

Opportunity Zones What Cities Should Know

About the National League of Cities

The National League of Cities (NLC) is the voice of America's cities, towns and villages. Representing more than 200 million people, NLC works to strengthen local leadership, influence federal policy and drive innovative solutions. Stay connected with NLC on Facebook, Twitter, LinkedIn and Instagram. NLC's Center for City Solutions provides research and analysis on key topics and trends important to cities and creative solutions to improve the quality of life in communities.

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Foreword

A zip code shouldn't determine the kinds of opportunities available to a person. But unfortunately, in many poorer communities across America, good jobs, affordable housing and resources are scarce. Local leaders have tried for years to even the playing field through programs and policies, but without increased strategic investment, it's hard to bring more opportunity to neighborhoods that have been left behind.

The opportunity zones program, established under the 2017 Tax Cut and Jobs Act, aspires to close that gap by incentivizing private investment in the 8,700+ designated zones around the country. Given its potential to attract billions of dollars to disinvested neighborhoods, it's no surprise that local officials are eager to see it succeed. At the same time, city officials must recognize the market will dictate where investments are—and are not—made.

For the opportunity zones program to succeed, it is critical that the people who lead our communities understand their roles when it comes to this program. Although

many of the major decisions, such as the tax incentive structure and zone locations, have already been decided by their governors and the federal government, local leaders already have access to numerous existing tools or strategies to maximize the positive impact of new development in these neighborhoods.

With this new guide, "Opportunity Zones What Cities Should Know," my hope is that local leaders feel empowered to leverage this tool to better the lives of their residents and have the resources to form more equitable communities for all.

In many ways, our communities define who we are as individuals. Let's continue to build the kinds of communities where everyone can prosper and thrive.

Sincerely,



CLARENCE E. ANTHONY
CEO and Executive Director
National League of Cities

Introduction

The opportunity zones program provides local and national investors with a package of tax incentives to encourage investment in economically distressed communities around the country. The program was created under the Tax Cuts and Jobs Act of 2017. In 2019, the federal government released additional regulatory guidance which provides more detail about how the program will work for investors.

Perhaps the most important feature of the latest regulatory guidance is that they made clear the program can support entrepreneurship and small business ownership as well as real estate investment. While the program is almost certainly going to be deployed primarily around real estate, new business creation is critical for the economic vitality of cities. New businesses represent the lion's share of net new jobs generated.

City leaders should take full advantage of this opportunity and consider a multi-pronged strategy to support young businesses and create thriving communities. This primer offers a view of the rules governing opportunity zones. It also offers broad strategies to help municipal leaders and local elected officials take full advantage of the program.

What counts as an opportunity zone investment

The U.S. Department of Treasury released its second tranche of regulations governing the opportunity zones program in April 2019. This release clarified what types of investments meet the criteria to be held in an opportunity fund and emphasized the potential for both real estate and business investment. Here are three examples that show the wide range of qualifying investments:

HOUSING DEVELOPMENT

For example: A local developer is building or substantially improving a multi-family rental housing complex. This investment would qualify whether the development was designated either affordable or market rate housing because the real estate is within an opportunity zone.

The Opportunity Zone Program

In 2018, governors selected more than 8,700 opportunity zones from eligible census tracts in their states. The zones were approved by the U.S. Treasury Department and will remain the same for the length of the program. Eligibility requirements for census tracts included poverty rates of more 20 percent or median incomes at or below 80 percent of the regional average. A small number of neighboring zones (five percent) in each state were permitted to exceed these thresholds if they were adjacent to a qualifying tract.

The opportunity zone program is not the first federal initiative designed to bolster investment in distressed areas. However, it gives private investors much more flexibility than previous programs, such as Empowerment Zones in 1993 or the New Market Tax Credits in 2000. For cities, that flexibility offers the potential for greater investment while at the same time raising the concern that many projects may have occurred without the tax credit.

One thing is certain, the scope of potential investment is significant. In 2017, U.S. households held an estimated \$3.8 trillion in unrealized capital gains that are eligible for the tax credit, these opportunity zones may be U.S. cities' largest means for economic development in decades. Given the scale of potential investment, local elected officials are eager to position their municipalities as attractive targets for investors. Yet, for many leaders, the excitement around opportunity zones has created more confusion than clarity as cities rush to prepare. Rushing, however, is not a necessary strategy. City leaders should instead consider long-standing municipal priorities and use opportunity zones as catalysts to achieving established goals.

