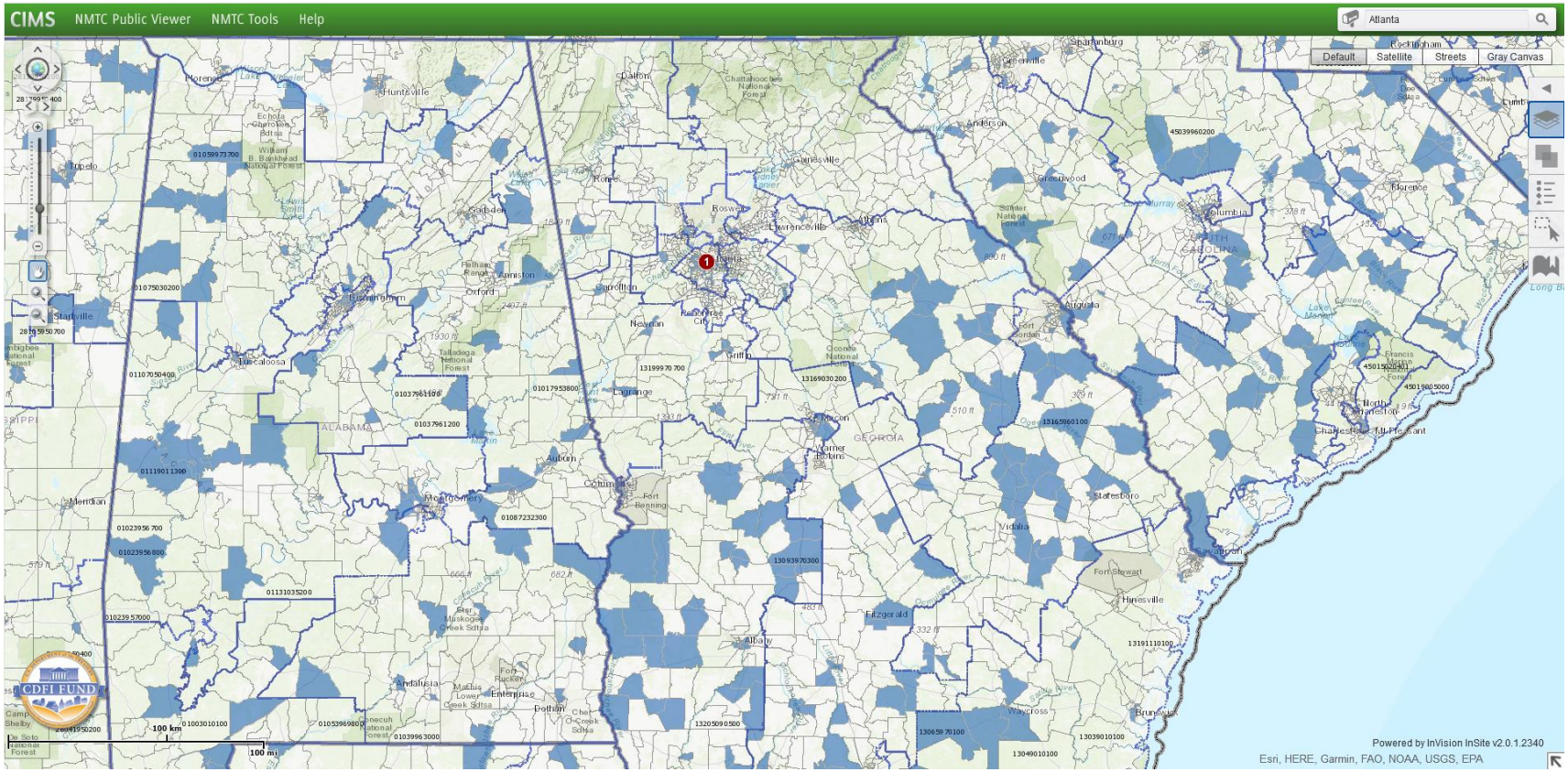
[4] See 26 U.S.C. § 45D(e). Qualifying LICs, under the NMTC, include census tracts that have at least one of the following criteria: (1) a poverty rate of at least 20%; (2) a median family income below 80% of the greater of the statewide or metropolitan area median family income if the LIC is located in a metropolitan area; or (3) a median family income below 80% of the median statewide family income if the LIC is located outside a metropolitan area. In addition, designated targeted populations may be treated as LICs. For more information, see CRS Report RL34402, *New Markets Tax Credit: An Introduction*, by Donald J. Marples and Sean Lowry.

