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Opportunity Zone Investment and Affordable Housing

In our current environment of constrained budgets and downward pressure on affordable housing investment, this NAHMAnalysis looks to a recent tax code change that could increase access to housing and opportunity in economically depressed communities: the creation of "Opportunity Zones" and "Opportunity Funds" as a new investment vehicle. This analysis examines how the new tax benefit could impact affordable housing in the qualified investment zones and beyond.

Background

The new tax benefit, enacted as part of tax reform in December 2017, has bipartisan origins and is designed to incentivize long-term equity investments in both business and real property located in underserved areas. Structured as a new tool for aggregating and deploying investments in areas of need, the investment vehicle hinges on a tax code change that allows for tax-preferred treatment of unrealized investment income (subject to capital gains tax) that are reinvested into an "Opportunity Fund" within 180 days. Ninety percent of those funds are then to be invested in a business property or interest located in qualified "Opportunity Zones," which are designated locally based on economic need.

Before making its way into last year's tax reform legislation, the bill to create the Opportunity investment vehicle was first introduced in both the House and Senate in 2016. Originally sponsored by Senator Tim Scott, a Republican from South Carolina, and former Representative Patrick Tiberi, a Republican from Ohio, the "Investing in Opportunity Act" gained significant bipartisan co-sponsorship over the following two years – including from prominent Democrats, such as Congressman Neal from Massachusetts, Senator Booker from New Jersey, and Senator Warner from Virginia.

The tax incentives for Opportunity Fund investment are significant, especially over the long-term: Not only is the tax on the original gain temporarily deferred, but the original tax liabilities are reduced by 10% or 15% as investments are maintained over a five- or seven-year minimum, respectively; at a ten-year minimum investment cycle, the taxpayer can elect to permanently exclude from taxable income the new gain earned on Opportunity Fund investments. The result is the potential for three separate tax benefits: temporary deferral of tax on the original gain; permanent exclusion of part of the deferred gain; and permanent exclusion of new gain. Importantly, taxpayers are not statutorily limited in the amount of realized gains obtained through Opportunity Fund investment.

What are Opportunity Zones?

After its enactment in late 2017, the IRS issued the first step in implementing the new tax benefit: establishing a timeline for Opportunity Zones to be identified by states and territories. In order to qualify, each "zone" had to meet certain income requirements that demonstrated historic underinvestment or a heightened need for opportunity investment. By midsummer of 2018, each U.S. state, Washington, D.C., and several territories had opted into the initiative by submitting their priority Opportunity Zone nominations, and the IRS completed its first 10-year zone designation shortly thereafter (figure 1).

Figure 1 Opportunity Zone Designations; Source: Enterprise Community Partners

The importance of place-based investment is undeniable: Unlike some previous federal initiatives designed to spur economic investment, this new investment vehicle emphasizes local control with regard to geographic targeting. According to an analysis by Enterprise Community Partners, about 11% of the total population of the U.S. and its territories lives within the designated Opportunity Zones (35 million people); over three-quarters of the zones are situated within metropolitan areas, but there is a near even split between urban and rural zip codes.

Households in the selected zones tend to have higher levels of rent burdens, lower homeownership rates and home values, and above-average populations of minority groups, including African American, Hispanic, and Native American. Compared with non-designated areas, the areas encompassed by the designated Opportunity Zones are more likely to be targets for other place-based federal programs, including subsidized housing: Over 25% of all affordable housing units are located in Opportunity Zones.

How are Opportunity Funds structured?

By offering tax-preferred treatment of capital gains that are reinvested in designated tracts, the tax benefit aims to spur new equity investments targeted at inequitable economic growth across the country; both individual and corporate taxpayers can reinvest an unlimited amount of gains into an Opportunity Fund. Early research estimates capital from Opportunity Funds will meet up to 30% of equity needed for projects, so a key component of the new vehicle will be the ability to coordinate with local leadership, localized economic development strategies, and debt financing programs to identify the best way for investors to engage. For example, Opportunity Fund investments could potentially be applied in conjunction with the Low-Income Housing Tax Credit (LIHTC), the New Markets Tax Credit (NMTC), and other programs designed to leverage private investment for both financial and social return.

In the past, leveraging private funds, innovation, and expertise for social good has proven quite successful for affordable housing investment. One example is of course HUD's Project-Based Rental Assistance program, which partners with private owners to offer place-based housing subsidies. Another example is the Housing Credit, which, according to the LIHTC database, has placed over 3 million affordable units into service between 1987 and 2016.

However, Opportunity Zones and Opportunity Funds act not as a *program*, but as a tax-preference, without the overarching structure of oversight, reporting requirements, and transparency associated with a "program": In contrast to the LITHC program, key elements of the Opportunity tax benefit include its immense flexibility (minimal restrictions on types of investment projects or investor/investment fund qualifications), as well as its local control (as described above, qualifying investment areas are selected at the state and territory level, and deals would likely be brokered locally). Similar to the Housing Credit program, long-term investment is incentivized through 10-year zone designations and through time-based increases in tax benefits. Lastly, a certain threshold of investment is encouraged through a "substantial improvement" test to the business property.

Looking Ahead: Promise and Peril

While the tax benefits are designed to pool resources for a strong impact, the potential for success is matched by investment uncertainty and the real potential for community displacement. Following its designation of Opportunity Zones in mid-summer, the IRS released FAQs on certifying Opportunity Funds, as well as clarity for investors, and recently released proposed regulations addressing the initial investment in and the creation of a qualified Opportunity Fund. There are still, however, a number of unanswered questions that relate particularly to penalties and tax consequences in certain scenarios that will shape Opportunity Zone investing over the next decade and beyond.

Despite the lingering uncertainty, the initiative has strong potential not only to increase investment in underserved areas, but to *reallocate* equity *from outside* of a particular zone with an eye toward "leveling the playing field." In fact, Opportunity Funds have garnered popular attention from various sectors. Some industry estimates put the total amount of unrealized capital gains in the trillions, and the White House recently established a "White House Opportunity and Revitalization Council" – with HUD Secretary Ben Carson at the helm – to target existing federal funding toward Opportunity Zones.

However, the very strengths of the initiative could also backfire when it comes to affordable housing and community development: the flip-side of flexibility is arguably a lack of oversight and transparency that ensures community advancement; the consequence of localized control could be the absence of a coordinated effort with overarching trajectories; and the result of a substantial improvement test could be to steer investment toward higher-end developments, as opposed to projects that target middle-income Americans or seek to maintain affordability for the existing community.

A recent congressional hearing exposed bipartisan concern about preserving flexibility while establishing accountability and transparency in the absence of statutory reporting requirements; in addition, witnesses and lawmakers alike explored the types of "guardrails" necessary for creating an impactful investment initiative while avoiding displacement in rapidly-changing neighborhoods. In addition, many local investment strategies emphasize housing affordability, and new entities have formed in response to the enactment of Opportunity Funds to help guide funds toward projects that support housing stability as a key opportunity factor in economically distressed communities. A number of industry groups also have continued to call for increased "guardrails," transparency, and oversight of the types of investments made through this new incentive.

Conclusion

In conclusion, the 2017 tax reform legislation resulted in a sea change for the affordable housing landscape, including a new vehicle for the reallocation of equity investment. These first years are critical in the establishment of a successful investment initiative, and NAHMA is monitoring developments closely for their impact on affordable housing. We will keep members up-to-date as regulations are released, trends are established, and opportunities develop for the continued advancement of housing opportunities in underserved communities.