LOCAL SERVICE SMALL BUSINESS

For example: A local wedding planner bases its operations and stores supplies and equipment at a location within an opportunity zone. Even though the business has clients outside the opportunity zone, it qualifies for the opportunity-zone tax credit because the majority of its assets are within a zone.

HIGH-GROWTH START UP

For example: A small global technology startup is headquarters in a co-working space within an opportunity zone. The startup sells its products to customers around the world online and has some staff abroad. But because its management and software developers are working within the zone, more than 50 percent of the company's total hourly compensation exists within the zone, which qualifies the business for the benefits of the opportunity zone program.



How Opportunity Funds Work for Investors

The program encourages investors to reinvest unrealized capital gains—that is, profits from earlier investments that have not yet been sold or exchanged—into new Opportunity Funds that are required to hold assets in the designated zones. **It's important to remember, investors can be anyone, located anywhere in the country, so long as their ultimate investment is made within an opportunity zone.** There are three parts of the incentive package for those who choose to invest in businesses and real estate in these areas:

Temporary deferral: After selling a profitable asset, an investor would typically include those earnings as taxable income and owe a 15 or 20 percent tax on their profits. If they put their earnings in an opportunity fund within 180 days of selling the asset, that tax bill is delayed until the investor takes their money out or at the latest, December 31, 2026.

What it means for city leaders:

▶ While this provision creates a significant tax incentive for investors to place capital gains in opportunity funds, that has little bearing on where investments will be made. In other words, the deferral encourages local investment, but doesn't impact which zones will actually see investment. Some zones will see investments, others will not.

“Step-Up” in Basis: To encourage investors to keep their money in opportunity funds, the program provides an additional incentive that reduces the amount of original earnings subject to taxation. Investments that remain within an opportunity fund for at least five years are able to exempt 10 percent of the original investment from taxation. If held for more than seven years, it is increased by an additional five percent, thereby excluding up to 15 percent of the original gain from taxation. In order to take advantage of the full 15 percent under current law, investors need to do so by December 31, 2019.

What it means for city leaders:

▶ There may be an initial rush for investors interested in the full tax benefit, but significant and more consistent investment will likely be made between 2020 and 2026. City leaders should be ready for investment by 2019, but plan for follow incremental investment over the next half decade.

Permanent Exclusion: Perhaps the largest potential benefit for investors and cities is the permanent exclusion provision, which pertains only to the increase in value of investments in opportunity zones. If a qualified opportunity fund investment is held for at least 10 years, it is not subject to any capital gains taxes upon its sale or exchange. In other words, investors that make money on their investment within the zone, do not need to pay any taxes on those additional profits. This provision applies to any investment made prior to the end of 2026 and, under current law, does not expire until 2047.

What it means for city leaders:

▶ Investors have a strong incentive to keep investments in the zones for at least 10 years—meaning these investments are fairly “patient”. It also means investors benefit by increasing the economic value of the opportunity zone over time. Cities should identify ways new investments can improve the long-term quality of a neighborhood seeking investment.