[5] See IRS Rev. Proc. 2018-16, p. 2, at https://www.irs.gov/pub/irs-drop/rp-18-16.pdf.

[6] Id., p. 3.

[7] See CDFI Fund, "Opportunity Zone Resources," at https://www.cdfifund.gov/Pages/Opportunity-Zones.aspx.

Figure 1. CDFI Fund Mapping Tool Showing Designated Opportunity Zones (OZs)



Source: CRS screenshot of CDFI Fund, CIMS mapping tool, accessed November 11, 2018, at https://www.cims.cdfifund.gov/preparation/?config=config_nmtc.xml.

Notes: Designated OZs are shown in blue. Congressional district borders have been enabled in the above screenshot.

P.L. 115-97 limits the number of census tracts within a state that can be designated as qualified OZs based on the following criteria:

- If the number of LICs in a state is less than 100, then a total of 25 census tracts may be designated as qualified OZs.
- If the number of LICs in a state is 100 or more, then the maximum number of census tracts that may be designated as qualified OZs is equal to 25% of the total number of LICs.
- Not more than 5% of the census tracts designated as qualified OZs in a state can be non-LIC tracts that are contiguous to nominated LICs.

Table 1 displays the maximum number of census tracts in each state or territory that were eligible for OZ designation under each of the two nomination criteria. These data, current as of February 27, 2018, were posted on the Fund's website before the qualified OZ recommendations issued by state or territory CEOs were certified.

Table 1. Maximum Number of Census Tracts Eligible for Opportunity Zone Designation, by State or Territory

	A	B	C
State/Territory	Total Number of Low-Income Community (LIC) Tracts in State	Maximum Number of Tracts That Can Be Nominated (the greater of 25% of All LICs or 25 if state has fewer than 100 LICs)	Maximum Number of Eligible Non-LIC Contiguous Tracts That Can Be Nominated (5% of Column B)
Alabama	629	158	8
Alaska	55	25	2
American Samoa	16	25	See Notes
Arizona	671	168	9
Arkansas	340	85	5
California	3,516	879	44
Colorado	501	126	7
Connecticut	286	72	4
Delaware	80	25	2
District of Columbia	97	25	2
Florida	1,706	427	22
Georgia	1,039	260	13
Guam	31	25	2
Hawaii	99	25	2
Idaho	109	28	2
Illinois	1,305	327	17
Indiana	621	156	8
Iowa	247	62	4
Kansas	295	74	4

State/Territory	A Total Number of Low-Income Community (LIC) Tracts in State	B Maximum Number of Tracts That Can Be Nominated (the greater of 25% of All LICs or 25 if state has fewer than 100 LICs)	C Maximum Number of Eligible Non-LIC Contiguous Tracts That Can Be Nominated (5% of Column B)
Kentucky	573	144	8
Louisiana	597	150	8
Maine	128	32	2
Maryland	593	149	8
Massachusetts	550	138	7
Michigan	1,152	288	15
Minnesota	509	128	7
Mississippi	399	100	5
Missouri	641	161	9
Montana	90	25	2
Nebraska	176	44	3
Nevada	243	61	4
New Hampshire	105	27	2
New Jersey	676	169	9
New Mexico	249	63	4
New York	2,055	514	26
North Carolina	1,007	252	13
North Dakota	50	25	2
Northern Mariana Islands	20	25	See Notes
Ohio	1,280	320	16
Oklahoma	465	117	6
Oregon	342	86	5
Pennsylvania	1,197	300	15
Puerto Rico	835	See Notes	See Notes
Rhode Island	78	25	2
South Carolina	538	135	7
South Dakota	69	25	2
Tennessee	702	176	9
Texas	2,510	628	32
Utah	181	46	3
Vermont	48	25	2
Virgin Islands	13	25	See Notes
Virginia	847	212	11

State/Territory	A Total Number of Low-Income Community (LIC) Tracts in State	B Maximum Number of Tracts That Can Be Nominated (the greater of 25% of All LICs or 25 if state has fewer than 100 LICs)	C Maximum Number of Eligible Non-LIC Contiguous Tracts That Can Be Nominated (5% of Column B)
Washington	555	139	7
West Virginia	220	55	3
Wisconsin	479	120	6
Wyoming	33	25	2

Source: CDFI Fund, "Opportunity Zones Information Resources," February 27, 2018, at https://www.cdfifund.gov/Pages/Opportunity-Zones.aspx.

Notes: These data are still available on the website, above, as of the publication date of this report.

Puerto Rico: The Bipartisan Budget Act of 2018 (P.L. 115-123) deemed each population census tract in Puerto Rico that is a low-income community to be certified and designated as a qualified OZ. As of the time these data were being posted, the maximum number of tracts that can be nominated by Puerto Rico as well as the maximum number of Eligible Non-LIC Contiguous Tracts that could have been included in that nomination was being determined by the Fund.

USVI: The U.S. Virgin Islands could nominate Eligible Non-LIC Contiguous Tracts, provided that the nominated non-LIC tracts do not exceed 5% of all nominated tracts (both low-income communities and nominated contiguous tracts). Thus the Virgin Islands could nominate no more than one of its Eligible Non-LIC Contiguous Tracts.

Northern Mariana Islands and American Samoa: Neither the Northern Mariana Islands nor American Samoa had any Eligible Non-LIC Contiguous Tracts.

What Is a Qualified Opportunity Fund?

P.L. 115-97 defined QOFs as any investment vehicle which is organized as a corporation or partnership for the purpose of investing in qualified opportunity zone property (other than another QOF) that holds at least 90% of its assets in qualified OZ property. Qualified OZ property can be stock or partnership interest in a business located within a qualified OZ or tangible business property located in a qualified OZ. Qualified OZ property must have been acquired by the QOF after December 31, 2017. For each month that a QOF fails to meet the 90% requirement it must pay a penalty equal to the excess of the amount equal to 90% of its aggregate assets divided by the aggregate amount of qualified OZ property held by QOF multiplied by an underpayment rate (short-term federal interest rate plus three percentage points). There is an exception from this general penalty for reasonable cause.

The IRS instructs corporations or partnerships seeking to become QOFs to self-certify this status by filling out Form 8996 as part of their annual income tax filings.[8] This self-certification process differs from the NMTC, in which the Fund takes prospective action to certify "community development entities" (CDE) before that CDE can receive an NMTC allocation.

[8] For more information, see IRS, "Opportunity Zones Frequently Asked Questions," at https://www.irs.gov/newsroom/opportunity-zones-frequently-asked-questions.

What Are the Tax Benefits for Qualified Investments?

P.L. 115-97 provides for three main tax incentives to encourage investment in qualified OZs:

1. **Temporary deferral of capital gains that are reinvested in qualified OZ property:** 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.[9]
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 (a) for at least 10 years and (b) until at least December 31, 2026, will be eligible to be marked up to the fair market value of such investment on the 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 (over 10 years) when the investment is sold or disposed.

Table 2 illustrates the tax benefits to a hypothetical investment of $100,000 in a QOF. This investment could be $100,000 in capital gains earned from the sale or disposition of another asset (e.g., real property) from outside of an OZ that is reinvested into a QOF within 180 days from the date of that sale or disposition. Taxes on these capital gains are deferred while the investment is held in a QOF.

Column A shows the investment's value over time, assuming a 7% annually compounded rate of return. This hypothetical investment is simplified to assume that an initial investment is made in a QOF in year one and the QOF constantly reinvests any returns to that initial investment (i.e., the QOF does not pay out a periodic dividends to the investor during the life of the investment).

Column B shows the increase in adjusted basis earned from holding that investment in a QOF over time: 10% of the original capital gain of $100,000 after the investment is held in a QOF for at least five years and 15% after the capital gain is held for at least seven years.