HOW THE TAX BENEFIT WORKS OVER TIME

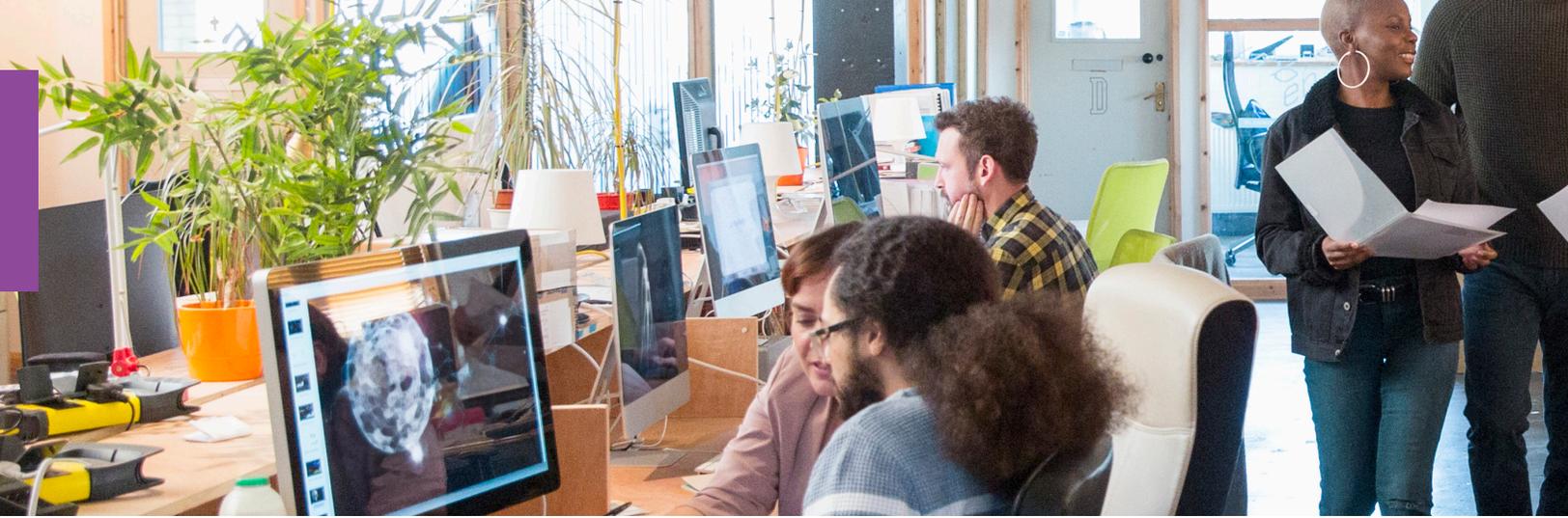


To show how this package of incentives encourages long-term investment in opportunity zones, consider the following example from the Congressional Research Service of a \$100,000 reinvestment in an opportunity fund that grows at 7 percent annually:

In years five and seven, the “step up” in basis flattens the growth of taxable gains, but in year ten, the permanent exclusion

provision kicks in and dramatically reduces the total taxable gains. Combining the entire package, in this scenario the final tax liability (\$85,000) is less than it was in the first year, even though the investment has nearly doubled in value.

Simply put, there is significant incentive for investors to be patient versus quickly flipping investments.



How Opportunity Zones Can Work for your Community

If your city includes one or more opportunity zones, it has the potential to leverage this program to increase investment in the communities within these zones. Here, we offer a few guiding principles for local elected leaders as well as perspectives from experts working in cities around the country about how to help your city benefit from this program.

Opportunity zones offer the chance to recommit to a long-term economic-development strategy. The program targets small geographies and encourages patient investment. As a result, it has the potential to attract a critical mass of investment over time enabling neighborhoods to become market-sustaining with or without the temporary tax advantage. But this will only come to pass if local leaders focus on projects that translate into moderate and long-term value creation, rather than “quick wins.” Local leaders should consider what projects best align with their regional growth strategies. To be successful, they must work with developers and investors to target those projects and ensure the deals have provisions that help ensure long-term appreciation.

In many cities, this work can be done by existing economic development infrastructure before creating new organizations. Opportunity zones have been cast by the media as an unprecedented

local intervention, but cities and states have a long history of both attracting outside investment and firms and place-based tax incentives. Instead of creating new organizations and activities, cities should first look to leverage their existing economic development entities.

The Amazon HQ2 bidding process provides some related insights: while the potential reward served as a distraction in some cities, others were able to use it as a galvanizing opportunity to pull together public, private, civic, and university leadership to address and strengthen existing priorities. For these cities, even though they ultimately lost the bid for Amazon, they were left with a shared vision and clarification of their strengths.

Opportunity zones have the potential to significantly benefit current residents, but only if city leaders commit to supporting that goal. Since there are no requirements that opportunity fund investments benefit existing low-income residents or businesses, there is growing concern around the



outcomes of the program. Some zones that were already primed for investment are at risk for increased market pressure and displacement of current residents or businesses. For an even larger share of zones, there may simply not be enough market potential to attract investment.

While city governments have no direct role in the opportunity zone program, cities do have the power to influence development via zoning or other regulatory measures. Local leaders can continue to use the tools at their disposal to either ensure that current residents and businesses benefit (in hot markets) or to increase the likelihood of investment in neighborhoods that experience persistent disinvestment. Such tools include community benefit agreements, state and local tax credits and incentives, and, in the case of some large projects, zoning and regulatory approval.

It can be a challenge to balance to build a favorable climate for outside investment while still ensuring that resources translate into real community benefits. As with all investment and business attraction strategies, some deals are better for investors than communities. This is particularly true when municipalities add financial incentives. Because the opportunity zone incentive is already generous, additional tax credits may not induce additional investment.

Opportunity zones are not just a real estate programs—local leaders should promote the potential for small businesses and entrepreneurs.

The opportunity zone program allows for investment in new and existing businesses located within a zone. City leaders should prioritize and attract investment into actual businesses, particularly those with the ability to grow and support job creation. Cities should also not expect or wait for private investors but should create their own strategies and priorities for investment in local companies. For instance, leaders can identify the businesses with potential for significant growth, or those neighborhoods in the greatest need of local businesses, within zones.

Opportunity zone investment is not a competition or a zero-sum game.

The pool of capital eligible for investment greatly exceeds the projected final size of the program, which means zones should not compete for dollars. Local leaders should focus on creating sound investment opportunities within their cities and not on the speed and scope of investment elsewhere. As with all new investment opportunities, there is the threat of a “race to the bottom”, where cities falsely believe they are competing with one another and only through increasingly generous giveaways can cities succeed. This is not the case for opportunity zones and may inappropriately jeopardize the municipality’s fiscal health.



Expert Perspectives

Coordinating in a large city with many designated opportunity zones

“Baltimore is attracting and supporting investments in high-impact projects across the city’s 42 opportunity zones that are positioned to grow the local economy, create benefits for residents and businesses, and align with city’s neighborhood investment strategy.”

BEN SEIGEL

Baltimore Opportunity Zones Coordinator
Baltimore Development Corporation

Designate a point person to track investments locally and best-practices nationally. As our dedicated opportunity zone coordinator, I serve as an information clearinghouse and a partnership builder, with a focus on tracking rules and best practices nationally, connecting investors with project sponsors, engaging communities, and monitoring investments and impacts.

Working with the city, the community, and private sector partners, Baltimore is maintaining an active pipeline of investment-ready projects that can be matched with opportunity funds and other investors, based on the investment criteria and project preferences of these investors.

Educate and involve the community throughout the process. One of my priorities is working at the community level to ensure that neighborhood organizations, leaders, and residents are informed about what opportunity zones are and how they can get involved as potential partners, project sponsors, or investors. Activities include community workshops and individual meetings with local developers, nonprofits, and others to provide an overview of opportunity zones and “workshop” potential projects.



Engaging local and national philanthropy

“Cities seeking to make the opportunity-zone tax incentive work for residents and businesses in their communities may find willing partners in philanthropy, especially community foundations. Some national foundations already are investing in advocating for a robust reporting framework, in developing an investment prospectus, and in creating forums for sharing best practices. Now is the time to reach out to philanthropists interested in your community. The key is asking for concrete assistance.”

JANE CAMPBELL

*Former Mayor of Cleveland, Ohio and
Senior Advisor to Public Private Strategies*

Help to create investable opportunities.

Success requires a pipeline of projects that meet both the community need and the return expectations of potential investors. Philanthropic investment can be crucial by providing early investment needed to take an idea to the project proposal stage. Creative philanthropic investment can play a role in reducing risk exposure for investors.

Demonstrate how to build wealth for current residents. Philanthropy can engage with investors and cities. These engagements provide seed capital for experimentation and demonstration transactions that intentionally include mechanisms to build wealth for current residents and small business owners. Strategies to minimize displacement risks could include commitments to hiring from within the community, providing financial upsides for local organizations, and/or

clauses for business owners to buy back their equity at a pre-agreed price. Philanthropic partners can demonstrate to the investment community that deals structured to meet the current needs of the community and create mechanisms for wealth creation throughout the process, including at exit, do exist.

Create tools to streamline the process.

Because opportunity zones are a new tool, template agreements and other documentation needed to enable transactions are yet to be developed. Philanthropy can help by investing in efforts to establish a collection of model agreements that could be shared across locations and projects. Such an investment would reduce transaction costs and help establish norms and expectations with respect to social impact.