Column C shows the qualified OZ investment return. This is the 7% annual rate of return after the $100,000 in outside capital gains has been reinvested in a QOF. This return is subject to capital gains tax if the investment is sold or disposed within 10 years.

Column D shows the basis for capital gains tax if the investment in a QOF is sold or disposed in any of the 10 years shown. One of the three major economic incentives to investing in a QOF is the permanent exclusion of capital gains earned after the acquisition of the QOF investment.[10] Put

[9] For more background on capital gains taxation, see CRS Report 96-769, *Capital Gains Taxes: An Overview*, by Jane G. Gravelle; and p. 409 in CRS Committee Print CP10002, *Tax Expenditures: Compendium of Background Material on Individual Provisions — A Committee Print Prepared for the Senate Committee on the Budget, 2016*, by Jane G. Gravelle et al.

[10] After P.L. 115-97 was enacted, some commentators raised concerns that legislative text created an ambiguity as to whether taxpayers could actually claim the exclusion of qualified OZ investment return gains after 10 years. This was because the capital gains tax exclusion on OZ investment returns provision requires the QOF to hold investments in an

differently, in Year 10, the taxpayer pays no capital gains tax on earnings in column C and is subject to capital gains tax on $85,000 ($100,000*0.85) that was initially reinvested in a QOF. In contrast, if the investment in the QOF was sold in year nine, the taxpayer would have to pay capital gains tax on all of the QOF earnings (column C) but would still have the benefit of the step-up in basis on the initial investment in the QOF (column B).

Table 2. Illustration of Opportunity Zone (OZ) Tax Benefits for a Hypothetical Investment of $100,000 in Reinvested Capital Gains

(Assuming an annual rate of return of 7%)

	A	B	C	D
Year of Investment	Investment Value	Increase in Adjusted Basis	Qualified OZ Investment Return	Amount of Capital Gains Subject to Tax if Investment is Sold or Disposed that Year
0	$100,000	$0	$0	$100,000
1	$107,000	$0	$7,000	$107,000
2	$114,490	$0	$14,490	$114,490
3	$122,504	$0	$22,504	$122,504
4	$131,080	$0	$31,080	$131,080
5	$140,255	$10,000	$40,255	$130,255
6	$150,073	$10,000	$50,073	$140,073
7	$160,578	$15,000	$60,578	$145,578
8	$171,819	$15,000	$71,819	$156,819
9	$183,846	$15,000	$83,846	$168,846
10	$196,715	$15,000	$96,715	$85,000[a]

Source: CRS calculations.

Notes: This hypothetical calculates OZ tax benefits from $100,000 in capital gains earned from outside of an OZ (e.g., sale of appreciated real property) that is rolled over into a qualified opportunity fund (QOF), assuming constant reinvestment over the life of the OZ investment (i.e., no periodic dividends issued from the qualified opportunity fund to the investor). Generally, taxes on accrued capital gains (or losses) are not due in a particular tax year until the gain (or loss) is realized. This example does not include any economic benefit from the deferral of the capital gains of the initial $100,000 investment rolled into the OZ investment.

a. 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 $96,715 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

OZ for 10 years. The OZ designations were authorized by P.L. 115-97 through 2026. Thus, unless Congress extended OZ designations in subsequent legislation, it would have only been possible for QOFs to hold investments in qualified OZs for a maximum of nine years (i.e., 2018 through 2026). However, the Department of the Treasury released proposed regulations on October 19, 2018 clarifying that the benefit available in year 10 would still be available even if the designations expire at the end of 2026. The proposed regulations state that the benefit will be available until December 31, 2047. Treasury claims that this interpretation is consistent with the legislative intent of P.L. 115-97. See Department of the Treasury, "Treasury, IRS Issue Proposed Regulations on New Opportunity Zone Tax Incentive," press release, October 19, 2018, at https://www.irs.gov/newsroom/treasury-irs-issue-proposed-regulations-on-new-opportunity-zone-tax-incentive. The related passage is on p. 16 of the proposed regulation.