Communicating the potential of your opportunity zones

“Opportunity zones will only realize their full potential if cities communicate the market potential of their designated tracts and unveil projects that are both investor-ready and community-enhancing.”

BRUCE KATZ

*Director of the Nowak Metro Finance Lab
at Drexel University*

Create one marketing document where investors can learn about your community and potential projects.

For example, Accelerator in America and Drexel University’s Nowak Metro Finance Lab created a template for a local Investment Prospectus that dozens of cities have used to show the potential of their communities. An Investment Prospectus is a mix of quantitative analysis and qualitative knowledge about the community. Building one requires collaborative action among public, private, civic and community institutions and organizations.

Communicate what makes your community unique but also how your opportunity zones compare to similar places around the country.

In creating their prospectuses, cities should pay particular attention to the “typologies of opportunity zones”— is your community near a large anchor institution? Is it an older industrial district

or a residential center? Another thing to consider are the emerging prototypes of deals.

The opportunity zone market will be created via norms and models that allow for routines to be established across the 8,762 opportunity zones. An investment prospectus allows you to express the unique assets and potential of your community in a template that the broader investment community can understand.

It is likely that many projects will require a blend of debt, equity and subsidy capital provided by disparate commercial banks, community development financial institutions, qualified opportunity funds, local and state governments and philanthropies. Cities should work towards building systems that makes the alignment of resources transparent and free of friction.



Attracting investment to smaller cities and rural zones

“Rural opportunity zones have unique challenges. However, in some cases those challenges have potential advantages, if communities can mobilize quickly and efficiently. We’ve seen rural Alabama communities attract opportunity fund capital by taking the following steps quickly.”

ALEX FLACHSBART

Founder of Opportunity Alabama

Convene a regional opportunity zone coalition. Getting community leaders, developers, landowners, local business owners, entrepreneurs, bankers, accountants, attorneys, and other key stakeholders together to learn how the program works can spark opportunity. Educating these stakeholders about what kinds of rural projects are best for investment can catalyze the formation of a coalition that meets regularly to work on three priorities: developing an opportunity zone strategy, identifying a pipeline of investable local projects, and building a comprehensive marketing document.

Connect with Investors. Go to market with your pipeline of projects and marketing document, including as many local partners as you can (to provide investors with more pipeline to review). While there are plenty of national investor groups out there, remember that there’s nothing like local capital for local projects. Make sure your local investors are a part of your coalition from the start. In some states (like Alabama), third-party organizations are interfacing with investors on behalf of communities. We’ve found this to be an effective, scalable model to help resource-constrained rural communities and would encourage others to replicate.

Looking Forward

The opportunity zone program may constitute the largest economic development-based tax benefit for cities in the nation's history. It may also simply accelerate investments that would have taken place regardless. Municipal leaders face the task of balancing the opportunities presented by the program with the risk of over-allocating time and precious public dollars (both operationally and in terms of additional tax advantages) to projects that the market would have produced without the program.

At the same time, elected officials are under pressure to move quickly given the timeframe of investments. But with targeted planning, understanding local assets, and deliberate partnerships, cities can leverage these opportunities to improve life for communities within the opportunity zones as well as for cities to reap financial benefits of the program for years to come.

The following resources provide more information about opportunity zones:

Economic Innovation Group:

Includes information on how opportunity zones work, including state averages of opportunity zones compared to national averages. eig.org

Enterprise Community:

Contains an interactive map for each opportunity zone having a report that measures five indices: housing, education, mobility, economic security and health. <https://www.enterprisecommunity.org>

Smart Growth America:

Interactive mapping tool with overlays of opportunity zone projects, such as brownfield sites. smartgrowthamerica.org

Urban Institute: Opportunity Zones:

Comprises tract-level data on all opportunity zones and a case study on Chicago. www.urban.org

Opportunity Zones:

An Analysis of the Policy's Implications: An in-depth look at how the policy works along with a table breaking down state opportunity zones

The Opportunity Zone Investment Prospectus:

Early Observations & Next Steps, Bruce Katz, Rick Jacobs, and Aaron Thomas. (Nowak Metro Finance Lab at Drexel University and Accelerator for America, 2019).

Opportunity Zones Investment Prospectus Guide:

Shows how five cities — Louisville, Oklahoma City, South Bend and Stockton — create a prospectus guide for the investment community that fits within their community plans

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