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).

Note that **Table 2** only shows the tax-related benefits of investing in a QOF. It does not include the economic benefits of deferring capital gains tax on the initial $100,000 investment, which would depend on the time value of money. From an income tax perspective, though, deferral of capital gains tax just delays a tax liability from one period to another.

Actual QOF investment structures could differ from the arrangement in **Table 2**. As seen in the New Markets Tax Credit (NMTC), investors have developed financial structures that increase the amount of other funding from either private or public sources that are used with the NMTC (i.e., increasing leverage on the NMTC investment).[11] Additional layers of financing structures could increase the complexity of investment arrangements and costs attributed to fees and transactional costs instead of development.[12]

OZ tax incentives are in effect from the enactment of P.L. 115-97 on December 22, 2017, through December 31, 2026. There is no gain or deferral available with respect to any sale or exchange made after December 31, 2026, and there is no exclusion available for investments in qualified OZs made after December 31, 2026.

What Economic Effects Can Be Expected?

OZs are an addition to the array of geographically targeted, federal programs and incentives for economic development. Examples of economic development incentives that are administered through the tax code include: the NMTC,[13] the low-income housing tax credit (LIHTC),[14] and the tax credit for the rehabilitation of historic structures.[15]

Although any one of these tax incentives might not be sufficient enough to generate a positive investment return from an otherwise unprofitable development project, developers may be able to "stack" the benefits of multiple, federal tax incentives (as well as any state and local incentives) in order to make a project located in one area more profitable than competing alternatives. Studies find that place-based economic development incentives tend to shift investment from one area to another, rather than result in a net increase in aggregate economic activity.[16]

Comparisons may be made between the NMTC and OZ tax incentives. The OZ tax incentives provide relief from capital gains taxation, thereby directly benefiting owners of capital rather than low-income populations that live in OZs.[17] Although the NMTC is an investment credit, it, like

[11] Under the NMTC, the investor receives a credit equal to 5% of the total amount paid for the stock or capital interest at the time of purchase. For the final four years, the value of the credit is 6% annually. Investors must retain their interest in a qualified equity investment throughout the seven-year period. The NMTC value is 39% of the cost of the qualified equity investment and is claimed over a seven-year credit allowance period. For more information, see CRS Report RL34402, *New Markets Tax Credit: An Introduction*, by Donald J. Marples and Sean Lowry.

[12] For more discussion, see Government Accountability Office (GAO), *New Markets Tax Credit - Better Controls and Data Are Needed to Ensure Effectiveness*, GAO-14-500, July 2014, pp. 5-20, at https://www.gao.gov/assets/670/664717.pdf.

[13] See CRS Report RL34402, *New Markets Tax Credit: An Introduction*, by Donald J. Marples and Sean Lowry.

[14] See CRS Report RS22389, *An Introduction to the Low-Income Housing Tax Credit*, by Mark P. Keightley.

[15] See National Park Service, "Tax Incentives for Preserving Historic Properties," at https://www.nps.gov/tps/tax-incentives.htm.

[16] For a discussion of the economic literature on geographically targeted development policies, see CRS Report R42770, *Community Development Financial Institutions (CDFI) Fund: Programs and Policy Issues*, by Sean Lowry.

[17] For more discussion on the effects of economic development policies targeting capital versus labor, see ibid.

the OZ tax incentives, also directly benefits capital owners. The NMTC can be distinguished from the OZ tax incentives in several ways, though. First, Congress has capped the amount of NMTC allocations that the Fund may issue per year ($3.5 billion), thereby making these applications competitive because the demand for NMTC allocations exceeds the supply provided by Congress. In contrast, the maximum amount of tax benefits conferred by the OZ tax incentives are uncapped, much like many tax provisions—if a taxpayer qualifies for the special tax treatment, then they may claim it.

Second, the Fund evaluates NMTC applications based on a set of factors. One factor is the potential impact that the investments supported will have on "community outcomes," including benefits to low-income persons and jobs directly induced by the investments.[18] Investments made by QOFs are eligible to benefit a broad range of potential projects, regardless of their potential "community outcomes."[19]

Third, NMTC recipients are required to adhere to a set of outcome-based reporting and compliance requirements.[20] These metrics track the location and type of projects funded by NMTC allocations.[21] No such outcome-based requirements are needed for OZ tax incentives.

Fourth, to become eligible for a NMTC allocation, a certified CDE must, among other criteria, have a primary mission of serving or providing investment capital to low-income communities. A governing or advisory board is supposed to hold the CDE accountable to that mission. QOFs are not required to be mission-oriented for the primary purposes of serving low-income communities or persons.

The Urban Institute analyzed the census tracts designated by the CEOs of the states and the District of Columbia, "scoring" each against measures of the investment flows they are receiving and the socioeconomic changes they have already experienced.[22] Tracts that were selected by the state's respective CEO and designated as QOZs were compared with eligible, nondesignated tracts not selected by the CEO. CEOs in Montana, DC, Alaska, and Georgia selected areas with the lowest levels of preexisting investment.[23] Conversely, CEOs in Hawaii, Vermont, Nebraska, and West Virginia selected areas with the highest levels of preexisting investment. The Urban Institute also found that:

> Designated tracks do have lower incomes, higher poverty rates, and higher unemployment rates than eligible nondesignated tracts (and the US overall average, which is as expected

[18] For examples of such criteria, see the "Community Outcomes" section of CDFI Fund, NMTC Program – Allocation Application Frequently Asked Questions, June 7, 2018, at https://www.cdfifund.gov/Documents/Updated%202018%20NMTC%20Application%20FAQs%20Document%20-For%20Posting%20MASTER.pdf.

[19] QOF investments made in the following categories are not eligible as investments in "qualified OZ business property": any private or commercial golf course, country club, massage parlor, hot tub facility, suntan facility, racetrack or other facility used for gambling, or any store the principal business of which is the sale of alcoholic beverages for consumption off premises. See IRC 1400Z-2 and IRC Section 144(c)(6)(B). Further, any capital gains earned from investments from the above types of projects are not be eligible for OZ tax benefits.

[20] For compliance reports, see https://www.cdfifund.gov/programs-training/Programs/new-markets-tax-credit/Pages/compliance-step.aspx.

[21] See various New Markets Tax Credit Program Public Data Releases at https://www.cdfifund.gov/programs-training/Programs/new-markets-tax-credit/Pages/compliance-step.aspx.

[22] Brett Theodos, Brady Meixell, and Carl Hedman, *Did States Maximize Their Opportunity Zone Selections?*, Urban Institute, May 21, 2018, at https://www.urban.org/research/publication/did-states-maximize-their-opportunity-zone-selections. State-by-state comparisons are available in a spreadsheet on the linked page.

[23] Id., at 4.

> given eligibility criteria). Housing conditions trend in similar ways, with lower home values, rents, and homeownership rates. The designated tracts are also notably less white and more Hispanic and black than eligible nondesignated tracts. Age compositions are comparable. Education levels are somewhat lower among designated tracts than eligible nondesignated tracts…In terms of this program, there appears to be no targeting on the basis of urbanization. There is no difference in the share of designated and eligible nondesignated tracts that are located in metropolitan areas, in micropolitan areas, or in non-core-based statistical areas.[24]

The Joint Committee on Taxation initially estimated that the OZ tax incentives will result in a revenue loss to the federal government of $1.6 billion over 10 years.[25] The revenue loss within the 10-year budget window is due to the relatively small revenue losses associated with the deferral of capital gains tax and the OZ basis adjustments in years five and seven. The largest tax benefit associated with OZ tax incentives, the exclusion of capital gains tax on qualified OZ investment returns in year 10, would fall outside of the 10-year budget window. Those revenue losses would not be expected until 2028 (i.e., fiscal years 2028-2029).

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[24] Id., at 8.

[25] Joint Committee on Taxation, *Estimated Revenue Effects of the "Tax Cuts and Jobs Act," As Passed By the Senate On December 2, 2017*, JCX-63-17, December 6, 2017, p. 6, at https://www.jct.gov/publications.html?func=startdown&id=5047.